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 Tuesday, January 12, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Daane
Mr. Hickman
Mr. Mitchell
Mr. Robertson
Mr. Shepardson
Mr. Shuford
Mr. Swan
Mr. Wayne

Messrs. Ellis, Bryan, Scanlon, and Deming, Alternate Members of the Federal Open Market Committee

Messrs. Bopp, Clay, and Irons, Presidents of the Federal Reserve Banks of Philadelphia, Kansas City, and Dallas, respectively

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Brill, Holland, Jones, Koch, Mann, and Ratchford, Associate Economists
Mr. Stone, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Molony, Assistant to the Board of Governors
Mr. Cardon, Legislative Counsel, Board of Governors
Messrs. Partee and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Hersey, Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors

Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Messrs. Willis, Holmes, Eastburn, Taylor, Baughman, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Boston, New York, Philadelphia, Atlanta, Chicago, Kansas City, and Dallas, respectively.
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Messrs. Fousek and Sternlight, Assistant Vice Presidents of the Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meetings of the Federal Open Market Committee held on December 1 and 15, 1964, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market operations and on Open Market Account and Treasury operations in foreign currencies for the period December 15, 1964, through January 6, 1965, and a supplemental report for January 7 through 11, 1965. Copies of these reports have been placed in the files of the Committee.

Supplementing the written reports, Mr. Coombs stated that the gold stock would be reduced by $200 million this week as a result of the French decision to step up their gold purchases. On the basis of other scheduled orders, the Stabilization Fund was expected to end the month with a balance of approximately $35 million

This would be inadequate to take care of other prospective orders coming through in February and another sizable reduction in the gold stock would have to be made, probably during the first half of February.

At the December 1 meeting, Mr. Coombs said, he had indicated to the Committee that the outlook was for a net reduction in the gold stock of at least $750 million in 1965. This was a conservative estimate; subsequent developments suggested that the prospective decline might well be on the order of $1 to $1-1/4 billion, even without taking account of the reduction that would be occasioned by the increase in the International Monetary Fund quotas.

There had been a heavy burst of speculation on the London gold market last week, owing to two major factors: first, the exaggerated discussion in the French press of the gold policy of the French Government and, second, widespread misunderstanding and misinterpretation of Mr. Roosa's reference in his final press conference to a prospective alteration of the 25 per cent gold reserve requirement. Buying pressure built up steadily last week, reaching a crescendo on Friday (January 8).

In accordance with a general understanding reached in 1961 among members of the Gold Pool, Mr. Coombs said, the Bank of England allowed the price to rise as a tactical measure up to a level at the fixing of $35.15 on Friday. After the fixing there were scattered transactions in a thin market at prices ranging between $35.16 and $35.19. Total turnover on Friday reached $31 million and the cost of intervention amounted to $28 million. The statement put out by the U.S. Treasury on Friday, reasserting the U.S. determination to maintain the $35 gold price and to convert official holdings of dollars at that price on demand, helped to restore confidence over the weekend. Yesterday, the Bank of England brought the price down to $35.14 by forceful tactics, and today the price dropped another cent to $35.13. This tactical maneuver of letting the price move up and then hitting the speculators had paid off, and it would be used again if needed. The heavy intervention made last week not only exhausted the Gold Pool reserve, which initially was $40 million, but put the Pool into deficit to the extent of $28 million. Accordingly, the Gold Pool selling arrangement was reactivated over the weekend at Basle, retroactive to last Friday. As the Committee would recall, the U.S. share of the cost of intervention was 50 per cent.

Since the last meeting of the Committee, Mr. Coombs continued, there had been a good deal of downward pressure on sterling and upward pressure on continental currencies in foreign exchange markets. By now the British had drawn a total of $745 million on the credits made available to them under the $3 billion credit package. Of this $745 million, $200 million had been used to repay prior debts and another $200 million already had been committed during the hectic days just before Thanksgiving. Thus, the British had used in the market a total of $345 million, net, of the package since its announcement. The Bank of England's forward operations had been more than three times as large as their spot operations. These large forward commitments, together with the exchange rate guarantee given on the $1 billion drawing on the IMF, provided a further major deterrent to a devaluation of sterling.

Yesterday and today, Mr. Coombs said, the sterling market atmosphere was somewhat better, and the sterling rate was driven up above $2.79 through sizable intervention yesterday. Renewed pressure on the pound might well appear over the coming weekend. One question in the offing was what Britain's trade figures for December, scheduled for publication on January 18, would show. If they indicated a significant decline in imports the market should behave much better. But if they showed deterioration the situation might become difficult again.

Mr. Coombs reported that at the weekend meeting in Basle Governor Carli of the Bank of Italy had discussed with him the problems arising from Italy's growing intake of dollars during recent months. The Governor thought it might be desirable to follow the procedure that had been used in 1962, when the U.S.

Treasury had taken over many of the Bank of Italy's forward lira contracts. Mr. Coombs indicated that he agreed, and planned to so recommend to the U.S. Treasury. In addition, Governor Carli thought it might be desirable for the System to draw on its swap arrangement with the Bank of Italy, and Mr. Coombs considered this suggestion also a useful one.

The atmosphere at the Basle meeting, Mr. Coombs continued, was characterized by as much apprehension and uncertainty on the part of the central bank governors as he had observed at any such meeting in the last four years. What the Europeans feared most was periodic evidence of simultaneous weakness of sterling and the dollar and the possibility of a joint speculative attack on the two key currencies. It was important to remember that the resources of the Gold Pool were limited to $270 million, and it would not take many days like last Friday to run through this amount in short order.

The central bank governors present at the meeting were unanimous in recommending early removal of the Federal Reserve's 25 per cent gold cover, Mr. Coombs said. They felt that uncertainty on this issue had been a major factor behind the recent speculative pressures, and they thought it would be preferable to remove the U.S. gold reserve requirement in one stroke rather than in two steps. Moreover, they thought that in explaining removal of the requirement major emphasis should be placed, if possible, on the importance of freeing the gold stock for international purposes rather than on the need to allow for prospective increases in the U.S. money supply.

Mr. Coombs remarked that the central bank governors expressed strong feelings on the urgency of this country's acting to curtail the volume of bank lending to foreigners, particularly term lending, and if possible also acting to curtail somewhat the outflow of direct investments. This was the position not only of France but of nearly all of the Common Market countries. Unless the United States acted, there was a clear risk of joint countermeasures by the Common Market countries.

Finally, Mr. Coombs said, many of the central bank officials were disturbed by the decision of France to step up gold purchases from the U.S. They felt that the manner in which this matter had been handled had seriously undermined their own positions with their respective governments.

Mr. Ellis noted that Mr. Coombs had referred to the possibility of a "joint speculative attack" on the pound and the dollar and asked what he had meant to imply by that phrase. Mr. Coombs replied that the attack on sterling had been interpreted in many quarters as also undermining the position of the dollar. It was widely accepted in the foreign exchange markets that if speculation against sterling led to devaluation of that currency--and to competitive devaluations of other foreign currencies--the position of the dollar might become untenable and there would be a major risk of its devaluation also. There also was a risk that certain central banks would decide to increase their gold ratios, as France had done. Spain had indicated that it would be buying gold, and Austria was likely to do so also; and other countries might react similarly, as they had in 1960. Along with purchases from the U.S. by foreign central banks, there easily could be a convergence over a short period of speculative demands on the London gold market, and thus on the Gold Pool, 50 per cent of which would be met out of U.S. stocks. As he had indicated in his statement, the present outlook was for a substantial reduction in the U.S. gold stock in 1965. It was quite possible that declines would have to be reported every month, and this would intensify the prevailing uncertainties. In his judgment, the dollar now was in a situation of acute danger; the progressive erosion of its position over the past five years had made the dollar vulnerable.

Mr Hayes asked if Mr. Coombs would express his own views on the matters discussed at Basle of the U.S. gold cover and of possible means of curtailing U.S. bank lending abroad. Mr. Coombs replied that he could not speak to the domestic aspects of the gold reserve requirement, but from the point of view of the foreign exchange markets he thought a complete removal of the requirement would do much to restore confidence. The more thorough-going the action the more clearly it would be understood abroad and the greater its effect would be.

With respect to curtailing foreign lending by U.S. banks, Mr. Coombs continued, he personally thought that some reduction of domestic credit availability would be useful. But to add a cutting edge, he would favor combining this with moral suasion designed to reduce foreign lending on a selective basis. In his judgment there were a number of arguments against extending the interest equalization tax to term loans of banks for this purpose. First, in many cases the one per cent tax would not be much of a deterrent; provision had already been made in many loan contracts to allow for the tax if it should be extended to bank loans. Secondly, the tax was a blunt and inflexible instrument that did not deal with the geographical nature of the problem. As he saw it, the main problem at present concerned U.S. bank lending to the Common Market countries and to Austria and Spain. These countries were accumulating large amounts of dollars and were increasingly inclined to use them as a bargaining instrument in dealing with the United States. But the tax would apply equally to countries such as Britain and Japan where it would be undesirable now to curtail U.S. bank lending.

In response to Mr. Mitchell's request for an amplification of the suggestion that moral suasion be used, Mr. Coombs noted that Second District banks presently reported all of their foreign term loan commitments to the New York Reserve Bank. What he had in mind was urging commercial banks in the national interest not to make any loans of relatively large size--perhaps $5 million or more--to designated countries. The list of such countries might be modified from time to time as circumstances changed. The banks involved in lending abroad were aware, of course, that their foreign loans added to the nation's balance of payments deficit. However, they were faced with a competitive problem; unless they knew that their competitors were also being asked to curtail foreign lending they were likely to feel that a refusal to make a particular foreign loan would mean foregoing a profitable opportunity with no gain to the national interest, because some other bank would make the loan in question. On several occasions in the past the commercial banks had demonstrated their willingness to follow such suggestions. For example, all banks had complied with requests not to participate in the financing of certain Canadian wheat sales--to Russia on one occasion, and to Japan on another.

Mr. Hickman observed that these earlier examples of the use of moral suasion were one-shot affairs, and Mr. Coombs was now proposing a continuing program of policing foreign lending by banks. He asked whether such a program, to be successful, would not require some quid pro quo in the form of a willingness on the part of the Federal Reserve to reduce domestic credit availability. To his mind, it was the present level of credit availability that was the basic cause of the problem, although he was not necessarily suggesting a reduction in credit availability at this time. Mr. Coombs replied that he would not describe reduced credit availability as a "quid pro quo", but he did agree that the administrative problems of the program would be lessened if banks had a smaller volume of funds to lend.

Mr. Hickman then noted that it might be difficult to implement the program if the specific objectives were being continually modified as the matrix of capital flows changed. Under such circumstances it might be hard for an individual banker to understand from week to week which loans were acceptable and which not unless there was some guiding group along the lines of a capital issues committee. There also might be some problem in coordinating the program among the several Federal Reserve Banks.

Mr. Coombs replied that he would not expect such problems to be serious. The program would not involve a great many details; rather, it would amount to suggesting to commercial banks in February, say, that they hold back on loans to certain countries, and then perhaps indicating in September that they no longer need hold back on loans to one or more of these countries. Within the System, the Reserve Banks readily could keep in touch with one another on the objectives being sought.

Mr. Mitchell observed that he thought it was difficult to justify using moral suasion of the sort discussed in a democracy, particularly if some quid pro quo was to be offered. He noted that a relatively small number of banks were important foreign lenders. Mr. Hayes responded that he did not think that any question of a quid pro quo was involved. What was proposed was to draw on the great patriotic instincts of bankers--instincts which as yet had not been tapped. In his judgment it clearly would be unreasonable to expect an individual banker to curtail his foreign lending if he did not know that his competitors also were doing so.

In reply to Mr. Hickman's question on the possible usefulness of controls on direct foreign investments, Mr. Coombs observed that these would be more difficult to administer than controls over bank lending because of the larger number of businesses involved. In any case, however, such controls would presumably lie in the province of the Department of Commerce and not the System.

Mr. Mitchell asked whether it was correct that some European governments were not prepared to take steps to curtail U.S. investment in their countries. Mr. Coombs replied that France's present objective evidently was to get the Common Market countries to form a united front, restricting U.S. investment in all those countries. When combined with trade restrictions against the rest of the world, this would tend to make the Common Market countries an increasingly self-sufficient and discriminatory unit. It was in the interest of the United States, on the other hand, to encourage the assimilation of the Common Market into a broader free trade area. The situation with respect to particular countries changed from month to month. When the Italians had been in difficulty last year, for example, a heavy flow of U.S. investment there had helped to ease the situation. Now the Italians were accumulating excess dollars. It was because circumstances were so changeable that he favored a flexible approach to the problem.

In the course of the preceding discussion Messrs. Daane and Young temporarily left the room.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period December 15, 1964, through January 11, 1965, were approved, ratified, and confirmed.

Mr. Coombs then noted that two System swap arrangements would reach the end of their terms on February 8: the $100 million, three-month facility with the Bank of France, and the $250 million, six-month facility with the German Federal Bank. He recommended renewal of the French swap line for another three months and of the German line for either six or twelve months, depending on the outcome of discussions to be conducted with the German Federal Bank.

> Renewal of the swap arrangement with the Bank of France for a further period of three months, and of the swap

arrangements with the German Federal Bank for either six or twelve months, as recommended by Mr. Coombs, was approved.

Mr. Coombs reported that two System drawings of Dutch guilders from the Netherlands Bank, which already had been renewed once, would mature next month; one on February 4 for $20 million equivalent, and another on February 10 for $10 million equivalent. At the present moment he saw no possibility of repayment, and consequently he recommended their renewal for another three months.

