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, D. C., on Tuesday, March 23, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Bryan
Mr. Daane
Mr. Ellis
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Shepardson
Mr. Clay, Alternate for President of Minneapolis Bank

Messrs. Bopp, Hickman, and Irons, Alternate Members of the Federal Open Market Committee

Messrs. Wayne, Shuford, and Swan, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Brill, Holland, and Koch, Associate Economists
Mr. Stone, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account1/

Mr. Cardon, Legislative Counsel, Board of Governors
Messrs. Partee and Williams, Advisers, Division of Research and Statistics, Board of Governors

1/ Left the meeting at the point indicated.

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 Roberts, Secretary, Office of the Secretary, Board of Governors

Mr. Strothman, First Vice President of the Federal Reserve Bank of Minneapolis
Mr. Patterson, First Vice President and General Counsel, Federal Reserve Bank of Atlanta
Messrs. Holmes, Mann, Ratchford, Jones, Tow, and Green, Vice Presidents of the Federal Reserve Banks of New York, Cleveland, Richmond, St. Louis, Kansas City, and Dallas, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Sternlight, Assistant Vice President, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis
Mr. Arena, Economist, Federal Reserve Bank of Boston
Mr. Rothwell, Economist, Federal Reserve Bank of Philadelphia

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 2, 1965, 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 March 2 through 17, 1965, and a supplemental report for

March 18 through March 22, 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 remain unchanged this week at $14.6 billion, after reductions in earlier weeks of the year totaling $825 million. So far these reductions had not had any serious effects on the dollar, perhaps partly because the French takings had been so well advertised that they had been discounted in advance. However, if U.S. losses should continue over the next several months, with new reductions every two or three weeks, there would be some rather serious effects. During the current month of March, it was expected that gold sales would reach a total of approximately $360 million and that the Stabilization Fund would end the month with a gold balance of roughly $65 million. In April, scheduled gold sales amounted to $135 million and probably would be further increased by other prospective sales to a total of at least $235 million.

In discussions at Basle at the time of the March Bank for International Settlements meeting, Mr. Coombs said, the other central banks concerned had accepted the U.S. proposal that the Gold Pool should continue to intervene in the London gold market, even if the Pool's resources of $270 million should become exhausted, with the cost of intervention being shared on the same pro rata basis as before. That decision would be reviewed at the time of the April meeting and he was hopeful that the new arrangement would be continued on a month-to-month basis. As of today, $180 million of the Pool's resources had been used up. Meanwhile, buying pressure on the London gold market had subsided, owing mainly, he thought, to a series of foreign central bank statements disavowing any support for the French gold program. The gold market, however, remained a highly vulnerable point in the defensive arrangements and further sizable reductions in the U.S. gold stock would be likely to stir up renewed speculation in the London market. There might be some possibility of acquiring from the Bank of England $100-$150 million in gold to cushion temporarily the prospective losses during April, but the basic solution, of course, lay in sharply curtailing the current flow of dollars to the continental European countries.

On the exchange markets, Mr. Coombs continued, the British report earlier in March of an improved trade performance during February temporarily strengthened sterling. Since then, sterling had shown a weakening trend owing to uncertainty regarding the April budget, to pressures generated in the Euro-dollar market by the U.S. balance of payments program, and, finally, to heavy maturities coming due on forward contracts entered into last December. The Bank of England's drawings on the swap line with the System, which had been reduced to $105 million at the end of February, had now risen once more to $325 million.

Mr. Coombs thought that the pressures on sterling were likely to continue until announcement of the April budget, which might very well decide the future of sterling. As of the end of February, the Bank of England had drawn $700 million on the short-term credit facilities provided by central banks, and it was possible that by the time the budget was announced their drawings would have risen to $1 billion or more. The implication was that most if not all of the British drawing on the International Monetary Fund would have to be used to pay off the central bank credits. Even if the British budget did prove to be a strongly corrective force, they still would have a rather slender reserve position, having exhausted much of the possibilities for drawing on the IMF.

Mr. Coombs remarked that repatriation of U.S. short-term investments in Canada had also been a major factor in the decline of the Canadian dollar rate from close to its upper limits a month or so ago to a level in recent days slightly below par. Similar pressure was also being exerted on the Japanese yen as customary sources of commercial financing in New York and the Euro-dollar market were becoming less readily available and more expensive.

During the past week or so, Mr. Coombs said, there had been some signs of minor improvement of the dollar against continental European currencies, and the dollar had strengthened further this morning. So far, however, there had been no sizable outflows of funds from the continental financial centers and it had not been possible to make any further progress in paying off the System's swap drawings, which now totaled $515 million.

Mr. Coombs observed that the U.S. balance of payments program seemed to be producing the pattern that many had expected of pressure on the Canadian dollar, sterling, and the Japanese yen, mainly owing to the curtailment of bank lending and repatriation of short-term investments of industrial corporations. In those two areas, he expected the voluntary restraint program to be fairly effective and to bring about a major improvement in the U.S. balance of payments statistical position. It remained uncertain, however, whether the necessary cutbacks in corporate direct investment on the continent of Europe would be achieved. There was considerable risk that corporations might try to satisfy their obligations under the voluntary restraint program by pulling back sizable amounts of short-term investments abroad, while maintaining intact much of their direct investment programs on the European continent. If that pattern should materialize, there might be a spectacular improvement in the U.S. balance of payments figures, heavy pressure on the Canadian dollar, pound sterling, and Japanese yen, and continuing losses of gold to the continent. During the month of March France might take in as much as $100 million, which would be fully converted into gold in April.

Mr. Coombs was inclined to think that further efforts should be made to restrain direct investment in the Common Market and other continental European countries. The European central banks also could help to restore payments equilibrium without exposing themselves to further inflationary pressures at home by encouraging, through the use of credit policy and other measures, outflows of short- and intermediate-term credit into the international capital markets. The Bank of Italy already was doing something along that line, and it was to be hoped that others would also. Unless such steps were taken, there was a distinct possibility that the curtailment in the flow of U.S. credit would produce a serious squeeze in the international credit markets, particularly in the Euro-dollar market.

In response to a question by Mr. Mitchell, Mr. Coombs said that the countries most likely to suffer from the credit squeeze he had mentioned were Britain, Canada, Japan, and a number of the less developed nations. The position of some large European industrial concerns also might become exposed; unless the central banks moved in quickly to supply additional credit as U.S. credit was pulled out, there could be a number of bankruptcies.

Mr. Mitchell then noted that there had been reports of weakness in some Japanese industrial concerns, and of several recent bankruptcies in that country. Mr. Coombs commented that since the war many Japanese concerns had been operating on thin equities and were heavily dependent on financing from the United States. If there was a serious contraction in the flow of credit to Japan, it was likely that the Japanese would find themselves under severe pressure.

Mr. Daane asked whether Europeans were not likely to fill the gap left by a contraction of U.S. credit abroad, in part by shifting deposits from the United States to foreign banks or foreign branches of U.S. banks or, possibly, even to the Euro-dollar market in general. Mr. Coombs replied that there was some likelihood of that occurring, but he considered it less desirable than the alternative in which European central banks made redundant dollar holdings available to their nationals. It seemed to him that the present situation offered those central banks an excellent opportunity to help themselves and the entire world without suffering any inflationary consequences.

Mr. Daane said he agreed that American corporations were more likely to pull back liquid funds than to reduce their direct investments abroad. He asked, however, whether it was possible that they might turn more to local sources for financing their foreign investments, perhaps with some official encouragement. That would not only help the U.S. balance of payments but might also eliminate the hard feelings that resulted when an American corporation obtained funds in the U.S. for foreign investment at a rate lower than that available to their foreign competitors.

Mr. Coombs replied that the U.S. payments balance would, of course, be helped by such a development, but he doubted that any official encouragement was necessary; European commercial banks now were being swamped by credit applications of subsidiaries of U.S. companies. Swiss banks might be able to expand their short-term loans to American firms, but they were not in a position to provide medium-term credits. More generally, European commercial banks were subject to fairly severe restrictions at the moment and would not be able to lend much to American firms unless the central banks eased their credit policies.

Mr. Mitchell asked whether Mr. Coombs would describe the mechanics of the operation under which European central banks could replace dollars repatriated by Americans. Mr. Coombs replied that in one possible sequence--which might be followed, for example, in Germany--commercial bank reserve requirements would first be lowered.

That would provide the commercial banks with additional mark availabilities with which they could undertake more financing of U.S. subsidiaries in Germany or could channel a greater volume of funds into the international credit markets. In the process a demand for dollars from European central banks would be generated, enabling the central banks to reduce their dollar holdings and thus kill two birds with one stone. There would be no effect on the U.S. balance of payments statistics, but there would be a desirable reduction in the overhang of surplus dollars at foreign central banks.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period March 2 through March 22, 1965, were approved, ratified, and confirmed.

Mr. Coombs noted that the Committee had approved a revision of the guidelines for foreign currency operations at its previous meeting on the understanding that it might consider further revisions at the present meeting to deal with a point raised by Mr. Ellis. Certain revisions were proposed in Mr. Broida's memorandum of March 16, 1965, which he understood were considered by Mr. Ellis to meet the problem satisfactorily. (Note: A copy of the memorandum referred to has been placed in the Committee's files.) The proposed revisions affected the first and second paragraphs of Section 4 of the guidelines, and in both cases involved replacing the words "may prove desirable" with the words "may be undertaken." The proposed new words had a more positive connotation, and Mr. Coombs felt it would be helpful if the Committee would approve the suggested revisions.

Mr. Robertson said that he had no objection to the proposed revisions as such. He thought, however, that the Committee should refrain from introducing increasingly liberal language into the guidelines that might serve to limit the extent to which actions taken under them were discussed with the Committee. It was desirable for the Committee to follow operations quite closely and to stay fully informed on them.

Mr. Coombs commented that the main limitations on foreign currency operations specified in the present authorizations and directives related to purposes and dollar amounts; otherwise, the authorities given to the Special Manager were fairly broad. The reason was that the Account Management often was confronted with situations that emerged suddenly and had to be dealt with immediately.

Mr. Robertson said he was aware of that problem, but would suggest that the Committee and staff lean over backward to discuss operations before rather than after the fact whenever possible. Mr. Coombs replied that he would endeavor to do so.

Thereupon, upon motion duly made and seconded, and by unanimous vote, Section 4 of the guidelines for System foreign currency operations was amended to read as follows:

4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;

(2) When it is deemed appropriate to supplement existing market supplies of forward cover, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;

(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;

(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies also may be undertaken in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

Mr. Coombs then noted that during April certain Bank of England drawings on its swap line with the System, in the amount of $80 million, would mature for the first time, and if, as seemed quite possible, they should wish to renew, he would recommend approval of such renewals.

> Renewals by the Bank of England of its swap drawings on the System were noted without objection.

Mr. Coombs noted that Federal Reserve drawings of $60 million on the Swiss National Bank, $50 million on the Bank of Italy, and $5 million on the National Bank of Belgium also would mature for the first time in April. In the absence of a reversal in the flow of funds enabling the System to pay off these swap drawings, he recommended their renewal for a second three-month term.

> Renewals of the System's drawings on the Swiss National Bank, the Bank of Italy, and the National Bank of Belgium were noted without objection.

Mr. Coombs reported that a $5 million drawing on the Netherlands Bank would mature for the second time on April 20. He was hopeful that it would be possible to acquire enough guilders to repay this drawing, but if it was not possible he would recommend a second renewal for a further period of three months. He noted that the Committee had authorized second renewals of a number of drawings at the previous meeting. The guidelines specified that drawings should be fully liquidated within 12 months, and in general actual performance had been better than that; the bulk of the System's drawings had been liquidated within six months.

Renewal of the drawing on the Netherlands Bank was noted without objection.

Mr. Coombs then observed that the Committee had received his memorandum dated March 18, 1965, recommending an increase of $100 million each in the swap lines with the Banks of Japan and Italy, and that later it had been advised that he was recommending an increase of $200 million, rather than $100 million, in the Bank of Italy swap line. (Note: Copies of the documents to which Mr. Coombs referred have been placed in the files of the Committee.) Toward the end of last week, after preparing his memorandum of March 18, he had received a suggestion from Governor Carli of the Bank of Italy that the swap line be increased by $200 million. Earlier, when a $100 million increase was under discussion, the Bank of Italy had apparently anticipated that a U.S. Treasury credit line of $100 million, extended to that Bank in March 1964, would be renewed at the end of its one-year maturity. However, the Treasury was reluctant to renew that credit line--which, incidentally, had never been used--because doing so would lock up an unduly high proportion of the limited resources of the Stabilization Fund. The Bank of Italy was hopeful that the System could, in effect, take it up under its facilities; hence the suggestion for an increase of $200 million rather than $100 million in the swap with the System.

As indicated in his memorandum, Mr. Coombs continued, Governor Carli was one of the staunchest supporters of the U.S. approach of relying upon mutual credit facilities to economize on gold settlements. He was inclined to concur in Governor Carli's appraisal of the size of the credit facility needed to help cushion the swings in the Italian balance of payments. More generally, conclusion of such a substantial increase in the swap line with the Bank of Italy would provide further evidence that even the Common Market partners of France were pursuing an approach diametrically opposed to the French call for a return to the gold standard. That, in Mr. Coombs' judgment, was an extremely important consideration. Moreover, such an increase in the swap line with the Bank of Italy might encourage Germany to be liberal in extending a direct swap line to the Bank of England sometime in May or June. For Germany to do so would represent an important breakthrough; it might mark the beginning of the development of third-country swap arrangements similar to those of the System, and to some extent such a development would take pressure off the dollar in its role as an international reserve currency. The debate between the American and French approaches was in an active stage at the moment, and although the $200 million figure was higher than Mr. Coombs originally had had in mind, on balance it would give added weight to the U.S. side in the debate.

Mr. Balderston asked what arrangements would be made to inform other countries with whom the System had swap arrangements of any action that might be taken with regard to the swap line with the Bank of Italy. He recalled that in June 1964, after a package of assistance to Italy had been developed, there had been some feeling that other nations had not been given adequate advance notice.

Mr. Coombs replied that normally other central banks were advised by Telex the night before a change in a swap arrangement was publicly announced. It would be possible, if the action on the Italian swap line was approved today, that its announcement could be delayed until after the Basle meeting in April, and that other central banks could be informed at that meeting. He would not anticipate any disagreement with the action. Another alternative would be to advise the other central banks by Telex several days before public announcement.

Mr. Daane said that the circumstances surrounding the action proposed now were quite different, in his judgment, from those of last June. He doubted whether other countries would consider an increase in the Italian swap line to be a sensitive matter.

Mr. Coombs agreed with this view. However, he thought Mr. Balderston had raised a good point regarding the desirability of advance notice. Perhaps such notice should be given one, two, or three days, rather than just a few hours, in advance. He felt that the central banks could be relied on not to disclose the action prematurely.

