

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington on Wednesday, September 14, 1955, at 10:45 a.m.

PRESENT: Mr. Sproul, Vice Chairman
Mr. Balderston
Mr. Earhart
Mr. Fulton
Mr. Irons
Mr. Leach
Mr. Mills
Mr. Robertson
Mr. Shepardson
Mr. Szymczak
Mr. Vardaman

Mr. Powell, Alternate Member of the Federal Open Market Committee

Mr. Williams, President, Federal Reserve Bank of Philadelphia

Mr. Riefler, Secretary
Mr. Rouse, Manager, System Open Market Account
Messrs. Daane, Rice, Roelse, Wheeler, and Young,
Associate Economists
Mr. Sherman, Assistant Secretary, Board of Governors
Mr. Koch, Assistant Director, Division of Research and Statistics, Board of Governors
Mr. Miller, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mr. Gaines, Securities Department, Federal Reserve Bank of New York

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meetings of the Federal Open Market Committee held on August 2 and August 23, 1955, were approved.

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Before this meeting there had been sent to the members of the Committee copies of a report prepared at the Federal Reserve Bank of New York covering open market operations during the period August 23-September 7, 1955, and at this meeting there was distributed a supplemental report covering commitments executed September 8-13, 1955. Copies of both reports have been placed in the files of the Federal Open Market Committee.

In commenting on the reports, Mr. Rouse stated that most of the activity in open market operations since the preceding meeting had taken place during the past few days. The high-light of the period, he said, was that the account had gotten through the Labor Day period with the use of only repurchase agreements, this period having turned out to be much easier than had been contemplated. The problem during the past few days had been one of a tendency for reserves to appear with the result that sales of securities had been made from the System account, both through runoff of maturing bills and outright sales in the market and to fill foreign orders, in the aggregate amount of \$186,300,000. In addition, repurchase agreements made last Thursday would mature today. While there would be a substantial pull against reserves and reserve positions of banks today and tomorrow, there would be outward payments by the Treasury and Mr. Rouse thought that free reserves might return to around the zero level for a day or two. However, a sharp reversal was anticipated the first of next week. Taking the period since the last meeting as a whole, Mr. Rouse felt that operations had been reasonably successful in accomplishing the objectives indicated by the Committee.

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In response to a question from Mr. Vardaman as to the tone of the market, Mr. Rouse made the further statement that the general attitude seemed to be that the market was becoming accustomed to negative free reserves. Very little "growling" had been reported to the account management.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the transactions in the System open market account during the period August 23-September 13, 1955, inclusive, were approved, ratified, and confirmed.

Mr. Young then made a statement on the current economic situation concerning which a staff memorandum had been sent to the members of the Committee under date of September 9, 1955. Mr. Young's statement was substantially as follows:

Currently available data suggest the possibility that the economy has entered a phase of decelerating advance. More irregularity in output trends is beginning to be evident, productivity gains in manufacturing and mining some months ago ceased to be a general phenomenon, manufacturing employment in durable lines has for several months been maintained on an overtime basis, output in several important industries is close to capacity potentials, the labor market has reached a fairly general state of tightness, and restrictive monetary developments, with higher interest rates, have been operating with mounting pressure to brake credit expansion.

Despite the prevailing high level of aggregate supply at close to full employment, a condition of demand pressure is still a feature of markets for industrial products. The considerable number of price advances occurring, with much talk of a more widespread price lifting to come, is presenting a scene perhaps best described as "prosperity inflation." The over-all stability of wholesale prices, such as we have been having, has reflected the offsetting movement of industrial and farm prices. Lower farm prices, especially for meats, seem likely this fall, extending this appearance of stability for average wholesale prices.

As to the specifics of the situation--industrial production for August is estimated to show only a small rise from July.

Automobile output, seasonally adjusted, was steady, and output of other consumer durables was up. Steel, machinery and equipment production, and output of construction materials all rose. Flood damage in New England reduced output of fabricated copper. In nondurable goods lines, output of apparel, rubber, and leather products was off. Mining output showed little change over July. The order backlog in manufacturing has continued gradually to work upward through July and, from trade reports, apparently also in August.