Renewal of the two drawings of Dutch guilders from the Netherlands Bank, as recommended by Mr. Coombs, was noted without objection.

Mr. Coombs then noted that of the $200 million authorization by the Committee to engage in forward transactions, a total of $154 million was employed at present and another $15 million had been committed, for a total commitment of $169 million. These forward operations had been extremely useful in reassuring the markets and in preventing an undue concentration of gold losses. Noting that he might have occasion to engage in additional forward operations of authorized types in the near future, Mr. Coombs requested the Committee to increase the dollar limit on forward transactions specified in the continuing authority directive for System foreign currency operations by $75 million, to a total of $275 million.

Upon motion made and seconded, and by unanimous vote, the second paragraph of the continuing authority directive for System foreign currency operations was amended, effective immediately, to read as follows:

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.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period December 15, 1964, through January 6, 1965, and a supplemental report for January 7 through 11, 1965. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Stone commented as follows:

Looking back in the record, I note that at the first meeting of the Committee in January of last year I commented that December of 1963 showed none of the turbulence that often characterizes that month. This time, however, we have been experiencing one of the more turbulent year-end periods in recent memory.

The Committee last met on December 15, the quarterly tax date. The money market was quite comfortable at that time, as it had been over the preceding few days (which included the December 10 dividend date), largely because banks in New York and in other major money centers across the country had worked themselves into basic reserve positions in which they would be able to meet without strain the demands they knew would converge upon them around mid-month. This situation was soon to change, however. Dealer credit demands picked up sharply as the month progressed, and these demands have continued into the new year as dealers acquired large holdings of rights in the advance refunding.

At the same time, a significant redistribution of reserves to country banks occurred. Over the past three weeks excess reserves averaged about $100 million higher than in the preceding three weeks.

A counterpart of the heavy and persisting credit demands and the movement of reserves to country banks has been a sharp deterioration of the basic reserve positions of major city banks. The large New York banks, for example, moved from a basic surplus position in the week or two preceding the tax date to a basic deficiency position averaging in the neighborhood of $500 million over the last two weeks of December; and then to a deficiency in the neighborhood of $1 billion for a few days last week. Large basic reserve deficiencies have also been recorded in a number of other major cities around the country. The 38 banks that report daily showed, as a group, a basic reserve deficiency averaging $585 million in the three full statement weeks since December 15.

Such a situation in money market banks has, of course, meant heavy pressure on the Federal funds market as these banks sought actively to acquire funds to cover their deficiencies. The volume of funds moving through the market has, if anything, been a little larger than usual, but the demands have been so enormous that all trading has been at 4 per cent, except for two or three hours on one particularly difficult day when a major bank bought funds at 4-1/8 per cent. Bank lending rates to dealers moved up as the banks' reserve positions deteriorated. From a general range of 4- 4-1/4 per cent at the time of the last meeting, such rates rose to a range of 4-3/8 - 4-1/2 per cent by the end of the year and have remained around those levels.

Our efforts to deal with these heavy pressures were complicated by unusually wide and unpredictable swings in market factors affecting reserves. Indeed, the average "miss" per day during the period was about $240 million, and on two days the misses were on the order of $1 billion; moreover, about three-fourths of the misses were in the direction of a lesser availability of reserves than the estimates had suggested.

Under these circumstances, repurchase agreements were a particularly useful device for moderating the strong pressures that weighed upon the money market during the period. And making those agreements at 3-7/8 per cent--until yesterday, when we made some at 4 per cent--helped both to keep the bill rate within the range indicated by the Committee and to insure the success of the Treasury financing. Indeed, I have little doubt that in the absence of these repurchase agreements at a 3-7/8 per cent rate the bill rate would have moved into the 3.90's during the second half of December. This would not only have been contrary to the Committee's wishes, but also would have posed a serious threat to the Treasury's plans for the advance refunding. For a rise in bill rates into the 3.90's would have been accompanied by a decline of some magnitude in prices of intermediate- and longer-term issues, and even a small decline might well have precluded Treasury financing within the 4-1/4 per cent interest rate ceiling. As it was, the longest option in the refunding had to be priced to yield a full 4-1/4 per cent, while the 1974 issue was priced to yield 4.24 per cent. In short, there was little or no room left.

Turning to the advance refunding itself, the operation was well received by the market. After a day or two of some nervousness over developments in gold, the refunding closed out with what appears to have been real success in achieving debt extension. Dealer holdings of the longer issue, however, total over $500 million, and the aggregate exchange into that issue was very large. The success achieved by the Treasury may be regarded, from a longer-run standpoint, as a dramatic indication of investor confidence in the interest rate outlook. In the short run, however, the market might well encounter some difficult problems in the process of distributing its large holdings to investors, particularly if we should experience again the kind of unsettlement in international financial conditions that occurred last week.

Mr. Ellis asked Mr. Stone to enlarge on his reasons for first making repurchase agreements at a 3-7/8 per cent rate and then shifting to a 4 per cent rate.

Mr. Stone replied that the 3-7/8 per cent rate had been addressed to the special circumstances of unusually heavy seasonal pressures which coincided with the Treasury's advance refunding operation. He had had no intention of retaining that rate any longer than necessary for the purposes of meeting the Committee's objectives and of avoiding impairment of the refunding. Yesterday (January 11), some relaxation finally became evident in the seasonal pressures that had weighed so heavily on the market since the latter part of December. As a result, the 3-7/8 per cent rate no longer appeared justified and repurchase agreements were made at 4 per cent.

Mr. Hickman asked Mr. Stone to comment on the usefulness of the new program of reserve reports from a sample of country banks, in light of the size of the recent misses in reserve estimates.

Mr. Stone said that the first results of the new country bank sample had become available on December 10, 1964. As with any new survey, there were bugs that had to be worked out; and it probably was more difficult to launch a survey of this kind in December than at any other time of the year. He had not felt sufficient confidence in the early results to rely heavily on them, so the new survey as yet had not been particularly helpful. However, he would expect it to become increasingly useful as experience was gained.

Mr. Holland said he felt much the same way. Refinements in methods were being made in this "shakedown" period, but the results to date were encouraging with respect to the probable ultimate usefulness of the new sample in reducing after-the-fact revisions in weekly required reserve and vault cash estimates. There was still the problem of day-to-day misses in estimates of operating factors such as float and currency. These elements were the major cause of the big misses Mr. Stone had mentioned earlier.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period December 15, 1964, through January 11, 1965, were approved, ratified, and confirmed.

Chairman Martin then called for the staff economic and financial reports, supplementing the written reports that had been distributed prior to the meeting, copies of which have been placed in the files of the Committee.

Mr. Brill made the following statement on economic conditions

I am afraid my remarks today are somewhat diffuse, since there are many facets of the present situation worthy of exploration. Out of the welter of words, I hope that three points will emerge: (a) the economy is still showing surprising moderation in the face of an inventory bulge of apparently very large proportions, (b) the present balance of forces appears likely to persist for the next few months, and (c) so long as this balance persists, the present stance of monetary policy seems to me to be appropriate to domestic needs.

Now as to the evidence. Before the onset of work stoppages last fall, the economy was growing at a rate of close to 5 per cent in real terms. Industrial production alone was increasing at over a 7 per cent annual rate. After the interruption resulting from the GM and Ford strikes, activity resumed with great vigor, as auto manufacturers pressed to make up for lost production and steel consumers continued to lay in stocks as a hedge against the possibility of a spring steel strike. The industrial production index in December is estimated to have jumped about 1-1/2 points, to a level some 7-1/2 per cent higher than that a year earlier. Employment rose to record levels and the unemployment rate edged down slightly.

A significant part of the December production rise was for stockpiling; two-thirds of the point and a half increase in the production index last month was accounted for by the auto and steel industries. Rough staff guesses put November-December inventory accummulation in the vicinity of an $8 billion annual rate.

Yet, even with this pace of activity and such concentration in inventory demand, it is hard to discern substantial evidence of inflation or inflationary psychology. Some upward price pressures persist, but they continue to be confined to specific areas and continue to be offset, at least in part, by decreases elsewhere. For example, pressures seem to be abating in the nonferrous metals markets as more supplies become available from private production and Government stocks, and building material prices continue to reflect the leveling off of activity in the construction industry.

On the other side of the ledger, the steel price situation remains touchy as the industry nibbles away at Administration resistance. The steel increases to date--at least the published ones--have had insignificant effect on the broad indexes, but there is always the possibility that, emboldened by the mild reaction so far, the industry may essay more substantial advances. By and large, however, there are few signs as yet in commodity markets that recent price increases are spreading or becoming cumulative or accelerating.

Neither do we see signs of inflationary psychology in security markets. There has been relatively little net advance in stock prices since early summer, and bond prices at year-end were generally about the same or a little higher than a year ago.

Many reasons can be attributed for this general market stability, after another year of substantial economic gain, a year in which a significant reduction was made in the extent of unutilized resources. I still prefer as an explanation the rolling readjustment theory. Last year we had important shifts in demands, the principal one being the shift from the Government to the private sectors. Federal spending held about level, while tax cuts permitted businesses and consumers to take priority in claiming additional resources. Within the private sector there was a shift from residential construction to industrial construction. More recently, there was a shift in consumer spending from nondurables to durables, and within durables from furniture and appliances to autos. As one type of final demand leveled off, another surged forward, keeping aggregate activity rising at a moderate but evidently sustainable pace. Industrial capacity utilization increased, thus maintaining incentives for continued investment, but not creating enough production bottlenecks to incur widespread price instability.

Most analysts seem to agree that for the next few months expansion will continue strong, reflecting a high rate of inventory accumulation, rising expenditures for fixed capital, and strong car sales. Other demands taken together are expected to rise only moderately further. Barring new serious work stoppages on the docks or the rails, aggregate activity will probably make up for the strike losses last fall. It looks as though the economy could continue on this path until it reaches the next set of hurdles, the first of which comes in early April when consumers have to face the bite resulting from underwithholdings on last year's income taxes. The second hurdle comes on May 1, the deadline for the new steel contract. Beyond that, increasing weaknesses loom, but this is not the focus of any remarks this morning.

Assuming such a somewhat unbalanced expansion can be sustained over the next two to three months without developing significant departures from price stability, it appears to me that the present posture of monetary policy would remain appropriate. Along with a large flow of savings, this policy has produced a structure of interest rates admirably suited to domestic requirements. Stable-to-declining long-term rates continue to encourage investment by businesses and State and local governments, while not subjecting already reduced housing activity to financial pressures. If relatively high short rates are having any domestic effect, it must be in the desirable direction of inhibiting some financing of inventories, although probably this impact is minimal.

The critical question is what specific policy objectives would contribute to maintenance of the present set of rate relationships. What volume of reserve additions would produce the appropriate banking system contribution to credit flows? Here we have to look to all the sources of funds banks can muster. Savings deposits, which spurted in November when consumers awaited the availability of new autos, apparently declined a bit from this peak but stayed relatively high in December, and may continue to expand rapidly as the new higher rates offered by banks exert a tug on funds which might otherwise flow to nonbank financial intermediaries.

However, faster gains in savings accounts may be offset in part by smaller rates of increase in CDs. The high cost to banks of CD money since the November rise in short-term rates appears to have discouraged aggressive issuance by many prime banks, and other important issuers had already curbed their CD activity starting last spring. Also, corporations seem to be displaying less interest in the CD market, perhaps reflecting a developing squeeze on the availability of liquid funds.

Thus, while banks may be, on balance, the recipients of a somewhat larger net inflow of time and savings accounts, some of this rising inflow will have been bought away from other lenders and will not represent a net contribution to the over-all supply of loanable funds. To balance fund supplies against prospective demands at current costs of credit, and to meet apparent cash balance preferences at current rates of return, would appear to require at least as large an expansion in private demand deposits over the next few months as occurred last quarter. It should be recalled that this fourth-quarter rate of expansion was well below that for the year as a whole. Possibly a more rapid pace will be in order for a while, if distribution of the present Treasury financing operation requires extensive and extended bank underwriting. But we should be able to read promptly from financial market performance if such reserve objectives are wide of the mark.

Mr. Holland then made the following statement concerning financial developments:

I should like to concentrate my remarks on just one or two issues this morning, taking advantage of the enhanced flow of information to the Committee in the form of the green book1/ and the draft staff answers to the agenda questions.2/ Before turning to the main thrust of my remarks, however, I should say that reports from outlying banks have made us revise down our estimate of December commercial bank credit growth to $1.1 billion from the $1.5 - $2.0 billion estimate in the green book. This reflected loan expansion about in line with the 11 per cent rate for the year as a whole, and some decline in securities holdings. Indeed, commercial bank additions to securities holdings over the fourth quarter as a whole averaged only about $200 million a month, well below the $800 million-a-month spurt in the third quarter. Such a characterization of bank credit expansion is somewhat less vigorous than one might have been led to make on the basis of weekly reporting member bank data alone, and reflects the fact that country bank credit expansion has lagged behind city bank expansion in parts of this period, most recently in December.

1/ The report, "Current Economic and Financial Conditions," prepared for the Committee by the Board's staff.

2/ The staff's prepared comments on certain questions considered by the Committee at this meeting, given at a later point in these minutes.

The large Treasury advance refunding clearly calls for an "even keel" policy, as the staff answer to Question 6 points out, probably until the next meeting of the Committee. But in the current circumstances, I think "even keel" can be construed to extend over a substantially wider range of events than in some previous financings. Let me explain what I mean. I think most discussions of the definition of "even keel" have boiled down its essential meaning to, "no change in money market or reserve conditions (or in any other arena of System action) that would be construed by the market as signalling a change in monetary policy."