Mr. Scanlon mentioned that it had been pointed out in earlier discussions that the sizes of the various swap lines should have some reasonable relationship with one another. He asked how the proposed increase in the Italian line to $450 million would affect the rest of the swap arrangements.

Mr. Coombs replied that the action recommended would make the Belgian and Dutch lines look relatively small, but perhaps that would be desirable. The System's swap line with the German Federal Bank was in the amount of $250 million, but if that Bank made a direct swap with the Bank of England of, say, $250 million also, the two could be considered additive. There would be important advantages to a British-German arrangement; for example, if there was a flow of funds from London to Frankfurt, it would be more convenient for the Germans to extend credit to the British than for the U.S. simultaneously to borrow from the Germans and lend to the British.

Mr. Daane said he agreed with Mr. Coombs that the Italians were strong advocates of the U.S. approach to the role of credit facilities in the evolution of the international monetary system. He thought the proposed increase in the swap line would be useful in fortifying their attitude.

In response to Mr. Mitchell's request for information on present and prospective drawings under the System's swap facility with the Bank of Italy, Mr. Coombs said that the System had a drawing of $100 million now outstanding. It would not be surprising if the Bank of Italy took in $300-$400 million during the May-September tourist season. The situation then would be likely to reverse; there seemed to be an inherent instability in the Italian balance of payments, with large surpluses tending to be followed by swings in the other direction. From time to time the swap line would be likely to be drawn upon by one partner or the other, but it was hard to predict the amounts. The U.S. was apt to be making drawings initially.

Mr. Robertson said that he had no adverse reaction to increasing the swap line by $100 million to $350 million, but he questioned the advisability of raising it to $450 million now. It seemed to him that $350 million would be sufficient to take care of this country's needs for the foreseeable future. He gathered from what had been said that the main reason for going to $450 million was political, and he thought it was a mistake to attempt to use the swap lines for political purposes. Moreover, to raise the Italian line to $450 million created a danger of imbalance in the relative sizes of the arrangements with various countries, and might produce more problems than it solved.

Mr. Hayes said he had understood that there was a good chance that the U.S. might want to draw as much as $450 million during the Italian tourist season. Mr. Robertson replied that the line could be increased when the need became evident. Mr. Coombs observed that the need might present itself rather quickly.

Chairman Martin said that, as he understood the matter, Governor Carli favored a $200 million increase primarily for economic rather than political reasons.

Mr. Coombs agreed. He added that the main political aspect to the question involved the pressure on the Bank of Italy from parties on both the right and left to buy gold with its dollar holdings. There were similar pressures in a number of other countries. The swap network gave central banks under such pressures an alternative to gold purchases that carried an exchange guarantee in terms of their own currencies.

Mr. Robertson said that he would expect the factor of prestige to lead to requests for increases in other swap lines if the Italian line was raised to $450 million. Mr. Coombs replied that in his judgment questions of prestige had not been important in discussions of the sizes of swap lines. In the past, changes in the swap lines had been in anticipation of swings in the flow of payments. There was a possibility that the Bank of Canada might suggest a higher figure, but he doubted that other central banks in the network would.

Mr. Daane said he thought the $200 million increase clearly was justified on the basis of the general concepts underlying the swap network. Moreover, he did not think political considerations should be brushed aside; it was helpful to have one of the leading Common Market countries on this country's side in the current debate on international monetary arrangements. While he would not favor the action solely on that ground, he thought it was an important supplementary consideration.

Mr. Hayes felt that the $200 million increase definitely was a useful step. The fact that Governor Carli had personally suggested it should carry a good deal of weight, he said.

Mr. Robertson commented that while he suspected that the proposed $200 million increase was not a desirable move, judgments obviously could differ on the question. Accordingly, he would not dissent from the action.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, an increase of $200 million in the swap arrangement with the Bank of Italy, to a total of $450 million, as recommended by Mr. Coombs, was approved.

Mr. Mitchell referred to Mr. Coombs' recommendation that the swap line with the Bank of Japan be increased by $100 million, and asked whether drawings by the Japanese were likely to mount rapidly in the coming period.

Mr. Coombs replied that that was a real possibility. Japan represented an important element in the international financial structure, and their prospects were worrisome. Indeed, if their customary sources of financing dried up, it might even prove necessary during the coming year to develop a major international package of credit assistance for them, as was done for Italy in 1964.

Thereupon, upon motion duly made and seconded, and by unanimous vote, an increase of $100 million in the swap arrangement with the Bank of Japan, to a total of $250 million, as recommended by Mr. Coombs, was approved.

Mr. Coombs noted that it was the Committee's practice to establish the dollar limit on the aggregate amount of foreign currencies that might be held under reciprocal currency arrangements at an amount equal to the sum of all individual swap arrangements. In view of the actions just taken to increase the size of the swap lines with the Banks of Italy and Japan, he recommended a revision of the continuing authority directive for foreign currency operations to increase this limit from $2.35 billion to $2.65 billion.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the first paragraph of the continuing authority directive for System foreign currency operations was amended to read as follows:

The Federal Reserve Bank of New York is authorized and directed to purchase and sell through spot transactions any or all of the following currencies in accordance with the Guidelines on System Foreign Currency Operations as amended March 23, 1965; provided that the aggregate amount of foreign currencies held under reciprocal currency arrangements shall not exceed \$2.65 billion equivalent at any one time, and provided further that the aggregate amount of foreign currencies held as a result of outright purchases shall not exceed \$150 million equivalent at any one time:

Pounds sterling
French francs
German marks
Italian lire
Netherlands guilders
Swiss francs
Belgian francs
Canadian dollars
Austrian schillings
Swedish kronor
Japanese yen

Chairman Martin then noted that a memorandum by Mr. Nettles of the Board's staff dated March 19, 1965, and entitled "Comments on reciprocal currency agreements with Mexico and Venezuela" had been distributed to the Committee for preliminary discussion. (Note: A copy of this memorandum has been placed in the Committee's files.) He asked whether Mr. Coombs would like to comment.

Mr. Coombs said that he was not inclined at the moment to make a specific recommendation regarding swap arrangements with Mexico and Venezuela. A similar question had been raised about a year ago, and he had thought then that such action would be premature. Before the Committee made a decision now it might be useful to hold further informal discussions with those countries and probably also with one or two European central banks.

In general, Mr. Coombs said, the case for arranging a swap with Mexico in the amount of, say, $50 million was fairly strong. The Mexican economy was tied in closely with that of the U.S. Their exchange system was wide open; at the time of the Bay of Pigs invasion, for example, Mexico lost $300 million in short-term capital outflows in a few months' time. Some cushioning by means of a swap line could have great value to them in stabilizing their reserve position; much the same considerations had led the System to negotiate a swap line with Canada. Mexico also was an Article VIII country under the IMF Articles of Agreement.

Venezuela's economic ties with the U.S. were not as strong, Mr. Coombs said, and their capital flows were not as volatile. In addition, Venezuela was not yet an Article VIII country, although it probably could attain that status fairly easily.

In due course, Mr. Coombs concluded, it probably would be useful to incorporate into the network one or two such countries who were managing their affairs well, but he was not sure that now was the appropriate time. That time might be close for Mexico, but he was less certain about Venezuela.

Chairman Martin asked how Mr. Coombs would view a swap arrangement with Peru. Mr. Coombs replied that he was unable to comment because he had not examined the question.

Mr. Bryan expressed doubt that it would be desirable to make a swap arrangement with Peru at the present time. More generally, he felt that the System might be getting into a troublesome area by considering further extensions of the swap network. He did not know how the difficulties could be avoided since questions of national pride were so deeply involved. He suspected that eventually the System would have swap lines with Mexico and Venezuela if those countries wanted them.

Mr. Mitchell said that he had discussed the Venezuelan situation on two or three occasions with Governor Machado of the central bank of that country, and could add an observation to the points covered in Mr. Nettles' memorandum. Venezuela had not bought gold for five years, but there was a possibility that they would decide to do so soon. They were this country's sixth largest trading partner, and were selling about twice as much to the U.S. as they were buying from it. Their reserves were about equally divided at present between gold and dollars, and they were getting restive about that ratio. Given the size of their dollar holdings, it would not be unusual for them to decide to buy some gold, and if they did so Mexico might do the same; one could not say how far the trend might go. Governor Machado felt that some sort of an arrangement would strengthen their credit position and also would strengthen their ability to resist domestic demands that they increase their gold ratio. Thus, a swap arrangement might be useful from the U.S. standpoint, and one probably would be desirable at some point although not necessarily immediately. Mexico ranked fifth among U.S. trading partners, and in view of Mexico's location and Venezuela's natural resources it was reasonable to expect that U.S. relations with both countries would continue to grow.

Mr. Wayne thought it would be helpful for the Committee to have memoranda providing information on current conditions within the two countries before attempting to reach a decision on the matter.

Mr. Robertson remarked that in his judgment the proposal involved utilizing swap arrangements for a purpose that was foreign to those originally envisaged for them. The System would be moving into the political field rather than limiting itself to efforts to protect the international financial positions of the U.S. and the other parties to the swaps. If arrangements were made with Mexico and Venezuela, no doubt other Latin American countries would request similar arrangements. It would be highly premature, he thought, to make swap arrangements with the two countries now.

Mr. Coombs noted that one basic purpose for the swap network was to protect the U.S. gold stock. Venezuela held $500 million in dollars, and could convert a sizable proportion of that sum to gold. Mexico had been buying gold from Canada. From the purely financial point of view--the defense of the U.S. gold stock--he thought there were good arguments for swap arrangements with the two countries.

Chairman Martin said he thought Mr. Coombs' point was valid. But it seemed to him (Chairman Martin) that, as Mr. Blessing of the German Federal Bank recently had suggested, it was necessary to have some understanding among nations regarding the role of gold. It was not possible for all foreign countries holding dollars to convert their holdings to gold, and he suspected that the swap network now was being used about as far as possible to supplement the gold exchange standard. That was one of the major, overall problems that had to be dealt with.

Chairman Martin then said that the matter of possible swaps with Mexico and Venezuela had to be considered carefully. He agreed with Mr. Wayne's suggestion that the Committee should have memoranda on Venezuela and Mexico, and, he would add, on Peru. Also, he noted that Mr. Furth had prepared a memorandum on Mexico and Venezuela which should be distributed. After receiving these documents the Committee could discuss the question further at a later meeting.

There were no objections to the Chairman's suggestions.

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 March 2 through March 17, 1965, and a supplemental report for March 18 through 22, 1965.

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

> The past three weeks provided a classic example of the way in which money market variables that are supposed to move together--and that generally do move together over the long run--can behave perversely in the short run. Against the background of the seasonally heavy liquidity needs associated with the dividend and tax dates, rates on most money market instruments moved upward. Major banks were paying 4.30 per cent on 90-day CDs; finance company paper moved up in rate after having declined briefly at the outset of the period; some trading in Federal funds occurred at 4-1/8 per cent on nearly every day, and on six days the heaviest volume of trading was at that rate; dealer loan rates posted by New York banks moved up to as high as 4-3/4 per cent; and dealer portfolios of acceptances rose to over $325 million to the accompaniment of developing discussion of an upward adjustment of that rate. While all this was going on, however, Treasury bill rates moved downward.
>
> I confess that I have no full explanation of the contrasting behavior of the bill rate on the one hand and other money market rates on the other. I suspect,

however, that a substantial repatriation of short-term funds from abroad is underway--that a part of the aggregate pool of corporate liquidity is being redistributed toward money market assets in this country and away from such assets abroad. While these funds may be spread among the whole range of our market instruments eventually, corporate treasurers seem initially to be concentrating them in the bill market until further decisions are made. And while these return flows in many cases require liquidation of dollar assets by foreign holders, the effects of such liquidation may not be, and probably are not, concentrated in the bill area, but rather are diffused and dispersed among many market instruments. And indeed, in some cases there may be no immediate foreign liquidation of a money market instrument.

The conduct of open market operations was complicated by the unusual behavior of short rates. If we had supplied more reserves to ease the pressure on other rates, we would very likely have triggered further declines in the bill rate. And if we had supplied fewer reserves, or had absorbed funds, as a means of dealing with the bill rate, we would have aggravated the situation with regard to other rates. We would, moreover, have had to reduce marginal reserve availability so far as to give a false signal to the market that the Committee had adopted a firmer policy at its last meeting. In these circumstances the Desk followed a middle course, trying to insure, on the one hand, that the market mechanism handled smoothly and well the heavy seasonal demands that converged upon it; and attempting to avoid, on the other hand, a situation in which the bill rate moved so low as to dilute the System's contribution to the balance of payments program.

As for the outlook for bill rates, it is particularly difficult to speak with any confidence right now. I doubt that the bill rate can go much lower if reserve and borrowing conditions remain as they have been recently; at the same time, if it is true that an important reflux of corporate funds is underway, the "normal" relationships among market variables may continue in suspension for a time, and the upward pull to which bill rates should be subject will not be fully exerted. Perhaps, therefore, the best guess that can be made is that, within the framework of present policy, the bill rate may stay about where it is or creep slightly upward.

Mr. Stone added that the Committee might be interested in the results of an informal survey that had been made by a Canadian money market dealer interested in placing U.S. funds in Canada. The dealer had contacted treasurers of 63 major U.S. corporations and inquired about their plans for dollar holdings in Canada. Forty-five of the treasurers reported that they planned to place no additional funds in Canada in the immediate future, and for the time being to repatriate funds as their Canadian investments matured. The remaining 18 treasurers indicated that they would continue to place funds in Canada but at a substantially slower rate than earlier.

Mr. Scanlon asked if Mr. Stone would expand on his reasons for believing that a continuation of current policy would lead to no change or only a slight rise in bill rates. Mr. Stone replied that that expectation was based on the assumption that some substantial reflow of funds from abroad would continue. He suspected such a reflow was occurring not only from the reported actions of corporate treasurers but also because it was the only obvious explanation of the recent divergent behavior of rates on Treasury bills and on other short-term instruments. However, he did not think that a continued reflow would force bill rates down much further, primarily because dealers were not willing to acquire additional bills yielding as little as 3.92 per cent when dealer lending rates at New York banks were ranging as high as 4-3/4 per cent. The high financing rates had not had much effect thus far because the demands for bills had been so great that dealer inventories of bills were relatively low.

In response to questions by Messrs. Swan and Wayne, Mr. Stone said that corporate treasurers were investing repatriated funds in Treasury bills--including those with maturities of less than 90 days--temporarily, until further decisions could be made. They were under instructions from their chief executive officers, who had been called to Washington, to bring funds back to this country. The bill market was the obvious place to put these funds for the time being; it was much broader than, say, the CD market, and large investments could be made quickly. He would expect that in due course funds would be moved out of bills and into other money market instruments in many cases.