Business inventories, as estimated from data much less adequate than one would wish for, showed a further moderate increase in July, the latest month for which information is available. At the end of July, inventories stood 3 per cent above the low reached at the end of last year. Meanwhile, sales had risen 6 per cent. Since industrial prices rose 3 per cent over this period, some part of the inventory rise has been a value rather than physical increase. A volatile aspect of the present inventory position is that with all of the talk of price increases going around, industrial buyers are tempted to stretch their discretionary ordering latitude to the limit.

Automobile sales in August strengthened from July on both the new and used car side. Stocks of new cars were reduced over the month and further reduction is expected this month. Used car stocks showed little change. Other consumer hard goods markets were strong in August, although less strong than in July. Output of household durables ran more than a fifth above a year ago. With continuing high retail sales of automobiles and other consumer durables, further instalment credit expansion at close to the \$500 million July rate may be assumed to have reenforced consumer demand based on income. Retail sales as a whole for August, including sales of both nondurables and durables, are estimated to have held at advanced July rate, about 9 per cent over a year earlier.

Activity in construction markets in August was about at the July level, just under spring levels. Contract awards continued to run well above a year ago. Housing starts in August were contraseasonally higher and at 123 thousand units again reached a seasonally adjusted annual rate of 1.3 million units. The rate for August of last year was 1.2 million units. This revival in housing starts confirms information from builders that the stock of unsold houses has been running low. In the mortgage market, commitment money is reported to continue tight but a close-to-record volume of mortgages is still being written under outstanding commitments.

Reflecting high and rising product demands and the considerable tax and labor cost incentives prevailing, the business plant and equipment expenditure plans most recently reported manifest a

decidedly optimistic tone. Third quarter expenditures, according to reports, should equal the 1953 peak level and fourth quarter expenditures should exceed that level. Investment plans of business generally seem in process of upward revision, so that fall columns of business news will feature the announcement of new expansion programs by many companies.

In commodity markets, demands for industrial and construction materials are very strong and supplies, particularly of metals, on the tight side. Price trends in these markets look upward. With higher material and wage costs, prices of many industrial products have been advanced. Farm prices, after fresh declines through much of the summer, leveled off about mid-August. Reflecting late season drought in the corn belt, corn prices have firmed a bit and prices of eggs and dairy products have risen seasonally.

Total employment has now reached record levels. Employment in nonagricultural establishments, after seasonal allowance, remains about stable at the high July level, somewhat short of the mid-1953 peak. The work week at factories averaged 40.8 hours in August. With average hourly earnings about steady over July, weekly earnings reached a new peak.

In the capital markets, partly reflecting tightening credit conditions and interest level adjustments, new flotations have been in reduced volume. Common stock prices have moved into new high ground, mainly on a cash investment basis. The preliminary report from the Stock Exchange indicates a small decline in customers' debit balances at member firms for the month of August. Security loans to customers at city banks to carry other than U. S. Governments also declined.

Business loans, consumer loans, and mortgage loans at banks have continued to increase, the former sharply. Security loans and agricultural loans have declined. Banks met their need for loan funds by liquidating U. S. Governments, in fact, liquidations were more than enough. Altogether banking developments point to a slight decline, on a seasonally adjusted basis, in the currency and demand deposit holdings of individuals and business. Turnover of demand deposits at centers outside New York has continued at the high level of recent months.

The recently effected advance in market interest rates was rapid, and current market levels approximate those reached in the early spring of 1953. In the early spring of 1953, the advance in market interest rates contributed to market uncertainty. Reflecting a better understanding of flexible monetary policy as well as greater confidence in the strength of underlying economic forces, the recent advance in rate levels has had little unsettling effect on market psychology.

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Abroad, production has continued to rise in industrial countries. Resource utilization in Western Europe has reached an intensive degree, with aggregate demand pressing fairly hard against available supply, thus giving rise to various inflationary symptoms. Inflationary pressures have been most acute and persistent in Britain and weakness in the sterling position has continued. There are signs, but by no means clear signs, that the Government's financial measures of correction are gradually taking hold.

Following a brief discussion of Mr. Young's report, Mr. Sproul called for comments with respect to open market operations.