Given the recent large oscillations in free reserves, the market obviously is now paying less attention to any change of, say, $50 million than it did earlier this year, and so we have acquired a correspondingly greater degree of freedom here to use if we wish. Similarly, short-term interest rate fluctuations seem to have been greater since the discount rate increase, and not always in the same direction. Thus, the three-month bill rate moved up relatively high in the cluster of short-term rates under seasonal and expectational influences earlier in December; and thereafter it has dropped relatively low in the money market rate structure as these earlier special forces were reversed, and additional downward pressure developed from "rights" sales in the advance refunding and also from less aggressive competition from bank sales of CDs. In the circumstances, I think further bill rate changes of several basis points either up or down would not upset the market, so long as the changes evolved from understandable changes in supplies and demands for bills and were not linked to actions in the monetary authorities.

Perhaps the least elbow room for maneuver in an even keel context attaches to such day-to-day financing rates as those on dealer loans and Federal funds. These have moved up to new highs since the turn of the year, under the twin impetus of the strong shift of reserves away from money market centers and the need for dealers to finance their large operations in connection with the Treasury refunding. Relatively sizable borrowings by city banks have also been a consequence of these events. Such developments have been fairly well understood by the market as natural sources of temporary pressure, and so produced no flurry of talk of changed Federal Reserve policy. Nonetheless, if such pressures are not relaxed a bit over time, particularly as dealers manage to work down their need for bank financing and if, as is expected, reserves do drift back to the money centers from out in the country, then market participants are likely to become increasingly of the view that it is monetary policy and not natural forces that are behind the persisting tightness, and this revision in attitudes and expectations could give rise to liquidating pressures in the short-term, and especially in the long-term, markets. I think, therefore, that the most practical operational constraints for even keel in this period might be to allow day-to-day financing conditions to slip back a shade toward pre-refunding levels. The degree of such decline could be either slight or more appreciable within an even keel context. and perhaps a middle-of-the-road view would be to allow day-to-day financing rates to go no higher than at present, and gradually to allow Federal funds rates to slip occasionally below 4 per cent and dealer lending rates to slide back toward 4-1/8 - 4-1/4 per cent and sometimes lower as January proceeds. This may seem to be focusing attention very narrowly, but I see no assured alternative to such a procedure, given the size of undigested new bond holdings that have been injected into the market by the unexpectedly appealing Treasury refunding. In particular, so large an addition to long bonds in dealer hands, financed by increased demands for day-to-day money, has served to tighten up very much the sometimes quite loose linkages between the money market and the long bond markets. For a time at least, for better or worse, any further instalment of "Operation Twist"--that is, any further upward push in money market rates without an increase in long rates--seems out of the question.

In so concentrating operational attention upon day-to-day market rates rather than on the 3-month bill rate, I recognize I am suggesting a departure of sorts. But I think there are reasons for believing that the bill rate currently is a less pertinent measure to both the Committee's international and domestic objectives than are day-to-day money market and bank reserve conditions. The statistics for this past year show a considerable willingness on the part of private foreigners to hold, in one form or another, the dollars that reached their hands as a consequence of our balance of payments deficit. Thus the interest rate and other attractions to them to hold dollar balances did not appear seriously inadequate. If policy is thus still reasonably free to concentrate on dealing with the causes of the deficit, rather than simply trying to keep it financed, then among the sources causing the deficit, the one most amenable to further influence by monetary policy--either general or selective--seems to me to be bank lending abroad. Bank lending policies can be changed over time, and money market and reserve conditions can contribute to such changes. We already have evidence, in the September and December surveys of bank lending practices, that both customer standards and costs of credit for some business borrowers are being tightened somewhat by a substantial portion of big banks. It is moot, however, whether such tightened lending practices affect foreign or domestic customers more. And the financing of orderly domestic expansion continues to depend upon the availability of both bank loans and also longer-term credit. The yields and terms in longer term markets are currently very much tied to day-to-day money market conditions because of the large dealer positions arising out of the advance refunding.

I conclude that both the international and domestic concerns of the Committee at the moment are more tightly related to the cost and availability of day-to-day financing in the market than to any other operational variables. Whether the Committee should choose to have such financing conditions tightened, eased, or left the same when the need for an "even keel" fades has to depend upon a balancing of international and domestic considerations. Whatever way that choice may be resolved, I think a case can be made that the safest way to communicate with the Manager in these weeks is in terms of desired day-to-day money market conditions.

Mr. Ellis referred to the question that Mr. Holland had described as "moot," and asked if he had any evidence as to whether the effects of a general reduction in the availability of funds would impinge primarily on foreign lending by banks. Mr. Holland responded that he knew of no reliable evidence on this question despite efforts such as he was sure everyone around the table had made to obtain it from the available statistics. At the moment, perhaps talking with bankers was the best method of getting clues as to how they would react to a reduction in the availability of funds. From discussions he had had with some bankers he suspected that both domestic and foreign loans of banks involved marginal and inframarginal cases. He emphasized that this judgment was based on hearsay and not on any firm evidence.

Mr. Hayes agreed with Mr. Holland that the most useful way of getting at the subject of bankers' probable reactions was to talk with them. He had talked about this with various New York bankers many times, and he had obtained the impression that their foreign lending was considered to be a more marginal activity than their domestic lending and would be more susceptible to curtailment by a reduction in the availability of funds.

Mr. Ellis remarked that there was another aspect to the problem--some banks outside of New York appeared eager to get into the foreign lending field. If New York banks cut back their foreign loans they might find the gap was being filled by other banks unless something was done to minimize the spread of this activity.

Mr. Hersey presented the following statement on the balance of payments:

> Looking back at 1964, one of the most striking features of our balance of payments was the unusually large build-up in U.S. short-term liabilities to commercial banks abroad, which last year was of the order of magnitude of $1-1/2 billion. This represents an increase in interbank balances, including liabilities

of American banks to their branches abroad and liabilities of foreign agencies and branches operating here to their head offices, plus any increase there may have been in holdings of short-term money market paper in this country for the account of commercial banks abroad. The countries concerned in this increase were primarily Britain, Canada, Japan, Switzerland, and Germany.

Because of this inflow of private banking funds, we had in 1964, at one and the same time, a deficit on "regular transactions" (the concept we have ordinarly focused on) of the order of magnitude of $2-1/2 billion, and a deficit on the "official settlements" basis of the order of magnitude of $1 billion. There was a striking contrast also in the trends within the year. The annual rate of deficit on regular transactions rose from under $2 billion in the first half of the year to over $3 billion in the second half. On the other hand, the annual rate of "official settlements," adjusted for seasonal variation as well as we can, dropped from somewhere near $1-1/2 billion in the first half to $1 billion and perhaps less in the second half. This difference in trends within the year reflects the fact that the large build-up of commercial bank balances was heavily concentrated in the second half of 1964, starting in fact in July and continuing in every month but September and December. A seasonal run-down is normal in December.

I have had to state all these figures in very approximate terms because we do not yet have comprehensive figures for the month of December, but only incomplete figures for the weeks ending on Wednesday. I should also point out that the difference between the two kinds of deficit is not due solely to the behavior of commercial bank balances. In addition, there was a much smaller normal growth of short-term balances belonging to private foreigners other than banks, but this was pretty well offset last year by a decline in the liquid assets held in this country by the World Bank and other international agencies.

Why did commercial banks help us out so greatly in the financing of the deficit on regular transactions in the second half of 1964? What does this development portend for 1965? If we could get a good answer to the first question, it would help in answering the second.

Previous large build-ups in commercial bank balances occurred in 1959, 1961, and 1963. The first was of the order of magnitude of $1 billion, but the other two were only of the order of magnitude of about $1/2 billion. A large decline occurred in the second half of 1960, after a very wide spread had opened up between U.S. and British short-term interest rates; that was also the time of the first flare-up in the gold market. I mention those earlier movements to emphasize that last year's build-up was relatively very large. Also, in contrast to the earlier movements, last year's build-up does not appear to have been stimulated in large degree by special inducements that foreign central banks, particularly the Bundesbank, gave their commercial banks to acquire and hold dollar balances in the United States or in the Euro-dollar market.

The plausible available answers to our first question are of three kinds. First, one might associate increases in foreign commercial bank balances here more or less directly with borrowing operations in the United States by those banks or their customers, in so far as the proceeds were not needed immediately for trade financing or other purposes. Canadian issues in our market were very large in the fourth quarter, and term lending by U.S. banks was heavy all through the second half. But when one pursues this explanation in terms of the countries involved or in terms of comparisons with earlier periods, it seems to be at best only a very partial explanation.

Second, one might be tempted to look for an explanation in terms of the placement of funds in New York by Canadian banks obtaining deposits denominated in U.S. dollars from U.S. corporations. Certainly for some of the monthly movements this explanation is valid. By half-years, however, it breaks down. The net outflow of U.S. corporate liquid funds into dollar deposits abroad was fairly large last year, but it was probably not significantly larger after midyear than before.

Third--and this may turn out to have been a fairly important factor--banks operating in the Euro-dollar market in London and elsewhere may have found the volume of U.S. dollar funds coming to them from all sources larger than they wished to employ in Euro-dollar lending abroad. In the case of American bank branches abroad, the relatively low rates they could pay on very short-term Euro-dollar deposits may have allowed them to obtain funds abroad for their head offices in this country at a cost below that of borrowing on 90-day

CDs here. An important element in this third explanation is the thought that the aggregate volume of Euro-dollar deposits was rising strongly after midyear, and British statistics do support this assumption.

Underneath all these complexities we are warranted, it seems to me, in seeing at the least an undiminished willingness of private foreigners to hold dollar balances, at least on into December. Possibly we can infer even more, that the uneasiness about sterling which began to develop last autumn contributed to the increase in foreigners' dollar holdings in the form of Euro-dollar deposits and so to the increase in commercial banks' balances in this country.

The implication of this line of thought is that in 1965, as and when confidence in sterling is restored, we may see some unwinding of the 1964 developments. In any case, it seems very unlikely that the build-up of commercial bank balances would again be as large as it was last year.

The aftermath of the sterling crisis may also affect other elements of the balance of payments in 1965. As British imports are cut back we will have one definitely unfavorable factor thrown into the pot of uncertainties about the outlook for the U.S. trade balance. While the outlook does seem favorable for a further general expansion of world trade, and for further gains in the U.S. share of exports in some markets, British measures of restraint, added to continuing French efforts to check inflation even at a sacrifice of near-term economic growth in France, could begin to modify this outlook somewhat. In the next few months, also, we may see more of a rise in U.S. imports than was occurring from last spring through October. We have just learned that in November imports were up sharply to above a $20 billion rate, from under a $19 billion rate in the late summer and early autumn. But in considerable part this was due to a speeding up of shipments to get ahead of the threatened port strike.

All things considered, it looks likely that our overall deficit on the official settlements basis will be higher in 1965 than the $1 billion level we have had in the past year and a half. This will tend to produce a further swelling of U.S. gold sales. To counteract these tendencies, and to help cope with the international political as well as financial problems they will involve, it will become increasingly necessary this year to look for policy measures that hold promise of halting the spill-over of bank reserve availability and of time deposits into foreign term loans and other foreign credits.

The seriousness of this problem of spill-over into foreign lending is indicated by the confidential data on foreign term loan commitments gathered by the Treasury from U.S. banks. These data show substantial increases in commitments since the middle of last year, to Europe as well as to other areas, and they suggest the continuation of the outflow on term loans at an annual rate in excess of $1 billion. This compares with an average rate of about $3/4 billion from the spring of 1963 to mid-1964. But since midyear the rate has been about $1-1/4 billion.

The sterling crisis is for us a timely reminder that, if not now, then perhaps later, acute problems can arise for a reserve currency country with a persistent disequilibrium in its international accounts. Perhaps we need a different mix of fiscal and monetary policies than any we have yet tried out.

Prior to this meeting the staff had prepared and distributed certain questions and responses for consideration by the Committee. These materials were as follows:

1. <u>Business activity</u>. In view of the length of this expansion period, are there indications of developing imbalances--in inventories, production relationships, or the composition of consumption--that suggest the possibility of either a cyclical topping-out or an overheating of the economy in the relatively near future?

The well-balanced expansion through September 1964 has since been disturbed by auto strikes and the possibility of a steel strike in the spring. Auto output is scheduled to be maintained at very high rates for some months ahead, at a time when steel output is responding to enlarged demands for precautionary stocks. Subsequently, we may face sharply reduced auto and steel output. Nevertheless, the bulge in inventory buying as it has developed thus far does not seem to be leading to overly buoyant business expectations and commitments or to a subsequent cyclical topping-out.

Limiting the overheating possibility are the facts that the labor force and industrial capacity are growing more rapidly than earlier and are adequate to meet most current and developing demands. For some of the nonferrous metals, the supply situation, which had been very tight, is improving. Consumer purchases of durable goods other than autos have been on a plateau for six months, and the earlier rapid rate of expansion in spending for nondurable goods has slowed. While residential construction activity may have bottomed out after its decline of last year, it is hardly an expansive factor. Federal purchases seem destined to change little in the months immediately ahead.

Other final demands, however, remain moderately expansive. Consumer incomes are rising at a fairly steady pace and consumer demands for autos appear strong. Business spending for fixed capital is still rising, as is State and local government spending. Such a balance of forces would be likely to result in a continued substantial increase in over-all output for several months, with the possibility of some slowing in the pace of expansion later in the year.

2. Labor markets. To what extent have recent labor contract settlements and recent developments in productivity been exerting upward pressures on unit labor costs?