Mr. Daane said he was prepared to admit the impossibility of projecting relationships among the different variables--which was one reason he opposed proposals for using rigid numerical targets in the directive--but he would still ask whether Mr. Stone thought a further reduction in the marginal reserve figures would leave the present discount rate in an untenable position, given the reflow of funds from abroad. To put his question another way, did the reflow offer the Committee some leeway for maneuver, if it wanted to take advantage of it?

Mr. Stone replied that he doubted whether any serious question would be raised about the discount rate unless the 3-month bill rate got up to 4-1/8 per cent or higher. In his judgment, the Committee would have some room for maneuver if the reflow continued.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period March 2 through March 22, 1965, were approved, ratified, and confirmed.

Mr. Stone then noted that a question had been raised at the preceding meeting of the Committee with respect to the volume of third-country acceptances in the New York Bank's portfolio of bankers' acceptances. In a memorandum to the Committee dated March 18, 1965, he had shown a breakdown of the Bank's holdings as of the end of December of 1963 and 1964, February 19, 1965, and March 12, 1965. (Note: A copy of this memorandum has been placed in the Committee's files.) In the Bank's customary survey of bankers' acceptances as of the end of February it was found that 48.6 per cent of total acceptances outstanding in the U.S. then had been drawn to finance third-country trade. As indicated in the memorandum, the proportion of such acceptances in the Bank's portfolio was smaller; on March 12, for example, it was 38.4 per cent. About 45 per cent of acceptances held by the Bank for foreign accounts on that date involved third-country trade. Mr. Stone added that he had not undertaken in his memorandum to advance arguments for or against holding such acceptances in the Bank's portfolio because as he had understood the Committee's request it was for a factual report.

Mr. Hayes said he had studied the figures given in Mr. Stone's memorandum and had thought about the question raised at the previous meeting. He still felt, as he had indicated then, that it would be unwise for the Committee to modify its policy and refuse to buy acceptances involving third-country trade. He was impressed by the fact that such acceptances were included in the credits to which the 105 per cent limitation--specified in the System's guidelines for restraint on foreign lending by banks--applied; hence control was being exercised at the source of this acceptance credit. The sale of an acceptance in the market to the New York Bank or to any other purchaser did not affect the original transaction; the credit concerned was still included in the 105 per cent limitation. If one assumed that there should be some kind of discrimination against such acceptances, it should take place at the time the banks created them. If it was felt that the volume of third-country credits was mounting undesirably and that they should be discouraged, that should be indicated directly; and, indeed, it was indicated in somewhat general terms in the guidelines.

Mr. Hayes said he also was impressed by the fact that Japan accounted for by far the greatest part of third-country financing; Mr. Stone's figures disclosed that as of February 19, $50 million of the $70 million of third-country acceptances held at the New York Bank represented the movement of goods to or from Japan. The whole Japanese position was a matter of top-level negotiation with that country, looking to the maintenance of the present level of financing for Japan with the exception of export financing. In his judgment it would be inappropriate for the Committee to act today to make third-country financing involving Japan virtually impossible. If the Committee changed its policy and refused to acquire third-country acceptances it would be necessary to inform the dealers, and news of the action would be conveyed to the market rapidly. This would seriously jeopardize the quality of the market. At the same time it was likely to result in some confusion, since foreigners presumably would continue to want such acceptances and the New York Bank would continue to buy them for foreign accounts. Moreover, the System had been working for 50 years, and particularly for the last 10 years, to promote the development of the acceptance market, and he questioned whether a decision now not to buy third-country acceptances would be desirable from the longer-run point of view.

In sum, Mr. Hayes said, System participation in the acceptance market on an across-the-board-basis--which happened, as Mr. Stone's figures indicated, to result in a smaller percentage of third-country acceptances in the Bank's portfolio than in total outstandings--was a reasonable procedure, in his judgment. He thought it would be neither desirable nor practical to start discriminating among the types of acceptances the System would buy.

Mr. Stone said he would like to emphasize one point Mr. Hayes had made. If the System began to discriminate against any class of acceptances that fact would be known immediately all over the country. Other market participants also would stop buying them, and dealers would begin to refuse to take them from banks, which in turn would become unwilling to create them. As a result, the volume of that class of acceptances outstanding quickly would drop to minimal amounts.

Mr. Robertson noted that he had been absent during the part of the previous meeting when the question under discussion first had been raised, and he had not had an opportunity to consider the matter fully. He asked whether the Committee would be agreeable to carrying the discussion over until the next meeting. No objections were made to postponement of further discussion.

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. Holland made the following statement on economic conditions:

> I think it is fair to say that every member of the Committee's staff has been analyzing the statistics on the

economy's performance with more than the usual intensity these past weeks. The reason is obvious. In its latest phase, for the first time in this remarkably long and stable business expansion, activity has clearly been rising at an unsustainably rapid rate. This will be plain from the size and composition of the fourth-quarter to first-quarter rise in GNP when it is published, but something like the current rate of upsurge actually began last November and December, as soon as the auto strikes were over.

How destabilizing will the inevitable let-down be? Certainly this will be importantly conditioned by the duration of the current spurt and the extent of distortions it interjects into business decisions. It is on these issues that I would like to focus my remarks this morning.

Insofar as duration is concerned, the general expectation is that the rate of expansion will have to slow in the second quarter. Such reasoning assumes a more restrictive Federal budget posture until midyear, and a less-than-seasonal spring rise in auto output from the very high levels already attained in catching up from last fall's strikes. Also assumed is a slowdown or even a reversal in steel inventory building after the scheduled May 1 labor contract termination.

What is the key evidence at hand on these points? As one measure of the Federal budgetary influence, the full-employment surplus is projected to amount to $4.8 billion in the April-June quarter, about half again as large as over the preceding nine months, before dropping back to a $1.4 billion deficit after midyear, assuming adoption of the Administration program.

In the auto industry, domestic deliveries held even in the first ten days of March, failing to show the usual seasonal increase. But even if customer takings of cars from here on out were to show no seasonal rise at all, auto production would undoubtedly be held at present rates for a month or two in order to rebuild dealer stocks to levels more in line with current sales.

In steel the present high rate of consumption has probably served to attenuate the phase of inventory building. Judging from the Census series on tonnage held, steel consumers had only managed to build up their steel stocks from about a 1.8-month to a 2.2-month supply by the end of January, the last month for which data are available. Several additional months of accumulation at the recent rate would be necessary before the peak 2.8-month stock ratio reached in 1962 and again in 1963 would be reattained. An earlier change of pace in steel buying could appear, however, if the labor picture should brighten. This may be helped by the pattern-setting implications of the can industry settlement which developed over the week-end, involving an annual increase in labor costs of about 3-1/2 per cent per man-hour.

This kind of decision, even if it does not spread to steel, is symptomatic of a kind of reasonableness in private decision-making that has seemed a good deal more prevalent during this current inventory bulge than in some earlier counterparts. In the past, over-ebullient business expectations engendered in such an environment sometimes have fostered overreaching price increases, extravagant wage settlements, generous hirings, and optimistic levels of capital spending for future capacity. In contrast, business performance on all these counts has been restrained throughout this long expansion, and particularly so in the rapid advance beginning last November. No inflationary wage settlements have been agreed to by major industries during this period. For the man-hours needed to increase output temporarily, manufacturers have relied in greater part upon larger overtime by existing workers, rather than new hirings. Some observers regret the potential reduction in unemployment thus foregone, but the economic distress from subsequent cutbacks to lower production levels will surely be less when it can consist of eliminated overtime checks rather than outright firings.

On the price point, businesses have made relatively few efforts to hang higher price tags on what they have regarded as temporary bulges in orders. Overall, the wholesale commodity price index is unchanged thus far in 1965; the chief elements giving rise to the upward tick in this index last fall--increases in nonferrous metals prices and a recovery in petroleum products--have since either leveled off or declined.

Capital expenditure programs have been increased, but even after allowing for some possible understatement of estimates, projected quarter-to-quarter increases in business plant and equipment expenditures run somewhat smaller than last year's quarterly advances. Perhaps more importantly, the capacity additions represented by such outlays appear well balanced with underlying product demands, both in total and by major industrial sectors.

Probably it is in the area of inventory investment itself that the greatest possibilities for miscalculation are created as a result of the current efforts to build up stocks. Moreover, efforts to perceive such miscalculations are very much hampered by the tendency for the early inventory statistics to be particularly unreliable around inflection points. For example, direct reports on inventory holdings continue to suggest more moderate levels of stocks than do the inferences to be drawn from the differences between independent production and consumption measures. We still cannot be sure whether inventory accumulation at an annual rate of, say, $10 billion, is a good description of the latest five months, although we know the first officially published figures will be substantially less than that, and perhaps for a short span of time or so within that period the final rate, after all eventual revisions, could even turn out to be somewhat higher.

We do know that the inventory investment over this period has not been monolithic. Earlier accumulations centered more in materials, but then later the focus shifted to work-in-process and finished goods. Last fall's additions were importantly in manufacturers' hands, while later data suggest that wholesale and retail outlets are now bearing more of the brunt of additions. Such a distribution of the weight of added inventories should increase the economy's ability to weather the moderation in rates of growth that seems to lie very close ahead.

The causes of that change in rate of growth relate too largely to very short-term inventory adjustments, and are impelled by too strong and special forces, to be amenable to much if any timely moderation by monetary policy. On the other hand, the inventory-caused bulge in demands over these past five months seems well enough perceived and sensibly enough dealt with by the private sector to eliminate a good part of its potentially destabilizing ramifications.

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

In attempting to draft a set of directives for consideration by the Committee today, the staff bogged down over the same problems that beset it--and the Committee--at the last meeting and on other recent occasions. The problem that continues to stump us is the inconsistent behavior among the financial measures that serve as guides to and targets for policy. We don't seem to be able to get quantities and prices both to move in a desired direction at once, and among the quantities and among the prices we get divergent behavior from time to time that is difficult to interpret and makes it even harder to specify policy objectives. This morning, I'd like to address myself to a few dimensions of the problem.

First, let me turn to the quantities. It is natural that attention should be captured by the rapid rate of expansion in the flow of bank credit. An 8 or 9 per cent annual growth in this variable is historically fairly unusual, and the 10 to 12 per cent rate of recent months is even more unusual. But so are the circumstances that give rise to such quantities. It is not often, if ever before, that monetary policy has had to operate under such constraints and imperatives as (a) a high rate of private saving, reflecting in part the effects of a cyclically unusual fiscal policy, (b) a need for balance of payments purposes to keep the level of interest rates--particularly short-term market rates--relatively high, and (c) a need for domestic expansion purposes to keep the cost of financing investment as low as possible, consistent with the desired level of short-term rates.

To meet these objectives within the limits of the specified constraints, we have depended in part on debt management maneuvers, but more importantly on monetary techniques to divert a large share of the private saving flow through the banking system. Banks have been encouraged to compete aggressively in order to keep these saving flows from depressing short-term market rates, and, in turn, have transformed the saving into long-term financing, thus satisfying objectives of monetary policy while creating new headaches for bank supervision.

Over the past four years banks have succeeded in capturing about a third of all credit flows, a proportion previously achieved in the postwar period only in recession years. But it might have been 50 or 75 per cent without having materially different effects on the economy, other than the increased discomforture of banks' competitors. GNP doesn't grow any faster just because housing is financed out of savings deposits rather than savings shares. Nor is there any empirical evidence to suggest that holders of bank time and savings deposits feel more liquid and behave differently from holders of other depositary claims or of open market instruments. It is hard to ascribe any unique or special meaning to bank credit changes that result primarily from the increased vigor of bank competition for saving flows.

Even if there were some special economic significance to the recent expansion in bank credit, there is little we could do about it, given our emphasis on interest rates as operating guides. So long as the quantity of reserves provided is determined principally by the need to maintain certain "conditions in money markets" (our euphemism for short-term market interest rates), and so long as the ceiling rates banks can pay to attract savings are set with an eye to keeping funds here rather than flowing abroad, we can't control the total quantity of bank credit flows. Even the Federal Reserve can't overdetermine the economic system. Under the given circumstances, we can give priority to our rate objectives or priority to flow-quantity objectives, but not to both.

Similarly, it has become increasingly difficult to set a meaningful objective in terms of desired changes in the money supply. While in the long run the demand for money may be interest inelastic (as suggested by our friends of the Chicago school of monetary economics), it certainly hasn't been inelastic in the short run. In particular, money supply has responded sharply to increases in the interest attractiveness of time and savings deposits. After each increase in Regulation Q, there has been a sharp burst in time and savings deposits, partly at the expense of other types of institutional saving and market instruments, and partly at the expense of money balances. But the bursts into time deposits and out of money have been short-lived--about three months--and then money demand has resumed, with growth in time deposits continuing but at a slower pace. Such switches out of money into time deposits can be accompanied by very sharp rises in total bank credit without necessitating significant changes in bank reserves, but the reversal of such deposit trends increases reserve needs. This makes it very difficult to lump changes in "the reserve base, bank credit, and the money supply" under the same blanket intention, as is done in the first part of the Committee's directive.

I say all this not in a spirit of criticism, but to illuminate an impending problem in specifying the Committee's near-term quantity objectives. The attractiveness of the new higher rates paid by banks on time and savings deposits is beginning to wane--on schedule. The rate of expansion in time deposits has been slowing down in recent weeks and that in money supply accelerating. While the increase in the money supply in the first half of March is overstated, reflecting largely the temporary disbursement of Government balances, it also probably heralds a return to a more normal rate of growth in money balances. If these deposit-shift trends persist, a directive pointed to "no change" in money market conditions probably would have to accommodate an acceleration in the reserve base and in the money supply, even with a slowing in the pace of bank credit expansion from recent exceptionally high rates.

I emphasize the "probably" not only because our knowledge of the linkage between quantities and prices is still so imprecise, but also because there appears to be, at the moment, some distortion in the constellation of interest rates that comprise "money market conditions." Most indicators of money market conditions indicate some tautness, even though the bill rate has eased significantly.

We don't know to what extent the bill rate decline is attributable to ephemeral factors--including the repatriation of funds from abroad or retention of funds originally destined for foreign money markets as a result of the introduction of the balance of payments program--or to a fundamental reappraisal by investors of longer-term credit demands and monetary policy. All we can say at the moment is that the bill rate appears out of line with the rest of the money market, and it is not clear which will move towards which.

My own preference would be to play it cautiously, for it seems somewhat premature to assume substantial and continuing success of the voluntary restraint program on the one hand, or complete subsidence of inflationary potential on the other. The fragmentary information available is favorable on both fronts. It might be more prudent in the short-run, however, to offset tendencies toward further reduction in bill rates, even if it resulted in some temporary slowing in reserve growth to do so, and not to resist a tendency for the bill rate to move back into closer alignment with other short-term rates if market forces propel it in that direction. It should be noted that the Treasury is not in an especially good position to provide help on this score, for its large cash balance probably limits debt management to small additions to the weekly bill auction.