Mr. Leach noted that the report furnished by the Federal Reserve Bank of New York projected free reserves during the week ending September 21 averaging about \$58 million negative, whereas projections prepared at the Board's offices indicated negative free reserves of about \$259 million for the period, and Mr. Rouse commented briefly on the reasons for the difference. Mr. Leach went on to say that he felt policy should continue to be one of gradually increasing restraint. He recalled that at the preceding meeting he expressed the hope that a large part of the needs for reserves in coming weeks would be met through the discount window. This had happened and discounts for the System had risen to around one billion dollars. This amount seemed about right under existing conditions but he would not be unhappy if discounts should increase by another \$100 million or so. If additional reserves were needed late in September and during October, as estimates indicated, they should be provided through open market purchases. Mr. Leach said that he would not favor another increase in the discount rate at the present time but he thought further gradual increase in the degree of restraint was desirable and would result from actions already taken by the System.

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Mr. Earhart said that the effects of a tight market were evident on the Pacific Coast. There was solicitation from the New York area of participation by Pacific Coast banks in longer-term loans as well as solicitation for Federal funds and call loans. There had also been some indication that banks which formerly held Commodity Credit Corporation paper did not care to continue to hold it since the discount rate had been at 2-1/4 per cent, which was the net yield to the banks on Commodity Credit paper. Banks indicated that they were screening loans more carefully than earlier. Mr. Earhart felt that the Committee should at least maintain and preferably increase slightly the pressure it had been exercising through open market operations.

Mr. Irons said that increasing pressure was noticeable among reserve city banks in the Dallas District, but that country banks were not under pressure. As to the economic picture, conditions in the Dallas area were strong. Mr. Irons felt that the situation called for maintenance of steady and gradually increasing pressure and at this stage he thought this should come preferably through market pressure rather than through a further increase in the discount rate.

Mr. Szymczak felt that the present policy should be continued. However, on the basis of the projections of free reserves, it might be necessary toward the end of September to use repurchase agreements and perhaps to make moderate outright purchase of bills.

Mr. Balderston said that he had been impressed with the fact that the central banks in Europe which he had visited recently were watching

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the moves of the Federal Reserve System in connection with monetary policy with great care. With respect to present policy, Mr. Balderston suggested that the Committee should maintain a steady situation during the immediate future. He would like to see a target or goal expressed in terms of a bill rate of from 2.10 to 2.15 combined with negative free reserves ranging from \$300 to \$400 million.

Mr. Powell said that in the Minneapolis area the results of the agricultural price declines were being felt more than he judged to be the case in other areas and he described the various measures which reflected that situation. He also noted that while borrowings by city banks in the Ninth District had been reduced recently, borrowings by country banks were somewhat higher. His view was that national credit policy should go along about as at present, putting pressure on the economy. However, he did not feel that the credit situation in the Ninth District was contributing much to the boom and he presently was in a rather passive frame of mind on credit policy.

Mr. Williams commented on recent changes in bank credit figures for the Philadelphia District. He said that the attitude of the directors of the Philadelphia Reserve Bank was that a further increase in the discount rate should be deferred, reflecting some feeling of concern as to any action that might cause further disturbance to the level of money rates.

Mr. Fulton described economic conditions in the Cleveland District generally as active with further plant and equipment expansion projected. Demand for loans was active but the liquidity position of banks had been

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impaired and, while banks did not feel they could decline to make loans for proper purposes to established customers, there was evident a feeling of tightness. On the other hand, Mr. Fulton said that there was an inflationary spirit throughout the entire district, including agricultural areas, and his view was that the Committee should lean toward tightness rather than to compromise its present policy or to relax anything now being done. If anything, a little more tightness would seem to be called for.

Mr. Shepardson said that the situation called for continuing firm pressure. He liked the proposal Mr. Balderston had made as to a target which included both rates and free reserves. He was inclined to think that in the last week or so the degree of tightness in the market had not been as great as the Committee had had in mind at its meeting on August 23, and he would favor continuing firm pressure during the next few weeks.

