

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington on Tuesday, July 29, 1958, at 10:00 a.m.

PRESENT: Mr. Martin, Chairman  
Mr. Hayes, Vice Chairman  
Mr. Balderston  
Mr. Fulton  
Mr. Irons  
Mr. Leach  
Mr. Mangels  
Mr. Mills  
Mr. Robertson  
Mr. Shepardson  
Mr. Vardaman

Messrs. Erickson, Treiber, Allen, Johns, and  
Deming, Alternate Members of the Federal  
Open Market Committee

Messrs. Bopp, Bryan, and Leedy, Presidents of  
the Federal Reserve Banks of Philadelphia,  
Atlanta, and Kansas City, respectively

Mr. Riefler, Secretary  
Mr. Thurston, Assistant Secretary  
Mr. Solomon, Assistant General Counsel  
Mr. Thomas, Economist  
Messrs. Daane, Hostetler, Marget, Roelse,  
Walker, Wheeler, and Young, Associate  
Economists  
Mr. Rouse, Manager, System Open Market Account  
Mr. Kenyon, Assistant Secretary, Board of  
Governors  
Mr. Koch, Associate Adviser, Division of  
Research and Statistics, Board of  
Governors  
Mr. Keir, Acting Chief, Government Finance  
Section, Division of Research and  
Statistics, Board of Governors  
Mr. Stone, Manager, Securities Department,  
Federal Reserve Bank of New York

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Messrs. Ellis, Jones, and Tow, Vice Presidents of the Federal Reserve Banks of Boston, St. Louis, and Kansas City, respectively; Mr. Baughman, Assistant Vice President, Federal Reserve Bank of Chicago; Messrs. Anderson and Atkinson, Economic Advisers, Federal Reserve Banks of Philadelphia and Atlanta, respectively; and Mr. Litterer, Business Economist, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 8, 1958, were approved.

Before this meeting there had been distributed to the members of the Committee a report prepared at the Federal Reserve Bank of New York covering open market operations during the period July 8 through July 23, 1958, and a supplemental report covering commitments executed July 24 through July 28, 1958. Copies of both reports have been placed in the files of the Federal Open Market Committee.

Reporting on open market operations, Mr. Rouse stated that everyone present had followed market developments with particular interest in recent weeks. The three-week period since the last meeting had opened with a short-lived rally following the Treasury's announcement that it had purchased \$589 million of the 2-5/8 per cent bonds of 1965, \$456 million of which would be retired. This was quickly followed, however, by the news of the Middle East crisis which, together with further evidence of improvement in business conditions, led to substantial price declines heightened by liquidation of speculative positions. Mr. Rouse reported that since the

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last meeting total System purchases of Government securities other than bills amounted to \$1,265 million on a commitment basis. This included \$1,090 million new 1-5/8 per cent certificates on a when-issued basis and \$175 million notes and bonds, of which \$110 million were September rights. The System purchased \$74.5 million bills in the market while an additional \$30 million were taken into the Account on a swap with a foreign account. On the other hand, the System Account made commitments for the redemption or sale of \$704 million bills during the three-week period.

Mr. Rouse went on to say that the money market had been generally easy, although there were one or two days earlier in the period when the Federal funds rate reached 1-5/8 per cent. He stated that the amplified volume of free reserves in the banking system did not seem to make any perceptible difference in market atmosphere during the period. The early reception of the 1-1/2 per cent tax anticipation certificates was satisfactory. There was some feeling at the New York Bank that the rate might be on the low side, but market people seemed to think that the terms were satisfactory.

Mr. Rouse went on to say that the Government securities market had a bad day yesterday, with some issues off as much as 1-1 1/4 points. The offerings, mostly small in size, were largely from speculative sources, but there was a virtual absence of buying. The market declined further in moonlight trading yesterday. Mr. Rouse reported

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that the average issuing rate in yesterday's bill auction was .984 per cent, with the stop-out running to slightly above 1 per cent.

At the request of the Chairman, the Secretary reviewed the telephone meetings of the Committee held during the period from July 15 through July 25, 1958, the minutes of some of which had not yet been distributed. He referred particularly to the action taken on July 18 authorizing the Manager of the System Account to buy for the Account in the open market, without limitation, Government securities in addition to short-term securities, and to the action taken on July 24 terminating that authority. In view of the latter action, he said, the Management of the Account was now operating under the directive issued by the Committee at the meeting on July 8, 1958.

Chairman Martin inquired whether there was any question about the effect of the July 24 action, as stated by the Secretary, and no questions were raised.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions during the period July 8 through July 28, 1958, were approved, ratified, and confirmed.

In supplementation of the staff memorandum distributed under date of July 25, 1958, Mr. Young presented the following statement on the economic situation:

Domestically, springback of economic activity has been impressive, so much so that it now looks as if April will mark the recession trough and May the first month of revival. In industrial countries abroad, the situation looks stronger than earlier reported, with possibility that depressed industries such as steel and textiles now may be a bit on the upgrade.

While Middle East war threats have not resulted in scare inventory buying, according to district reports, shift towards inventory accumulation because of stronger final demands must surely be part of the explanation of recent pickup in output and improvement in the labor market.

For some months, the equity market has reflected investor expectations of inflationary revival. Recent stock price and trading behavior would seem to indicate that latest information on financial factors--the very high current rates of time deposit and monetary expansion, the continued ease of bank reserve positions, the general state of abundant liquidity through the economy, and the Treasury's large deficit--is being interpreted as confirmatory of inflationary expectations. Any other interpretation of recent stock market action is hard to make rational. Second quarter earnings reports for the 214 manufacturing companies so far reporting show combined earnings 38 per cent below the second quarter of 1957 and up only 2 per cent from the first quarter of this year.

As to details:

The preliminary GNP estimate for the second quarter shows modest rise from the first quarter, with about the same rate of inventory liquidation for the two quarters. The estimate of inventory liquidation, in the light of other evidence, looks high so that later downward revision of the inventory liquidation estimate would not be surprising.

Evidence accumulating on industrial production for May and June confirms the broad range of increased output reported at the last meeting. Even equipment and ordnance industries, which had been declining for more than a year, experienced modest rise. Output in consumer lines was at a rate only 5 per cent under a year ago. Output of materials and parts was also up sharply, and farm machinery output rose. New orders for machine tools have edged up in the past sixty days.

It now appears that steel activity and automobile assemblies in July will experience only a seasonal decline. With strength continuing to feature output in many other industries, it seems possible that a further one point rise

in the index of industrial production will be recorded for July.

Latest data on the labor market in May and June also confirm broad strengthening of employment demand. The June rise in unemployment was about seasonal and was mainly accounted for by the addition of students and graduates to the labor force. June unemployment among workers 25 years or more of age stabilized, and long-duration unemployment declined.

In July, initial claims for unemployment have declined further--to about a third ahead of a year ago compared with three-fifths ahead of last year in May and June. Incidentally, the longer hours worked per week in May and June raised sharply average weekly earnings in manufacturing. At \$83.10, June weekly earnings averaged \$2.30 above April and were higher than any month last year.

Construction activity in July is currently estimated to be rising further, with residential up sharply, public construction up some, and industrial construction again down. Contract awards just reported for June show the highest volume recorded for any single month on record--an eighth higher than in May and almost a fifth higher than June a year ago.

In June, one out of three housing starts was governmentally underwritten, compared with one out of six such starts in the first quarter. Requests for FHA and VA appraisals are still rising in July. Mortgage funds now are reported to be generally available for FHA financing and available in about half of the metropolitan areas for VA financing. Dwindling in mortgage rates has apparently halted temporarily, but the wider gap between bond and mortgage yields established early in the year still prevails, making mortgages very attractive to lenders.

Personal income, which at \$352 billion in June was about back to the level of last August, is confidently estimated to be rising further in July. This July rise is reflecting the pay raise for Federal employees, with full impact of the retroactive increase, plus additional benefits to unemployed workers under the Temporary Unemployment Compensation Act, plus higher wage payments generally for more hours worked and more employed workers.

Department store sales, seasonally adjusted, hit their recession low in February. Subsequently, they have risen steeply. The preliminary level estimated for July puts department store sales about one per cent higher than a year ago.

Automobile sales in the first twenty days of July were clearly improved from the first twenty days of June, running

a fifth under last year compared with over a fourth less in the first six months. With dealer stocks further reduced about 20,000 units, manufacturers have raised somewhat their production schedules for July.

Consumer instalment credit, from preliminary indications, continued to liquidate in June, though at a somewhat slower rate, again mainly due to a reduced origination of new car paper in automobile financing. Repossession and delinquency rates, though higher than a year ago, have shown persistent downdrift in recent months.

The decline in foreign demand for American exports has apparently leveled off, and perhaps demand has revived moderately. Figures for May, the latest month for which a report is at hand, show fairly consistent marks of pickup. Meanwhile, American import demands apparently continue to hold steady.

Crop prospects continue to indicate a harvest equal to peak years. Net farm income for the first six months was the highest since 1953 and over a fifth ahead of the first half of last year.

Average wholesale prices have risen half a per cent since mid-June, wiping out the decline from the March peak. Especially important in the recent rise has been the advance in prices of industrial materials. Price increases have occurred for scrap metals, copper, tin, rubber, wool and cotton textiles, hides, plywood, coal, and fuel oils. The average of finished goods prices has apparently held stable; one noteworthy price advance, however, was a 3 per cent increase for automobile tires. Farm prices since mid-June have experienced some decline but less than in the preceding month. The decline this past month has reflected lower prices for livestock and some further decline in fresh fruit and vegetable prices, offset by a modest advance in grain prices.

Average consumer prices rose fractionally again in June. The further rise was accounted for entirely by a moderate further advance in price for services. The July index of consumer prices is expected to show little change from June.

Abroad, in Western Europe, there has evidently been some decline in industrial activity from the first to the second quarter, mainly reflecting liquidation of steel and textile inventories. With other demands holding up, there is now more optimism with respect to activity over the balance of the year. In Canada and Japan, activity in recent months has been showing moderate rise. Elsewhere the situation is

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not apparently worsening, except financially; inflationary problems of many development and material areas continue to be acute.

Mr. Thomas made the following statement with regard to financial developments:

During the past two weeks System operations have been largely concerned with techniques of market manipulation at the sacrifice of the objective aims of adjusting monetary availability to current economic needs. Whether and how these operations might have been avoided present questions of judgment and opinion to which there are no precise answers. The important problem now is how to return to operations directed toward the major objectives of System policy.

The principal reasons for the weakness in Treasury bond prices, which occasioned the support action, are varied but fairly clear. They include: the technical position of the market resulting from the large build-up of speculative positions in bonds by temporary holders led on by expectations of continued declines in interest rates, the large volume of Treasury borrowing in prospect for coming months, the growing feeling that incipient economic recovery will be accompanied by rising interest rates; and finally the uncertainties arising from mid-East difficulties.

The middle two of these factors--economic recovery and heavy Treasury borrowing--are likely to be continuing influences for many months ahead. Their conjuncture presents problems for Federal Reserve policies. The task before this Committee is to adjust its policies to deal with these forces. They will presumably bring about expansion in credit demands. Unless these demands are met from current savings or existing liquidity, there will be pressure for increased bank credit and also for rising interest rates. Any attempt to keep interest rates from rising would hamper the allocation processes of credit markets and interfere with the use of existing savings to meet credit demands. It would also cause an expansion in bank credit and in the money supply that would sooner or later become inflationary. Interest rates should be permitted to adjust to market forces, with no more expansion in bank reserves than is needed for sustained economic growth without inflation.

Under pressures that have already developed, bond yields have risen sharply since mid-June. Long-term Government bonds rose from an average of 3.14 per cent to 3.40 per cent, and Treasury issues maturing in three to five years rose from 2.14 per cent to over 2.50 per cent. Outstanding high-grade corporate bonds rose more moderately from 3.56 to 3.70 per cent. Offering yields on new issues have had to be raised. Bond yields are higher than at any time this year and are generally above yields that prevailed prior to late 1956. Short-term rates have fluctuated somewhat but those on Treasury bills have continued at a low level as investors have sought liquidity. Coupon rates on recent new short-term Treasury issues have been higher than the 1-1/4 per cent rate on the June offering.