Only a few major contracts have been negotiated since the auto settlement. Some of the settlements have provided for larger than guidepost increases, while others have provided for smaller gains, but the average appears to be about in line with over-all changes in productivity.

With the auto settlement not providing for any increase in hourly money wages this year, average hourly earnings in manufacturing have shown no acceleration in their rate of rise. At the end of 1964, average hourly earnings in all manufacturing were only 7 cents, or 2.8 per cent, above December 1963, a smaller rise than in the previous 12-month period.

Fringe benefits have been rising more rapidly than money wage payments; over the past year, fringes increased 4.3 per cent per employee in manufacturing. Total compensation per employee in manufacturing, including both money wages and fringes, was about 3.3 per cent higher in late 1964 than a year earlier, close to the guidepost and below the indicated rise in output per manhour.

In recent months, changes in output per manhour in manufacturing have been obscured by the auto strikes but there is no evidence of a slackening over the past year in the high rate of increase of about 4 per cent. This increase was about the same percentage as in 1963 and 1962.

Total labor costs per unit of output in manufacturing have been showing no significant trends this year. Unit costs in individual months have been up as well as down. In September and October unit labor costs rose somewhat, partly because of the auto strikes. In November, with output at G.M. resumed, they declined. With the automobile industry back at full production and with total manufacturing output continuing to rise, unit labor costs in manufacturing in December probably dropped back to pre-strike levels.

3. Price developments. Is there any evidence to suggest that businessmen are expecting an inflationary price drift in the period ahead? Or that demand pressures are extending the area of price increases or accelerating the recent slight updrift in the over-all price indexes?

There are occasional indications in the press that some businessmen are expecting an inflationary price drift, but these reports are too limited to provide evidence of any developing inflationary psychology among businessmen.

Actual price performance to date has not been such as to confirm inflationary expectations. Following a rise of .4 per cent between mid-September and mid-October, the industrial commodity price index increased only .2 in November and .1 in December. The fourth-quarter rise reflected primarily recovery in fuels, back to the year-ago level, and further increases among nonferrous metals. General spreading of price increases to other markets in response to demand pressures does not appear to be occurring.

However, current strong demands for most types of steel, partly to hedge against a strike threat to supplies, are sustaining higher prices for some steel products. The industry has announced increases of 2 to 3 per cent for galvanized products, citing in part the increased cost of zinc. The direct effects of these increases on the total index is negligible.

Recently, upward pressures appear to be abating for some nonferrous metals. Tin prices fell sharply after announcement of an increase in the amount of the metal available from the stockpile. Copper production has recovered from the strikes and other disturbances of last summer and recently prices in the London metal market and in domestic markets for futures and scrap have declined substantially.

There is no evidence of acceleration of consumer price increases and the consumer index in November continued 1.2 per cent above a year earlier.

4. Balance of payments. How have developments with respect to the pound sterling affected the U.S. balance of payments and the willingness of foreigners to hold dollars?

So far, Britain's difficulties have probably had little net effect on either the U.S. balance of payments or the willingness of foreigners to hold dollars. Both favorable and unfavorable effects can be identified, although few of them can be measured closely.

During the first 9 months of 1964, Britain's large current account deficit contributed to the U.S. current account surplus. The U.S. balance on current transactions with Britain was $320 million more favorable in this period than it had been a year earlier, and U.S. exports to some other countries may also have benefited temporarily as a result of unsustainably large U.K. imports from those countries. As Britain cuts its deficit, these favorable influences will be reversed. But there is no evidence that such a development was yet making itself felt by the end of 1964.

Postponement of the British Government loan repayment at year-end increased the U.S. deficit by $138 million in the fourth quarter. But changes in private capital flows seem to have worked in the other direction. Short-term outflows of U.S. private capital to Britain were reversed in the fourth quarter during the sterling crisis, and long-term outflows probably diminished. Fragmentary data on securities transactions suggest that flows of foreign capital from Britain into U.S. nonliquid assets stopped shrinking during the fourth quarter, and may even have increased.

There is little evidence of any reduced willingness of commercial banks abroad and other private foreigners to hold dollars. Flows of foreign private capital from all countries into liquid assets in the United States do not seem to have changed greatly in total as a result of sterling's difficulties; they continued to be exceptionally large through November, and the December reversal seems to have been of roughly the usual seasonal proportions.

Some recent central bank decisions to purchase gold for dollars may have been influenced by sterling's difficulties and related uncertainties. But France had repeatedly intimated its desire to exchange dollars for gold for a variety of reasons, although the sterling crisis may have provided the excuse and influenced the timing. Spain was already exploring the possibility of buying gold, in line with its earlier policies, several months before the sterling crisis broke.

Private demands for gold have been stimulated by the uneasiness about the future of exchange rates and gold parities--an uneasiness generated by the sterling crisis and recently accentuated by the prospect of French conversions of official dollar holdings into gold. Private purchases of gold cannot, however, be taken as a reflection of distrust solely of the dollar. Frenchmen, for example, have recently been moving into gold out of French francs. Increased private demand for gold in the past two weeks makes it likely that the United States will be called upon to supply additional gold to the London pool.

5. <u>The money market, bank credit, and money supply.</u>
(A) How has the mixture of higher short-term rates, including the higher discount rate, and the lower member bank borrowing affected the rate of expansion in bank credit and money?
(B) As year-end money market and bank reserve pressures subside, what relationships are likely to emerge among the proximate target variables of policy, i.e., free reserves and money market conditions? In turn, how are these likely to be related to credit and monetary expansion in the near-term?

A. The rate of expansion in bank credit and money continued in December at a pace not very far below that for the year as a whole, as the influence of higher discount rates and associated higher short-term rates was counteracted by higher nonborrowed reserves and reduced member bank borrowings. The daily average bank credit expansion in December, at 7.1 per cent (annual rate), however, was considerably slower than November's exceptional 12.1 per cent; this turn-around was influenced in part by bank sales in December of Treasury tax bills acquired in late November, and a paring down of Government security dealer borrowing. The rate of growth in money also slowed in December, and was below the 4 per cent growth for the year as a whole, but time and savings deposit growth was slightly above its yearly rate, even though major banks were less active in the CD market.

Basically, the continued December money and credit expansion was sustained by a substantial increase in the growth of nonborrowed reserves supplied by the System, as borrowed reserves declined from pre-discount rate action levels. In this way Federal Reserve open market operations counteracted much of the constricting effect on money and credit expansion which might otherwise have stemmed from increased member bank reluctance to borrow at the higher discount rate. Such operations, undertaken in the context of continuing heavy demands for credit and a shift in reserves away from city banks in the latter part of December, produced larger free reserves in the banking system as a whole and prevented tautness in the money market from becoming extreme.

B. Money market and bank reserve pressures normally subside after the year-end, but there are more uncertainties than usual in the picture this year. The Treasury refinancing operation, discussed in the following question, is one. The strength of loan demand is another, as the extent of borrowing to finance inventory accumulation is not yet clear. The maintenance of money market pressures throughout the second half of December and into early January--as typified by a consistent 4 per cent Federal funds rate and relatively high dealer loan-rates--may indicate some continuing heavier than usual credit demands, as well as the sharp movement of reserve funds away from major city banks.

The continuing money market tautness has contributed to moderating the usual seasonal decline in bill rates (intensified this year by demands coming out of the advance refunding), and the 3-month bill rate closed at 3.78 per cent on Friday, down 11 basis points from its recent high. A reflux of reserves to central money markets would tend to reduce this tautness, as will the unwinding of the financing pressures arising out of the advance refunding. Offsetting these easing influences, in part, will be the Treasury sale of tax bills later this month and possibly also continuing contraseasonal strength in loan demands. Given these developments, bill rates might fluctuate within perhaps the 3.75 to 3.85 per cent range, although the shortest-term money market rates might adjust downward. This could be consistent with member bank borrowings averaging somewhat above and free reserves somewhat below their December levels, but not back to their fall peaks. Money and credit expansion could continue substantial, nevertheless, reflecting both the assumed strength in loan demands and the large volume of Treasury financing activity this month.

Should credit demands relax seasonally over the balance of January, and particularly if there should simultaneously occur a redistribution of reserves from country to city banks, free reserves averaging around the levels of the past few weeks would probably be associated with a bill rate at current or even at somewhat lower levels. Federal funds would trade below the discount rate more frequently than recently and borrowings would be relatively low.

If the maintenance of a firm Federal funds market and the restoration of a higher bill rate is desired, this would then probably require an increase in borrowing and a reduction in free reserves to around the target levels prevailing last fall. It is hard to say how much the bill rate might increase with free reserves back to such levels, but a reasonable guess might be in the 3.85-3.95 per cent range.

6. Money and credit markets. What is likely to be the short-run effect on money and capital markets of the current Treasury financing operation, and what constraint (if any) does it place on current monetary policy?

The current Treasury advance refunding, which involves $22.1 billion of publicly-held securities and is the third largest such offering on record, will place some constraint on monetary policy in coming weeks. Books were closed for the financing on January 8, and settlement date will be January 19. But the terminus of an "even keel" monetary policy in a refinancing such as the current one is clearly not susceptible to a hard and fast rule. It depends essentially on actual market developments in the period after the books are closed. At a minimum, however, it seems likely that "even keel" will be required for much, if not all, of the balance of this month.

It appears that dealers will come out of the advance refunding with relatively large holdings of long-term securities. Indeed, early indications suggest that their holdings of the 4-1/4 per cent bonds of 1987-92 alone will exceed $500 million. International financial developments will be among the major factors conditioning the speed and price at which dealers will be able to distribute these securities to investors.

In the week following announcement of the current refunding, long-term interest rates showed little change, although earlier they had risen slightly in anticipation of the exchange offering. The mildness of this initial long-term interest rate adjustment was similar to experience in the July refunding. But after that refunding, long-term rates did come under upward pressure later in the summer. Dealers had emerged from the July refunding with a record net long position of $1.2 billion in securities maturing in more than 5 years. Nevertheless, the System did shade its policy very cautiously toward less ease beginning in mid-August.

An advance refunding of large magnitude poses problems for monetary policy not only in the long-term market but also in the short-term area. In last July's operation, bill rates came under considerable downward pressure before the books were closed in mid-July. These pressures were moderated in some measure by a Treasury bill strip offering; and the months following July were a period of rising rates, partly for seasonal reasons. By contrast, the current advance refunding will be followed by a period in the latter part of January and in February when seasonal pressures have at times in the past tended to produce lower bill rates. But so far in the current financing only moderate downward pressure has been in evidence, as dealer bill positions have remained substantial, dealer financing costs have remained high, and the Treasury has announced a $1-3/4 billion auction of June tax bills to raise new cash.

7. <u>Monetary policy</u>. In light of these and other considerations, what policy with respect to bank reserves and money market conditions would be appropriate for the next three weeks?

Chairman Martin then called for the go-around of comments and views on economic conditions and monetary policy, beginning with Mr. Hayes, who made the following statement:

I would like to make a brief comment on the new procedure whereby the Board's staff lists specific questions for our attention and discussion. While I can see that we have gained important advantages by this encouragement of a focusing of Committee members' comments on issues of current significance in policy formation, I also feel that some of the questions, such as that dealing with the balance of payments, were rather narrow--although I realize there was no effort to confine our discussion within these narrow limits. In several of the areas covered by the questions I have purposely ranged over somewhat broader territory in formulating my comments.

1. Domestic business activity. The domestic economy moved up toward the end of 1964 in almost automatic response to the end of the October-November auto strikes. While the year ended on a strong note, not all of the momentum of the first three quarters appears to have been regained. However, apart from the steel industry, the economy is still demonstrating well-balanced growth; and the outlook for 1965 remains relatively bright. Strength in retail sales, which seems likely, together with the expected continuing accumulation of steel inventories, could well push GNP up very rapidly early in the year. High consumption of steel, as well as stockpiling, is gradually reducing excess capacity to produce unfinished steel; finished steel capacity is already tight. The extent of business sluggishness in the second half of 1965 will depend importantly on the size of the first-half steel build-up, and also on the extent to which fiscal policy provides a stimulus in the second half. While it is much too early to try to quantify any such stimulus, there will doubtless be a considerable improvement in this respect in the second half, not only because of probable excise tax cuts and larger planned expenditures, but also because of elimination of the drag arising in the first half from 1964 personal income tax underwithholdings and the speed-up of corporate tax payments.

2. Labor markets. Except for the automobile industry, most major wage settlements in 1964 appear to have been within a range roughly consistent with national productivity gains. However, it is too early to judge to what extent the more generous auto settlements may set a pattern. The steel settlement will be of crucial importance, and at the moment there is no indication of its probable terms. It was disturbing that the announced increase in prices of galvanized steel found an immediate response from the steel union to the effect that this would provide an additional reason for a generous wage settlement.

It seems unreasonable at this time to expect any material improvement in total unemployment during 1965. But as many of us have stressed so often, the problem cannot be solved merely by increasing over-all demand through expanding credit more rapidly than we have been doing--even if other considerations permitted us to follow such a path, and of course they do not.

3. Prices. Price indices continue to show a high degree of stability, although industrial wholesale prices are still under some moderate upward pressure. Fortunately, there has been some easing recently in world commodity markets at a time when, domestically, cost pressures are threatening to build up. The price threat is still a serious long-range danger rather than an immediate problem. But I think its seriousness is perhaps minimized a little too much in the staff's answers to the relevant questions.