Such a cautious monetary policy is recommended only as an interim action until our vision clears. Three weeks from now we should have a clearer reading on international capital flows and wage negotiations, which would permit a longer-term decision as to the appropriate posture of monetary policy.

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

On account of the disruptions caused by the port strike, it will be some time before we can get a reliable reading on trends in the current account of the balance of payments.

The key questions about underlying forces affecting the current account are familiar ones. First, to what extent will world trade, and U.S. exports, be slowed by British efforts to correct their balance of payments and by the efforts of France and other countries to check inflation? The adjustment of British trade has barely begun. France seems as determined as ever to halt the present rise in costs and pressure on prices, even if that means allowing a recession in French business activity. Success in their effort will help them to preserve the strong payments position that France got out of the devaluation of 1958. The second question is: is the U.S. competitive position continuing to improve? On this, one may note that U.S. wholesale prices of producers' equipment have risen 2 per cent in the past year and a half. There are reports of growing delivery lags for products such as machine tools for which order backlogs have become large.

In the private capital account, at least one major change has occurred in the last few weeks: the drying up of the previously massive outflow of term loans from U.S. banks. Little can be said yet about the outflow of short-term bank credit. And we can't yet be sure whether the quarterly reflux of corporate liquid funds in March was greater than seasonal this year.

As to the banks' term lending, we do have some useful information. Confidential data on commitments show a very abrupt drop after the President's message to Congress on February 10 and the coming into effect that day of the IET on most term loans to developed countries. In the 4 months and 10 days up to February 10, commitments for term loans had totaled $1.6 billion, of which $350 million were made within the first ten days of February. In the rest of February and first half of March, new commitments--now going almost entirely to the less-developed countries--were well under $100 million, and they may have been less than the present rate of total amortization reflows.

Data on actual net outflows, as opposed to commitments, show a revised figure for January of about $250 million. I would guess that the net outflow in the first ten days of February may have been of the same order of magnitude as the January total. Taxable loans committed after August 5 of last year had to be disbursed before the Gore Amendment was put into effect if they were to escape the tax.

If the net outflow on term loans, which may have been close to half a billion dollars in the first six weeks of the year, has now virtually dried up, one would expect to see some impact on the spread between U.S. money market rates and rates abroad, especially the sensitive rates in the Euro-dollar market.

In fact, London Euro-dollar market rates did rise more than seasonally from mid-February up to March 10, after which they eased off somewhat. Mere cessation of the U.S. term loan outflow could have been one factor in the tightening. Much of the term loan borrowing in January and early February must have been done ahead of real needs, in order to beat the IET, and there is indirect evidence that borrowers were putting some of the proceeds into Euro-dollar deposits. This indirect evidence is the sharp rise reported by member banks in their balances due to foreign branches, in the four weeks after January 20.

If the United States is to make progress toward the objective of re-establishing the dollar as an unquestioned reserve currency, we will need to reduce the deficit financed by official settlements, as well as the overall deficit, and that means avoiding a drawing down of the large balances which commercial banks abroad have built up in the United States over the past two years. Interest rate tendencies in the Euro-dollar market will have some bearing on the changes in these balances.

Spreads between Euro-dollar rates and U.S. rates on CDs were narrower on the average in 1964 than in earlier years. This was one reason why commercial banks in Europe (including U.S. branches) channeled more than $1 billion of short-term funds to the United States in the 12 months through last January. The inflows were fairly large in March and April of 1964, when CD rates were relatively high; and again in the summer, when the Euro-dollar market was easing off a little. They were largest of all in November, when the sterling crisis broke.

Although the rate spread, as measured by 90-day rates, was smaller on the average in 1964 than in earlier years, it was tending to widen a little as interest rates in most European markets were rising, while ours were fairly stable up to October. Then from October to February (if we make a crude adjustment for seasonal variations) it appears that Euro-dollar rates moved up somewhat less than rates in the United States. I would suggest that among the reasons for this relative ease in the Euro-dollar market from October to mid-February was the feeding of Euro-dollar supplies from two sources. The first source was the movement of private funds out of sterling. The other source, indirectly, was the heavy outflow of U.S. bank credit.

Now that these sources of supply of the Euro-dollar market have lessened (and, perhaps, Canadian banks may be drawing funds out of the market, to meet U.S. corporate withdrawals of funds from Canada), Euro-dollar rates seem for the moment to stand somewhat higher relative to U.S. rates than they did a year ago. While three-month U.S. Treasury bill rates and CD rates in the secondary market are up by about 1/2 per cent and 3/8 per cent, respectively, Euro-dollar 3-month rates are 5/8 per cent above their March 1964 level.

These comparisons remind us that the U.S. policy of the last few years for restraining capital outflows, which focused on gradual changes in money market rates and deposit rates, was deprived of much of its potential effect by the general rise in interest rates in Europe, where monetary authorities have been endeavoring to control inflationary pressures. It seems to me that we are getting closer to the heart of our problem with our new policies of prohibitive taxation of some term loans and of restricting the availability of U.S. bank credit to foreigners. But interest rate differences, both short-term and long-term, may still plague us.

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) Business activity--What are the implications for the sustainability of economic expansion that can be drawn from recent surveys of plans and attitudes and other information with respect to (a) business spending for new plant and equipment and inventory investment; and (b) consumer purchases of autos, other durable goods, and housing?

Recent information on economic activity, including surveys of business and consumer spending plans, suggests that expansion in overall economic activity will continue in the near future, although probably at a more moderate pace than in the first quarter. The evidence is not unambiguous; major questions still relate to the prospects for inventory investment and consumer buying of autos and other goods.

For autos, consumer buying plans suggest a substantial rise in sales from 1964 levels, but nothing like the 20 per cent gain over a year ago shown by the January-February sales figures. It is likely that sales have been above a sustainable rate, partly because of the existence of a backlog of demand built up during the strikes last autumn. In fact, sales of new domestically produced autos in early March declined slightly, in contrast to the normal seasonal rise at this time of year, and the year-to-year gain narrowed abruptly. It is possible that the downward adjustment to a lower (seasonally adjusted) level of new car sales may now be taking place.

The inventory situation, usually difficult to interpret because the statistics are not especially reliable, also continues to be clouded by the effects of past and possible future work stoppages. Accumulation in November and December was exceptionally high. In the current quarter it is likely to continue heavy, despite reports that the high rate of steel use is preventing the desired rate of accumulation, and despite the results of the February survey which indicated that manufacturers expected to add much less to their stocks this quarter than in the final quarter of last year. Part of the current rise in total business inventories is in distributors' stocks, mainly automobile dealers. Even if steel accumulation should begin to taper off soon, as a result of more favorable contract negotiation prospects or the achievement of desired stock levels, it is likely that auto inventories will continue to rise for some time. Dealer stocks are still on the low side--relative to a year ago and relative to sales. The principal threat to sustained activity would come from continuing accumulation of stocks, followed by a concomitant cut-back in steel and auto orders, a possibility for late spring or early summer.

There are other potential inventory problems--in consumer durable goods other than autos, in apparel, and in textiles. Retail sales data for home goods and apparel increased only a little further from the advanced levels reached last autumn, and for major household durable goods reported buying plans were down moderately from a year ago.

Meanwhile, production of home goods and apparel and inventories of these goods held by distributors and manufacturers increased appreciably.

While downward adjustments are in prospect for inventory investment and auto sales, moderate expansion is likely to continue in the rest of the economy. Recent surveys of investment plans and information on new orders for equipment and on construction contract awards all imply continuing growth in business expenditures on new plant and equipment in the near future. Business plans call for steady expansion this year at a pace only moderately less rapid than last year. Continuing expansion into coming months also seems assured for consumer spending on services and State and local government spending on goods and services. The expansionary impact of these outlays is likely to be offset, in part, by a leveling out in residential housing activity. After midyear, additional stimulus to the economy is expected from the proposed increase in social security benefit payments and reductions in excise taxes.

(2) Balance of payments--What indications are there of actual and prospective changes in capital flows to and from the United States since the President's mid-February message on the balance of payments?

Little statistical evidence is yet available on the impact of the President's balance of payments program on outflows of capital from the United States. Data on capital flows in March, the first full month of the program, will not be received for another month.

The fragmentary information available suggests, however, that capital outflows have been reduced in the last month:

(1) a more than seasonal rise in Euro-dollar rates this month, which would be consistent with larger than usual withdrawals of U.S. corporate funds from this market;

(2) a decline of more than 3 cents per ounce in the price of gold in the London market over the past two weeks, possibly reflecting initial effects of the program sufficient to dampen gold speculation;

(3) a general strengthening of the dollar in foreign exchange markets;

(4) weekly payments indicators which, though based on incomplete coverage, show a surplus in the last four weeks as compared with a large deficit for the previous six-week period.

Besides some reflow of liquid funds, there may well have been a reduction in outflows of long-term bank loans to developed countries from the reportedly very heavy rates of the first half of February. More generally, U.S. lenders and investors may have hesitated in their activities pending clarification of the program and its application to them. There have been reports of such an attitude. Also, new commitments on term loans to foreigners dried up after February 10 to less than $100 million (and virtually nil for developed countries) between then and mid-March, as compared with $350 million in the first ten days of February alone. It remains to be seen, however, how much of this seemingly favorable initial response will prove transitory, and what forms and dimensions the ultimate response to the program to limit capital outflows will take.

(3) Bank credit and money--What responses do banks appear to be making to the combination of reduced reserve availability, higher costs of funds, enlarged inflows of time and savings deposits, and strong business loan demands?

Reflecting strong loan demand and somewhat tauter bank reserve availability in recent months, lending terms on business loans have tended to tighten, particularly on interest rates and compensating balances. Early reports on the March lending practices survey indicate that most banks reporting firmer policies in the December survey moved further in that direction in March, and that additional banks were making similar adjustments.

At the same time, net deposit growth has been large, mainly reflecting the acceleration in time and savings deposit inflows in the November-February period. Most of the increased time and savings deposit inflow was in response to general rate increases and the promotion of relatively new instruments, such as savings and investment certificates.

Banks also raised more funds this year than in the early months of other recent years through issuance of CDs, notwithstanding the relatively high rates needed to attract these funds. At New York City banks, outstanding CDs have risen quite steadily, but at outside banks, after rising sharply in January, they subsequently declined. With prime banks recently paying 4-3/8 per cent on 6-month maturities, within 13 basis points of the ceiling, it is possible that some nonprime banks may be encountering difficulties in retaining funds under the revised ceilings.

In addition to meetings strong loan demands, banks inceased their holdings of municipal and agency issues by $1.5 billion over the first two months of 1965. In addition, banks participated heavily in the Treasury's January advance refunding.

With the cost of obtaining funds from the Reserve Banks, in the Federal funds market, and through issuance of CDs appreciably above the bill yield early this year, banks made large reductions in bill holdings in January and early February. Thus, banks have substituted longer-term Government and municipal issues for shorter-term securities in their portfolios and bank liquidity has declined further.

Other adjustments which some larger banks appear to have made in response to the enumerated environmental changes include more aggressive bidding for Federal funds, which has driven the effective rate above the discount rate on several occasions in early March, and efforts to obtain increased correspondent bank participation in broker and other suitable types of loans. Also, excess reserves (seasonally adjusted) have averaged somewhat lower in recent weeks.

(4) Business financing--What do business loan and money market developments up through the March tax date suggest as to the state of corporate liquidity and basic business needs for bank financing?

Available data on business loan and money market developments through the March tax date suggest that while business needs for bank financing continue strong, this apparently has not been associated with any marked deterioration in aggregate corporate liquidity. Perhaps to a greater degree than usual, however, there are striking differences within the business sector; some corporations are borrowing heavily and others are supplying large amounts of short-term funds to the market.

Tax and dividend borrowing was concentrated in the week of March 17, when business loans at New York City banks rose by a record amount, after declining the preceding week. While the net increase over the two weeks combined was not as large as in some earlier years, when corporate tax payments were smaller and a larger volume of tax anticipation securities was outstanding, it followed record expansion in January and February.

A substantial part of the rise in business loans so far this year has reflected special influences, including borrowing for foreign purposes and short-term borrowing by selected industries related to needs arising out of the dock strike and the buildup of steel inventories. Much of the remainder has been in domestic term loans, reflecting in part the continuing upward trend in capital outlays.

Meanwhile, corporate cash flows have increased sharply in the first quarter, particularly in industries operating at peak rates such as autos and steel. The resultant availability of funds from these sectors of the business community has been reflected in continued demand for money market instruments. Thus, the Treasury bill market was unusually firm over the tax period, with yields declining on strong investment demand and light tax-date selling. Dealer bill positions, which usually show an appreciable tax period rise, declined slightly. Banks retained more CD funds than usual over the tax date and finance companies have been finding funds readily available on commercial paper in the 30-89 day maturity range.

(5) Money market and reserve conditions--Assuming a continuation of current monetary policy, what range of money market conditions, interest rates, reserve availability, and reserve utilization by the banking system might prove mutually consistent during coming weeks?

The March dividend and tax dates passed with a surprising lack of money market pressures. While dealer loan rates in New York were on the high side and the Federal funds market was generally taut, Treasury bill rates actually declined during the period, as bill demand was sizable and tax date selling minimal. In the banking system, small net borrowed reserves during the past two statement weeks were accompanied by member bank borrowings averaging just under $400 million.

As to long-term interest rates, the apparent early indications of success for the Administration's balance of payments program have quieted market expectations of a more restrictive general monetary policy, and this changed view has been reflected in the recent advances of Treasury bond prices. Corporate and municipal markets also seem to have stabilized since early March, with good investor reception of the enlarged volume of new offerings.

More uncertainty than usual prevails about the relationship that might obtain in the coming weeks between free reserves and short-term interest rates. Net bank reserve positions have averaged a minus $25 million in the last four weeks--a tauter position than earlier this year--but bill yields have still tended to decline. Some of the downward bill rate pressures of recent days may subsequently abate or even be reversed, with free reserves still remaining within the range of recent weeks. However, it should be noted that we are now entering a period when there is little net seasonal pressure on bill rates one way or the other. Also, further repatriation of liquid funds from abroad would tend to continue downward pressure on domestic money market rates from this source.

If in the weeks ahead it were desired to bring bill yields back closer to the discount rate, it might require persistent net borrowed reserves, perhaps averaging around $50 million. This would be consistent with Federal funds trading principally at 4 per cent, but with frequent transactions at 4-1/8 per cent, and with a continuation of relatively high dealer loan rates; such rates in turn would help to support bill yields. In light of current and prospective saving flows, however, these money market conditions would not likely produce any significant change in long-term rates.