Current estimates of Treasury borrowing needs, after allowance for market support operations and actual and prospective attrition, indicate borrowing of \$9 billion or more by the end of December. These can be covered by the \$3.5 billion tax certificates now being offered, by an additional \$3 billion of borrowing around mid-October, by an increase of \$100 million each in ten of the weekly bill issues at some time during the autumn, and possibly by another cash offering of some \$2 billion in December. This volume of borrowing, together with a reduction of about \$4.5 billion in the Treasury's cash balance, would cover a half-year cash deficit of \$10 billion and cash redemption of outstanding debt of about \$4 billion (including some agency issues).

It is estimated that even with an economic recovery equalling that of 1954-55, the Treasury's cash deficit for this fiscal year as a whole would be around \$9 billion, but a higher figure is likely. To cover debt retirement that will occur in the last half of the fiscal year substantial additional cash borrowing would be necessary in that period. Assuming a reduction of about \$5 billion in the exceptionally large cash balance of the Treasury at the beginning of the fiscal year, the net increase in the public debt both for the first half and for the fiscal year as a whole would be about \$5 billion. The absorption of this amount of securities by investors should not be an insurmountable obstacle, although the flotation of perhaps as much as \$18 billion of new issues in the course of the year presents formidable problems.

The striking development of this year has been the continued large demands on the capital market by business

corporations, as well as by State and local governments. New corporate issues in July, swelled by the U. S. Steel Corporation \$300 million offering, amounted to about \$1,150 million, an amount exceeded in only three months of the past two years. Offerings by State and local governments, at \$575 million, were larger than had been expected, although less than in several earlier months of the year. These various issues have been successfully floated notwithstanding unsettlement in the Government securities markets, but yields have been higher than earlier in the year.

Calendars of new issues for August are light, as is generally the case in that month. With capital expenditures continuing to decline in the months ahead, corporate borrowing should decline, and corporations might also be able to rebuild their liquidity.

Common stock prices have risen to new high levels for the year and are only moderately below the peak of a year ago, with trading volume heavy, despite reports of declining corporate earnings. There has been a moderate increase in stock market credit.

Total loans and investments at city banks declined by nearly \$2 billion in the four weeks ending July 23, following an increase of \$3.7 billion in the preceding four weeks. The substantial net increase for the eight weeks compares with no net change in the same period last year. In July of this year banks showed declines in their loans on securities and their holdings of securities, which had increased even more sharply in June. The July decline in business loans exceeded the moderate June increase, in contrast to last year when the July decline was much less than the sharp expansion in June.

U. S. Government deposits at city banks declined in the four weeks ending July 23 by nearly \$4 billion, slightly exceeding the increase of the preceding four weeks. At least half of the funds thus distributed were apparently used for reduction of bank credit and some went into the build-up of other deposits. Demand deposits adjusted, which had shown little change in June, increased by over \$1.1 billion in the past four weeks, in contrast to a small decline in the same period last year. Last year in July there was a much greater than seasonal increase in demand deposits, but most of it occurred at banks outside leading cities. Presumably the increase for all banks in July this year will exceed that of last year. This would raise the seasonally-adjusted figure of the money supply above the peak reached a year ago.

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Interbank deposits at city banks have increased somewhat more so far in July than they did in the same period last year, indicating some accumulation of funds by nonreporting banks. The recent growth in time deposits practically ended in July.

Member bank reserve needs declined in July as a result of a \$360 million decrease in required reserves and a small decline in currency in circulation. Both of these decreases were somewhat less than had been projected on the basis of the usual seasonal pattern, reflecting the previously mentioned seasonally adjusted increase in the money supply. Reserves were absorbed by a reduction of close to \$400 million in the System portfolio and by a further gold outflow of a little over \$100 million. The gold outflow has slackened compared with previous months, while foreigners have increased somewhat their dollar assets. Weekly average free reserves moved within a range of \$450 million to \$700 million. They are expected to average about \$500 million in the current statement week.

Next week, reserves will be supplied by System payment for the new certificates and released by a decrease in required reserves resulting from a continued drop in Treasury tax and loan balances. Allowing for a runoff in System holdings of this week's bill maturities (not included in estimates shown in the table) and other factors absorbing reserves, free reserves may average close to \$1.2 billion, in the absence of further System operations. They will be reduced next week by over \$200 million as a result of a required reserve rise resulting from the Treasury cash financing, partly offset by other factors. If System holdings of bills are reduced, free reserves might decline to about \$800 million. Assuming usual seasonal changes in monetary demands without expansion, a further moderate outflow of gold, and some further Treasury cash financing, free reserves would be likely to continue close to or above \$700 million until late in October.

In order to avoid an undue expansion of bank credit, greater restraint than that would presumably be required. To reduce free reserves below the \$500 million level would call for sales of about \$300 million of bills in addition to redeeming System holdings of regular maturities this week and next.

With the level of reserves prevailing and the large volume of cash redemptions of recent maturing Treasury

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securities, funds should be available in the money market to absorb such a reduction in the System's portfolio, as well as to take on the new Treasury offer of tax anticipation certificates. The delicate question is what might be the effect of such operations upon a bond market that is in the process of adjusting to an expected and probably inevitable higher level of interest rates. It is possible that any attempt to retard this adjustment by support operations may only make it more severe in the end.

Chairman Martin noted that the next regular meeting of the Committee was scheduled for Tuesday, August 19. In looking back, he thought it was a good thing that the policy directive was not changed at the meeting three weeks ago. However, he hoped that each person in his remarks today would direct attention to clause (b) of the directive. The Treasury offering would be over tonight, and the Treasury then would be out of the market for about two months. Therefore, it seemed advisable in the discussion today to consider what should be done to meet the situation. For clause (b) of the directive, the Secretary had suggested "to recapturing redundant reserves," while he (Chairman Martin) had in mind "to absorbing reserves whenever consistent with an orderly market." While he did not feel that there should be any dramatic change in the directive, the words "to contributing further by monetary ease" seemed to him to be inappropriate at this time.

The Chairman then turned to Mr. Hayes, who presented the following statement of his views on the business outlook and credit policy:

Both current statistical data and the recent improvement in business sentiment suggest that an uptrend in economic activity may now be under way. Considerable doubt remains, however, as to whether expansionary forces will gather much momentum before autumn and whether the recovery will be vigorous enough to result in a satisfactory rate of utilization of labor and plant capacity by the year-end or even in early 1959.

The crisis in the Middle East has injected major new uncertainties into the outlook, and we cannot ignore the possibility that it may trigger a strongly inflationary trend. So far, however, there is fortunately no convincing indication of such a development. The initial speculative flurry in the commodity markets accompanying the outbreak of the crisis appears to have lost most of its steam, and informal inquiries we have made provide no evidence at all of a rush toward precautionary buying on the part of either business firms or consumers. We discussed this point at last week's directors meeting, and the above view was confirmed unanimously. I might add, just as a matter of interest, that our directors expressed the hope that direct price and wage controls would be initiated immediately if our forces should become involved in actual fighting in the Middle East, in order to avoid the kind of price movement which we experienced in the Korea crisis.

It does seem likely that at a minimum the heightened international tensions will lead to widespread reconsideration of inventory policies both because of greater emphasis on the need for ample supplies in the event of a sudden emergency and because of greater expectation that price increases may now be effected more readily than had previously been considered likely, with the Middle East crisis serving as a catalyst. In my view, slackening in the rate of inventory liquidation has probably already been a major cause of the upturn in business to date, together with some improvement in final demand, and this trend may be expected to continue.

The recent gains in gross national product, industrial production, employment and average hours worked are encouraging, as are the pronounced upswing in housing starts, the increase in defense orders, and the demonstrated stability of consumer spending, which should continue to make a good showing under the influence of rising personal income and somewhat more optimistic consumer attitudes. Reports that the decline in corporate profits may have

been slowed or even reversed in the second quarter may have encouraging longer-run implications with respect to plant and equipment spending programs.

On the other hand, I still feel some concern over the probability that even a rather substantial advance in over-all business activity during the remainder of the year could still leave a relatively high level of unemployment if "latent" productivity gains built into the economy as a result of the recent investment boom are translated into actual gains as the rate of plant utilization rises. There is also a possibility that, in the absence of any sharp forward push in major areas of final demand, the upswing might lose its momentum after a few months and thus fail to maintain sound recovery.

The current cash financing of the Treasury is somewhat larger than had been expected before it became clear that an abnormally high attrition in the recent refunding was inevitable. I must confess that I have some qualms as to the rate which has been set for the new tax certificates, as it seems to be uncomfortably close to the market, whereas some leeway would have seemed desirable in view of the experience with the refunding. At least it is a satisfaction to know that the Treasury should now be out of the market until October. It is also good to know that the Treasury is moving now to obtain a more realistic debt ceiling which should prevent a recurrence of last fall's artificial Treasury financing problems.

In the area of bank credit, the four weeks to July 16 witnessed a sharp reduction in loans and investments--equivalent to something less than half of the increase of the preceding four weeks. According to our estimates, the seasonally adjusted money supply at the end of June, although showing an annual rate of increase of 2.7 per cent over the December figure, was still \$1 billion below the peak of last summer. But, with the prospect that the banks will be called on to finance the major portion of the Treasury's deficit in the second half of the year, and after allowing for seasonal loan expansion, the seasonally adjusted money supply may increase rapidly during the latter half of the year. However, if we view this in longer perspective, the growth in money supply for the four years 1955-58, even with an increase of, say, 6 per cent this year, would average a little over 2 per cent per annum, which does not appear unreasonable.

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As for policy, the growing evidence of business improvement, together with the possibility that the degree of ease prevailing in recent months might produce a very rapid expansion in bank credit and the money supply, raises the question whether we should consider some modification of this degree of ease. My view, however, is that there will be time to consider such a move after an additional month or two of observation, which might permit a better appraisal both of the vigor of the recovery and of the danger of a crisis-induced inflationary trend. In the meantime, we should probably be content to restore free reserves to about the level of \$500 million prevailing up to the time of the recent Treasury refunding. (Parenthetically, I might say that while the figures are distorted and we are prospectively running way above that this week, I do not think that in terms of actual atmosphere there has been any material change from the degree of ease prevailing before the recent upset market.) This will undoubtedly call for some outright sales in addition to bill runoffs, and besides bills it may prove useful to sell some of the System Account's certificates to help meet this need without unduly depleting our bill holdings. At the same time we cannot overlook the fact that the Government securities market is understandably still in a very uneasy state, based in good part on fears of a change in monetary policy, and that we may conceivably be faced with a recurrence of disorderly conditions in the coming weeks.

Furthermore, I am troubled by the thought that the rise in bond yields may conceivably have carried far enough to constitute a threat to the recovery process. It seems to me that we should resist any further deterioration in the capital markets and do what we can to promote stability and eventual strengthening of these markets. Admittedly I am puzzled as to how this can best be done.

Under these circumstances, and especially in view of today's Treasury cash offering, I would prefer at this time not to alter the directive by eliminating the word "further" from the phrase "contributing further by monetary ease to resumption of stable growth of the economy"--although it may be well to do so or to make some other change in wording at an early subsequent meeting. I would therefore feel inclined not to adopt the wording that has been proposed by the Secretary. Believing as I do that we should avoid at this time even any suggestion that we may contemplate a change in basic policy, I would be opposed to a change in discount rates. Although the recent growth in stock market credit suggests that it would be well to keep this area under close surveillance, the growth has not been of such

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magnitude as to provide justification at this point for considering higher stock margin requirements. Finally, in view of the continued unsettled conditions in the U. S. Government securities market and the delicate international situation, I think it would be unwise to make any public statement indicating termination of the instructions, publicly announced on July 18, by the Committee to the Manager of the Account to purchase Government securities in addition to short-term Government securities.