Mr. Robertson said that the degree of restraint the Committee had been maintaining had been wholesome but that he felt the Committee had been doing "too little too late". The recent restraint had been exercised on the same basis that the earlier policy of ease was exercised, that is, all the errors were being made on the side of ease rather than tightness. Too much attention was being given to the volume of free reserves and not enough to money rates which, in his opinion, would provide an effective indication of the Committee's objectives. Mr. Robertson said that he

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avored increasing the degree of restraint, that we were in a boom economy, that he felt the ebullience was greater than had been brought out in the economic review and in other comments this morning, and that he would like to see Committee policy point toward a bill rate above the 2.15 figure mentioned by Mr. Falderston--at least up to and perhaps above the discount rate. He would hope that the System might be in a position to raise the discount rate further although he doubted this could be done prior to the Treasury's October financing. In sum, he hoped the Committee today would adopt a policy of greater restraint than was indicated at the preceding meeting of the Committee and that it would look for evidence of this increase in restraint in the money rate structure.

Mr. Mills said that he shared the general tone of the views expressed that the direction of System policy should be toward restraint and rising pressure of restraint. He had a question, however, growing out of Mr. Rouse's opening statement, as to whether the Committee might be too aggressive in some of its actions. It had already taken a series of actions withdrawing reserves from the market and reducing the liquidity of banks. If the Treasury's operations were now to result in an abrupt depletion in the supply of reserves, a "kink" could develop in the market. If a "kink" resulted from stringency in the situation, he hoped the Committee would be prepared to meet the situation with whatever assistance might seem appropriate under the particular circumstances. He referred to the Treasury's financing operations for October, stating that some additional reserves would be necessary during that period if the financing costs were to be

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kept within reason. As to "moving too fast" and then having to correct the situation just as sharply, Mr. Mills felt that it would be preferable for the Committee to shade its operations so that it would not move too aggressively toward reducing reserves with the consequence of having to correct that situation sharply. He recalled that during the fall of 1954 there was a release in November of pentup emotion that expressed itself immediately in the stock market and this was followed by a change in the general business climate. Mr. Mills felt that there was the possibility of a similar recurrence growing out of the Labor Day holiday period. There had been rising activity in the stock market during the last few days which might gain momentum, and, if this developed, it might be reflected in increased credit use and might also be reflected in further enthusiasm and lack of caution in planning by the business community. If the Committee were confronted with such a situation, he would agree with the proposal for greater restraint expressed by Mr. Robertson although for a slightly different reason. He felt the System should not rule out a further increase in the discount rate--such an increase would be as much a signal of caution to the public as a reflection of a rising cost of money to the business community. On the other hand, he agreed that, with the Treasury financing operation coming in October, an increase in the discount rate during the period immediately ahead would be confusing. Mr. Mills went on to say that if the tone of the discussion thus far at this meeting was to be reflected in positive action during the remainder of this month, there would be a further distinct reduction in the supply of reserves and an increase in

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money rates. Such an increase in money rates might produce a very difficult pricing problem for the Treasury in connection with its October financing.

Mr. Rouse commented that presumably the Treasury would make its offering for new money around October 3 or 4, which would be about the time of the next meeting of the Committee, and that payment would be called for around October 17.

Mr. Vardaman was of the opinion that there had been considerable leveling off in the situation and said that he did not observe the exuberance that he thought he felt a few weeks ago. The continuing pressure which the System had been exercising had been producing good results. He would not like to see additional tightening during the next two weeks, not only because of the Treasury's financing but because the System should permit actions already taken to have their effect. It might be that the first meeting in October would indicate it was time to increase the discount rate again or to take other actions which would prevent too much exuberance toward the end of the year. However, unfilled orders had not built up as had been anticipated and the inventory situation had not developed as might have been feared. Mr. Vardaman felt credit policy should continue about as at present, that pressure should not be increased, but that the Committee should be in a standby position and if a stringency such as Mr. Mills referred to should occur, it should be prepared to call a special meeting to take care of the situation.