Such money market conditions are likely to be accompanied by a slower expansion in total bank credit than the 12 per cent annual rate in January and February. The margin of short-term funds costs over bill yields should work to dampen total bank credit and deposit expansion, although continuing strength in loan demands may work in the opposite direction. The recent slackening in time deposit growth, and the resumption in money supply expansion, suggest that the initial effects of rate changes under the Regulation Q ceilings have waned. The money supply increased sharply in early March, associated in part with a temporary and unusually large reduction in U.S. Government balances. Further expansion in the demand deposit component of the money supply would be consistent with the money market conditions assumed above, although at a much slower rate than in the first half of March and probably at a rate below the 4 per cent of late summer and fall of 1964.

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:

1. Business Activity. The domestic business situation continues to be very strong, and despite uncertainties--notably with respect to labor negotiations in the steel industry--prospects for a sustained upward movement over the remainder of the year

are good. Industrial production, employment, personal income, and retail sales all rose in February. As expected, both inventory accumulation and heavy sales of new autos are contributing importantly to what seems to be an excellent first quarter; but inventory-sales ratios are still low. The outlook has been strengthened by the latest plant and equipment survey, which suggests that a pattern of upward revisions, similar to that which occurred in 1964, is developing. Further upward revisions could make the 1965 advance even stronger than that of 1964. Unemployment remains in the same general range as in recent months. The mild updrift in industrial wholesale prices that began last fall appears to be persisting.

2. Balance of payments. Although available statistics do not yet fully reflect current trends in our balance of payments, there are several signs that the President's balance of payments program is beginning to have a significant effect on capital flows, especially short-term capital flows. The February deficit was large, inasmuch as the flow-back in the last half of the month failed by a wide margin to equal the outflow earlier in February. Fragmentary data point to surpluses in early March. Sizable repatriation of short-term funds placed abroad by United States corporations is indicated by the very rapid upsurge of Euro-dollar rates, and other foreign short-term interest rates, as well as by the behavior of the exchange markets; and, since February 11, new term loan commitments and drawings of loans to developed countries have been negligible. The initial psychological impact of the program has been substantial, at least in the financial area. We must see to it that it is well sustained.

3. Bank credit and money. Bank credit advanced again at a robust pace in February, led by another very large expansion in business loans; and business loans apparently scored a further sharp gain around the March tax date. In the 14 months ended in February, bank credit increased at an annual rate of 8.6 per cent as against 7.5 per cent a year earlier, and business loans rose at an annual rate of 13.8 per cent, as against 9.5 per cent a year earlier. While there were some special factors at work, including activities in anticipation of the balance of payments program, the main influence at the moment appears to be a strong loan demand generated by rapid economic expansion. Bank loan-deposit ratios generally moved up further during the month, and by

significant margins. The sizable February growth in bank credit was accompanied by an actual decline in the private money supply, while U.S. Government deposits expanded. On the other hand, time deposits posted a near-record expansion. It seems to me that these divergent developments reflect largely a response to the November revision of Regulation Q, as has happened following earlier revisions. Thus the recent performance of the money supply should not be interpreted as evidence of a restrictive monetary policy. Indeed, the staff's memorandum on reserves notes that "...private demand deposits and the money supply as a whole apparently are increasing rapidly in March, reversing the February decline." This points up the danger of attaching excessive importance to short-run changes in the money supply. On balance, the recent record of total bank credit and total bank deposits still suggests to me the desirability of some slow-down.

The repatriation of funds by United States corporations has probably contributed to the decline of several points in U.S. bill rates. This decline has occurred despite a continued firm tone in the money market that has resulted in steady or rising yields on other short-term instruments over the same period, and despite the occurrence of corporate and dividend tax dates that are normally associated with upward pressures on bill yields. There is a risk that a persistent widening of the spread of foreign short-term rates over our bill rate may in time attract a reverse flow of funds that could partly undo the initial favorable effects of the President's program.

Monetary policy. It seems to me that several factors point to the wisdom of some further reduction in reserve availability. These include (1) the desirability of bringing the bill rate back to around 4 per cent, (2) the desirability of moderating the current excessively rapid rate of growth of bank credit, and (3) above all, the need to give stronger backing to the President's program to ensure its longer-run success. The very healthy state of domestic business gives us scope for a further modest policy change without any real risk to the economy. The coming three weeks offer an appropriate time for action, since the need for an even-keel period in connection with the Treasury's May refinancing might interfere with the possibility of a policy change at the April 13 meeting. Also, the recently reported heavy gold

> losses provide a background of some urgency for a modification of policy.
>
> It seems to me that net borrowed reserves might fluctuate generally in a range of zero to $150 million, with the hope that the bill rate might move back close to the discount rate. Since foreign and domestic observers are likely to interpret any action taken now as being aimed mainly at restoring U.S. bill rates, the impact on intermediate and longer-term rates should be small. However, the policy move should be definite enough to signal to the market that a change of atmosphere has occurred.
>
> The wording of the directive should be changed to reflect the recent gold losses and to indicate a moderate change of policy with respect to the rate of expansion of bank credit and with respect to money market conditions. Alternative B would seem quite satisfactory, subject to some minor changes in wording.1/

Mr. Shuford noted that, as had been discussed, economic activity in the nation had been advancing rapidly in recent months. Employment, production, incomes, and sales all had risen significantly. Wholesale prices had moved up over the past six months in contrast to near-stability over the past six years as a whole. In the Eighth District production and employment had been increasing as rapidly, if not more rapidly, than in the rest of the nation.

Mr. Shuford observed that attitude surveys pointed to continued expansion in business plant and equipment expenditures and in outlays for consumer durables; and to a moderation in the rate of inventory growth. Those developments, if attained, appeared to

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1/ The two alternative draft directives prepared by the staff are appended to these minutes as Attachment A.

be consistent with continued economic growth. Businesses had been accumulating inventories at an unusually fast pace and some slowing seemed desirable even though inventories were still low relative to current sales.

Recent developments in foreign exchange and Euro-dollar rates as well as the weekly balance of payments estimates indicated a marked reduction in the outflow of capital since the President's message, Mr. Shuford continued. Foreign loans and investments by banks in the Eighth District were limited, but he had talked with the four banks in the District that reported on Treasury forms. Those banks supported the voluntary foreign credit restraint effort and were cooperating. Reports indicated that there was a somewhat stronger foreign demand for credit, and some foreign borrowers were reported to have contacted a few banks seeking new or increased lines of credit. Thus, there were indications even from interior banks that the program was receiving attention--and perhaps taking hold--but it was too soon to make a reliable evaluation of its effectiveness.

Business loan demand in the District, particularly in St. Louis banks, had been very strong in recent months, Mr. Shuford observed. The net increase in borrowing during the week ended March 17 was greater than normal for that tax period. Bank attitudes in the District with respect to extensions of credit had not changed materially in recent months--at least not quite as much as the green book[1] reported that they had changed in the nation as a whole--but some District banks were firming rates on a selective basis. Corporate holdings of liquid instruments were large, but with the expansion in business investment the demand for credit also was strong.

Assuming no change in policy, as in the fifth question posed by the staff, Mr. Shuford felt that the pattern of money market and reserve conditions that would develop was highly unclear. On balance, however, he thought Federal funds were apt to continue in relatively short supply, with rates at 4 per cent and at times a little above that figure. Short-term bill yields probably would range from their recent levels to slightly below the discount rate, especially if the outflow of capital from the country was limited, and long-term interest rates probably would change little. Free reserves might stay within $50 million of the zero level. With those money market conditions, he would anticipate a continued growth in bank credit and time deposits, although some slowing in time deposit growth might occur as the stimulative effects of the recent change in Regulation Q wore off. Total member bank reserves probably would continue to increase in an irregular fashion. The money supply might be expected to begin rising soon, but at a slower rate than last year; in his opinion that would be desirable at this time.

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

In summary, Mr. Shuford said, he thought the domestic economy was expanding rapidly, and it appeared that the voluntary program was reducing the net capital outflow. The existing conditions in the money market as well as the level of interest rates and growth in bank reserves and money appeared appropriate for the near future in view of the economic situation. He favored no change in policy at this time while the Committee awaited a little better perspective on the national and international situations, and he would not change the discount rate. Alternative A of the staff's drafts for the directive was satisfactory to him.

In a concluding comment, Mr. Shuford referred to Mr. Hayes's observation that even keel requirements might interfere with the possibility of a policy change at the April 13 meeting of the Committee, and noted that he had understood that the Treasury would not be engaging in any substantial financing operations until May.

Mr. Stone indicated that under the present schedule the Treasury would be consulting with its Advisory Committees concerning the May refunding on April 27, and would announce the terms of that operation on April 28, with books open during the following week.

Mr. Bryan observed that the Sixth District's economy was robust. New jobs had kept insured unemployment low and increasing personal income supported a high level of consumer spending. Businesses and consumers had in recent weeks contributed to a strong expansion in bank loans, and modest gains had occurred in the farm sector.

Mr. Bryan said he would attempt brief answers to some of the staff's questions.

1. The surveys seemed to indicate that plant and equipment spending would continue to bolster the economy throughout 1965. Consumers still had strong, if somewhat diminished, buying intentions. By early summer, if not earlier, some downward shift apparently would take place in durable goods inventory buying; but that expectation might be radically altered on the upside by any important tendency to an upward drift in prices. Altogether, he thought that it was too early to make a confident prediction regarding the entirety of 1965. However, barring important strikes, and with an excess of caution, he expected no great slowdown in economic activity in the next three months; and if he were to guess, he would guess that substantially the present level of economic activity would extend much further into 1965.

2. Mr. Bryan said he had little firsthand information on the balance of payments problem and had to accept Secretary Dillon's testimony to the International Finance Subcommittee in which he reported a spectacular decrease in loans to developed countries since February 10.

The voluntary credit restraint program apparently had made many more banks and other businesses aware of reporting requirements than they had been before, Mr. Bryan continued.

Perhaps in a desire to establish as large a base as possible for the 5 per cent limitation, perhaps in a belated accrual of candor, several banks in the District were "finding" new foreign accounts and some apparently were going to start reporting for the first time. That might have the perverse effect of actually increasing recorded short-term outflows temporarily.

Mr. Bryan did not know whether to be alarmed or uneasy, or simply to regard the matter as a normal growth. But according to figures maintained at the Atlanta Bank, the Treasury at some point in early March was short something over $1 billion in foreign currencies. The Federal Reserve System was short about $577 million. Those figures, to his mind at least, indicated how imperative it was that the United States attain a balance in its international payments.

3. Banks obviously had been changing their portfolio mix; but Mr. Bryan was not at all certain that the shift was a result of reduced reserve availability. It seemed to him more nearly the result of higher costs of funds in the Federal funds market, and a recently large inflow of time and savings deposits at higher costs.

4. Business loans at weekly reporting member banks had been exceptionally strong during the first quarter, Mr. Bryan said. Some slowing occurred in the week of March 10, and he was aware that everything could be explained away, but even so the

gain from year-end 1964 amounted to over $1 billion. In the comparable period last year, business loans had declined by $1.3 billion from year-end 1963. In both cases the buildup of such loans in the last quarter of the year had been sharp. Federal funds had been tight during the past three weeks, as pressures on bank reserves had mounted. Although there was considerable lag in the published data, corporate liquidity had continued to decline as working capital expanded. The bulk of increased current assets had gone to increase receivables and inventories. It appeared that in spite of continuing large cash throw-off, business as a whole still required heavy increments of bank credit, especially in time of good or booming business.

The fifth question, Mr. Bryan said, was a jigsaw puzzle, and beyond his capacity. He would have to listen as his colleagues put together an answer.

As for national policy, Mr. Bryan continued, with the exception of the Federal funds rate, Governments had been edging down in yield from recent peaks. He understood that foreign rates in the meantime had been trending upward over the last few months. That divergent development was to be expected as foreign capital markets were thrown back on their own resources and U.S. supplies of capital had to find domestic outlets. Any further divergence of rates would make the voluntary credit restraint program the more difficult.

In addition, Mr. Bryan noted certain reserve figures. Since August of last year, when the Committee was to have a slight change of policy direction, total reserves had increased 5.8 per cent; nonborrowed reserves, 5.4 per cent; required reserves, 5.7 per cent; and required reserves against private deposits, 5.1 per cent. While he could not prove the point, he had the feeling that those reserve increments were well above anything that the economy could long stand without an inflationary evolution. Meanwhile, he could not look with equanimity on price developments--either in wholesale prices or in consumer prices.

Although Mr. Bryan did not advocate a change in discount rates, he believed that in such a situation the Committee had no choice but to proceed to make more of the reserves going into the banking system borrowed reserves rather than provided reserves. Thus he suggested, if reserves were to be measured by a free reserve target, that the Committee retreat to net borrowed reserves averaging about $50 or $60 million over the next three weeks, with a weekly range between $125 million and zero net borrowed.

Mr. Bopp reported that economic activity had stopped increasing every month in the Third District after two years in which consecutive month-to-month rises constituted the predominant pattern. Although unemployment was at relatively low levels compared to earlier years, it no longer was decreasing in most of the District's labor markets. Output measures also reflected the leveling-off process. It was not that a downtrend had begun; rather, the upward movement of economic activity had slowed very substantially.

Mr. Bopp said that he would limit his further remarks primarily to the staff's question on initial responses of banks to the foreign credit restraint program.

In general, the five Philadelphia reserve city banks engaged in foreign lending had been cooperative, despite some questions over interpretation of the guidelines, computation of base figures, and like matters. Although it was too early as yet to get a firm idea of what the future might hold (indeed, base figures had not yet been computed for any of the banks), some straws in the wind were disclosed by a survey completed last week.

First of all, Mr. Bopp remarked, the banks did have working ideas of their base figures; the four largest presently were at 100 per cent or less of their working base. The fifth bank, which was the smallest foreign lender, stood at 108 per cent. Thus, there was room for some expansion within the prescribed limits by Philadelphia banks.

Asked where they expected to be with respect to the 105 per cent limit by July 1, Mr. Bopp continued, four of the banks indicated that commitments now on their books could put them well over the limit (two indicated they could go up to 125 per cent of the base period if all commitments were taken down), but all four were optimistic that they could stay within the limit. The fifth bank, accounting for about 20 per cent of foreign lending, reported that firm commitments and scheduled take-downs would bring it to roughly 110 per cent of the base by July 1. Finally, when asked if any diversion of foreign loan demand was coming their way from New York or elsewhere, three of the banks indicated they had been approached by customers who evidently were finding it difficult to obtain accommodation elsewhere.