Mr. Johns said that although there appeared to be evidence, perhaps convincing evidence, that some improvement in business had occurred, was occurring, and might continue to occur, he had not yet been able to reach the conclusion that the time to indicate a change in policy--at least a radical change in policy--had arrived. Although it would appear that reserve projections were much higher than would have been the case except for the events of the last ten days--perhaps higher than the Committee would like them to be-- he had the feeling that rapid steps to absorb redundant reserves--assuming that anyone knew how many were redundant--might be misconstrued. It was his feeling that, at least for a while, the toleration of some redundant reserves might not be harmful, and therefore he would be inclined to move cautiously rather than precipitately.

Mr. Johns said that he had not come to this meeting prepared to argue for a change in the directive and that, for reasons which he was not able to state clearly, he felt unsatisfied with the suggestion that the Committee merely say in clause (b) that operations were going to be conducted with a view toward absorbing redundant

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reserves. Instead of language along these lines, he would prefer to leave the directive about as it stood. He would be a little more inclined than Mr. Hayes to argue for a change in margin requirements. Although some might say that the increase in stock market credit outstanding was not unduly large, it was continuing and had been going on for some time. In the circumstances it might be that the Board could appropriately conclude that it should attempt to slow down the utilization of credit for that purpose.

Mr. Bryan made substantially the following statement:

Economic statistics in the Sixth District give an increasingly clear picture of economic recovery. It is our judgment that national economic statistics also give the same increasingly clear picture.

The matter of overshadowing importance at this time, however, seems to be the extremely grave problem of managing monetary policy and Government finance. It is my own judgment that it would be only the slightest exaggeration to say that we face in monetary policy and national finance a situation of approaching crisis. This situation is compounded of a number of elements, all of them tending to be cumulative rather than self-cancelling.

1. Economic recovery is obviously in process. The process will be stimulated in the next several months as Government spending from deficit finance is piled on top of a natural economic recovery and the Government deficits appear as private deposits available for expenditure. The process of economic recovery, in the light of recent history, creates the expectation of an upward adjustment in interest rates.

2. The natural adjustment of interest rates upward is compounded by a genuine loss of confidence in the future integrity of the dollar as a store of value. There has been continuous, pervasive, and increasingly convincing propaganda to the effect that inflation is inevitable. That propaganda now carries almost universal conviction. Such an almost universal conviction means that the increase of yields on fixed income obligations is destined to be greater than would

be likely as an uncomplicated response to economic recovery.

3. The problem of yields on fixed income obligations is increased by the fact that the banking system has intended to use its increased security holdings and security loans, on some timely occasion, to provide the cash requisite to the acquisition of higher yielding loans. The same is true in varying degree of other investors and investing institutions. This means that we are likely to face a continuing, though probably irregular, attempted liquidation of Government securities from these sources in the next several months.

4. The normal liquidation for the purpose of using fixed income securities as a source of cash has been increased by the revulsion in Government security prices. The revulsion itself has created in both the banking and nonbanking groups a large number of unwilling holders of Government and other fixed income securities.

5. The perversity of markets being what it is, the prospective increase in yields is likely to have the effect of hastening and of increasing fixed income offerings as borrowers endeavor to advantage themselves by getting ahead of anticipated increases in yields.

6. The sophisticated investment public has been shocked by an ill-considered Treasury support operation in the 2-5/8s. The sophisticated investing community has been even more shocked by the System's operation that began on the presumption of correcting disorder but that turned promptly into one of the most massive support operations ever undertaken. The shock has been the greater because the support operation has been so resounding a failure and because it seems to forecast the use of the Federal as a complaisant medium of inflation.

We will be well advised in such a situation, I think, not to be deceived by the possibility of temporary rallies or the assurances of bond dealers or possibly institutional investors. The wound to confidence in my opinion goes too deep for simple reassurance or for cure by exhortation.

We will do better to listen to the investor who says, "I intend to get out of bonds on the first rally but think I am foolish. I'd probably better dump my bonds now.".. to the investment house that says, "Bonds are out the window for anyone who wants to keep his money"....to the banker who says, "I used to think there was some hope of stopping inflation. Now, I guess there really isn't a chance...."

These are just overheard by chance in a single minor town, Atlanta.

What I am trying to say in listing the foregoing points is that, in my judgment, we are facing a very real deterioration of confidence, approaching crisis proportions within the foreseeable future. Under such circumstances, the fundamental problem, both for the System and the Treasury, is the restoration of confidence in the future of the dollar. This will not be easily accomplished, but all other monetary and economic problems pale into insignificance.

In approaching the solution to the problem a recognition must be had of certain points:

a) We face the real possibility of a radical adjustment of interest rates upward, the more particularly in the longer sectors of the market, and more or less despite anything that the System can do about it. If this be considered an alarmist possibility, we should ask ourselves, "Who wants a long bond, or even an intermediate obligation, if he is convinced that inflation is a continuing certainty?" If it be believed that we can stop the adjustment by supplying unlimited reserves to the banking system, then we should recall that the investment community and a considerable segment of the public at large is now sufficiently sophisticated to realize that our action simply makes inflation the more certain, so that, by an unlimited supply of reserves in an effort to prevent the upward adjustment of yields, we confront ourselves with the probability of a perverse effect, our very action increasing the severity of the adjustment apparently in the making.

b) We should also recognize that if we stand in the way of the market, whether on the theory of nudging or probing or on the basis of some preconceived yield, or in an effort, sincere though mistaken, to do the Treasury a favor, we are likely to wind up by monetizing a considerable fraction of the public debt and, as said, making the revulsion against fixed income obligations, now a probability, practically a certainty.

c) The Treasury is under the necessity of getting the national finances in order. A deficit of insignificant proportions, when related to the gross national product and, indeed, even desirable as an encouragement to economic recovery, now contains the seeds of disaster when considered in the light of what I would call a rapidly developing confidence crisis.

Now we have the question of what can be done. I think that the first step to take is to resolve that we will not

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stand in the way of yield readjustments. The faster those come the better. We should assist them by getting free reserves below \$500 million and getting them there promptly. Also, at some opportune time the public should be reassured that the System is not going to be an engine of inflation. I do not quite know how you give that assurance except to increase the discount rate at the first opportunity. These steps all entail risks, risks that none of us would have imagined three weeks ago but which must be accepted in order to avoid greater risks. That we are compelled to accept them is the consequence of recent events and recent policy.

I am in favor of changing the directive.

Mr. Bopp made substantially the following statement:

In general, business developments in the Third District continue to show some improvement. There has been a marked change to a more optimistic attitude toward the business outlook. Businessmen report that inventory liquidation has been mostly completed and that employment prospects are improving slowly.

The Mideast crisis is reported to have had practically no effect as yet. Businessmen indicate no moves to restock, and there is no evidence of anticipatory spending by consumers. There are reports that labor unions, with contracts coming up for renegotiation, would like to delay such negotiations until the foreign situation clarifies.

Several problems confront the System in the realm of monetary policy. The immediate problem is to work down the level of free reserves, now projected at nearly \$1.2 billion for the week ending August 6, to a more appropriate level. This requires either liquidation of earning assets or an increase in nonreserve liabilities.

Substantial liquidation of bills should be pursued even though the yields might rise to, say, 1-1/4 per cent so long as this does not unsettle the money and capital markets unduly. At the same time it would seem appropriate to attempt to negotiate with the Treasury an increase in its balance at the Reserve Banks to absorb reserves for a temporary period as needed. The inherent merit of this move is reinforced by the fact that the excess reserves were created in support of the Treasury financing.

An even more difficult problem, though not perhaps as urgent, is whether operations outside the short-term market should be limited to purchases and thus become a one-way

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street. If so, over time we will tie up more and more of our resources and thus reduce our ability to restrict. The portfolio of short securities sets the limit to the amount of reserves that can be absorbed through their liquidation. Although the System is not near that limit at the moment, it might be well to consider the possibilities of liquidating other than the shortest issues on appropriate occasions, as in periods of restraint, rather than defer such liquidation until the portfolio of bills has been exhausted.

With regard to the directive, I would be in favor of a change of the general type mentioned by Chairman Martin, that is, to absorb reserves consistent with an orderly market.

Mr. Fulton reported that in the Fourth District there seemed to be a change in sentiment, a feeling that the last quarter of the year would be materially better than the present level of activity. The steel industry, he said, was reporting a better July than it had at first anticipated, with some orders coming in for August and September delivery, particularly in the automotive field. It was reported that all segments of users were buying some steel, mostly as the result of over-liquidation of inventories. However, unemployment was not being relieved to the extent that the increase in activity would seem to warrant. It would seem that there had been some additions to productivity and, as Mr. Hayes had said, the unemployment figures might be something to conjure with for some time. Capital investments, it seemed, were not going to take the same number of men as heretofore.

Mr. Fulton said he agreed that the open market operation in which the System had just participated was a saving one--or designed

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to be to some extent a saving one--for the Treasury. To retain in the System Account indefinitely the securities which had been purchased would deprive the System of a flexibility that it needed. Therefore, he would favor running off those issues, or other issues in the short-term sector, and he felt that those in the market would understand such an operation. Inasmuch as the Committee had announced that the System was going into the market for a definite purpose, there should be no one-way street and the System should have the right to come out again.

Mr. Fulton said he concurred in the feeling that the increase in stock market credit had been very substantial and that an upward revision in margin requirements might be appropriate. It would have a sobering effect on the gyrations of the stock market and it would have a salutary effect on the long-term end of the bond market.

Mr. Fulton went on to say that the System should absorb the large accumulation of reserves in the banks as rapidly as possible without upsetting the market. They might be dormant at present because of the rapidity with which they were created, but they would not stay that way very long and System operations therefore should be aimed at reducing them very materially.

Mr. Fulton said he thought it would be appropriate to change the policy directive, possibly along the lines of some of the directives that the Committee had issued at times in the past which

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indicated a desire to sustain growth in the economy without encouraging inflationary influences.

Mr. Shepardson said that Mr. Bryan had stated eloquently his own feeling about the present situation. As far as the general economy was concerned, he thought that there had been clear evidence of some change in direction. While one could not yet say that developments were reaching an explosive point on the upside, the evidence of a change in the offing had exerted an effect on the total market situation. With respect to the exercise that the System had gone through during the past several days, he did not understand at the time, and he still did not see, to what extent the System had helped. However, regardless of the effect of the Treasury financing the operation had put the System in a position from which it must extricate itself as promptly as possible.

Mr. Shepardson said that he saw a great deal in Mr. Bryan's thesis of a loss of confidence. When the economy moved into a downturn, the System had moved aggressively to make possible a recovery, but with frequent statements that at the appropriate time it must have the courage to move with equal vigor on the other side. The developments of the last week, he said, made it necessary to move vigorously at this time to absorb some of the redundant reserves, and in so doing the Account should not necessarily limit itself to bills but use any appropriate action that could be taken. As

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quickly as possible, the Committee should try to recapture the position that it had lost in this recent period.

Mr. Shepardson said that he would favor a change in the policy directive along the lines that Chairman Martin had indicated.

Mr. Robertson made the following statement:

I have spent some time trying to ferret out the good aspects of such a miserable bit of monetary-policy back-sliding as has been witnessed over the past ten days, and have found some in the form of lessons:

1. Not only must we be on our guard against panicky reactions in such circumstances--all of us, I suppose, are now only too alert to that danger--but we must also beware of being so wary of that hazard that we do not act with sufficient speed and decisiveness when the situation really demands it. We responded too readily to the cry of "Wolf!" on this occasion, and we may do so again; but such experiences must not cause us to disregard the warning signs and remain passive and complacent when the situation actually calls for vigorous measures.

2. The experience indicates the need for being more explicit in our directions to the Manager of the Account so that we cannot be so easily maneuvered from an action "to correct a disorderly market" to one designed to "support a Treasury issue."

3. The experience indicates the futility of "support" actions. We add to the reserve supply at a time when we should be reducing it and still by such action we do not prevent attrition in substantial amounts, which, of course, is the motivating reason for the action. At the same time by adding to the money supply at exactly the wrong time we multiply the difficulties of making monetary policy an effective instrument in maintaining a proper economic equilibrium.