Mr. Sproul then made a statement substantially as follows:

1. The Committee's usual able review of recent developments in the business and credit situation has underlined the great strength in the general economy and the further evidence of upward pressures on prices as the economy presses closer to the full utilization of its productive resources, while pointing out some deceleration in the rate of expansion. At the same time there does not appear to me to be sufficient evidence of imminent and severe inflation, and speculative excesses, to justify further and more vigorous action in the field of credit policy. The continued advance in production and employment has been based largely on strong consumer demand and high levels of capital investment. The dangers of a price-cost spiral developing, accompanied by inventory speculation, must be balanced against the attractive goal of continued and orderly growth in the economy at high levels of production and employment. And the dangers of excesses in consumer credit, or mortgage credit, must be balanced against our own ability to reach these areas effectively, by general credit controls, without running equal or greater risks of restricting credit unduly in other areas.

2. The ideal role of bank credit is to meet the real needs of this economy of high level production and employment, without contributing to inflationary developments as competing demands for raw materials and finished products tend to press against available supplies. By and large, bank credit has been filling this role. While business loans of reporting member banks have continued their upward movement during the past several weeks, the total volume of loans and investments has been little changed--as loans have increased the banks have sold investments to nonbank investors. This has been the pattern pretty much throughout the year. As a consequence the money supply of the country declined in absolute amount during the first seven months of the year about in line with the experience of recent preceding years, and an increase in the velocity of use of money has been necessary to keep the money factor roughly in line with expanding economic activity.

3. Without claiming too much for credit policy, I think the banking statistics are impressive evidence of the constructive influence of Federal Reserve actions during this period of expansion. A gradual lessening of reserve availability, emphasized by increases in the cost of reserves, has kept bank credit more or less in line with economic needs, without throttling business growth and without throwing the capital markets into disorder. This has been true even as we stepped up the pressure in recent weeks, allowing seasonal demands for credit to snow up in increased borrowing by member banks at the Reserve Banks, and raising discount rates twice within a short period. I think it is now time for a breather--not relaxing but not intensifying restraint--until we have more evidence of the probable

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course of the economy during the last quarter of the year and of the consequences of actions we have already taken.

4. Fortunately, if that is the right word, this period of stabilization would coincide with a period of Treasury financing when, in any case, our secondary responsibility for the success of debt management would suggest a period of stability. During the period September 15 to October 15 the Treasury will be in the process of preparing for, offering, and receiving payment for about \$2.5 billion of new money securities. Again fortunately, however, the borrowing will be of a character--short term tax anticipation obligations--which does not require much sustained conditioning of the market before or after sale. The period during which our freedom of action will be somewhat curtailed should be relatively short.

5. During this period, and I would expect following it also, our sights should be shifted from free reserve targets to member bank borrowing and the entire structure of interest rates. Member bank borrowing has reached as high as \$1 billion recently and borrowing of this general magnitude, for the present, would maintain the pressure we have put on the banks allowing for the usual intra-monthly variations due to movements of float and other more or less ordinary market factors. The capital markets have behaved well so far, avoiding those exaggerated expectations of a restrictive credit policy which can set off a spiralling and disorderly movement of yields and prices. This is the reward, I think, of gradual rather than aggressive pressure. Aggressive pressure is usually only justified in the face of more serious inflationary developments than we have yet encountered and should be reserved for meeting such developments.

6. The open market policy which this brief analysis suggests is to try to continue the present degree of actual pressure, which should further permeate the banking system and the money and capital markets the longer it is maintained, while allowing the Treasury to work out its immediate financing problem in as favorable a climate as possible. In the light of present forecasts of the reserve situation it further suggests that, between now and our next meeting, we may have to use repurchase agreements and outright purchases to prevent an unwanted intensification of pressure, but that we should provide reserves to the banking system reluctantly rather than readily.

Continuing, Mr. Sproul said that while he did not wish to seem to speak for another member of the Committee, he had discussed the situation with Chairman Martin just before the latter left for Turkey and that he

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believed the views he had just expressed concerning the near-term course of open market policy were substantially the same views that Chairman Martin held. Mr. Sproul said that from the discussions it appeared that during the period of the Treasury's financing in October, the Committee would be doing its best job if it maintained pressure, neither relaxing nor intensifying the existing general level of pressure. This might be characterized as continuing the present policy with the understanding that if errors were to be made in carrying out the policy they might be on the side of restraint, although the Committee would not seek to make errors on that side.

Mr. Robertston said that he could not go along with such a program.