Mr. Bopp then turned to national economic developments. The economy continued to be characterized by basic, underlying strength, he said, and there existed an overall margin of unused resources which appeared to be sufficient to meet prospective growth in aggregate demand. However, the economic froth stemming from past and possible future labor problems was creating some industrial imbalances. Nevertheless, he concurred with the opinion that tighter money would be of questionable effectiveness in slowing the present rate of inventory accumulation and, because of time lags inherent in monetary actions, might possibly deter future investment at the precise time when inventory decumulation had become a drag on the economy.

Given the present general stability of industrial prices, the continuing high level of unemployment, and preliminary indications that the President's balance of payments program was beginning to become effective, Mr. Bopp would make no change at this time in the general posture of monetary policy. Accordingly, he favored alternative A for the directive.

Mr. Hickman remarked that as the Committee knew by now, he usually had very strong views on developments and policy. But this was a period of transition, and it was difficult at such times to be certain or to take very strong positions. So far as the statistical record was concerned, business continued at a near-boom level, but logic indicated that some things soon had to begin to slide. Uncertainty also prevailed on the monetary side. Steps had been taken which logically should improve the U.S. balance of payments, but the results thus far were inconclusive.

Auto production and sales had been maintained at extremely high levels, Mr. Hickman observed. Some upward revision of the forecasts for the year might be in order. No one believed, however, that the present pace of production, at an annual rate of close to 10 million cars, could be sustained for long. Perhaps a straw in the wind was the fact that prices of used cars sold at auction had been declining since January.

The steel situation had not changed since the last meeting, Mr. Hickman continued. Ingot output remained at nearly 140 million tons, seasonally adjusted annual rate, but the sharp drop that was expected by all analysts in the industry was still in the cards, although it had been deferred. While labor-management negotiations were making a ponderous beginning, nothing decisive had occurred to clear the air, either as to the prospective date of settlement or its contents.

The staff's answers to the staff's questions seemed to Mr. Hickman to be reasonably complete, but he proposed to express a few independent thoughts. First, recent surveys of business plans and attitudes seemed to him to be more than usually difficult to evaluate; but then he had to confess to a general skepticism regarding the survey technique of economic forecasting. According to the most recent Commerce-SEC survey, plant and equipment expenditures would be up by 12 per cent this year, whereas at the present time a year ago the increase for 1964 had been expected to be 10 per cent. Since actual expenditures in 1964 had exceeded the forecast by 4-1/2 percentage points, one might take the latest reading as bullish if the circularity of the figures was overlooked. Plant and equipment expenditures would rise by more than current projections if business expanded vigorously throughout 1965--but that was precisely the question to be answered.

The latest survey figures on manufacturers' expectations for inventories and sales seemed to be self-contradictory, Mr. Hickman said, and even less reliable than the spending figures. Moreover, the past performance of those figures indicated that they should be used with extreme caution. The latest survey of consumer intentions to purchase cars showed a decline from October, but declines almost always occurred at this time of year. Here again, the evidence was inconclusive.

Secondly, Mr. Hickman continued, it was still much too early to measure the effects of the voluntary credit restraint program, but there were a few signs that suggested ultimate success. The Euro-dollar rate had moved upward more than seasonally from early February to mid-March. In his discussions with bankers throughout the Fourth District, he had been assured that the guidelines would be met to the extent legally possible under existing loan agreements. The stream of new commitments had been curtailed, but almost every bank reported a rise in outstandings under existing agreements. Thus, so far as the banking sector was concerned, things might appear to get worse in a statistical sense before they got better, but the expected outcome was favorable. No figures were available as yet in the District for nonbank financial institutions.

Thirdly, Mr. Hickman said, recent monetary developments were clouded by the fact that the March tax and dividend dates had just been passed; thus the statistics raised more questions than they answered. The domestic money market had not shown the usual pressures associated with March tax and dividend dates, despite the fact that business borrowings at New York banks had risen by a record amount. The reported slowdown in the expansion of time deposits during March was apparently associated with maturing CDs around the tax date. The money supply moved upward in early March, sympathetically with the decline in time deposits and a reduction in the Treasury balance. He did not attach much significance to those developments.

Finally, monetary policy seemed to Mr. Hickman to have been appropriate in the past three weeks, as indeed it had been since the turn of the year. Borrowings had averaged more than $400 million in February, but were a little too low for his taste in early March. At the last meeting, he had recommended a free reserve target of between zero and plus $50 million, but it seemed to him that the Committee should begin to think now of a lower target if the voluntary credit restraint program caused a return flow to New York of funds that would be redundant unless absorbed by System action. As goals for the next three weeks he recommended borrowings of about $400 million, free reserves below the zero line (say, between zero and minus $100 million as a target), a bill rate between 3.95 per cent and 4.05 per cent, and Federal funds at 4 per cent or higher most of the time. He believed the current directive would accommodate the kind of mild tightening he had in mind for the next three weeks, but he would have no objection to alternative B of the staff's drafts, providing the reference to gold was eliminated; if the U.S. could improve its balance of payments, the gold flow would take care of itself.

Mr. Daane said that the direction of his own thinking had been indicated by his earlier question to the Account Manager as to whether there was room for the Committee to firm reserve availability a bit further without creating expectations of a discount rate change or making the present discount rate untenable. If he understood all the nuances of Mr. Brill's analysis, it also led in that direction. In Mr. Daane's judgment the Committee should pay more than lip service to the general proposition that monetary policy was a flexible instrument. One virtue of monetary policy was that in a real sense the Committee was able to shift course at three-week intervals, or even more often if necessary.

For the coming three weeks Mr. Daane was inclined to think in terms of a somewhat lower net borrowed reserve figure.

He did not have an overt move in mind; perhaps $25 or $50 million in addition to the current figure of about $50 million net borrowed reserves would be appropriate operationally. A slight shift of that sort, he thought, would be supportive of the voluntary restraint program. In his opinion it would be premature now to attempt to judge the probable impact of that program, and it certainly was too soon to estimate its effective duration.

Mr. Daane said he had been impressed by comments on the quality of credit he had heard at the American Bankers Association meetings at Princeton last week, although he had not yet been able to assess their full significance. The bankers were almost unanimously of the view that a considerable deterioration in credit quality was both in process and in prospect. The head of one of the largest New York banks had said frankly that his bank was making loans of poor quality. Apparently the deterioration had proceeded further than current statistics indicated.

Mr. Daane continued by observing that he had thought somewhat lower reserve figures could be achieved within the present policy directive, simply by giving the Account Manager somewhat greater leeway to err on the side of tightness, but he would not object to the adoption of either alternative A or B. If alternative B was adopted, however, he would be slightly concerned about one possibility; namely, that if the market came to believe that the System had decided to firm policy again, there might be a general conviction that still further firming was in prospect and, consequently, an undesirably large shift in expectations.

Mr. Mitchell said that he believed that alternative A was appropriate for the directive. He concurred in much of the analysis of the domestic situation offered by Messrs. Bopp and Hickman. It seemed inevitable to him that declines soon would appear in some economic statistics--for example, in the figures for housing, automobiles, and steel--even though total industrial production might be little changed. He would have no objection to increasing domestic short-term interest rates if he thought that would help bring the balance of payments under control, but he did not think that it would. It was desirable, in his judgment, for Euro-dollar rates to rise in order to use the market mechanism to induce central banks in Europe to withdraw their holdings from the U.S. and sell them to their commercial banks to invest in the Euro-dollar market (with the result that U.S. liabilities would be to commercial banks abroad rather than to central banks). A competitive rise in domestic short-term rates might weaken the market incentive to reduce holdings of dollars in the United States given to the central banks by rising Euro-dollar rates. Funds had to be shifted from New York to the Euro-dollar market for the present problem to be solved, and the unwillingness of European central banks to hold dollars had to be faced by relieving them of dollars. An opportunity to get some reluctant holders out of dollars appeared to be opening up as U.S. corporations and banks withdrew from the Euro-dollar market; given some market incentive the gap might be met in part from the deposits in the U.S. of foreign central banks.

Mr. Shepardson said that the oral presentations today and the staff's answers to the questions, as he interpreted them, all indicated a continuing high level of economic activity. There was a possibility of some letdown at a future date as a result of a steel settlement and other factors that had been mentioned, but at present practically all elements seemed to be moving at a high level. The Committee had been concerned because the money supply had not risen over the past few months, but according to the figures for early March it was expanding at a high rate again. The growth rate of money often showed large short-run changes for reasons that apparently were not wholly understood.

Bank credit was expanding at an unduly high rate, Mr. Shepardson continued. That fact, together with the balance of payments problem, led him to conclude that it would be appropriate to move to somewhat firmer conditions. To the extent that the reflow of funds from abroad continued, he noted, there would be additions to the supply of funds to be disposed of domestically.

While Mr. Shepardson favored the type of policy called for in alternative B of the staff's drafts, he thought a different sequence for the statements in the first paragraph would be preferable to improve the emphasis. Also, he would consider it desirable to replace the words "to assure full success of" (the voluntary restraint program) with the words, "to reinforce"; while the Committee could make a contribution to that program, it was not within its capacity to assure its success. Specifically, he proposed the following language for the first paragraph:

> The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy and the continuing need to improve our international balance of payments, as highlighted by the heavy gold outflows in recent months. In this situation, it is the Federal Open Market Committee's current policy to seek to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures while accommodating moderate growth in the reserve base, bank credit, and the money supply.

Mr. Robertson made the following statement:

> Business activity seems to me to be continuing to expand at a rate that does not call for any change in monetary policy. We have two major industries where activity seems unsustainably high--autos and steel. But we also have another industry, housing--every bit as important as these two--where activity ought to be regarded as unsustainably low.
>
> I would no more favor a tighter monetary policy just to damp down autos and steel than I would vote for an easier policy simply in order to bolster housing activity. These special industry developments ought to be allowed to work out their own natural adjustments to changing market conditions, so long as these developments are not so extreme as to upset the whole economy. And, in fact, a few early signs of remedial adjustments in each of these areas can be seen. The economy as a whole meanwhile seems to be resisting the destabilizing pressures from these particular industries very well. Commodity prices continue stable on average, and I gather the outlook for further GNP expansion through the rest of the year is now for a

somewhat steadier and more assured advance than might have been expected a month or two ago. All this adds up, in my mind, to no reason for change in monetary policy for domestic reasons.

On the balance of payments side, signs of the constructive effects of the new program of restraint seem to be multiplying. Now if we can hold firmly to this line for a reasonable period of time, our problem of capital outflows will be very much ameliorated. The implication of this for monetary policy, I believe, is that we should hold our course steady at this juncture--neither tightening to compound the effects of the program, nor easing because of the extent to which our payments problem has been reduced.

I think we need to be very careful, however, to think through what is a monetary policy of "no change." In focusing as much attention on the three-month bill rate as we have in this and recent sessions, we come very close to a "bill rate only" policy. And we ought not to blind our eyes to that fact. Even setting aside long-run considerations of principle, the practical considerations of the moment counsel against "bill rate myopia." Such arguments as have been advanced in the past for special attention to the bill rate have depended importantly, as I understood them, upon two assumptions: (1) that covered differential yields on three-month bills were a good measure of the rate incentives to international capital flows; and (2) that net movements of liquid funds out of the United States were a critical weakness in our payments position.

Whatever merit they may have had in the past, neither of these assumptions is appropriate now. Our technicans have been warning us repeatedly that the covered bill rate differential is inadequate and undependable as a measure of the rate incentive to capital flows, and that is certainly true at the present moment when bill rates in this country are low relative to other money market rates. Second, some reflux now seems to be taking place in liquid funds, which were moved abroad earlier for reason of interest rate differentials. I suspect it is a good deal easier for banks and businesses to decide to move these liquid funds back home than it is to alter longer-run lending, investing and borrowing programs.

I regard bank lending as the critical part of our program, and I think we should be watching very closely those conditions that alter bank willingness to lend. But

> here the bill rate is not the most indicative measure. The most relevant money market conditions to observe are how much banks are being led to borrow at the discount window, and at what rate; the amount of Federal funds available and the prevailing funds rate; what it costs banks to sell certificates of deposit, and how much they are managing to sell; and what banks are moved to charge for whatever dealer lending they are willing to do. It is this whole complex of measures that we should have in mind when we tell the Manager to maintain money market conditions about the same as have prevailed in recent weeks. In point of fact, all these measures <u>except</u> the bill rate have remained firm or even tightened somewhat over the March tax and dividend period. I would not like to see them made tighter, but allowed to range around their late February-early March levels, even if the bill rate by itself sagged a bit more for a time. I would assume all this might involve free reserves fluctuating moderately around zero, but not consistently negative. It is with this understanding that I would vote in favor of the "no change" version of the current directive as drafted by the staff, alternative A.

Mr. Wayne reported that Fifth District business had continued to expand about in line with trends in the nation as a whole. The Reserve Bank's latest survey indicated a further rise in optimism among businessmen and bankers, and manufacturers again reported gains in new orders, shipments, and employment. Most textile and furniture plants continued to push capacity to the limit to meet delivery schedules that extended further into the future than ever before in recent years.

Nationally, Mr. Wayne said, business activity apparently continued at a very fast pace, accompanied by rising optimism on the part of businessmen. To the extent that such spreading optimism colored recent surveys of plans for spending on capital equipment and inventories the latter were suspect as guides for forecasting. Such plans were subject to continous adjustment in the light of business developments. Mr. Holland had suggested a fair degree of stability in the private sector reflecting moderation in inventory and wage policies. The net result was that the surveys gave a fairly strong indication of some increase, especially in the first half of the year, but left much uncertainty as to the amount of the increase.

Several preliminary indications of the effectiveness of the voluntary restraint program on foreign lending were encouraging, Mr. Wayne remarked, and they gained significance because they fitted into a logical pattern of what might have been expected. To some extent, impossible to define, those preliminary developments might have been the natural result of the cessation of the heavy lending which had preceded the inauguration of the program rather than a consequence of the program *per se*. The System should be encouraged by the early results but not enough to reduce its efforts.

In the past three weeks financial markets had been definitely stronger, Mr. Wayne observed. Bill rates had declined, contrary to the normal seasonal pattern, and the tax-exempt market, which recently had been heavily congested, had shown a substantial recovery. While those developments were unfolding here, the voluntary restraint program had brought a definite tightening effect abroad. Interest rates were distinctly higher in Europe and in other parts of the world. As a result, the interest rate differential between the

United States and Europe was now greater than it had been three weeks ago.

Mr. Wayne thought the Committee should continue to support the voluntary restraint program by maintaining firm conditions in the domestic market. That might well require a reserve availability somewhat below the levels of the past two weeks. Conditions in the domestic economy would seem to permit if not to justify such a reduction. The pace of activity in a number of major industries could hardly be described as less than feverish. Those industries included automobiles, steel, textiles, furniture, and aluminum, and perhaps others. The growth in bank loans in the past two months indicated that funds had been readily available to encourage that feverish pace. It appeared to him that the Desk had maintained reserve availability within the range indicated by the Committee at the previous meeting but that rate of availability had not produced the degree of firmness which he understood had been indicated in the directive. Hence, he would favor returning to that degree of firmness by reducing reserve availability. He wished he could agree with Mr. Mitchell, but he felt that a widening of the rate differential between the U.S. and Europe might subject the voluntary program to irresistible pressures and bring it tumbling down like a house of cards.