4. The experience also shows how easy it is to slip--once you have gone off the wagon--and do things which you later hate to try to justify but which at the time seemed worth doing--I refer, of course, to "swaps." We should not engage in swap transactions even when, as in this case, it seemed to be to our advantage to do so.

We must put the experience of this past ten days behind us and strike out on the basis of the lessons with energy and rectitude to get back on the straight and narrow path,

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the path of monetary righteousness--a path which permits monetary policy to be most effective in keeping the money supply in proper relationship to economic conditions, without being warped out of shape and effectiveness by being used for such purposes as underwriting Treasury issues and altering interest yields and prices in various segments of the Government bond market in accordance with some preconceived pattern which does not seem to jibe with the forces of the market place.

If we believe in a free market--as I trust we do--we must permit it to function even when its results seem to veer from our own concept of a proper pattern and even when it seems to be creating difficulties for the Treasury in its financing program.

Mr. Robertson said he would take it for granted from the reports of Mr. Young, Mr. Thomas, and others around the table that economic conditions unquestionably were on the upswing and that the Committee's policy of monetary ease, as indicated in the current policy directive, was no longer appropriate. As to operations, there should be a tightening to the fullest extent possible by runoffs and sales of bills and other short-term securities. Perhaps this should be augmented by changes in reserve requirements and margin requirements. However, the longer-run view would indicate that those actions might not be appropriate now; they might be needed later on when inflationary pressures call for vigorous countering moves.

Mr. Robertson said he agreed with those who had advocated a change in clause (b) of the policy directive and would suggest "to absorb reserves to the fullest extent consistent with an orderly market." Language of that kind would put emphasis on the need for

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for absorbing reserves but would provide also for maintaining a consistent position.

Mr. Mills said that the month of July 1958 was going to be recorded in the history of the Federal Reserve System as a turning point. None could argue that this was not a period that would take hard thinking and require hard decisions. Mr. Mills said that he shared all of Mr. Bryan's concern about the deterioration of confidence in the financial community. However, his own approach to the correction of that kind of a situation was exactly opposite, and he would like to make the case for intervening to support the Government securities market.

Mr. Mills then made the following statement:

The Federal Open Market Committee is faced with the difficult decision of whether to

- (1) allow prices on U. S. Government securities to find a new trading level unassisted by Federal Reserve System action; or
- (2) vigorously support the U. S. Government securities market.

It is argued that if let alone, the U. S. Government securities market will settle down to a new low level of prices at which two-way trading will resume actively. In favor of keeping the Federal Reserve System out of the market, it is further argued that the drastic drop that has taken place in the prices of U. S. Government bonds reflects a realistic alignment of long-term interest rates to a possibly protracted period of international emergency and to a return to a Federal Reserve System policy of credit restraint to control incipient inflationary pressures that are making their appearance along with rising business activity. Fundamentally, those who favor a hands-off approach to Federal Reserve System policy action place economic considerations ahead of the growing threat of a financial emergency.

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In the light of the present situation and especially because of yesterday's further substantial drop in the prices of U. S. Government securities, there are cogent reasons for attacking the financial emergency in advance of developing Federal Reserve System credit policy solely for economic considerations. In my belief, the Federal Reserve System would err in allowing prices for U. S. Government securities to suffer further serious reductions or to temporize with such a situation by half-hearted support actions undertaken at succeeding lower stages in the prices of U. S. Government securities. Such a policy would tend to force U. S. Government bond prices steadily lower, increase the volume of offerings, and threaten a market panic, all of which would make the Federal Reserve System's problem of correcting a badly disordered market condition most difficult. Moreover, to delay action in supporting the U. S. Government securities market will stand to aggravate the difficulty of handling the substantial volume of reserves that would presumably have to be injected into the commercial banking system at some future date when System action to support the market could no longer be put off.

As a practical matter, the Federal Reserve System's problems have already been complicated by the fact that so many commercial banks have extended the maturities of their investments in U. S. Government securities and may now be frozen into such positions by the market depreciation in their holdings, which depreciation would grow further as long as the prices of U. S. Government securities should continue to fall. The financing problems of the United States Treasury are involved in this situation in that to the extent that commercial banks have become frozen into their investment positions in U. S. Government securities, their power to free themselves from such investments in order to engage either as underwriters or investors in new issues of U. S. Government securities is correspondingly eliminated, except as the Federal Reserve System should follow the economically undesirable and inflationary alternative of constantly supplying the commercial banking system with new reserves in order to support their participation in U. S. Treasury financing operations.

Everything considered, Federal Reserve System action to vigorously support the U. S. Government securities market is called for at this time.

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Mr. Vardaman said that he agreed with Mr. Bryan in his excellent photographic exposure of the situation with reference to the paramount need for restoration of confidence, and assurance that the System will not become an operational aid to inflationary pressures.

He also agreed with Mr. Bryan's analysis of the effects of our recent operations in the Open Market Account; and he believed strongly that the Federal Open Market Committee should allow the pattern of interest rates to reach, in as orderly manner as possible, a logical level, in view of the economic recovery apparent, and in view of the international situation.

Mr. Vardaman said, in passing, that he would like to express his opinion that telephone meetings were generally unsatisfactory, and even dangerous, and should be avoided except under real emergency conditions, and stated that he did not think that a temporarily disorderly market would ordinarily be a sufficient cause for such a meeting. He pointed out that, in his opinion, these telephone conferences had a potentially panic aspect which was not fair to the participants, since the participants were denied the advantage of meeting face to face with their other members and allowing a full discussion of the grave problems. In substance, he felt that any problem which was serious enough to warrant a telephone meeting made it all the more important that the situation should be dealt with by a personal gathering of the members of the Committee.

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As to the directive, Mr. Vardaman stated that he felt the words "further" and "ease" should be eliminated, and suggested that a proper wording might be something like "to contributing by appropriate monetary policy to sustainable growth of the economy." He would not make any reference in the directive to orderly market conditions or to absorbing redundant reserves.

Mr. Leach said that favorable economic signs were widespread in the Fifth District. The cotton textile industry had had encouraging market developments in recent weeks which portended a better second half, bituminous coal was facing an improved demand situation, and cigarette production continued to do well. In fact, manufacturing man-hours figures for June showed gains in virtually every line, as did employment in nonmanufacturing industries. Despite smaller acreages, the outlook for 1958 farm production was considerably improved over 1957's record. Department store sales for July were now estimated at 5 per cent above June for the best monthly total this year, due partly, but not entirely, to increased trade in the District of Columbia following the Federal pay increase. The supply of funds for residential mortgage loans continued sufficient to exert downward pressure on rates. The most common rate on conventional loans appeared to be 5-1/2 per cent but some of the Reserve Bank's contacts reported rates as low as 4-3/4 per cent on prime loans.

Mr. Leach said, with respect to policy, that he was worried, as he had been at the July 8 meeting, about further increases in the

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liquidity of the banking system and the economy if the System continued net free reserves at the \$500-\$600 million level. Moreover, there was stronger evidence now than three weeks ago that there had been a definite change in economic conditions and prospects since the current directive was adopted on March 4. In early March the economy was in a rapid decline which had persisted for several months, with no reversal in sight. Accordingly, a policy that was appropriate then seemed clearly inappropriate now, when economic developments were increasingly favorable. He would not like the record to indicate that the Committee had seen no change in economic conditions between March 4 and the present time.

Mr. Leach went on to say that in his judgment the System had already supplied ample liquidity. The financial stage had been set for economic recovery and in his opinion recovery was under way. Providing redundant liquidity would be highly dangerous because it would aggravate inflationary pressures in the future, and he would therefore favor a shift to less ease. Admittedly, such a change would be difficult to implement in the immediate future because of current Treasury financing and the large payment that would be made on August 1 for the new certificates that the System Account purchased last week. However, it now appeared that there would be quite an interlude before the next Treasury financing and he considered it imperative to move toward less ease as soon as practicable.

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This implied net free reserves below the \$500-\$600 million level that had been maintained up until now, and it made a change in the directive highly desirable. In considering such a change the Committee might want to look at the outstanding directive and see what about that directive it did not like. For example, it now appeared that resumption of economic growth started in April or May. Also, consideration might be given to whether the word "ease" should be continued in the directive; personally, he thought that it should be continued because the upturn was still very small and there was still a long way to go before achieving complete recovery. One way in which clause (b) of the directive might be worded to reflect a change in emphasis toward less ease would be the following: "to contributing by monetary ease to recovery of the economy without creating redundant liquidity." In making these comments, he was assuming that the System would endeavor to recapture as soon as possible the reserves that would become available on August 1.

Mr. Leedy stated that the economic situation seemed to provide clear evidence of the direction in which policy should be moving but that other elements in the picture today tended to obscure the economic considerations. In particular, he referred to the inflationary psychology that was rampant, fed in part by the situation in the Middle East, and to the Treasury's needs for the balance of this year. To him, it was difficult to reconcile support of the

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Government securities market with the System's responsibility to provide only the requirements of the economy as far as the money supply is concerned. It seemed to him that the Committee would have to face up to that problem and make a very positive decision. He was not going to make any judgments from hindsight as to what had been done recently, but it seemed to him that from this point forward, with the Treasury having announced that it would be out of the market until October, the System should move as quickly as it could to get back into the position that prevailed before the recent open market operations took place. In saying this, he recognized that there might be great difficulty due to the uncertainties in the market, but he had the feeling that continued participation by the System in the market by way of support operations might have an effect opposite to that intended. In other words, the System might actually be contributing to inflationary psychology.

Mr. Leedy expressed the view that the policy directive must be changed if it was going to reflect accurately what was intended between now and the Committee meeting on August 19. The operation that he had in mind would mean orderly absorption of some of the redundant reserves to the extent possible. In these circumstances he had drafted as a possibility for clause (b) the following: "with a view to the orderly absorption of reserve funds in excess of those

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required to provide monetary ease for the resumption or promotion of stable growth of the economy." He expressed the view that as soon as possible, consistent with the market situation, an announcement should be made to the effect that the directive authorizing the Manager of the Account to operate in all sectors of the market had been withdrawn. Such a statement, of course, would have to be carefully worded. It should point out that Committee policy continued to be one of operating in other than short-term securities if necessary for the correction of a disorderly market. It seemed to him that the very fact that public notice had originally been given might cause some uncertainty in the market and that in fairness to those dealing in the market word should be given that the directive announced on July 18 was no longer in effect.

Perhaps, Mr. Leedy said, the time was approaching when there should be less ease than there had been. For the next three weeks, however, if it were possible to cut back to the point before the recent open market operations took place, he felt that that would be doing extremely well. Afterward, it might be appropriate to take a look to see whether a lesser degree of ease should be the policy.

Mr. Allen reported that a survey of Seventh District businessmen and bankers indicated that the situation in the Middle East had as yet had little, if any, effect on business plans or conditions. There seemed to be agreement, he said, that inventory liquidation should end

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soon, because it had proceeded for so long without a corresponding drop in gross national product and because the Middle East situation and the prospects for further inflation would bring about at least a review of inventory situations, and possibly actions. Local producers of steel and copper products reported that the pickup in orders which was reported in May and June was continuing. A price boost for steel of \$5 or \$6 per ton was still generally expected, probably in August. Opinions expressed at a meeting of Chicago area housing economists on July 23 confirmed improvement in that sector. New mortgage lending by savings and loan associations was running well below 1957 earlier in the year but was now somewhat higher. Employment trends appeared to be moderately upward in all States in the district except Michigan, although it was doubtful that any State other than Iowa was witnessing better performance than the nation. One encouraging sign was the call back of 1,000 workers by Caterpillar. Sales of road-building machinery had begun to improve several months ago but inventories were so heavy that there had been no need to increase production.

Mr. Allen said that a number of local firms had told the Reserve Bank that they were enjoying a substantial improvement in output per worker. Employees seemed to be putting forth a greater effort, personnel managers had been able to be more selective on new hirings, and absenteeism had been reduced very sharply. For

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some firms the increase in output per worker, both white collar and blue, appeared to be in the order of 4 or 5 per cent over the past six months to a year. All of this suggested that unemployment might remain fairly high even if over-all activity improved significantly from now to the end of the year. In Detroit, for instance, where unemployment was expected to run between 315,000 and 335,000 in late August as a result of the model changeover shutdowns, unemployment of 200,000 was expected even after the new models were in production. The Michigan Employment Commission stated that eight years' seniority would be the minimum requirement when rehiring began, and out-migration of low seniority workers would doubtless occur.