4. Balance of payments. The international situation contrasts sharply with the relatively satisfactory domestic picture. I have become increasingly disturbed by the uneasy state of international markets, and their susceptibility to rumors and distorted interpretations of current developments. The dollar is particularly vulnerable in this sort of situation, and it has become a matter of first priority for us to move our balance of payments far closer to equilibrium. While the final data for December are not yet available, the over-all deficit expanded sharply in the fourth quarter to somewhere close to a $4 billion annual rate, and the full-year 1964 deficit is now likely to exceed $2.5 billion. Despite the high proportion of last year's deficit financed through enlarged private holdings of dollars, dollars are finding their way into the hands of European central banks which are unwilling to increase their holdings, and our gold stock faces significant inroads over the coming months. While sterling has of course been the main focus of fears in financial markets, the general feeling of uncertainty has spread to other currencies, with the resulting sharp rise in speculative demand on the London gold market--abetted, of course, by the inexcusably long drawn-out and exaggerated press coverage of the French gold takings and by foreign misinterpretation of newspaper leaks with respect to the 25 per cent gold requirement. The latter might well have been avoided had it been made clear at the outset that the main purpose of eliminating the 25 per cent requirement would be to show the world dramatically that our entire gold stock is available to meet our international obligations.

We cannot afford to temporize any longer with our payments problem, which lies at the root of the erosion of confidence in the dollar and the erosion of American bargaining power in international economic negotiations.

As we analyze the composition of our payments deficit, we find that an unexpectedly strong gain in our trade balance in 1964 was offset by an increase in private capital outflows, which can be estimated to aggregate about $5.6 to $5.8 billion in the year. Bank loans to foreigners accounted for a good share of this total and were especially high in October and November, with Europe an important outlet. (December data are not yet available). In November term loans alone rose by $165 million.

5. Money supply and liquidity. December data on bank credit are always hard to evaluate, and this December is no exception. I think it is safe to say, however, that the impact of the System's late-November moves has so far remained mainly confined to money market rates. Credit and the money supply have continued to expand at about the same rates over the last two or three years despite the System's gradual moves toward lesser ease. As year-end pressures subside, somewhat lower bill rates are likely to be associated with a given level of free reserves than in the past few weeks.

6. Money and credit markets, and Treasury financing. With settlement for the advance refunding still to be completed next week, and with the market ending up with a large volume of the longer issues still to be distributed to investors, we shall have to avoid, probably for the rest of this month, any action that would unduly affect the long-term area. Granted the need for abiding by this limitation, we should at least see to it that short-term rates do not come under downward pressure. And by the time of the next meeting, in view of the routine nature of the February refunding, we can probably feel very little inhibition because of Treasury considerations.

7. Monetary policy. It seems to me undeniable that our international problem has advanced closer to the center of the stage than a few months ago and that monetary policy should be moving to help reduce our deficit. In other words we should, I believe, be seeking a somewhat reduced rate of growth of bank credit, with open market operations directed toward this end. Were it not for Treasury considerations, I would like to see a fairly rapid move to money market conditions and bank reserve positions that would result in a slowdown of bank credit expansion, even if this involved moderate net borrowed reserves; but for

the immediate future, it would probably be best merely to counteract any seasonal tendencies toward lower bill rates. If we preserve about the present atmosphere in the money market, with bill rates in the 3.80 per cent to 3.90 per cent range, we shall be providing adequate support to the Treasury's program. After the Treasury financing is settled next Tuesday this policy would probably result in a somewhat reduced level of free reserves.

The directive should be changed, I believe, to give greater emphasis to our concern for the dollar's international position, and to recognize the Treasury financing.

I am coming reluctantly to the conclusion that our critical balance of payments problem calls not only for a less easy monetary policy but also for some form of direct restraint on foreign bank lending. To my mind some form of moral suasion is greatly preferable to extension of the interest equalization tax to cover bank loans. Moral suasion would, in my judgment, probably be more effective, besides being more palatable and less likely to become permanently frozen into our financial system. There is only a rather small number of banks ready and able to lend abroad in very substantial amounts. But it also seems to me apparent that any selective effort of this kind will be made a great deal more acceptable here and abroad and more effective if it can be demonstrated that the System is simultaneously doing its part to reduce the prevailing degree of general credit availability.

A policy aimed at reducing the growth of bank credit from the 8 per cent annual rate that has prevailed for some time would not, in my opinion, significantly affect the further growth of the domestic economy. But it would imply that more of the burden of stimulating growth, if such stimulus is needed, will have to be provided by fiscal policy. Perhaps this is already in the cards.

Mr. Ellis said the most noteworthy aspect of New England's year-end performance had been a reversal of the relative positions of financial compared with production activities. When measured by manufacturing output, factory and nonfactory employment, unemployment, construction contracts awarded, and consumer spending, the year-end gains compared more favorably with the national performance than earlier. On the other hand, when measured by loan, investment, and deposit trends, regional expansion since the discount rate action in November had lagged both national performance and year-end 1963 activity.

Boston banks, Mr. Ellis continued, reported across-the-board strength in loan demand and an expectation of a less-than-seasonal run-off during the next two months, partly traceable to inventory hedging in steel. Several bankers reported an increase in the frequency of customer inquiries on how to hedge against devaluation, on when and under what conditions gold could be bought, and even on what effect could be expected on domestic business if the British should devalue sterling.

Mr. Ellis said he would consider the first three questions on the list suggested for discussion today as a group. As to whether there was evidence that the economy was heading for either a cyclical topping-out or an overheating, in all honesty and somewhat begrudgingly he had to conclude that the available evidence was not conclusive on either score. The recent run-up from October to December in industrial commodity prices had, in his analysis, tended to support an expectation that price pressures were about to break out, given the recent rate of expansion in bank credit. And yet, since the sharp advance in October, the price rise had virtually petered out in the reported index, although he sensed that the pressures were still present.

Mr. Ellis remarked that the green book analysis of wage cost increases in manufacturing was quite reassuring when related to estimated productivity gains, but that analysis applied only to the manufacturing sector. It seemed probable that the wage and salary advances in services and construction had less opportunity to be offset by productivity gains and would show up in price pressures.

Concerning question 4 on the balance of payments, Mr. Ellis could only underscore the obvious point that the sharply increased attention to the possibility of devaluation of the pound had increased concern about the position of the dollar. Release of balance of payments data for 1964 could not help but attract attention to the deterioration from the first to the fourth quarter. He had great sympathy with Mr. Hayes' position that reduced general credit availability would tend to restrict foreign lending, but he (Mr. Ellis) lacked evidence that the initial impact would be on foreign loans. He had some reservations about the usefulness of moral suasion. It would be easy to bring suasion to bear on the largest banks, but many other banks were ready and willing to make foreign loans. He was unwilling to accept the thesis that domestic credit availability should be reduced for the only purpose of reducing foreign lending. Such an approach would be too blunt; more specific measures were needed. He would be inclined to extend the interest equalization tax to banks.

As to question 5, it seemed apparent to Mr. Ellis that the recent mixture of interest rates and reserve availability had allowed business loan expansion to match last year's rapid advance. Total bank credit had not matched year-ago advances because of a different Government financing schedule, but projected loan demand suggested that credit expansion over the next few months would be substantial.

If it were not for the fact that the current Treasury refunding required an even keel atmosphere, Mr. Ellis said, he would be inclined to emphasize the importance of not allowing covered interest rate differentials to open widely against the dollar with the recovery of sterling that was expected later this month or next month. He would accept the staff's guess that a free reserve level in the neighborhood of the targets before the discount rate action--about \$50-\$100 million--would be associated with a bill rate in the 3.85-3.95 per cent range. Such bill rates, he thought, would be consistent with the goal he had described for covered rate differentials. Borrowings under those circumstances might rise somewhat from their \$170 million average to about $300 million. But the need for even keel during the Treasury financing had to take precedence over his inclination toward a higher target for bill rates.

Mr. Ellis remarked that he personally would prefer to see the Committee adopt the staff's draft "trial" directive as its official directive for this meeting. However, assuming that the majority favored the present format, he would propose one revision in the draft of the regular directive prepared by the staff.1/ His suggestion was to delete the words "may continue to" near the beginning of the second paragraph, and simply say ". . . seasonal pressures require a larger than usual degree of flexibility in operations . . . ."

Mr. Irons reported that the Eleventh District was experiencing a moderate expansion somewhat similar to that in the country as a whole, although some indicators were showing slight deviations in both directions. Construction had declined a bit in the last month or two, but construction of downtown office buildings was continuing. Farm cash receipts were estimated to be off this year, probably by 7 to 9 per cent. On the other hand, District industrial production was strong, and crude oil output was rising. Employment was moving up and unemployment down, and retail trade was quite strong.

1/ Appended to these minutes as Attachment A.

Mr. Irons noted that member bank borrowings had declined recently to levels that often were nominal, and the year-end seasonal rise was less than normal. District banks were active in the Federal funds market, with purchases recently averaging over $500 million and sales almost that much. Use of Federal funds by small country banks was increasing; many were playing their reserve margins closely, expecting to avoid deficiencies by buying Federal funds at the last minute. With respect to District bank credit as a whole, loans had increased substantially more than investments had decreased. Demand was strongest in the consumer loan category, but other loans also were up. Demand and time deposits continued to grow. He was concerned by the tendency of some small country banks that were not market wise to gain deposits by increasing their use of CDs, and he planned to watch developments of this type closely.

Mr. Irons thought that there was an increasing trend toward credit pyramiding in the Eleventh District, and cited some illustrative examples. He did not know whether this trend was widespread nationally, but he thought it might lead to trouble in the future.

In talking with District businessmen, Mr. Irons remarked, he did not get the impression that they were thinking about potential inflation in the usual terms, such as rising wage costs. Their primary concern was with the position of the dollar and what could be done about the present difficulties. They also were giving thought to the possibility of a rather substantial increase in Federal spending in the second half of 1965 after the passage of legislation implementing the "Great Society." Their concern about potential inflation was related to the international problem and to this expected increase in Federal spending.

Mr. Irons said his views on national conditions did not differ greatly from those contained in the staff responses to the questions that had been distributed. The over-all situation appeared to be one of continuing strength and moderate expansion, with few actual imbalances. There were some threats of future problems, however, including the destabilizing potential of inventory developments and the possibility that wage increases and labor difficulties would lead to rising costs. He was inclined to believe that the unemployment rate would remain near 5 per cent in the next few months. He could see no strong indications of inflationary developments in the price statistics; individual prices were going in both directions. He thought, however, that the trend would be toward higher prices as rising elements of costs began to seep through in the period ahead.

Mr. Irons observed that the Committee was prevented from making any substantial policy change in the next three weeks by the Treasury's advance refunding. He thought the international problem was the most serious of those facing the Committee now. It seemed to him that the position of the dollar could not be disassociated from that of the pound, and that developments of the past several weeks had tended to weaken the dollar. The large volume of dollars that had been accumulated by European banks represented a potential future claim on the U.S. gold stock, and that in itself tended to weaken the U.S. position. He did not particularly like the idea of using moral suasion to reduce bank lending abroad, but he thought it might be worth trying before applying more formal controls, such as extending the interest equalization tax to banks. As he understood it, the banks involved in foreign lending were relatively few in number and large in size, and he thought they would recognize their patriotic responsibilities.

Mr. Irons favored retaining reserve availability about where it was. He thought this would yield a bill rate in the 3.80-3.90 per cent range, and would bring covered international rate relationships roughly into balance. This probably was the most the Committee could expect to accomplish in the next three weeks. After that period, Mr. Irons would be inclined to place greater emphasis on the international situation and to look seriously toward some further lessening of credit availability. He did not think such a move would damage the domestic economy if it was not carried to excess. One could not be certain that it would help the international situation, but it would be a step in the right direction. In conclusion, Mr. Irons said that the staff's draft directive was acceptable to him.

Mr. Swan said he found little to disagree with in the staff comments on the distributed questions and he had little to add on these subjects except for a few footnotes relating to District developments. One concerned current steel inventory accumulation and the possible unsettling effects when it ended. Steel producers in his area reported that customers were making little or no effort to increase stocks by buying from western mills, in contrast to the national situation. The reason, in part, might be that the canning industry--which along with construction was the District's largest user of steel -expected the steel labor situation to be settled before their peak season in the fall. There also had been no signs in the District of hedge buying of steel from foreign producers.

Mr. Swan's second point concerned one aspect of the price situation. There had been some fairly substantial lumber price increases in recent weeks related to shutdowns of mills because of flood damage and to interruption of shipments because of similar damage to railroads and highways. However, this was a temporary development, and the situation should return to normal in a few months. Flood damage in the lumber industry had been confined largely to the redwood area in Northern California, and redwood production accounted for about 12 per cent of the total lumber production in the District.

Mr. Swan observed that there was little question about the appropriate policy for the next few weeks in view of the Treasury refunding. However, he shared the increasing concern about the international situation. He was not certain about the extent to which the situation might have deteriorated recently but obviously it had not improved. He had to admit that he did not have any ready solution to the problem. He shared Mr. Ellis' uncertainties about the effectiveness of moral suasion and about the possible impact of a substantial reduction in credit availability on foreign relative to domestic loans. Considering the problems of sterling, the question of the U.S. gold cover, the matter of direct investment abroad, and the question of extending the interest equalization tax to foreign term loans of banks, it seemed to him that some kind of consistent, coordinated approach to the problem had to be developed, some elements of which presumably would lie outside the Committee's authority. He was not sure just how this could be accomplished, but he felt that it would be undesirable to take any one of the various possible actions without giving considerable thought as to how it would be related to other possible actions. With respect to the gold cover, he shared Mr. Coombs' view that it would be desirable to remove the requirement entirely and not in part.