Alternative B for the directive appeared to Mr. Wayne to express the posture which he considered appropriate.

Mr. Clay remarked that the staff analysis of business activity covered the situation very well and indicated the rather pronounced uncertainties concerning some sectors of the economy. It had to be assumed that the pace of activity in steel and autos was not sustainable and that the recent rate of increase in aggregate economic activity would not continue. Unless offset by significant expansion in other sectors, readjustment in steel and autos could have a pronounced impact upon the overall level of economic activity. The timing of that impact was not clear, and its degree was clouded by both the uncertainty of timing and the question as to whether the readjustments in steel and autos would converge. Those forthcoming developments were destabilizing in nature and could prove dangerous to a continuation of the business upswing at the present advanced stage. However, the underlying trends in the economy were rather reassuring, despite the possibility of an irregular pattern of economic activity over the course of the year.

While preliminary indications as to recent international payments developments probably told little as to the success of the Administration's program, Mr. Clay said, the short-run evidence was on the positive side. Or, to put it another way, it would be discouraging if the new program, the expectations created by it, and the initial financial responses had not made a noticeable mark on the various markets involved. On the other hand, concrete evidence as to the effectiveness of the program was going to require considerably more time to develop.

Tenth District city banks appeared to have responded to the changes in financial environment in much the same way as outlined in the staff comments, Mr. Clay continued. Contrary to much of last year when business loan demand deviated from that in the nation, business loan demand had been strong in District banks this year. Moreover, the expansion had not been confined to primary metals and automobiles, but had been spread throughout the range of business loan categories. Selective interest rate increases had been made in recent months, but it apparently had not been possible for District banks to increase interest rates on loans to national firms with prime credit ratings. The faster pace of time deposit growth following the modification of Regulation Q had slowed down recently at District banks. Portfolios had been readjusted so as to increase holdings of municipal securities and reduce somewhat holdings of Governments, and to lengthen the maturities of the Governments held.

Special factors affecting loan expansion and lack of direct evidence as to the effect of international payments developments complicated the making of a judgment as to monetary policy, Mr. Clay said. Those factors particularly complicated the selection of the targets for monetary policy implementation. In the present state of flux, it would seem logical to him to attempt to maintain policy essentially unchanged, about in line with the decision made at the previous meeting of the Committee. The Treasury bill rate had declined slightly since that time. With the uncertainties involved as to all of the factors impinging on the bill rate, however, it would not seem appropriate to instruct the Manager to reduce credit availability to whatever extent necessary to bring about a 4 per cent bill rate, even though a bill rate approximating the discount rate remained the Committee's goal. While the Committee was not seeking a continuation of the rate of increase in bank credit that had occurred in January and February, that was not likely to continue in view of the slower rate of growth in time and savings deposits. Alternative A of the draft current economic policy directive would fit such a policy prescription, Mr. Clay said. No change should be made in the Federal Reserve Bank discount rate.

Mr. Scanlon turned directly to the staff questions.

1. Economic activity in the Seventh Federal Reserve District continued to rise, he said, paced by autos, steel, and producers' durables. While the outlook for autos and steel continued uncertain, the outlook for machinery and equipment was strong and appeared to be getting stronger. Midwest businessmen were generally optimistic, as were consumers. Some capital expenditure programs of steel and machinery producers were falling behind schedule because of shortages

of skilled workers at both the construction site and the machinery manufacturing plants.

Mr. Scanlon believed those developments were generally consistent with the Board staff's comments on the first question. He detected a somewhat greater feeling of strength in the economy, but that might be because of the importance of the durable goods industries in his District.

2. Mr. Scanlon thought it was too early to get any meaningful fix on the effects of the voluntary restraint program on the balance of payments, but the evidence he had seen and the reactions he had encountered were consistent with the staff statement. Bankers and other businessmen appeared to be taking the program seriously and were reviewing their portfolios to find ways to meet the guidelines. There was concern on the part of some of the banks that the Commerce Department program might be less restrictive and, consequently, less effective than the Federal Reserve program. Those banks that had estimated they were above the target levels as of mid-February now indicated they hoped to be close to target levels by the end of March. As would be expected, those banks which had recently been expanding their foreign business rapidly, especially some of the medium-and small-size banks, had the greatest difficulty in making necessary adjustments.

3. On balance, Mr. Scanlon observed, banks had sold U.S. Government securities and acceptances, had reduced dealer loans,

and had paid somewhat higher rates for time deposits in order to meet loan demands. But they also had added to their municipal and agency securities. Weekly reporting banks in the Seventh District showed a smaller net rise in total credit since the end of January than a year ago, but that might reflect repayments on the unusually large loan increases of the two previous months. Reserve positions of the District's money market banks were more comfortable than he had anticipated.

Considering the large increases in seasonally adjusted reserves and bank credit, as estimated for all member banks for January and February, Mr. Scanlon found it difficult to see how the situation could be described as one of reduced reserve availability. To some extent, higher average borrowings had to represent a substitute for other short-term sources of funds on which rates had risen. At the same time nonborrowed reserves had been increased.

4. Mr. Scanlon said he had nothing to add to the staff's comments on business financing developments in recent weeks except to note that widespread discussion of the balance of payments program might have had some effect on expectations of both borrowers and lenders and thereby tended to boost availability of funds in domestic markets. The strong demand for business loans and the moderate sales of Treasury bills over the tax date appeared to give

conflicting signals with respect to corporate liquidity. He thought it quite likely that more than the usual amount of conflicting indicators might be seen in the weeks ahead as the voluntary restraint program took hold.

5. With respect to money market and reserve conditions, Mr. Scanlon thought that two factors might play an impotant role during the next few weeks. Repatriation of funds in consequence of the balance of payments program might heighten interest in Treasury bills and might exert downward pressures on bill yields. At the same time, the expected cutback in foreign lending combined with the disappearance of such special factors requiring financing as the dock strike might lead to slower growth in loan demand. It seemed to him that the impact of those forces would be for a given level of free reserves to be consistent with both somewhat lower bill rates and a somewhat slower rate of credit expansion than in recent weeks.

Under current conditions, Mr. Scanlon said, he would like to maintain the firm tone in the money market of the past week but he would dislike seeing the bill rate pressed any lower. His feelings regarding policy were similar to those expressed by Mr. Daane; he would not favor overt action today but would like to see firmness maintained, and he judged that that program could be accomplished under alternative A for the directive. By the next meeting, the Committee should have a better opportunity to judge the effects of the voluntary credit restraint program and should have some clarification on the disparity between short-term bill rates and other short-term rates.

Mr. Strothman commented that the Ninth District apparently was about to close its books on a very good first quarter--a quarter marked by a continuing economic expansion and, moreover, a balanced expansion. According to the Reserve Bank's most recent survey, District manufacturers were expecting first-quarter profits and output and, to lesser extent, employment, to be above their fourth-quarter levels. It was quite possible that the increase in profits would be substantial.

Current but fragmentary information suggested that District employment was continuing to grow and that unemployment was continuing to decline, Mr. Strothman said. That was what State employment offices across the District reported. Also, the District "help wanted" index seemed to indicate that demand for labor was up rather sharply.

Mr. Strothman had observed no marked change in prices in the District. Although there were reports of price increases, both for raw materials and finished products, the modal response continued to be "no change."

With respect to factors bearing on future prospects, Mr. Strothman said he had only two comments to make. First, there had been some buildup of inventories among District firms; and second, fragmentary evidence suggested an increase in new orders and in the backlog of orders. The increase in new orders was impressive; the inventory buildup likewise was impressive, but in an undesirable way.

Generally speaking, then, Mr. Strothman concluded, it appeared that the current general economic posture and outlook in the Ninth District were much like those of the nation.

Turning to the financial scene, Mr. Strothman remarked that perhaps he should start by saying that the demand for commercial and industrial loans evidently was still strong. He attributed the strength, at least in part, to the continuing inventory buildup. The mid-February to mid-March increase in commercial and industrial loans for reporting banks had been much greater than seasonal. However, other forms of bank credit had decreased in recent weeks, with the result that total bank credit of reporting banks also had declined sharply, not only on a seasonally adjusted basis but also absolutely. That development reflected the sharp contraseasonal decline in bank deposits, both demand and time, that had occurred in the last few weeks. The decline was particularly reflected in the recent reduction in reporting-bank holdings of short-term Treasury securities. The declines in total credit at reporting banks, and in their demand

and time deposit totals as well, came after increases for all Ninth District banks which persisted from the beginning of the year through mid-February. Only the trend of commercial and industrial loans had continued uninterrupted. When the numbers became available, Mr. Strothman said, it would be interesting to see whether the recent trend-breaking declines also had been experienced by nonreporting banks in the District.

Mr. Swan said that in California and Washington, the only States for which February data were as yet available, agricultural and nonagricultural employment had increased and the unemployment rate had declined--a reversal of the situation in January. The farm labor situation still was quite unsettled, but it could lead to a considerable reduction in truck crop acreage, particularly of tomatoes, and to considerably less credit to finance processing. However, it still was early enough for the situation to change, and exactly what the ultimate outcome would be remained to be seen. As the Committee knew, Secretary of Labor Wirtz was visiting the area now to see whether there should be any change in policy with respect to bracero labor.

In the three weeks ending March 10, Mr. Swan remarked, total credit extended by weekly reporting banks in the District increased. A rise in holdings of other securities more than offset a reduction in holdings of Governments and a substantial decline in loans, including business loans. The business loan decline, which was rather widely distributed and in total about twice that of a year earlier, was in marked contrast to the increase in the rest of the country. Moreover, the increase in holdings of other securities in large measure reflected a special situation involving a substantial purchase of Federal Housing Authority issues by one bank.

Twelfth District banks had not been borrowing heavily from the Reserve Bank, Mr. Swan said. In fact, during the six weeks ending March 17 the District's weekly percentage of national member bank borrowings ranged between 4 to 1 per cent. District banks also had been in the Federal funds market as sellers and had been making advances to security dealers. On the other hand, reports of the banks participating in the business loan survey supported the national indication of some firming in rates and other conditions on loans.

Mr. Swan remarked that he agreed with the staff statement in reply to the first question, that recent information "suggests that expansion in overall economic activity will continue in the near future, although probably at a more moderate pace than in the first quarter." Granting all of the present uncertainties, that seemed to him to be the most reasonable conclusion.

Although there was no conclusive evidence as yet regarding the effectiveness of the voluntary credit restraint program, Mr. Swan said, the Reserve Bank had received every indication of support from member banks in the District. It appeared, however, that most of the District banks would show an increase from the end of January to the end of February in foreign credit extensions and commitments, undoubtedly because of activity in early February. As Mr. Shuford had reported was the case in the Eight District, some banks in the Twelfth District reported calls by some foreign borrowers investigating opportunities for new or increased credit lines.

It seemed to Mr. Swan that, with the business situation strong but, if anything, moderating slightly rather than accelerating, there was no basis in the domestic situation for a firmer policy. Nor did he see any basis for such a policy in the foreign situation, with the voluntary credit restraint program just getting underway and with the early indications that it would be effective. Consequently, he favored no change in policy; he would like to see a continuation of current conditions in short-term markets. The bill rate had been declining recently, but as the Manager had reported there were definite indications of firmness in other money market conditions. He was not particularly concerned about the bill rate decline; he would be concerned if the easing extended throughout the short-term area, but as far as he could see there were no indications of such a development at this point. He was inclined to expect the bill rate trend to reverse, but he would not be concerned if the rate temporarily fell somewhat below its present level and he saw no reason for acting for the specific purpose of raising it. Along with Mr. Robertson, he would hope that current money market conditions could be maintained with free reserves fluctuating around zero.

Mr. Irons reported that most economic conditions in the Eleventh District were strong; although there were minor changes in both directions, business activity was moving within a narrow band at a high level. Employment and industrial production were up a bit, and construction was down, but it was hard to determine in the shortrun how significant such changes were.

At banks, Mr. Irons said, commercial and industrial loans had been strong during the recent period. Among the major loan categories, only construction loans had not increased. Investments were off a bit, with sales of U.S. Governments more than offsetting increases in other investments. Demand deposits were down slightly, but time and savings deposits had shown substantial increases. The positions of banks apparently were a little less liquid than before. Banks were not increasing their borrowings from the Reserve Bank, but they had substantially increased their net purchases of Federal funds. Bankers reported that their rates on loans were edging up on an individual borrower, negotiated basis. He also had heard some general observations to the effect that there was deterioration in the quality of some of the bank credit being extended.

National business conditions also were strong, Mr. Irons continued. There were a number of uncertainties in the picture, but in his judgment the elements of weakness were outweighed by those of strength. Demand was at a high level and industrial production was continuing to rise. Planned plant and equipment expenditures were large. Inventory accumulation had not been quite as great as had been believed, and stock-sales ratios continued low.

Mr. Irons said that the indications for the voluntary credit restraint program seemed favorable both nationally and in the District. He had received unqualified statements of support for the program from the 13 or 14 banks with which he had talked. However, almost all of those banks had asked for additional reporting forms so that they could rework their December figures; it seemed that some loans had been overlooked in the original reports. That introduced a new kind of uncertainty. A week ago he had thought that many of the District's banks were not over the 105 per cent guideline level, but he could not say how the picture would look when the revised forms were received.

Mr. Irons thought that fairly good cases could be made both for maintaining the present posture of policy and for shifting a bit further toward a firmer policy. But the range of difference in the alternatives under discussion seemed to him to be quite small. In view of the many uncertainties in the situation, his inclination at present was to maintain the posture of policy about as it had been during the past three weeks; that, in his judgment, would not be damaging to the international situation or to the domestic economy. He would favor net borrowed reserves in the zero to $50 million range and would not be disturbed if there was some rise in member bank borrowing. He would expect the rate on Federal funds to be at levels of 4 - 4-1/8 per cent. He was not sure what Treasury bill rate would result because of the various factors affecting it at present; while he would prefer no further decline in the bill rate he would not advocate deliberate action to increase it unless greater difficulties developed in the market than there had been in the past three weeks. He would not change the discount rate. It might be possible to continue the current directive--there was something to be said for not changing it--but he had no particular objection to alternative A of the staff's drafts.