Mr. Allen went on to say that, as he had reported at recent meetings, the agricultural areas of the district were for the most part in good shape. Crop conditions continued favorable across the corn belt. Allis-Chalmers and International Harvester reported that sales of farm machinery and equipment were above 1957 for the first half of the year.

Continuing, Mr. Allen said that business loans at the district's reporting member banks had continued to decline, as had been the case in the nation. Because there was so little use of the Reserve Bank's discount window, he was not as fully informed as he would otherwise be regarding the investment portfolio situations in member banks, but he did know that two of the largest banks overinvested--speculated was the word--in the 2-5/8 per cent issue.

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As to open market policy, Mr. Allen said he was sad and unhappy about what had happened in the last few weeks. Because it bore out what someone had said this morning, he wished to read his comments at a telephone meeting on April 24, 1957, when the Treasury was urging the System to enter the market to support what it feared would be an unsuccessful financing operation. Mr. Allen then read the following comments:

The Treasury in its past financing has taken political action with bad economic results.

Characteristically, as happens in every country, they want the Central Bank to bail them out. They don't want or dare to admit their mistakes--for political reasons.

If we bail them out it is at the expense of the country--which is not the right thing to do--and furthermore, it is the way to our own ruin. Once we assist by bailing out--then we are responsible--and we should confine our responsibility to our own field--in this and any other administration.

The Treasury--and Burgess in particular--are control-minded--we should not be--we should be market-minded. If Burgess were in our shoes he would help the Treasury because he is control-minded. We must keep ourselves and the Desk--market and not control-minded.

Mr. Allen said it might be argued that those comments did not apply to the same extent at present. However, he thought that they applied in large measure. Even at that time, he recalled, the international situation was advanced by the Treasury as an argument.

It was obvious, Mr. Allen said, that he hoped the Committee would "get back on the wagon and take the pledge again." Last Thursday the Committee apparently did decide to go back on the wagon and he hoped that the public would be advised as soon as possible.

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Mr. Allen said it seemed obvious that the directive should be changed. Of the suggestions that had been made, the wording proposed by Chairman Martin would suit him best at this time.

Mr. Deming stated that the economic picture in the Ninth District, based on a review yesterday, tended to support the feeling expressed at this meeting that an economic upturn had occurred in the country. Within the district, however, there was weakness in the mining areas of Minnesota, Wisconsin, and Michigan, and the Reserve Bank had taken a hard look at the mining sections through field investigation. There were now about 25,000 people unemployed in those areas, 2-1/2 times the number unemployed last year, and it appeared that this situation would continue through the balance of the year. So far this year, Lake Superior ore shipments were down 60 per cent from a year ago. Copper was off only 6 per cent but 1957 was 6 per cent below 1956. While the tourist business was good, it was not as good as had been hoped for and it was not enough to offset all of the adverse factors. People were running out of regular unemployment compensation benefits and, although all three of the States had passed legislation to utilize Federal loan funds to extend payments, those payments also would run out before the mining regions were restored. That was the major area of weakness in the district, and otherwise everything was quite good.

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Mr. Deming said that, having been on vacation for three weeks, he had formed his impressions of open market developments from reading about what had transpired. He shared some but not all of the concern expressed about the return to inflationary psychology. While he was sorry that the System had had to go into the market last week, it was an action taken in the light of the circumstances. Now, however, the System should get back as quickly as possible to a lower and more realistic level of free reserves although, in view of the present state of the market, he would not favor operating on the selling side except in the shortest securities.

Mr. Deming said he was not sure that the System had contributed so completely as had been suggested to an excessive liquidity position of the banking system. Statistics compiled recently in the Ninth District showed that the country banks had gone very strongly into long-term securities to meet earnings problems, and to a more limited extent the same thing also was true of the city banks. Therefore, with the change in the interest rate structure the banks were not in quite as liquid a position as might have been thought, and the presumed upward adjustment in rates would act as something of a brake.

Mr. Deming felt that it would be a serious mistake to take any dramatic action at this time to underline the point that the

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System feared inflation. The System's record, he thought, was quite good. He would not favor a discount rate change at this time for he believed that the hazards of an upward adjustment would far outweigh the gains. If it were decided to make a change in the policy directive, he would want the directive to reflect the economic change that the Committee saw in process as well as the unique temporary intervention in the market. He would suggest "to contributing to the continuance of economic growth while absorbing redundant reserves."

Mr. Mangels stated that further economic improvement was evident on the West Coast as in other parts of the country, although the degree of improvement was rather moderate. Business firms seemed to have resumed buying to restore inventories for current needs but there was no evidence of undue and unnecessary inventory accumulation. In the course of a recent informal survey it was indicated that this would not be worthwhile for business for in the event of a national emergency prior precautionary inventory increases would be taken into consideration in subsequent allocation of materials. Therefore, they were just continuing to take care of items in short supply. There was some evidence, Mr. Mangels said, of a little more strength in defense supporting expenditures. Increases were noted in employment at Government ordnance plants, and the airplane factories were maintaining steady employment. While retail sales were holding up

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well, there were indications that July might be somewhat lower than June. Housing starts had improved materially; the Federal Housing Administration had advised the Reserve Bank that requests for inspections and appraisals in the second quarter were double those in the second quarter of 1957. Also, there was some demand for twenty-five year, 10 per cent down-payment mortgages. Auto sales in June were down somewhat from May but this probably reflected a seasonal pattern. Industrial plant construction had not shown a great deal of improvement, either in terms of actual construction or planning, but in the second quarter heavy engineering contract awards exceeded the same period in 1957 by 11 per cent. Although employment was up 1/2 per cent in June, there had not been any moderation in unemployment totals. Insured unemployment dropped less than seasonally in June and it appeared that unemployment for July would be slightly above the national average, due primarily to material increase in the labor supply on the West Coast. In Oregon and Washington the new unemployment compensation year started July 1, which would result in quite a rise in claims because unemployed persons who had exhausted their benefits would be reinstated.

Mr. Mangels said that, although real estate loans were up \$17 million and agricultural loans were up \$14 million, total bank loans for the three weeks which ended July 16 were down \$47 million, most of the decline having been in loans to Government securities dealers.

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The rather substantial increase of \$355 million in demand deposits was four times the increase last year, and for the three-week period the increase was almost as large as for all banks in the United States. Time deposits continued to increase. Bank borrowings were virtually nil and Federal funds sales exceeded purchases slightly in moderate volume.

Turning to the national picture, Mr. Mangels said that there were rather clear signs of a bottoming-out of the recession. There were some signs that a pickup was being generated, but no conclusive evidence that this pickup would be permanent. Instead, it might be on a somewhat temporary basis. With regard to the international situation and its effect on Federal Government expenditures, Mr. Mangels said that unless the Government expanded its position in the Middle East or was drawn into other ventures, there might not be any great increase in Federal expenditures. Nevertheless, there would be a heavy calendar of Government financing and refinancing for the remainder of this year, and it would probably be necessary to supply additional bank reserves in the next few months. There probably would be considerable churning in the market because of the large number of holders with large amounts of securities who did not exchange and allowed the maturities to mature. The new Treasury cash offering might absorb some of those funds.

Mr. Mangels felt that a change in the policy directive along the lines suggested by Chairman Martin would be quite

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appropriate for the next three-week period. Because the present volume of free reserves was above the range of the normal thinking of the Committee, the objective should be try to get back to a more normal basis--somewhere around \$500 million or perhaps a little less. Mr. Mangels went on to say that he saw no reason to change the discount rate at the present time. He felt that it probably would be in order to make some announcement of the Committee's return to a "bills only" policy but that it might be advisable to wait a little while until the situation settled. Then, it might be announced that as of a particular date the special authority was terminated and the System had not intervened in the market since that time.

Mr. Irons stated that he would not dwell on the specifics of the economic situation in the Eleventh District. In general terms, however, recent economic developments both in the nation and the district convinced him that the worst of the recession had been seen and that the country was moving into a period of recovery. In the circumstances, System policy should now be related to the rate of economic recovery, and the degree of potential inflation apparent in that development, rather than to the recession and various problems that might arise out of it. In view of his appraisal of the economic situation and because of his feeling that System action should be governed by the economic pattern and not predominantly by the Treasury's problems, he felt that the Committee

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should move away from ease. Accordingly, he would like to see the words "contribute further through monetary ease" taken out of the directive. While he would not want to shift to a policy of real restraint, he would move away from ease and, feeling that a change in policy of that sort would be beneficial, he would not be disturbed if the market recognized it. Some of the trouble in the Government securities market, he said, had been the result of bad appraisals on the part of the market, and he would not be concerned about taking action that could be regarded as an indication of a change in policy. To recapture or absorb a large part of the reserves that had been put into the market, he would take advantage of every runoff possibility. He would favor selling bills whenever possible and he would not be opposed to selling other short issues if the Account was "out of merchandise in bills." The problem that the System must face arose out of the economic situation on the one hand and the Treasury's deficit financing problems on the other hand. If the System followed the economic approach in its policy, it seemed almost inevitable that there would be rising interest rates, while the danger of the other course was inflation. As for himself, the choice would be one of not preventing a rise in interest rates rather than to continue monetizing the public debt and permit inflation. In line with his appraisal of policy and appropriate System action, he would expect to see rising short-term rates in the market, and he would like to see the present

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discount rate level become more realistic in relation to such rates. While he would not favor a change in the discount rate at the moment, possibly that might be appropriate in a comparatively short period, especially if some of the present degree of ease were removed so as to permit market rates to move up. He favored proceeding through open market operations to absorb this ease and reach toward less artificial conditions in the market.

Mr. Irons also said that he would favor a change in margin requirements for there had been a considerable increase in the amount of credit outstanding in the stock market. There were inflationary undercurrents in the market and he questioned whether the Board should permit them to be supported by additional injections of credit. It was his estimate that between January and the present time the amount of credit in the market had increased about 20 per cent.

Mr. Irons felt that the directive should be changed now. As previously indicated, he would like to take out not only the word "further" but also "monetary ease." He concurred in the suggestion of Chairman Martin, but he would not favor the suggestion of the Secretary because it would tie the Committee too specifically to correcting a particular development. Another possibility would be "to foster sustainable economic recovery and growth in the economy by providing reserves consistent with economic requirements and orderly market conditions." Mr. Irons commented that one could not

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discard from consideration the matter of orderly market conditions. There is a difference, he noted, between operations to correct disorder in the market, when it appears, and operations to support a Treasury offering. The concept of orderly market conditions appeared to belong in the directive, and he questioned restricting the directive to absorbing redundant reserves.

Mr. Erickson stated that a review of conditions in the First District following his return from vacation indicated that the worst of the recession had probably ended. The New England manufacturing index went up in May for the first time in seven months and went up again in June. Employment likewise was up in May and again in June, with 48,000 more workers employed in June. Also, for the first time in several months manufacturing employment exceeded the previous month. May of last year was an all-time peak in construction, and May of this year was also a good month. While department store sales in June were disappointing, first and second week figures in July were appreciably better, probably due to the fact that Boston stores were open on Saturdays for the first time in a number of years and weather conditions were conducive to shopping. In June, as in May, the Massachusetts retail price index declined, the vacation business appeared not to be meeting expectations, and the Reserve Bank's survey of mutual savings banks showed that deposit growth continued at a higher rate than last year. In July, to date, the Reserve Bank's discount window had been used less on a daily average than

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in any other month since January 1952.

Turning to policy, Mr. Erickson said that he did not favor any change in the discount rate but believed that the directive should be changed. Of all the suggestions made thus far, he preferred the suggestion of Chairman Martin. As rapidly as possible, the Account Management should work toward getting the level of free reserves down to the \$400 million level. He would sell bills first, but if the objective could not be accomplished with bills he would use other short-term securities. Mr. Erickson hoped that the bill rate would move up, and also the Federal funds rate.