Mr. Swan agreed that in carrying out an even keel policy until the next meeting it would be necessary to be concerned with money market conditions other than bill rates. But the bill rate also had to be considered, and he favored a rate in the 3.75-3.85 per cent area. He doubted that downward seasonal pressures were going to be as strong in the coming period as they might have been under different circumstances, and he would not be particularly concerned if free reserves declined somewhat. The staff's draft directive was acceptable to him with the amendment that Mr. Ellis had proposed.

In calling on Mr. Deming, Chairman Martin noted that he recently had been designated as Under Secretary of the Treasury for Monetary Affairs and consequently that this was the last meeting Mr. Deming would attend as a member of the System and as an alternate member of the Committee.

Mr. Deming said that business activity in the Ninth District was moving along reasonably well at present, although conditions were a shade less expansive than in the nation as a whole. Loan expansion was quite strong in December--larger than in 1963 and only a little below the record of 1962. The increase was particularly strong at country banks, where farm refinancing was becoming increasingly important. A recent business survey revealed about the same degree of business confidence as a year ago.

Mr. Deming's only comment with respect to the staff's list of topics was in connection with item 4, on the balance of payments. He had no quarrel in general with the facts given relative to the immediate effects of the sterling crisis on the U.S. payments balance, but the tone of the discussion was considerably more optimistic than he felt. The situation was quite delicate and was likely to remain so for some time.

Mr. Deming said he would make no comment on policy for the period ahead except to emphasize the possible problems in the after-market for the 4-1/4 per cent bond that had been issued in the refunding. He had found Mr. Holland's analysis of the appropriate definition of even keel at present to be quite interesting, and he agreed with it in general.

Mr. Deming noted that he had been attending meetings of the Committee for almost eight years and that recently he had read over the record of policy actions for 1964 and had looked back over some of the earlier entries. It seemed to him that the performance of the Committee was impressive. There was a healthy element of self-criticism and the Committee was constantly striving to improve its operations. But perhaps the Committee was so concerred with shortcomings in such matters as the state of knowledge regarding linkages in the economy and the quality of available data that it tended to underrate its own performance. In his judgment the Committee's record of policy decisions over the past several years was one of which it could be proud.

Mr. Scanlon said he was in general agreement with the staff comments on the first three questions regarding business activity. He had one regional comment on wages. Wage increases in the construction and farm machinery and auto parts industries were reported to be causing these firms to attempt price increases. Analysts close to those industries believed that recent wage increases exceeded gains in productivity. In general, however, the strengthening of prices appeared more closely related to increased demand for products than to wage adjustments, as, for example, in steel.

His views on question 4 were similar to those of Mr. Ellis, Mr. Scanlon remarked. He was certain that a less easy monetary policy would eliminate some marginal loans--both foreign and domestic. He had been surprised to find a hesitancy on the part of some large banks in the Seventh District to agree that such action would necessarily change the attractiveness of some of their sizable foreign credits. While he was not opposed to trying moral suasion he was not as convinced as Mr. Hayes was that it would be completely effective, in view of the attractive rate differential on foreign loans.

With respect to the U.S. gold cover, Mr. Scanlon observed that the attitude of District bankers was quite different from a few years ago. To many, the question was not whether the requirement should be changed but when and how this should be done; and some were quite critical that more had not already been done to accomplish a change.

Regarding question 5 concerning the money supply and liquidity, Mr. Scanlon agreed with the staff comments in section A. He also agreed with the discussion in section B, except that he tended to assume a rather strong loan demand whereas he inferred that the staff had some uncertainties on this score. Despite this difference,he came out at about the same place as the staff had. Contrary to the experience in most areas, Chicago banks had sold an exceptionally large volume of CDs over the past two weeks. This might have been done in anticipation of strong loan demand, although that was not certain

Mr. Scanlon agreed with the staff comments on item 6, relating to money and credit markets. He noted that in the December returns of the Reserve Bank's quarterly survey of the District's ten largest banks, dealing with interest rates charged on loans to business borrowers, there was no evidence that rates had risen. In fact, some small declines had been reported.

Mr. Scanlon favored no change in policy. He would continue to place primary emphasis on the short-term bill rate and preferred a range in the 3.75-3.90 per cent area, with free reserves permitted to find their own level. The staff's draft directive was acceptable to him and he did not favor a change in the discount rate.

Mr. Clay considered the staff's draft answers to the questions submitted for Committee consideration to be well done and acceptable as the basis for policy formulation. He thought it was obvious that the Committee continued to be faced with the dual problems of encouraging expansion of domestic economic activity and alleviating problems on the international financial front. For the period immediately ahead, there also were seasonal financial pressures to deal with and Treasury financing to take in account.

Over all, Mr. Clay said, monetary policy should remain essentially unchanged for the period ahead In view of the Treasury financing activities, it would be desirable to make no overt change in policy in any case. Quite apart from Treasury financing, in his judgment analysis of the domestic economy called for a continuation of monetary expansion. And, in the present context of international financial developments, continued pursuit of the interest rate objectives of recent weeks seemed to be advisable. Thus, it appeared logical to him to maintain the general monetary posture adopted at the time of the discount rate increase.

However, Mr. Clay felt the uncertainties of seasonal financial developments would require somewhat more latitude in open market operations with respect to the range of both money market conditions and reserve availability. In his view, money market conditions should be the primary guide with a Treasury bill rate generally in the range of 3.70-3.90 per cent. While reserve availability should be a secondary consideration, it should be the aim of operations to provide reserves on a scale that would permit bank credit to increase on a seasonally adjusted basis.

The economic policy directive draft prepared by the staff appeared quite satisfactory to Mr. Clay, and he would make no change in the discount rate.

Mr. Wayne said that recent business developments in the Fifth District generally reflected continuation of established trends and appeared to be substantially in line with national conditions. There were, however, two items that might be of interest for future policy considerations. First, this year's flue-cured tobacco acreage had been cut nearly one-fifth, but the reduction in dollar income would depend on other variables, particularly on yield per acre which increased sharply last year. Second, a change in the sentiment of businessmen and bankers was discernible in the Richmond Bank's most recent survey. While a sizable majority still expected business to hold steady or improve, there was a distinct decline in the strength of these expectations.

Mr. Wayne agreed in general with the staff analysis on the first question, relating to business activity. He saw no significant evidence of any impending cyclical topping-out or of any overheating in the economy in the near future. Available data indicated that inventory increases now in progress were related chiefly to fear of a steel strike rather than to inflationary expectations. Despite a continuing high level of business investment, there was yet no evidence of a large build-up of excess capacity.

On the subject of labor markets, while Mr. Wayne had serious reservations about statistical measures of productivity, available evidence suggested that recent wage increases generally had been about in line with the productivity guideposts. The major test in this area, however, was still ahead and the proof of the pudding would come with the steel settlement.

Indications of higher prices, Mr. Wayne noted, were less in evidence now than they were four weeks ago. Domestic capacity and foreign sources of supply appeared sufficient to prevent demand pressures from extending or accelerating price increases in the immediate future.

As to the balance of payments, Mr. Wayne remarked that if the whole range of forces now pressing on the international exchanges were included, it was clear that major consideration in policy decisions had to be addressed to the problems found here. Mr. Hayes' analysis was most persuasive to him.

Mr. Wayne noted that the rate of expansion of bank credit and the money supply in December appeared to have been slightly below that in other recent months. For the next few weeks, downward seasonal pressures on short rates, reinforced perhaps by money market effects associated with the latest Treasury refunding, would probably mean that a lower level of free reserves would be necessary if short rates were to be held within the recent range.

Mr. Wayne saw nothing in the current or prospective business situation that suggested the need for any change in monetary policy at this time. In the international field, however, the situation was much less satisfactory. The suggestion by Mr. Coombs that the Committee should attempt from month to month, or from season to season, to shift credit flows in geographic terms by moral suasion was inherently dangerous, he thought. This seemed to him to fall somewhat more clearly in the field of foreign relations than in that of monetary policy. He was impressed, however, with the desirability of some form of direct intervention to restrain further flows of credit abroad rather than resorting to what he believed would be massive and untenable reductions in credit availability to the domestic economy if the Committee should rely solely on monetary policy to apply this restraint. Perhaps some form of moral suasion should be tried, but in his opinion the Committee would have to and should underscore its concern by reducing credit availability somewhat.

It seemed to Mr. Wayne that the Committee had to maintain and perhaps raise short-term rates so long as the international situation remained as precarious as it was now. In the face of the large return flow of reserves to be expected in the next few weeks and the apparent net reduction in available supplies of short-term securities as a result of the current Treasury financing, such a policy probably would require substantially lower free reserves than had prevailed recently. He favored a continuation of the policy of placing primary emphasis on the bill rate, and he would aim to keep that rate within the range discussed at the last meeting, i.e., 3.75-3.90 per cent, although he would hope it stayed in the upper portion of that range. The draft directive was probably acceptable for the next three weeks.

Mr. Robertson then made the following statement:

I want to say a word of commendation to the staff for the material they have supplied to us for this meeting. I do not know how much longer they can keep this up--coming up with new and relevant questions, or even with new answers to the same old questions--but I find it very helpful and I would like to encourage it. In particular, I appreciate the efforts, in the answer to question 5, to nail down a little more the possible linkages among money market, reserve, and credit variables. I know this is hard to do, but it is central to good decision-making on the part of the Committee and good communications with the Desk.

By and large, I find myself in accord with the conclusions drawn by the staff in answering the questions distributed last week. I am gratified by the way the rest of the economy is responding with seeming moderation to the spurt of inventory accumulation in automobiles and steel. It reminds me somewhat of the way the economy earlier withstood the potentially inflationary impact of the sharp bulge in nonferrous metal prices, with the resulting sensible over-all price performance noted in the answer to question 3. I have no special comment on question 4 other than to question the completeness and the significance of the assertion, in the third paragraph of the answer, about a reversal of short-term outflows of capital to Britain and the surmise about long-term outflows, and to assert that if the last sentence of that paragraph is correct, the result is not one to have been hoped for in light of the British plight.

I have some reservations about the easy assumption in question 5 that a reflux of reserves from the country banks to the central money market will occur soon enough to take any lasting sting out of the unusual money market tightness of the last few weeks. It seems to me that tightness needs to be relaxed promptly, and if the natural reserve flows should not be quick and sizable enough for this, then open market operations should step in. In this connection, I suggest the bill rate alone will probably not be a dependable guide to general money market conditions, just as it has not been these past few weeks, under the special depressing

> influences of both the reversal of year-end seasonal pressures and the purchases of bills by the sellers of "rights" in the Treasury refunding. If bill rates should drop so far as to be of concern from a balance of payments point of view, there is, as all of us know, a selective instrument ready for use in coping with such special pressures--additional Treasury issues of new bills. Similarly, there is available another selective instrument--IET for banks--to resist another development of concern, the increased volume of foreign term loan commitments by a handful of big banks.
>
> In applying the general instruments of monetary control, our focus should be on general market considerations. At this moment, our immediate general responsibility should be to keep the complex of money market conditions on an "even keel" while the Treasury advance refunding is in process. Underlying that responsibility is another--not to permit money market and reserve pressures to develop in a way that will restrain the availability of money and credit at what could be a very unpropitious time, given the undoubted lags in the influence of monetary policy and the prospective change of pace in domestic demands.

Mr. Robertson added that the proposed directive was, in general, adequate. However, he thought it would be desirable to amplify the final clause, which read "open market operations over the next three weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks." This clause, in effect, called for an even keel; but an even keel posture could be maintained while leaning toward either tight or easy conditions, and he was concerned about the possibility of tightness. He thought it would clarify the instruction and be helpful to the Manager if a phrase was added after the words "recent weeks" along the following lines: "and to the extent consistent with this, maintaining growth in non-borrowed reserves at a rate about in line with that of the last quarter of 1964." Mr. Robertson noted that the growth rate in the last quarter had been 4.9 per cent.

Mr. Shepardson said he had only one general comment to make on the questions suggested for discussion. Although he recognized that it was hard to find much evidence in the figures, he still had the feeling that potential pressures on costs and prices were latent in the domestic situation and that the Committee needed to be constantly alert to them. The status of the current labor negotiations did not seem to be encouraging in that respect.

Mr. Shepardson agreed that the foreign situation had become more serious in recent weeks and that more attention had to be given to it. In his opinion, there were disadvantages both to moral suasion and to applying the interest equalization tax to longer-term bank loans. Moral suasion was not a particularly desirable technique for a supervisory agency to use because it gave an advantage to those who did not cooperate. An equalization tax on longer-term bank loans probably could be avoided by borrowers and lenders through short-term credits made with the understanding that they would be renewed on maturity. On the other hand, he did not know of any alternatives that were likely to be effective, and perhaps one or both of these approaches should be tried. He thought that if such methods were used they should be accompanied by some reduction in the availability of reserves. Reduced reserve availability need not impinge on domestic needs for credit if the special measures were effective in curtailing foreign lending.

Mr. Shepardson agreed that the immediate situation called for a policy of even keel. He shared Mr. Robertson's view that the proposed wording of the directive could be interpreted in various ways; it could be taken to call for maintaining market conditions as easy as in the last two weeks or for maintaining the somewhat firmer conditions of earlier weeks. He would hope that the words "recent weeks" would be interpreted to encompass this whole period, thus allowing for the possible development of market conditions similar to those of three or four weeks ago. He favored the draft directive with the changes that had been suggested.

Mr. Mitchell said that an even keel policy was the only alternative available to the Committee for the period until the next meeting and that he was willing to accept Mr. Holland's analysis of the appropriate definition of even keel now. In his judgment the bill rate should be permitted to reflect the expected seasonal weakness in the market. He suspected that the overhang of the securities issued in the advance refunding would last beyond the date of the next meeting, and that the Committee might be faced with the need for continuing to maintain an even keel then. This was particularly likely if there were market rumors of a tightening of policy to supplement a program of moral suasion against foreign lending.