Mr. Ellis reported that the New England economy continued to expand steadily as measured by employment, production, and construction data adjusted for seasonal and irregular influences. The newest and strongest evidence of such growth appeared in the results of the Reserve Bank's annual survey of capital spending intentions, which covered a sample of New England manufacturers accounting for one-fifth of the District's manufacturing employment. Tabulations were still incomplete, but present indications were that manufacturers planned to increase capital expenditures in 1965 by about 20 per cent over last year's outlays. As a reference point on accuracy, a similar survey last year suggested a projected 16 per cent increase, while a still imcomplete tabulation indicated that the actual gain in 1964 was a little over 12 per cent.

Turning to the first of the staff's questions, concerning business activity, Mr. Ellis said that he had found Mr. Holland's report today to be highly perceptive, but it was not conclusive with regard to the outlook. Mr. Ellis' own judgment was that economic expansion was likely to be sustained throughout the year with a discernible inventory bulge traceable to the steel wage negotiations.

Mr. Ellis remarked that, even though the staff's answer to the first question asserted that recent survey results "all imply continuing growth" in capital outlays, the capital investment prospects were clouded by conflicting evidence. The National Industrial Conference Board's survey of capital appropriations indicated a decline in appropriations in the fourth quarter of 1964, which suggested an investment slow-down concentrated in the second half of 1965. However, the more recent Commerce-SEC survey offered contradictory evidence of growing investment outlays throughout the year. On balance, Mr. Ellis preferred to rely on the more recent survey, at least until there was further confirmation of the level of appropriations.

Mr. Ellis noted that no solid evidence was available as yet regarding the effect of the balance of payments program on international capital flows. He could offer only the reports of two large insurance companies that they had put a dead halt to all foreign commitments, at least until such time as the outlines of the voluntary credit restraint program became clearer for themselves, for banks, and for corporations. He reported that there was widespread concern about the loopholes that might be found by nonvolunteers or semivolunteers in the program, particularly in the corporate category.

Concerning bank responses to the combination of forces affecting their position, Mr. Ellis reported that District banks were expressing satisfaction bordering on surprise with the strength of business loan demand beyond that traceable to tax borrowing. It was apparent that New England weekly reporting banks had made more substantial shifts in the composition of their loan portfolios in the past year than was true of the national pattern. He judged that that was due to the basic strength of loan demands; business loans had expanded by 14 per cent, real estate loans by 17 per cent, and consumer loans by 11 per cent. All other categories of loans had actually declined at District banks, in contrast to expansions in those categories nationally. In addition to changing the composition of their loans, District banks had moved heavily out of Governments and into municipals.

Mr. Ellis noted that he had been participating in the daily telephone conference calls recently but did not have the explanation for the current "perverse" behavior of money market variables, to use Mr. Stone's term. He suspected that the seeming inconsistencies reflected imperfections in the market. But they might also reflect more basic forces. For example, if it was true that corporations were not sending short-term funds abroad and in some cases were returning them, it was natural to expect them at first to put the funds into short-term Governments, as Mr. Stone had suggested, and for rates on those securities to sag. Later the corporations presumably would spread the funds to other markets. Secondly, the recent high dealer loan rates at New York banks might reflect the distribution of reserves around the country. Member bank borrowings during the past three weeks had averaged about $100 million less than in the preceding three weeks; perhaps that was traceable to the greater availability of reserves away from the money market centers. The dealers were reaching out into the Federal funds market for funds they needed and, while rates on loans at New York banks had risen, dealers were relying less on those banks than earlier.

The impact of the reflow on the bill rate had resulted in a decline of 6-8 basis points since the Committee's previous meeting, Mr. Ellis observed, and the rate was continuing to sag. The existence of apparent inconsistencies in the variables did not relieve the Committee of the need for a choice as to which variables it should lean on most in setting policy for the next three weeks. It was possible that the seeming inconsistency reflected a basic incompatibility between the unrestricted provision of Federal Reserve credit required to hold average net borrowed reserves at the target level and a 4 per cent bill rate. The Committee last had moved from a positive to a negative net reserve position in 1958-59 and the corresponding short-term bill rate then had been 3 per cent. That raised the possibility that the Committee was trying to overdetermine the economic system- to borrow Mr. Brill's phrase--in setting targets with respect to both net reserves and bill rates.

Mr. Ellis said he thought the Committee should avoid the natural tendency to wait another three weeks for vision to clear. He agreed in general with the staff's specifications of the relations that were likely to prove mutually consistent in coming weeks, as given in their answer to the final question. And he agreed with Mr. Hayes' position on policy. In Mr. Ellis' judgment, the Committee should move to soak up some of the repatriated funds to keep domestic credit availability unchanged. He favored an attempt to restore short-term bill rates more nearly to the 4 per cent level.

As a start, he would expect consistently negative reserve positions and would accept net borrowed reserves in the \$50-\$100 million range. He favored alternative B for the directive, and thought Mr. Shepardson's suggestions for revising the first paragraph were good.

Mr. Ellis noted that it had been nearly a year since Mr. Broida's memorandum analyzing the Committee's directives had been prepared. The Committee had made substantial changes in its procedures concerning what had been called "elements 1 and 2" of the directive in the subsequent memoranda from Messrs. Mitchell, Swan, and himself, but it had not yet succeeded in holding a full discussion of elements 3 and 4. He asked whether the Committee would judge it helpful to have the staff again review past progress and present practice, and prepare a new appraisal of the present directive in the light of current needs.

Mr. Wayne commented that the Committee had discussed the matter in question, although it had not reached a conclusion.

Mr. Ellis replied that the Committee had discussed elements 1 and 2 at great length, but he was referring specifically to elements 3 and 4. A general discussion of the desirability of specifying numerical quantities in the directive, as called for in the original proposals for the latter two elements, had been scheduled repeatedly, but review of the minutes of Committee meetings since August 1964 documented the fact that such a discussion had not materialized.

Chairman Martin said he thought Mr. Ellis' suggestion was a good one. There being no objection, it was understood that the staff would proceed with a study along the lines Mr. Ellis had indicated.

Mr. Balderston said that Messrs. Hayes, Bryan, Shepardson, Wayne, and Ellis already had described his own prescription for policy over the next three weeks. Not wishing to repeat the arguments he had advanced at the previous meeting, he would simply remind the Committee that over a four-year period bank credit had been expanding at an annual rate of 8 per cent, and he would reiterate his belief that that rate of expansion was too fast for continued safety. It already had contributed to the outflow of bank funds abroad and perhaps was setting the stage for price advances and other evidences of inflation at home. In this connection, he would commend for the members' reading the Committee's minutes for the year 1957, which he thought they would find of some interest at present.

In his view, Mr. Balderston continued, the Committee had a responsibility to help staunch the hemorrhaging of bank funds by providing such conditions as would give the voluntary restraint program a fighting chance to succeed. In his judgment neither a voluntary restraint program, nor even a harness of selective controls, could be fully effective if the loans and investments of banks continued to rise at such a high rate. To permit the present rate of bank credit expansion to continue would strengthen the pressure to put bank funds to work in the more lush pastures abroad. In his view, if the Committee did not move steadily, although smoothly, toward a slower rate of reserve growth, the System would have failed to support the voluntary restraint program.

Whatever was to be accomplished had to be done now or the chance to help make the program a success would have passed, Mr. Balderston said. Relatively easy reserve availability would so tempt a few individual banks to find loopholes as to provide excuses for others to emulate them. Balancing on the thin edge between the urge for profits and the urge to be patriotic, banks would find adherence to the guidelines much more expedient if the pressure on them to lend and invest was reduced. They would feel such pressure less if more of their reserves were being supplied at their own initiative by discounting instead of at the initiative of the System.

Turning to the domestic scene, Mr. Balderston remarked that there were evidences of an incipient inflationary outburst that should be heeded now while there was time for precautionary measures to function. The index of wholesale prices was 1 per cent higher than the average prevailing in the first nine months of last year; sensitive commodity prices had shown no tendency to recede after the run-up last fall; as Mr. Hersey had reported today, prices of producers' equipment--which was so important in U.S. exports--were 2 per cent higher than 1-1/2 years ago; and the papers daily were citing reports of either price increases or intentions to raise prices for various industrial commodities.

Mr. Balderston urged that the free reserve figure be lowered progressively and gradually during the period when monetary actions could be taken without disturbing Treasury financings. If the System was to readjust its posture during the current calendar year, time was of the essence. The tightening of policy should be gradual enough for the impact upon bill rates to be experimental, but steady enough so that the increase in bank credit was diminished significantly from the 8 per cent rate of the past four years.

To achieve those ends, Mr. Balderston urged further steps now towards firmer money market and reserve availability conditions, with the Desk aiming in the next period at a range for net borrowed reserve of \$50-\$150 million. Such a policy would imply some increase in member bank borrowing from the System. With that policy shift--and he would emphasize that he was calling for a shift rather than an easy continuation of the status quo--the bill rate probably would move above 3.95 per cent and perhaps would penetrate the discount rate. He was willing to pay that price because he thought the Committee would be unable to stop the outflow unless it acted now.

It was true, Mr. Balderston continued, that the Federal Reserve could not by itself bring about equilibrium in the nation's balance of payments. But it was equally true that too long an adherence to a very modest lessening of ease would fall short of the contribution that the System should make. The time to curb the outflow of dollars by reducing the supply of bank credit was now, while the voluntary restraint effort had youthful vigor. In the face of crisis, steady movement in the right direction would seem to be called for; the present was a time of international crisis. For the Committee to resort again to the status quo would verge upon a lack of policy, in his judgment.

Mr. Balderston concluded by noting that he favored alternative B for the directive, with the revisions suggested by Mr. Shepardson.

Chairman Martin said that in view of the lateness of the hour he would confine his comments on the current situation to a few observations. First, this was the only year of the current business expansion in which he had heard no discussion at all of the "February doldrums." He thought that was significant, as an indication of the strength of business conditions. It was necessary, of course, to anticipate a slow-down at some point, since the millennium had not been reached. Secondly, he could not believe that selective controls ever could be effective without some buttressing by general controls. In Chairman Martin's opinion the timing of the Committee's policy actions had been reasonably good.

A majority of the Committee appeared to favor a policy change today, the Chairman noted, but the magnitude of the shift advocated by most was so slight that it was difficult to say whether it would prove significant. To call for a change of about $50 million in free or net borrowed reserves was to attempt to exercise a high degree of precision, and he questioned whether such a change would have any real effect on current conditions in the money markets. Nevertheless, he also favored a slightly firmer policy. He thought the shift should not be large enough to encourage expectations of an immediate increase in the discount rate, nor should it be so slight as to encourage expectations that the Committee was going to ease policy shortly. He was not sure how a change of the indicated magnitude could best be accomplished, but he thought it desirable not to have market expectations get carried overboard in either direction. Suggested alternative B for the directive seemed to come closer to spelling out such a policy than did alternative A, but the Desk probably could operate in the same way under alternative A and still be within the framework of the directive. If the Committee chose alternative B, he would favor the revisions that Mr. Shepardson had suggested.

By a slight firming of posture today, the Chairman continued, the Committee would be indicating that it was willing to buttress the voluntary restraint program by using monetary policy flexibly. At the same time, the flow of savings was so large that there was really little reason for a change in the prime rate by banks. Granting the present lack of meaning of that rate, there was little or no evidence of any conditions in the money markets that would lead to a change. And the flow of savings was such that even with a moderately less easy monetary policy there might be slight reductions in mortgage rates, at the other end of the spectrum. That was an aspect of current conditions in the money and capital markets that made it difficult to use old benchmarks in deciding on policy.

Chairman Martin then referred to Mr. Mitchell's observation that it might be helpful to have a wider spread between interest rates here and abroad, and said that he questioned that conclusion.

Mr. Mitchell replied that he thought the Committee should discuss the question fully some time soon; it was an extremely important issue. He was convinced that it was necessary to do something to reduce foreign central banks' holdings of unwanted dollars, and he felt, as indicated earlier, that a higher Euro-dollar rate and a widened spread between that rate and U.S. short-term rates was one way of accomplishing that objective.

Chairman Martin said he agreed that further discussion of the matter would be desirable at some point.

The Committee then returned to consideration of the directive. After discussion, the Chairman suggested that a vote be taken on a directive with a first paragraph essentially like that proposed by Mr. Shepardson and with a second paragraph taken from alternative B of the staff's drafts.

> Thereupon, upon motion duly made and seconded, 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:

The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy and the continuing need to improve our international balance of payments, as highlighted by heavy gold outflows in recent months. In this situation, it is the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next three weeks shall be conducted with a view to attaining slightly firmer conditions in the money market.

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

It was agreed that the next meeting of the Committee would be held on Tuesday, April 13, 1965, at 9:30 a.m.

The Chairman then noted that tentative plans would call for the two subsequent meetings to be held on May 4 and May 25. The May 4 date, however, conflicted with the Second Meeting of the Governors of Central Banks of the American Continent, to be held in Uruguay during the first week of May. Several members of the Committee and staff were expecting to attend that meeting. Accordingly, it might be best to shift the Committee meeting tentatively planned for May 4 to May 11. After May 11, the Committee could return to its normal schedule, and plan to meet next on May 25. There was agreement with the Chairman's suggestion.

At this point all members of the staff left the meeting, and the Committee went into executive session. Subsequently, the Chairman reported that in the course of the executive session the Committee, upon motion duly made and seconded and by unanimous vote, had accepted the resignation of Mr. Robert W. Stone as Manager of the System Open Market Account, effective as of the close of business March 23, 1965, and had selected Mr. Alan R. Holmes, Vice President of the Federal Reserve Bank of New York, to serve at the pleasure of the Federal Open Market Committee as Manager of the System Open Market Account, effective March 24, 1965, on the understanding that Mr. Holmes' selection was subject to his being satisfactory to the Board of Directors of the Federal Reserve Bank of New York.

Note: Advice subsequently was received that Mr. Holmes was satisfactory to the Board of Directors of the Federal Reserve Bank of New York for service in the capacity indicated.

Thereupon the meeting adjourned.

Ralph A. Young

Secretary

Attachment A

CONFIDENTIAL (FR) March 22, 1965.

Draft Current Economic Policy Directives for Consideration by the Federal Open Market Committee at its Meeting on March 23, 1965

Alternative A (no change in policy)

In light of the economic and financial developments reviewed at this meeting, including the generally strong further expansion of the domestic economy and the continuing need to improve our international balance of payments, it remains the Federal Open Market Committee's current policy to accommodate moderate growth in the reserve base, bank credit, and the money supply. This policy seeks to support fully the national program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures.

To implement this policy, System open market operations over the next three weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Alternative B (slightly firmer policy)

In light of the economic and financial developments reviewed at this meeting, including the generally strong further expansion of the domestic economy and the continuing need to improve our international balance of payments, highlighted by heavy gold outflows in recent months, it remains the Federal Open Market Committee's current policy to accommodate moderate growth in the reserve base, bank credit, and the money supply. This policy seeks to assure full success of the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures.

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