With reference to System operations during the last ten days, Mr. Erickson noted that continuing Committee policy calls for the System to go into the market in the event of a disorderly situation. While he was surprised that the operations had to be so massive, that may have been necessary. He would not favor an announcement of the termination of the special authority given to the Manager of the Account since under present conditions there might still be a disorderly market. Therefore, he would not make any announcement until the market was clearly out of that situation. He would favor allowing interest rates to seek their true level, but in the event of a clearly disorderly condition the System would have to go into the market.

Mr. Balderston stated that although he would subscribe to the wording for clause (b) of the policy directive which had been

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suggested by Mr. Irons, his own point of view would be emphasized by the phrase "to absorbing redundant reserves and eliminating free reserves as rapidly as possible without creating a disorderly market." The System having taken unusual and emergency action last week, he believed that the directive should be pointed toward escaping from the situation that had resulted. In his view, Mr. Balderston said, reserves had in fact been redundant since early June. While the recession might not have bottomed out permanently, the decline certainly had ceased for the moment and business psychology had again turned ebullient. He went on to say that the excess of bank reserves that he thought was present even before the Lebanon incident might have stemmed from adhering too long to a fixed level of free reserves and perhaps the Committee had been deceived by the appearance of market tightness, especially in New York City, caused by heavy bank securities investments. To put it another way, the Committee might have tended to watch the depth of the water in the irrigation ditch rather than the use of the water in the fields being cultivated.

Mr. Balderston said he believed in the use of the free reserve figure as the best language available for indicating a target or goal. However, adherence to a \$500 or \$600 million level of free reserves week after week pressed reserves into the banking system in such fashion as in his judgment to make the banking system unduly liquid. Accordingly, the Committee now found itself unpleasantly surprised

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by having that credit used in places where it was not constructive, such as in the stock market at the present time. The emergency action of last week therefore accentuated a problem which was already serious from the economic point of view, because the credit that the System had supplied was tending to be misused. The question, then, was what to do about so serious a situation. Mr. Balderston believed that sufficient bills and other short-term issues should be sold to more than reverse the recent emergency action. Rather than return to free reserves of \$500 million, he was thinking of the elimination of free reserves as steadily, consistently, and rapidly as possible right up to the point of disorderliness in the market because he felt that the price of bonds would have to drop four or five points. If free reserves were eliminated--and he hoped that could be accomplished prior to Labor Day--he would favor raising the discount rate  $1/4$  of a percentage point, and then  $1/2$  of a percentage point, in order not to repeat the "pitty pat" policy followed in 1956. With regard to the question of publicizing the return to a "bills only" policy, he said that he would favor no announcement. Rather, he would merely stay out of the market.

Chairman Martin began his remarks by commenting that it would not be possible to "change the world" between now and August 19, the date of the next scheduled meeting of the Federal Open Market Committee. In view of the statements that had been

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made around the table, he thought that he should say something by way of observation on the matter of principle and the Treasury. It was terribly important, he said, for all to realize that the Committee was dealing with the most difficult problem in political science in the whole world. In order to maintain perspective it must also be realized that the Federal Reserve System, like others, can occasionally make mistakes; one should not blame the other fellow all of the time and sit in a vacuum. Furthermore, it is necessary to look at one's own mistakes before looking at the mistakes of others. As persuasive as were Mr. Bryan's comments about loss of confidence, it was not too long ago, he recalled, that Mr. Bryan was advocating a reduction in reserve requirements as essential to the promotion of economic recovery. The Chairman, too, had been in error a great deal, and no one can claim to be correct 100 per cent of the time. This pointed up the need for flexibility and, as he had remarked on other occasions, "steel which bends is much stronger than iron which breaks." On several occasions he felt that the System had let itself get into the position of the iron that breaks.

Chairman Martin said that he also felt that he must say a word on behalf of the Treasury, for the Treasury and the Federal Reserve are working toward a common objective. It might be that

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both of them could be completely right but that neither would attain the objective. At present there was a very fortunate situation at the Treasury because both Secretary Anderson and Under Secretary Baird were just as anxious as anyone to correct the current situation. Of this, there was no question at all in his mind. They were dealing with a very difficult problem that the System had compounded for them, for if the System had not been as intent on following an easy money policy there could not have been the speculative fever that developed and finally culminated in the speculation in the 2-5/8 per cent bonds. The Treasury probably had made some technical errors, but those errors were easy to make when the Treasury had to consider that the Federal Reserve was following a policy of further ease.

The Chairman then commented on the extent to which he believed in maintaining operating procedures or principles. On the other hand, he said, the Committee should not throw up its hands the first time circumstances developed which made the Committee realize that some flexibility was required. He recalled, and said he was delighted by the fact, that the special authority given at the second afternoon meeting on July 18 was granted by unanimous vote of the Committee. He went on to say that the cry of "wolf" always looks bad in retrospect. However, at the time

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the action was taken no one knew what would happen over the week end which preceded the Treasury financing. It might have been perfectly right to say "just step aside and the market may not collapse," but if fighting had actually occurred in the Middle East the Committee probably would now be glad that it took action in the way that it did. Also, regardless of theories, when certain things are involved the public will not sit by and let the situation go unheeded. He might be in error in that opinion, but it was certainly something that the Committee must bear in mind at all times. The market, he said, is a free market but one in which the Federal Reserve System does participate. Many times he had expressed his own dissatisfaction with that participation, and work must be done continually on the System's relationships with the market. However, unless a situation should develop where the Treasury is deliberately forcing the System and the System knows that the Treasury is wrong, it will be necessary to proceed on a "give and take basis."

Chairman Martin reiterated that both Mr. Anderson and Mr. Baird were just as anxious as the Federal Reserve to correct the current situation in the most effective way. He also repeated that he believed the Federal Reserve had a real share in the problem that the Treasury faced with the 2-5/8 per cent bonds, because the policy of easy money that it pursued permitted speculation to the extent that had occurred.

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Continuing, Chairman Martin said that it was well to have different views within the System. He was glad that Mr. Mills had presented a statement on behalf of the position that the System should support the Government securities market even though he did not agree with that point of view. The Chairman went on to say that he rather got the impression from the comments around the table that perhaps the System was taking itself a little too seriously, and perhaps he was falling into the same error. However, he again pointed out that the Committee was now addressing itself to a three-week period. At the moment it seemed fairly clear that, without risking a market collapse, the Committee probably could not do a whole lot to mop up excess reserves in that period of time. Assuming the success of the Treasury's offering today, on August 19 the Committee would have a clear field for whatever it wanted to do with respect to monetary policy. The System, he felt, had an obligation to pick up all of the reserves that it could, and he thought it was clear that the majority of the Committee wanted to do that in order to reestablish a position which had been completely distorted by the events of the last two weeks. However, the element of confidence described by Mr. Bryan was involved in what could be done during this period. Personally, he would not want to give up the fight against inflation or assume that the recovery now developing should make the Federal Reserve throw up its hands. What the

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Committee was faced with over the next three weeks was to try to recover as far as possible its position and poise, and in conversations with those outside the System not give way to defeatism. The view that must be presented to the public was that the System was not licked but would continue the fight. Also, the Committee must do everything possible to aid the Manager of the Account in a period like this. Naturally, members of the Committee might disagree with some of the things that he did, but the Manager was under pressure. It must be borne in mind, the Chairman said, that the struggle in which the System was now engaged is a never-ending one. In his opinion, the System had made remarkable progress within the limitations of its powers. For example, there was a large Federal budget and if the System had not moved in the way that it did there might well have been a substantial tax cut in addition to the larger budget.

The Chairman said he did not think that the System had lost any of its basic principles in the recent operations. The real battle with inflation probably was coming in the 1960s, so it was important for each person to try to keep his feet on the ground. When mistakes were made, one should not just say that it was a mistake but try to see what the benefits and failures were and then move forward.

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Today, Chairman Martin said, the Committee seemed to be in agreement to a surprising extent. The question was principally the wording of the policy directive, and there could be a lot of views on that question. When he considered it in the light of the three-week period ahead, he was inclined to think that perhaps Mr. Riefler had a point. At this time it was difficult to appraise the situation and spell out a directive in precise terms, and language that would achieve the Committee's short-run purpose therefore would seem desirable. Then, at the meeting on August 19, the Committee could spell out a more effective directive, perhaps along the lines mentioned by Mr. Deming, Mr. Irons, or others.

There were expressions of agreement around the table with Chairman Martin's suggestion.

Mr. Hayes stated that, although he had always questioned whether the directive should get into detail rather than basic policy changes, there was no question in his mind about the recapturing of redundant reserves. He said that he was a little concerned, however, that if the redundant reserves were recaptured within the ensuing three-week period the Management of the Account would, in effect, be left without any directive.

Comments on this point stressed the unlikelihood that the redundant reserves could be absorbed in the next three weeks. Mr. Rouse observed that if they were recaptured before the August 19

meeting it would be possible to call a meeting of the Committee by telephone and consider the need for a new directive.

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

(1) To make such purchases, sales, or exchanges (including replacement of maturing securities, and allowing maturities to run off without replacement) for the System Open Market Account in the open market or, in the case of maturing securities, by direct exchange with the Treasury, as may be necessary in the light of current and prospective economic conditions and the general credit situation of the country, with a view (a) to relating the supply of funds in the market to the needs of commerce and business, (b) to recapturing redundant reserves, and (c) to the practical administration of the Account; provided that the aggregate amount of securities held in the System Account (including commitments for the purchase or sale of securities for the Account) at the close of this date, other than special short-term certificates of indebtedness purchased from time to time for the temporary accommodation of the Treasury, shall not be increased or decreased by more than \$1 billion;

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

At the last meeting<sup>\*</sup> of the Committee consideration was given to a suggestion for increasing from \$50 million to \$75 million the limitation on outright holdings of bankers' acceptances by the

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\* Refers to meeting on July 8, 1958.

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Federal Reserve Bank of New York. However, in view of differing opinions which were expressed, a decision on the matter was deferred. Subsequently, under date of July 25, 1958, there were distributed to the members of the Committee copies of a memorandum from Mr. Rouse discussing, on the basis of the minutes of the Federal Open Market Committee and its executive committee, the apparent objectives of the authorized acceptance operations. The memorandum suggested that the authorizations of the Committee appeared to contemplate coordinating acceptance operations with Government securities operations and that such coordination was not contrary to the System's objective of fostering interest in the acceptance market merely because, on certain occasions, the New York Bank had been prevented from filling orders received from foreign central bank correspondents.

In supplementation of Mr. Rouse's memorandum, Mr. Hayes made the following comments:

1. The record seems to me pretty clear that the Committee, besides undertaking to encourage the development of the acceptance market, has adopted a policy of making our acceptance transactions consistent with our general credit policies.

2. Although the size of these transactions is admittedly minute by comparison with our Government security operations, acceptances do have characteristics which make them a convenient money market instrument for effecting open market operations.

3. The New York Bank has felt that consistency with Government security operations would be accomplished most effectively if week-to-week changes in acceptance holdings were always in the same direction as changes in Government security holdings. Perhaps this concept has been a little too rigid.

4. Our principal interest being to develop a larger and more active acceptance market, it is logical that our aim should be mainly in the direction of a greater domestic interest in the market, in which foreign buying already plays a disproportionately active role. We believe that the very fact of the Federal Reserve Bank's being consistently in the market is one of the best means of stimulating this domestic interest.

5. At the same time, our interest in providing a well-rounded service to the foreign central banks justifies our making considerable efforts to satisfy those banks' needs, provided that in so doing we are not being inconsistent with our general credit policies. I think there is room here perhaps for a somewhat more flexible approach to the matter of week-to-week changes in holdings. That is, I would see no harm in our reducing our acceptance holdings by a modest amount for a week while we were adding to Government security holdings, or vice versa--provided we were showing a consistent interest in the acceptance market by having at all times a substantial and reasonably stable portfolio.