Mr. Mitchell was pleased to note the increased degree of acceptance of the proposition that selective measures were needed to deal with the balance of payments problem, which he and some other members had advanced for a long time. He agreed with Mr. Coombs that some positive steps had to be taken. He thought Mr. Coombs' suggestion concerning the gold cover was exactly right; it should be removed completely, and on the grounds of making gold available for international purposes. The second essential was to get the U.S. balance of payments into the black. But he disagreed somewhat with the suggestion that moral suasion be used as a major means of achieving this end. In his judgment the technique of moral suasion was hostile to the tradition of creating an environment in which people could seek their own advantage in terms of costs and returns. It was for this reason that he preferred use of the equalization tax or something similar. Defects of the present tax could be remedied--it could be extended to banks, the one per cent tax rate could be increased by legislation, renewals of short-term credits could be treated as long-term lending, and so forth.

Mr. Mitchell thought that something also had to be done to limit direct investment abroad. While the immediate problems of taking steps in this area might be more difficult than in other areas, it was important to remember that tax deferral privileges under present law added to the advantages of foreign over domestic investment The previous Administration had been unsuccessful in its attempt to remedy this situation, but the present environment was more conducive to a change in legislation. However, while he disagreed on methods, he considered the question of specific techniques to be less important than the need for corrective action on the deficit.

Returning to the subject of moral suasion, Mr. Mitchell said he was not sure who would do the persuading but he hoped whoever did would not commit the Committee to some particular course of action. The Committee had never bound itself to a specific policy; it always had taken the position that it would make its decisions from meeting to meeting in light of the circumstances prevailing at the time. He thought it would be extremely unwise to give assurance to anyone that the Committee would depart from this principle if it possibly could be avoided.

Mr. Hickman said that, contrary to the staff report in the green book, he did not believe that "sustained moderation" was an accurate description of the mood and the performance of the domestic economy. At the moment the forward movement of the economy, which in his judgment was neither moderate nor sustainable, reflected an accidental conjuncture of two unbalancing forces--the frenetic post-strike catch-up of the auto industry and hedge buying of steel.

During December, Mr. Hickman noted, the auto industry had produced cars at about a 9 million annual rate, and the steel industry had operated at a rate well in excess of 135 million ingot tons per year. Neither of those rates, by any stretch of the imagination, could be regarded as moderate or sustainable for any appreciable length of time. It was his impression that there had not as yet been much foreign buying of steel as a hedge against a steel strike.

The behavior of the index of industrial production during recent months, Mr. Hickman continued, could be analyzed into a subcycle of rapidly changing activity in steel and autos superimposed on moderate growth of most other sectors of the economy. Some indication that steel and autos were the prime movers was provided by the fact that, according to the latest figures of the Board's staff, two-thirds of the 1-1/2 point increase in the industrial production index in December was attributable to a 0.7 point increase in autos and a 0.3 point increase in steel. Looking back a bit, the trough of the steel-auto subcycle was in October when the General Motors strike occurred. The timing of the upper turning point of the subcycle obviously lay ahead--probably only a few months ahead if one looked to the auto industry to finish replenishing dealer inventories and probably somewhat further ahead if one looked only to the steel industry. If the two industries turned down together, there was apt to be a fairly sharp jolt to the economy which would be difficult to absorb. The jolt would be somewhat easier to absorb if the downturns came at different times.

Mr. Hickman reported that in the Fourth District almost all measures of business activity had advanced in December, but like the national economy most advances were due to the rebound following the auto strikes. One factor in the District of perhaps national interest was a sharp jump in the nonbuilding component of construction contracts due to a $175 million electric generating plant being installed near Pittsburgh. This was by far the largest project reported for the entire nation in 1964 and one of the largest on record.

Mr. Hickman then turned to the staff's questions.

1. Business activity. In his judgment there was overheating going on now in the auto and steel industries in the

sense of unsustainable rates of production, pressures on capacity, and scrambling for inventories. The direct causes of this overheating were exogenous (recent auto strikes and impending steel negotiations) rather than the length of the current business expansion. He noted that in the staff's answer to this question overheating was referred to as a "possibility" and the risk of a cyclical topping-out was minimized. His own feeling was that overheating was an actuality and a cyclical topping-out was a very real possibility.

2. Labor markets. Mr. Hickman said he doubted very much that additional costs arising from recent labor contracts were fully reflected in the official statistics. Pension costs, for example, were difficult to estimate precisely. The wage part of the auto settlement would not be included in the figures until October. In the absence of a full statistical showing the Committee was put back on its own guesses. His guess, which was consistent with strongly-held views of industrialists on the Cleveland Bank's Board of Directors, was that if the generous auto settlement was passed on to steel and other industries labor costs would rise faster in 1965 than productivity, and profit margins would be squeezed.

3. Prices. Mr. Hickman remarked that according to Steel Magazine's recent survey, businessmen in metalworking industries expected selling prices and unit costs to increase

in 1965 by 1.7 per cent and 3.0 per cent, respectively. Another indication of possible price pressures was revealed by the fact that the price diffusion index of the National Association of Purchasing Agents in November and December was at the highest level of the current expansion. Many purchasing agents reported that they were attempting to combat future price increases by negotiating long-term contracts.

The staff's answer to this question focused only on prices, Mr. Hickman noted, with no reference to cost increases that might have to be absorbed. Businessmen appeared to be more concerned with upward cost pressures in 1965 than with price increases. In short, they were worried about profit margins.

4. Balance of payments. Mr. Hickman noted that pressures on sterling caused a postponement of British interest payments to the U.S. in the fourth quarter of 1964, which brought an immediate deterioration in the U.S. balance of payments. The 15 per cent surcharge on British imports would have an adverse effect on U.S. exports as long as it was in effect. More importantly, British sales of dollars to support the pound had added substantially to dollar holdings of central banks. Unless the pound strengthened appreciably and the British gained dollars and used them to repay drawings on its swap line with the System, excess dollar holdings of foreign central banks might

be converted into gold. Against this background, Mr. Hickman would be willing to try moral suasion to check the flow of foreign credit, perhaps coupled with some slight shift in credit availability after the refunding. He felt that the interest equalization tax was a blunt and unpalatable instrument, and he would consider it a second choice.

5. Money supply and liquidity. Mr. Hickman commented that the Administration's concern about the level of interest rates had placed the System in the position of having to maintain the 91-day bill rate below the discount rate. The discount rate had thus become a penalty rate in the sense that member banks sold bills and other short-term securities rather than borrow at the discount window. Accordingly, to prevent short-term rates from rising, the System had allowed free reserves to rise in December, while member bank borrowings declined. The net result was that the marginal credit supply increased. Despite this, the actual rate of growth in bank credit was not excessive in December, reflecting the absence of Treasury financing and a sharp decline in dealer loans.

6. Money and credit markets. Mr. Hickman said the Treasury advance refunding had added substantially to the volume of long-term securities outstanding in the market and had reduced almost equally the amount of short-term issues outstanding.

This was a reverse "operation twist," which increased long-term rates and lowered short-term rates. The operation, like other debt-lengthening measures, affected economic growth, since it reduced the volume of long-term funds available to finance private investment.

In light of the various factors he had discussed, which did not all point in the same direction, Mr. Hickman favored no change in monetary policy, at least for the next three weeks. That was to say, he would attempt to promote an increase in the money supply of about 3 to 4 per cent, and in bank credit of about 6 to 8 per cent. He thought that this would call for free reserves in a range of $75 million plus or minus $100 million and a bill rate in a range of 3.75-3.90 per cent.

Mr. Hickman would accept the staff's draft directive with the revision suggested by Mr. Ellis. He favored leaning toward the side of slightly less ease during the period of even keel.

Messrs. Daane and Young returned to the room during the course of Mr. Hickman's remarks.

Mr. Bopp said that rather than comment on each of the questions prepared he would limit his remarks mainly to the subject of inventories. Perhaps the greatest present threat of imbalance arose from the potentially sizable swing from accumulation to decumulation of inventories associated with labor negotiations in the steel industry. He had reviewed inventory movements associated with steel contract negotiations since 1953 and one particularly pertinent fact emerged. Only in 1953 did a recession follow immediately after a negotiation period. In all other cases, economic activity continued at high levels for a considerable number of months following the steel settlement.

One other fact distinguished the negotiation period in 1953 from those occurring since then, Mr. Bopp noted. The later negotiations all came fairly soon after the beginning of cyclical upswings. The talks in 1953, however, began almost four years after the trough point in 1949. The record of the 'fifties and 'sixties, then, indicated that the economy had weathered most of the inventory swings associated with steel contract discussions. The outstanding exception was the one case when the contemporary business expansion had lasted for an unusually long time.

The record supported one other obvious point, Mr. Bopp said. Fluctuations in durables inventories were greater the longer a period of negotiation extended and, of course, they were severest when a steel strike occurred.

The Reserve Bank's contacts in the steel industry indicated that if the current steel negotiations led to a settlement by May there might be about 8 or 9 million tons of extra steel in inventory. Superimposed on a normal inventory of 12 or 14 million tons, this was enough to cause a considerable inventory runoff at a time when a Federal cash surplus also would temporarily inhibit further economic advances. Offsetting this was the evident strength in total demand. Nevertheless, a settlement early in May implied a combination of depressing events occurring at the same time.

If settlement came later in the year, following a Taft-Hartley "cooling-off period" and perhaps a strike, the inventory swing was likely to be considerably greater, Mr. Bopp said. According to the Bank's local sources, the steel industry now found it difficult to supply steel at the rate users wanted to accumulate it, but industry estimates were that between 3 and 4 million more tons would be accumulated by July. This would occur after the period of temporary Federal cash surplus, and perhaps after Federal action to stimulate the economy through new tax reductions and spending programs. But the business upswing would then be that much older, and stimulus from increased capital spending, according to present estimates, might by then be weak or nonexistent. All things considered, the potential disturbance to the economy seemed likely to be greater the longer a settlement was postponed.

In any event, Mr. Bopp remarked, whether the settlement came earlier or later, postwar history suggested that steel negotiations were less troublesome to the economy when demand was strong. Thus, it would seem the prudent course for monetary policy in coming months to provide moderate stimulus to promote that demand.

Turning to the nearer-term future and abstracting from the even keel required during the next few weeks, it seemed to Mr. Bopp that recent developments provided little basis for any general tightening of monetary policy. Over-all wholesale commodity prices remained stable; indeed, even the industrial commodity component appeared to have leveled off. Moreover, capacity in place and that coming on stream seemed ample to meet prospective final demand. Meanwhile, unemployment remained unacceptably high and, with large prospective additions to the labor force in 1965, might well go higher.

The balance of payments, of course, remained a difficult problem, Mr. Bopp observed. The widening deficit in the fourth quarter was discouraging; yet, the special factors responsible had to be kept in mind and the dangers of a tradeoff in favor of less ease had to be weighed carefully in the present business environment.

On balance, Mr. Bopp would make no change in the general posture of monetary policy. He would be prepared to retain the recent flexibility in marginal reserve availability if needed to maintain substantially unchanged longer-term interest rates and moderate growth in money and credit. He was agreeable to the draft directive with Mr. Ellis' proposed amendment.

Mr. Bryan said there were few developments in the Sixth District calling for comment. Trends in the District differed a little from those in the nation in a few areas, such as construction contract awards, the money supply, and total deposits and currency, but none of the differences seemed particularly significant. He would make a selective response to the staff questions.

On the first question, regarding business activity, Mr. Bryan was perhaps not as concerned with the current inventory build-up as some others because, aside from fabricated metal products lines, inventory-sales ratios had not changed significantly. He also was inclined to expect considerable stability in production over the next few months. Because capital expenditures were continuing to rise, an abrupt drop in output did not seem likely. His general answer to the first question, then, was that no great imbalances were obvious at the present time. But he would temper this conclusion with the observation that it was not the obvious but the obscure hazard over which one usually tripped.

Regarding labor market developments, Mr. Bryan said he would withhold judgment for the reason Mr. Hickman had indicated.

As to prices, it seemed to Mr. Bryan that if businessmen were expecting inflationary price developments their expectations apparently were moderate and by no means universal. Otherwise the evidence of hedging would be clearer; the liquidity of the economy and the Committee's policy of providing reserves would have provided ample means to expand as a hedge against an expected inflation, and by now the economy would have been thoroughly overheated. He agreed, however, with those who had suggested that there was widespread concern about the prospects for the dollar. At a meeting of the directors of the Atlanta Bank last Friday many questions had been raised on the gold cover and on developments in the foreign exchange markets.

With respect to the balance of payments, it appeared to Mr. Bryan that the prospect was for a turbulent situation in which massive forces, whose net effects he could not foresee, would be at work.

Mr. Bryan said that at this time of the year he ordinarly would expect bank reserve positions to ease and corporations to be buyers of securities, but because of recent and prospective Treasury financing operations it was by no means certain that the Committee could count on such developments now. With an international situation that at best was confused, and with a national situation in which there were confusing forces of great magnitude, he felt that a bill rate objective was once more the logical one for the Committee to pursue. He favored a policy of essentially even keel, with the bill rate in the 3.75-3.90 per cent range.