6. Since we are entering a season when acceptance financing is expected to expand, and in view of the upward trend in outstanding acceptances over a period of years, and with our present holdings uncomfortably close to the \$50 million limit, it would seem highly desirable to raise that limit to \$75 million.

Mr. Robertson stated that he had prepared a paper on the subject before receiving Mr. Rouse's memorandum. However, after reading the memorandum he would not want to change his own paper at all. He then read the following statement:

I am going to outline briefly the development of Federal Reserve System participation in the bank acceptance market over the past four years. This little history, of which the proposal now before us is the latest episode, demonstrates how necessary it is for

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this Committee to be ever vigilant, in order to avoid finding itself in a position it never intended to assume.

Early in 1954 it was suggested that we take the initiative in purchasing some \$20 or \$30 million of acceptances in order to "free demand generally from administered rate constriction and to make market rates responsive to changes in the demand for and supply of acceptances." I discussed this proposal in my memorandum of June 1, 1954, in which I expressed doubts and presented four questions that I felt should be clarified before the Committee acted on the proposal.

The proponents of the proposal did not attempt to answer the questions presented in my memorandum, but the proposal nevertheless was reactivated some months later. In March 1955 the subject was again presented to the Committee, although the original objective--to "free demand generally from administered rate constriction"--was no longer presented as a basis for action. The Committee authorized System purchases of bank acceptances in an amount not to exceed \$25 million; the Chairman stated that the System "should avoid any 'finagling' in the market but should participate in a very modest way in order to show the interest of the central banking organization." This limited objective made our action relatively innocuous, in my opinion, although I felt that the acceptance market would receive more convincing assurance of Federal Reserve interest if we resumed the "back-stopping" procedure that worked quite well in the 1920's.

In view of the fact that the System intended, in effect, simply to maintain a token portfolio of bank acceptances to show its interest in that market, the Committee expressly provided that transactions in bank acceptances "would be entered into only when consistent with the general credit policies of the Federal Open Market Committee." In other words, our general credit policies necessarily were to be paramount, and the Committee's subordinate objective of showing interest in the bank acceptance market would not justify purchases or sales of acceptances in circumstances where such action would be inconsistent with current credit policies.

At the Committee's March 1955 meeting, approval of the actual form of the resolution on this subject was

delegated to the executive committee. The resolution approved by the executive committee did not provide that acceptance transactions should be entered into "only when consistent with the general credit policies," but provided instead that such transactions were authorized,

"at such times and in such amounts as the executive committee may deem advisable and consistent with the general credit policies."

The change in emphasis may seem insignificant, but later events reveal that such a change in emphasis can be the first step in the unintentional development of a policy quite different from that originally intended.

At our meeting in March 1956 we renewed the authorization to the New York Reserve Bank to hold up to \$25 million of acceptances. However, our published explanation was that the action was taken "on the grounds that the System should assist in the further development of an acceptance market in the United States...." Literally this was not inconsistent with the original purpose of "showing the interest of the central bank organization in this market," but the new language hinted at a more aggressive participation.

The attitude of the Trading Desk on this subject was perhaps reflected in the following statement in a July 1956 publication of the New York Reserve Bank on "Federal Reserve Operations in the Money and Government Securities Markets":

"...expressing a general intention to vary the size of this holding /i.e., of bank acceptances/ in a manner that would parallel other Federal Reserve action in the money market (the available supply of acceptances permitting), the Committee on March 29, 1955 authorized the Manager of the System Open Market Account to begin purchases...."

"...the scale of operations in the acceptance market has not reached magnitudes that could be considered significant in supplementing operations undertaken in the Government securities market to influence the money market and general credit conditions." (page 88; underlining added)

As far as I am aware, this Committee never expressed an intention that the holdings of bank acceptances should "parallel other Federal Reserve action in the money market," but this idea apparently existed at the Trading Desk.

At the November 27, 1956 meeting the maximum limit was raised from \$25 million to \$50 million, and this increased authorization was renewed without change in March 1957.

The memorandum attached to Mr. Riefler's covering memorandum of July 7, 1958 recommends that the maximum limit now be raised to \$75 million. The camel's head and neck are now following his nose into the tent, but even more important is the explanation of the proposal, which opens the way for the entire animal to move in-- in fact, it hints that he is already in possession. The memorandum reveals that our acceptance holdings have been increased recently in order "to be consistent with increases in System holdings of United States Government securities." Referring to the existing \$50 million limit, the memorandum further states that

"...if we were to continue to coordinate acceptance activities with other market operations, our acceptance holdings could quickly reach the limit."

This language cannot reasonably be interpreted otherwise than as meaning that the Trading Desk regards its transactions in bank acceptances as paralleling, as far as possible, the operations in Government securities. This Committee never has authorized dealings in acceptances as a supplementary means of effectuating our general credit policies--a sort of small-scale "me too" operation, along with Government securities transactions. If bank acceptance transactions have been entered into for these purposes, such action goes beyond the scope of the existing authorization.

To sum up, the Committee in 1955 decided to hold a modest portfolio of bank acceptances "as a means of showing the interest of the central banking organization." By 1956 the explanation of our operations was that "the System should assist in the further development of an acceptance market." Later that year the maximum was increased to \$50 million. Now it is suggested that the ceiling be raised to \$75 million, but far more important is the first casual intimation that bank acceptance transactions should be used (and apparently already are being used) as one of our mechanisms for implementing general credit policy.

It is conceivable, although very unlikely in my opinion, that there are sound reasons for effectuating our credit policies through operations in acceptances as well as in Government securities. If this is so, however, the recommendation should be openly presented, and supported, on that ground, so that the Committee will have an opportunity

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to reach an informed judgment and to make a deliberate decision on the matter. If the Committee were to take the recommended action on the basis outlined in the memorandum referred to, it might later find that it had been jockeyed into adopting bank acceptance operations as a regular tool of general credit policy without ever having realized that it was doing so.

Mr. Hayes said that he was at a loss to understand what Mr. Robertson feared. If, in operating in acceptances, the New York Bank happened to be paralleling open market operations, he could not see what harm was being done. It was clear to every member of the Committee that acceptance holdings were being changed week by week and there was no thought, he said, of having any concealed objective. He saw nothing irreconcilable between encouraging the acceptance market and using the bankers' acceptance as an instrument of open market policy.

Mr. Robertson said that he did not agree. The matter had never been put forward on the basis that the acceptance would be used as an additional open market instrument; instead, it had been put forward in terms of showing an interest in the acceptance market. To go outside of that and use the acceptance as an open market tool was in his opinion inconsistent with the position that the Federal Open Market Committee had taken. He did not like the idea of taking an authorization given on one basis, gradually getting more and more into the market, and finally taking control.

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Mr. Hayes replied that he disagreed with Mr. Robertson's view of the importance of the New York Bank's share of the acceptance market. He pointed out that when the acceptance authority was first granted, \$25 million was just as big a share of the market, proportionately, as \$50 million is today, for the size of the market has increased markedly. In response to a question, he observed that acceptance holdings are also limited to 10 per cent of total acceptances outstanding as shown by the most recent bankers' acceptance survey and that at present \$75 million would represent 5 per cent of total acceptances outstanding.

After further discussion relating to the view of the New York Bank regarding the authorization if the total volume of bankers' acceptances should increase substantially further, Mr. Balderston said that he had never heard a reasoned argument for participation in this area as a means of fostering foreign trade. He thought, however, that such an argument probably could be advanced. Therefore, before the Committee reached a final decision on the suggestion made by the New York Bank, with which he had some sympathy, he would like to have the staff advise the Committee what national advantage they could see in using acceptances as an open market instrument. Mr. Robertson, he said, had performed a useful service in warning the Committee not to proceed without knowing what it was doing, but

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he (Mr. Balderston) was concerned with the leadership of the United States in foreign trade and he would not wish to have a decision made by the Committee that would prevent participation in something that might be to the national advantage.

After Mr. Robertson said that he thought such a staff presentation would be appropriate, Mr. Hayes said he had thought it was a foregone conclusion that the acceptance market was one that the Committee wanted to encourage. He did not think that this was a point at issue today, but he would have no objection to a study such as suggested.

Chairman Martin commented that he thought the position had been clear--at least it had always been his own position--that the Committee wanted to do what it could to help the acceptance market. As he understood it, the differences of opinion related to how the System could be of most help, and there were two sides to that question.

In response to a question by Mr. Shepardson, Mr. Hayes said that, in general, it had been the approach of the New York Bank that the extent of its own activities did not make a large difference in the amount of acceptances that foreign buyers were getting. Foreign buyers were already so predominant in the picture on the demand side that from the standpoint of developing the acceptance market the New York Reserve Bank did not feel that it had to be so solicitous about

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them. Therefore, the Reserve Bank had not felt that it was hurting the acceptance market if on occasion its own activities were the cause of foreign buyers not being able to obtain quite as many acceptances as they desired.

Mr. Allen noted that there are relatively few banks operating in acceptance credits to any large extent. The New York banks, of course, do what is to their best advantage; if they are loaned up otherwise and want to handle an operation by means of an acceptance, they will do it. If they wish to handle a transaction by means of a clean note, they will do it that way. Mr. Allen said that few people he talked with--people who regularly invest for a short term--had ever heard of acceptances. Therefore, he was rather inclined to feel that being friendly to the acceptance market meant encouraging the dealers to get out and sell acceptances, with some small participation, if necessary, to take pressure off the dealer.

Mr. Hayes said he rather liked the idea of actively considering the merit of the acceptance as an instrument from the open market standpoint. He went on to say that the New York Bank had received some good comments in the past from the Board's staff regarding the usefulness of the acceptance as a money market instrument. If the study previously suggested was to be made, perhaps the Committee would also like to have an opinion on how good an instrument the acceptance is for open market operations.

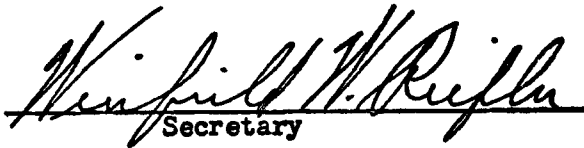
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After some discussion of the points that had been raised by Messrs. Balderston and Hayes, Messrs. Thomas and Marget were requested to submit a paper for the Committee's consideration relevant to those points. At the same time it was agreed to table for further discussion the suggestion of the New York Reserve Bank for an increase in the limitation on bankers' acceptance holdings.

It was agreed that the next regular meeting of the Committee would be held on Tuesday, August 19, 1958, at 10:00 a.m.

Thereupon the meeting adjourned.

  
Secretary

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington on Tuesday, July 29, 1958, at 2:45 p.m.

PRESENT: Mr. Martin, Chairman  
Mr. Hayes, Vice Chairman  
Mr. Balderston  
Mr. Fulton  
Mr. Irons  
Mr. Mills  
Mr. Robertson  
Mr. Shepardson  
Mr. Vardaman 1/  
Mr. Deming, Alternate for Mr. Mangels

Messrs. Allen and Treiber, Alternate Members of the Federal Open Market Committee

Messrs. Bopp, Bryan, and Leedy, Presidents of the Federal Reserve Banks of Philadelphia, Atlanta and Kansas City, respectively

Mr. Riefler, Secretary  
Mr. Thurston, Assistant Secretary  
Mr. Solomon, Assistant General Counsel  
Mr. Thomas, Economist  
Messrs. Hostetler, Walker, and Young, Associate Economists  
Mr. Rouse, Manager, System Open Market Account  
Mr. Kenyon, Assistant Secretary, Board of Governors  
Mr. Keir, Acting Chief, Government Finance Section, Division of Research and Statistics, Board of Governors  
Mr. Stone, Manager, Securities Department, Federal Reserve Bank of New York

Mr. Tow, Vice President, Federal Reserve Bank of Kansas City; and Messrs. Anderson and Atkinson, Economic Advisers, Federal Reserve Banks of Philadelphia and Atlanta, respectively

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1/ Entered the meeting at point indicated in minutes.

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Mr. Rouse, at whose request this meeting had been called, noted that in his remarks at this morning's meeting he had referred to the condition of the Government securities market in yesterday's light trading. The members of the Committee had subsequently received a summary of conditions in the market at 11:00 a.m. today. Following the Committee meeting, he had talked with the Trading Desk and had found that another wave of selling was developing. This was in accord with the pattern that the market had been following; it would steady for a time and then another wave of selling would develop. That seemed to be the course of events again today. The market yesterday was down in a number of cases in terms of thirty-seconds, and it was down in similar amounts today. The 3-1/2 per cent bonds of 1990 were now down to 98.

Much of the time, Mr. Rouse said, there were no bids and no buyers. One dealer had been able to work out some swaps but had not been able to do outright business. The outstanding Treasury certificates were off a thirty-second in some cases, and the new ones were quoted below par and were available in volume. The whole picture was one of gloom and a fading market, and reports from dealers were to the effect that the element of speculation in the market was greater than anyone had visualized. One dealer termed the market disorderly in the sense that there were no bids, while another expressed the view that the market was "in the disorderly range."

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An insurance company spokesman was of the opinion that the market had been disorderly for days.

In response to an inquiry from Chairman Martin, Mr. Rouse summarized available information on subscriptions for the new Treasury 1-1/2 per cent tax anticipation certificate. In the course of his summary he said that a private survey of 25 large banks by a securities dealer indicated subscriptions by those banks amounting to \$2.7 billion, which led the dealer to estimate that the allotment would be around 50 per cent. However, the picture was not yet clear enough to make accurate predictions about the fate of the issue.

Continuing, Mr. Rouse said it seemed to him that the amount of potential selling in the Government bond market was not known. After a price decline which had by now certainly reached the four or five points mentioned by Mr. Balderston at this morning's meeting, one might expect that there would be an unwillingness to take the losses entailed in those prices and that selling would tend to dry up. However, speculative holders who had delayed selling, in the thought that prices would get a little better and that the System would step in, might now feel that it was better to get out.

Chairman Martin commented that the sooner such elements got out of the market the better it would be from the standpoint of the System.

Mr. Rouse agreed. He went on to say that the System undoubtedly would be criticized if this was really a disorderly market

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and the System had not appeared in it for the last two or three days. Turning to available alternatives, he said that one possibility would be for the Federal Reserve Banks to do a little "arm-twisting" as far as the subscriptions to the Treasury certificates were concerned, in an effort to assure that the financing did not "fall out of bed." As to possible System intervention in the market, Mr. Rouse expressed the view that it would be unwise to try to do more than insert a few bids through brokers in a nameless way in the hope of having a modest amount of transactions at levels as the market went down. To go direct to the market and start to buy would invite an avalanche of offers, and that, of course, was something to avoid. Furthermore, if the Federal Reserve acted to support the market, the speculators would be apt to stay in.

Mr. Rouse stated that he was inclined to recommend staying out of the market, or at most doing something through brokers in a nameless way and attempting some arm-twisting with respect to the certificate subscriptions.

Chairman Martin asked whether it was not too late in the day for the System to do anything that would substantially affect the subscriptions, to which Mr. Rouse replied that he thought a little could be done. Of course, the word would get around to some extent and the official closing time of the market is only nominal under prevailing market conditions.

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The Chairman then stated that the Committee seemed to be right up against the wall and that it seemed best to stand or fall right here. Personally, he would be disposed to stay out but watch carefully. He then called upon the other members of the Committee for comment.

Mr. Mills said that he could not add anything to the statement which he made at this morning's meeting. He strongly believed that the System Account should intervene aggressively and support the market. If the Committee was not disposed to do that, he would be fearful of making bids on a declining basis through brokers without revealing the source. There is general public knowledge that the Open Market Committee meets at three-week intervals, so he presumed there was an understanding that a meeting had been held today. The market therefore would be looking for an indication of System policy today, or certainly at the opening of the market tomorrow, and if support was not forthcoming the market could reasonably reach the conclusion that the Committee had refused to declare a disorderly condition and had abandoned the market. Under those circumstances, there could be complete disorder.

It was an unfortunate circumstance, Mr. Mills said, that today the books were open for subscription to the new issue of Treasury certificates, for if the System intervened in the market the inference would be drawn that its primary, or at least a secondary, purpose had been to assist the Treasury rather than to correct a disorderly market.

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In response to a question from Mr. Rouse, Mr. Mills verified that even so he would advocate going into the market, with full knowledge of the risks involved. Intervention on the part of the System might inspire a greater volume of sales rather than stem sales. However, in almost all cases sales made at the present levels would involve losses, and it was difficult for him to reason that people would willingly take those losses if there was an indication that the market would be stabilized by the institution that had the ability and armament to provide stability.

At this point Mr. Vardaman joined the meeting and Mr. Rouse reviewed for him the market situation that had resulted in this meeting being called.

Mr. Hayes said that he favored going into the market last time but that he was troubled by the thought of going in on a very temporary basis, really with the Treasury financing primarily in mind, and then almost immediately pulling out. If he were doing it himself, he would be glad to go in, but only on the condition that the System was going to stay in for quite a while and cushion the market. Since he saw no disposition in that direction on the part of the majority of the Committee, he would not want to go into the market now.

Messrs. Irons, Allen, Leedy, and Vardaman expressed agreement with the view that the System should stay out of the market

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today and see what happened. In response to an inquiry by Mr. Vardaman regarding the inference to be drawn from the use of the word "today" in these comments, Chairman Martin said he did not think it was fair to ask the Manager of the Account to take the responsibility. It was fortunate, he said, that the Manager was here today and that this meeting could be held.

The remaining members of the Committee, except Mr. Mills, then expressed concurrence in the view that the System should stay out of the market today, as did the other Reserve Bank Presidents who were present.

In response to a question raised by Mr. Balderston, Mr. Keir said that the 3-1/2s of 1990 would have to fall to 95-13/32 to sell on a 3-3/4 per cent yield basis. Mr. Balderston said he asked the question because he felt that if and when the System had to intervene in the market again, it should be when the price level was such that the System could make its intervention stick, and so convincingly that other market forces would come in to assist and "pick up the ball" from that point.

Mr. Bryan inquired as to possibilities if the Treasury offering today were to fail, and Mr. Thomas commented that the Treasury had plenty of money on which to operate for a time, for it would, of course, get something from today's offering. If necessary, one possibility would be to increase the weekly bill auction.

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Mr. Bryan then inquired about the possibility of using the direct borrowing authority on a short-term basis while the Treasury was regrouping its forces, as opposed to System assistance to the market on a scale that could not be foreseen. He agreed with a comment by the Chairman that one could hardly expect a regrouping of the market within a period of a few days.

After some discussion of the question raised by Mr. Bryan, Mr. Robertson suggested that in any event there was not much that the System could do between 3:10 (the present time) and 3:30 to affect the outcome of the Treasury offering. Mr. Rouse said that he did not concur completely. He felt that the System could do something; that System action would have a little effect on the success of the Treasury issue.

In a restatement of his position, Mr. Hayes said that he had aligned himself with the majority, but reluctantly. If he had felt that the majority would go as far as he personally wanted to to, that is, to have a sustained cushioning of the market, he would favor that course. In reply to an inquiry by Mr. Vardaman, he said that the cushioning might be at descending, but slowly descending, prices.

Mr. Rouse commented that he was puzzled about the significance of the 3-3/4 per cent rate mentioned by Mr. Balderston as against the present rate. He noted that the 3-1/2s of 1990 had moved in price to

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where they were close to a 3.60 yield basis. If Mr. Balderston was thinking in terms of the possibility of a shooting war, it was his (Mr. Rouse's) thought that the present rate might be as satisfactory as a  $3\frac{3}{4}$  per cent rate at which to hold, for otherwise the level of rates on business credit might be extremely high. A  $3\frac{3}{4}$  per cent rate to the Government would mean about a 4.35 rate on AAA bonds, about 4.75 on AA bonds, and perhaps  $5\frac{1}{2}$  per cent on bonds rated BAA. Thus, there would not be much room for flexibility, for the rates would almost be up against the ceiling.

Mr. Balderston replied that the Canadians evidently concluded that for them a  $4\frac{1}{2}$  per cent rate would be appropriate for 25-year bonds. He asked what rate was reached under free market conditions at the height of the 1955-57 boom.

Mr. Rouse commented in response that if the Treasury had had to do any long-term financing, a 4 per cent bond would have been required.

Mr. Balderston said that his  $3\frac{3}{4}$  per cent rate was on the lower side of the range that he thought would be indicated in the event of a shooting war. More likely was a combination of an expensive cold war and expansionary conditions in the civilian sector of the economy. A combination of private and public borrowing under such circumstances would push the price of money up so that a 4 per cent level was as likely as any other. Asked by Mr. Vardaman whether

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his comments meant that he would favor entering the market at the 3-3/4 per cent level, Mr. Balderston said that he would put his answer in terms that he would not want to see "the cat's tail cut off inch by inch."

Mr. Vardaman then stated reasons why he felt that the ultimate level of rates might be higher than suggested by Mr. Balderston. For these reasons, he said, he would want to think a long time before stepping into the market at the 3-3/4 per cent level and offering encouragement that the market would stick at that level.

Mr. Balderston commented that a 4 per cent yield for the 3-1/2s would mean a price of 90, and that he thought a drop to such a price would mean a more disorderly market than could be tolerated.

Chairman Martin raised certain questions about the likelihood of institutional selling at present market levels and about the rumored possibility of a situation of panic developing.

Mr. Hayes commented that he did not think it was the level of prices as much as the lack of a market that was disturbing to public psychology. If he were managing the portfolio of a bank or insurance company, Mr. Hayes said, he would be slower in going into the market next time, and Chairman Martin expressed agreement with that comment.

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In further discussion of the questions raised by the Chairman, Mr. Vardaman said that he could not imagine holders dumping securities, for the tax-saving stage was now past. A more likely prospect was a virtual suspension of trading, following which trading might be renewed on a more realistic basis.

Mr. Hayes said he saw a big difference between where rates might go under inflationary psychology and where they might go in the event of a shooting war. It was quite clear to him that in the latter event yields could go up to a 4 per cent basis, but he was not sure whether that would be the right rate. At present, he noted, yields were already in the upper part of the range established over a 50-year period.

Additional comments were to the effect that at a certain level it would be hoped that a self-correcting movement would occur in the market. Mr. Allen agreed with Mr. Vardaman in thinking that present holders of bonds would not be apt to get panicky and that they would tend to sit tight, knowing that they had good bonds. That, he felt, would be true in the case of banks holding the 2-5/8 per cent bonds, at least until a strong loan demand developed.

Mr. Bryan returned to the possibility of a failure of today's Treasury issue and use of the direct borrowing authority, if necessary, in order to avoid acute embarrassment. He asked whether such a course would not be less shocking to the market than for the

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System to bail out the Treasury with unlimited funds.

During a discussion of that point, Mr. Hayes commented that one could not look with any sort of equanimity on the failure of a Treasury financing, and Chairman Martin expressed agreement. Mr. Hayes also made the comment that every dollar the System put into the market last week had saved more than a dollar in the way of attrition. When some doubt was expressed by Messrs. Vardaman and Robertson, he said that without question the System operations had caused a number of people to exchange.

At this point Mr. Rouse, who had left the room to talk with the Trading Desk, returned and said that although there was not too much selling of securities, buyers continued to be missing from the market. However, the market had not gotten any worse; in fact, it might be a little better. A dealer's survey indicated that the large banks included in the survey were subscribing to a little over \$3 billion of the 1-1/2 per cent tax anticipation certificates. At the request of the Treasury, a representative of the New York Bank was approaching some of the New York City banks informally for information on their plans and some line on the situation therefore might be available in the next hour.

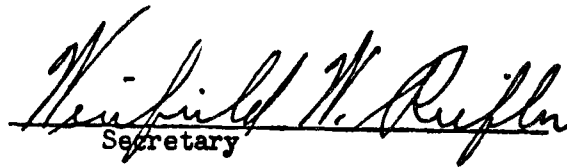
Chairman Martin then stated that another telephone meeting of the Committee would be held tomorrow morning at 10:45 a.m. to

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appraise early developments in the market.

The meeting then adjourned.

  
Secretary