Speaking to the longer term of perhaps three or four months, Mr. Bryan believed the money supply and reserves could not long continue to increase at recent rates without laying the groundwork for a considerable inflationary development. There had been an essentially moderate and probably sustainable increase in the money supply narrowly defined. But in his judgment, under present circumstances some portion of time deposits should be included in the money supply--the Committee had to go back to the old idea that money was anything that did money's work. Recent increases in time and savings deposits had been rapid; they had expanded at annual rates of over 15 per cent in the last three months and over 12 per cent in the last year. When some portion of these increases were added to the 4.1 per cent rise that had occurred in the narrowly defined money supply in the last year, it revealed a development that Mr. Bryan did not think was sustainable. Similarly, he did not believe that total reserves, nonborrowed reserves, and reserves against private demand deposits could continue to increase for long at the rates that had been achieved in the last quarter without developing an inflationary potential.

Mr. Bryan noted that there had been a great deal of discussion today on the relative merits of moral suasion and legislation for dealing with capital outflows. He agreed that something had to be done. Generally speaking, he disliked moral suasion, although he thought it might work in the present situation. But he would much prefer to have the interest equalization tax extended to banks, whether by administrative act or by new legislation. In his opinion some controls also would be required over direct investments abroad. Experience with loan administration under section 13b of the Federal Reserve Act suggested to him that there was likely to be a problem of leakage--of loans made for nominally domestic purposes that in fact facilitated the flow of funds abroad.

Mr. Shuford commented that economic activity in the Eighth District had been on a plateau during the early months of 1964 but rose markedly from August to the end of the year. District employment increased at a 3.7 per cent annual rate from August to November, recovering from the auto strikes in October. Manufacturing output rose at more than a 10 per cent rate from August to November and spending, as measured by check payments, increased at a rate a little higher than 3-1/2 per cent in that period.

Most indicators of banking activity in the District rose from August to December, Mr. Shuford observed, continuing the growth trend of the preceding eight months Total loans increased at more than a 1 per cent annual rate and investments expanded at nearly a 4 per cent rate. However, business loans in the District declined at nearly a 5 per cent rate from August to December, despite a rather marked rise in the St. Louis area. Deposits at District banks expanded from August to December at a much higher rate than loans and investments. Most of the growth resulted from an increase in time deposits, which rose at more than a 12-1/2 per cent rate; demand deposits increased at about a 7-1/2 per cent rate. Borrowings from the Reserve Bank had been nominal recently.

Mr. Shuford commented that he had found the staff questions and answers quite helpful, and he had no areas of serious disagreement with respect to either the facts or the conclusions presented. From discussions about prices with District businessmen and bankers he had gained the same general impression others had reported today--that there was increasing concern in the business community with respect to the position of the dollar and of the U.S. balance of payments. However, he had found a little more concern about possible price developments than some others had. Many of the businessmen with whom he had talked expected price advances as a result of the steel situation. They thought that the settlement in the steel labor negotiations probably would be in excess of the administration's guideline, and they expected the steel industry to attempt to raise prices even if the settlement was within the guideline. Various factors would, of course, set limits to these expected price increases, but they still would be in the upward direction and their effects would carry over into other areas. In sum, business and other opinion in the Eighth District was that there was somewhat more pressure on prices now than had been evident earlier.

Mr. Shuford commented that it was clear from today's discussion that everyone recognized the international problem as paramount among those facing the Committee at present. He could not be sure what course he would favor with respect to moral suasion until he had given the question more thought. Like others, he would be highly reluctant to see any specific controls imposed to restrict the free flow of trade and of funds. But the situation was serious, and he felt that the System should take whatever helpful actions it could in the areas for which it was responsible. He thought that the interest equalization tax should be extended to banks with any desirable and feasible elaborations of its provisions, but he feared that this might take more time than was available in the circumstances. Perhaps the System should do what it could in the area of moral suasion rather than simply wait for enactment of legislation. Two years ago, in a roughly similar situation, the Committee had felt that actions outside the area of monetary policy were called for and had hoped that monetary policy could be relieved of part of the burden. Some actions had been taken by the Administration then, but the necessary fundamental improvement had not been achieved; even though the balance of trade had moved in a favorable direction the country once more was faced with a serious problem. Actions beyond the System's jurisdiction again were called for, but the System also had to carry some part of the burden. In his judgment both lines of attack should be pursued.

There were some questions in Mr. Shuford's mind as to the best approach, from psychological and other standpoints, to the matter of removing the gold cover requirement. However, he personally favored removing the requirement entirely.

Mr. Shuford favored no change in monetary policy for the reasons already discussed, of which the imminent Treasury financing was predominant. He appreciated Mr. Holland's analysis of the appropriate definition of even keel for this period. However, he would not favor using dealer lending rates and similar factors as the main guide to operations; in his judgment short-term rates should continue to be the principal guide for the

Desk, and he favored a bill rate in the range of 3.70-3.90 per cent. Mr. Shuford thought he had developed a better understanding of the meaning of "tone and feel" of the market from having participated in the daily conference call for the last four weeks. The Desk had been faced with some difficult problems during this period, and in his opinion it had done unusually well in dealing with them.

Mr. Daane said that the prescription for policy in the next few weeks seemed crystal clear in light of the size of the Treasury refunding and the need for the market to digest the securities issued. He thought the current tone and feel of the market should be maintained as nearly unchanged in coming weeks as was humanly possible. Looking further ahead, he would be somewhat concerned about continuing the current degree of credit availability in light of the expansion already experienced and against the background of the present critical situation with respect to the balance of payments and the position of the dollar. But it was unnecessary to pursue this subject further at the present time.

With respect to the new procedure that had been followed at this meeting and the previous one, Mr. Daane noted that the Committee was striving to improve its analysis of the economic and financial developments underlying its policy decisions and to improve its communications. He had found the staff questions and answers extremely useful in sharpening the focus on basic considerations. He was somewhat disturbed, however, by the fact that there was so much repetition in the discussion. Although he had not been present at the last meeting he had read the minutes closely and noted that many members seemed to feel an obligation to comment on every question in the list. In his judgment, it would be more useful to view the staff's questions and answers as a briefing document that was extremely helpful in sharpening the Committee's focus on important issues rather than to assume that they imposed a requirement on every member of the Committee to present his own analysis of each issue. To his way of thinking the latter course unduly extended the length of the meeting and the length of the minutes. It also posed a problem with respect to the policy record entry and it interfered with the give and take of discussion.

Mr. Balderston said he thought it was fortunate from the point of view of the Committee's relations with the Treasury that another alumnus of the Federal Reserve, in the person of Mr. Deming, would be occupying the position of Under Secretary of the Treasury for Monetary Affairs. He was prompted to make this observation especially because of his pleasure in noting that Mr. Mitchell and others had implied in their comments this morning that finding solutions to the international problem was as important to the well being of the country as was the state of the domestic economy.

For the immediate future, Mr. Balderston said, the Treasury refunding called for maintaining unchanged the conditions in the money market. He could not say now how far beyond the next meeting an even keel would be desirable, but he would not necessarily favor continuing to protect the Government security dealers indefinitely until they had disposed of all of the 4-1/4 per cent bonds acquired in the refunding. In his view it was appropriate to expect the dealers to assume some risk in their operations. The draft directive as amended was acceptable to him.

Mr. Balderston said he would like to make two further points now because he thought that Committee members should give particularly intensive consideration during the coming three weeks to the question of what action would be appropriate at the next meeting. His first point concerned the possible benefit to the balance of payments of moving toward restraint on bank credit. Some change in policy seemed vital to undergird whatever special approaches to the problem were attempted. As long as domestic conditions were as strong as they promised to be in the first quarter, and as long as the flow of financial savings remained high, it appeared to him that monetary policy could make some contribution to the international situation without damage to the domestic economy. Such a contribution was the responsibility of the System. Domestic corporations appeared to be relying more on bank credit than on the capital markets to finance such investment as could not be financed with internal funds. For nearly three years, from 1962 through the third quarter of 1964, bank credit had expanded at a relatively stable rate, averaging about $19-1/2 billion a year, although the ratio of bank credit to total funds raised during that period had, of course, dropped somewhat. The annual percentage rate of growth was continuing at around 8 per cent. He was reminded of the willingness of the United States to finance German industry after the first World War through bonds yielding 8 per cent, knowing that the money was being invested in enterprises that would not earn so high a return.

Secondly, Mr. Balderston said, despite the satisfaction often being expressed with respect to the health of the current domestic expansion, he thought a few telltale signs of illness were now beginning to appear. In his judgment one should not be content with the facts that the wholesale price index was no higher now than five years ago and that the rate of increase in the consumer price index had not accelerated; during those five years greater progress could have been made in increasing the price competitiveness of American goods. The rise in the U.S. trade surplus was traceable to the fact that other countries had inflated more than the United States had. It was not necessary that all of the gains in efficiency be translated into increases in wages and fringe benefits. The test of these propositions was that dollar holdings were being built up in foreign monetary centers, and these dollars were being used as bargaining instruments against the United States. He wanted to see this situation come to an end.

Moreover, Mr. Balderston said, even the vaunted price stability was showing signs of terminating; in the fourth quarter wholesale prices excluding farm and food products rose 0.6 per cent. He would not want to say that the economy was faced with price inflation but, given the fact that the international situation was the prime consideration at the moment, he thought there should be progress in the direction of reducing the prices of exportable goods.

Mr. Balderston observed that bank credit should be used constructively, not speculatively, and he noted that earlier in the meeting Mr. Irons had expressed a concern similar to that which he felt on this score. The present expansion thus far had been characterized by balance and by the high degree of prudence evident in the decisions of business managers. But with the change that seemed to have occurred recently in inventory policies he sensed that there now was an element of speculativeness abroad that the Committee was helping to feed through its current monetary policy.

In a concluding observation, Mr. Balderston said that solution of the longer-run problem of the continuing accumulation of dollars by European central banks was of vital importance, and this problem had to be attacked by both the Administration and the System. Much discussion of the problem seemed to blur the fact that France had enough dollars to demand substantial amounts of gold, to say nothing of Spain and other countries. He would like to see the Government's foreign spending and lending attacked first; the country was earning a substantial return on private long-term investments abroad. He would favor attacking next the term loans of banks and direct investments in European countries. If moral suasion was to be employed in any form he hoped that it would be accompanied by sanctions of some sort because otherwise it could have inequitable effects.

Chairman Martin said he had found the discussion today stimulating and worth while; it was good to have the opportunity to bring the various viewpoints of members more sharply into focus. He thought Mr. Hickman had made a useful contribution in his analysis of the staff's answers. Because the matters being dealt with involved human choice and judgment, there inevitably were many imponderables.

The Chairman said he had little to add to the discussion this morning. It seemed perfectly clear that everyone was in favor of maintaining an even keel in the money market for the next three weeks. There was some disagreement as to how "even keel" should be defined under present circumstances, but the Committee always was faced with this kind of problem in its deliberations. In light of a Treasury financing so successful that it led to some complications, he thought it was apparent that the conditions in the money market prevailing during the current period should be maintained as closely as possible over the next few weeks.

Chairman Martin favored the amendment to the staff's draft directive that Mr. Ellis had suggested; namely, to delete the words "may continue to" in the second paragraph. He noted that Mr. Robertson had suggested the addition of a clause at the end of this paragraph, but he questioned whether the clause would add much in view of the different shades of emphasis around the table. He suggested that a vote be taken on the staff's draft directive with Mr. Ellis' proposed amendment.

Mr. Hayes suggested adding the following language at the end of the first paragraph: "particularly in view of the current unsettlement in financial markets abroad." Mr. Mitchell concurred in the suggestion, noting that a considerable amount of concern on this subject had been expressed in the discussion today.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

> In light of the economic and financial developments reviewed at this meeting, and taking the current Treasury refunding into account, it remains the Federal Open Market Committee's current policy to facilitate continued expansion of the economy by accommodating moderate growth in the reserve base, bank credit, and the money supply, while seeking to avoid the emergence of inflationary pressures and to strengthen the international position of the dollar, particularly in view of the current unsettlement in financial markets abroad.

> To implement this policy, and recognizing that international uncertainties and shifting seasonal pressures require a larger than usual degree of flexibility in operations, System open market operations over the next three weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

It was agreed that the next meeting of the Committee would be held on Tuesday, February 2, 1965, at 9:30 a.m.

Chairman Martin commented that he thought the Committee was making progress on the matter of the directive. He noted that Mr. Daane had spoken about the length of the minutes under the new procedure, and he had some sympathy with Mr. Daane's comment. However, the Committee did have the problem at each meeting of uncovering the various shades of emphasis in the views of members. He thought progress was being made in this connection also.

The Chairman noted that the Committee had planned to discuss the question of quantification in the directive after conclusion of the regular agenda today. He proposed that the discussion be deferred until the date of the next meeting, to allow more time for members to think about the question. Also, Mr. Mitchell had distributed a memorandum on this subject today that would provide a good basis for the discussion, and it would be desirable for the members to have time to study this document. (Note: A copy of Mr. Mitchell's memorandum has been placed in the files of the Committee.)

There were no objections to the Chairman's suggestion.

Thereupon the meeting adjourned.

Ralph A. Young

Secretary

Attachment A

CONFIDENTIAL (FR) January 11, 1965.

Draft language for current economic policy directive for consideration by the Federal Open Market Committee at its meeting on January 12, 1965

In light of the economic and financial developments reviewed at this meeting, and taking the current Treasury refunding into account, it remains the Federal Open Market Committee's current policy to facilitate continued expansion of the economy by accommodating moderate growth in the reserve base, bank credit, and the money supply, while seeking to avoid the emergence of inflationary pressures and to strengthen the international position of the dollar.

To implement this policy, and recognizing that international uncertainties and shifting seasonal pressures may continue to require a larger than usual degree of flexibility in operations, System open market operations over the next three weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.