Mr. Shepardson said that operations in the recent past impressed him as not having attained what the Committee indicated as its goal at its meeting on August 23. Errors in attaining the Committee's goal would undoubtedly be made but these errors had tended to be mostly on the side of ease, and his view was that there might at least be compensating errors which would approach more nearly the objective indicated by the Committee.

Mr. Earnhart said that he would concur in this view. He felt the existing pressure should be maintained and his suggestion would be that if errors were made in carrying out operations, they be on the side of greater restraint.

Mr. Leach concurred in this view.

After further brief discussion, it was agreed that the general policy for the period between now and the next meeting of the Committee

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should be to continue the general program of restraint indicated at the meeting on August 23, with the understanding that operations in the open market should be handled in a manner which would result in errors being on the side of greater restraint rather than ease.

Mr. Robertson disagreed with this conclusion for the reason that he felt a policy of increasing restraint should be pursued.

Mr. Earhart referred to a situation in the Twelfth District in which some commercial banks had indicated that in view of the recent statement issued by the Chairman of the Federal Home Loan Bank Board with respect to borrowing by savings and loan associations from the Home Loan Banks, commercial banks were being approached by savings and loan associations with requests to borrow funds to enable them to take up commitments they had made on real estate mortgages. He wondered whether other Districts had experienced the same situation.

Mr. Sproul stated that he understood the general situation was under discussion between the Home Loan Bank Board and the Treasury and he also understood that the Board was watching developments to see whether steps were needed to clear up the intent of the Home Loan Bank Board regarding borrowings in this field.

Mr. Robertson stated that he had received an inquiry from representatives of the Farm Credit Administration in connection with proposed legislation which would permit Federal Reserve Banks to make advances to member banks secured by obligations of the Federal Land Banks at the discount rate. It was his hope that this proposal, which had been made on at least one occasion in the past, would again be dropped.

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Mr. Sproul referred to the authority given by the Committee to the Federal Reserve Bank of New York at its meeting on August 23 for repurchase agreements and inquired whether there was any suggestion for change in the authority approved at that meeting.

There was unanimous agreement that the Federal Reserve Bank of New York be authorized to enter into repurchase agreements with non-bank dealers in United States Government securities, subject to the conditions for such agreements prescribed by the Committee at its meeting on August 23, 1955.

Mr. Rouse referred to the existing authorization under which the Federal Reserve Bank of New York is authorized to acquire bankers' acceptances to an amount not in excess of \$25 million at any one time. (See minutes of June 22, 1955 meeting of Committee at which authorizations theretofore granted by the executive committee and still in effect on June 22, 1955 were adopted by the Committee; and authorization previously given by executive committee at its meeting on March 29, 1955.) Mr. Rouse suggested, for reasons which he indicated, that this figure be increased to \$50 million.

Mr. Mills raised the question whether an increase in the amount of bankers' acceptances purchased by the Federal Reserve System was desirable under present circumstances, particularly whether such an increase at the present time might indicate that the Federal Reserve System was becoming a "banker of last resort to the acceptance dealers."

There followed a brief discussion of Mr. Rouse's suggestion during which Mr. Sproul suggested that the staff be requested to prepare a memorandum on the matter for consideration at the next meeting of the Committee

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This suggestion was approved unanimously.

Mr. Rouse stated in response to a question from Mr. Sproul that he had no suggestion for change in the general directive to be issued to the Federal Reserve Bank of New York at this meeting.

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

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

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

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

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Mr. Szymczak said that last Friday Senator Douglas called him on the telephone and referred to a discussion he had had with Mr. Sproul and himself several years ago in which the Senator mentioned that he would like to learn more about open market operations. The Senator suggested that he now pay a visit to the New York Bank for the purpose of observing operations on the security desk and otherwise with a view to becoming more familiar with the open market procedures, indicating that this might be done between October 20 and November 1. He also suggested that he would like to take a qualified economist with him to assist him in observing and analyzing the details of the operations.

Mr. Sproul said that Mr. Szymczak had discussed this matter with him and that he felt the Committee would wish to reply to Senator Douglas that it would be glad to have him observe the operations of the Committee at the Federal Reserve Bank of New York. The response should indicate, however, that information as to the policy of the Committee and details as to its operations could only be furnished to the appropriate committees in the Congress in accordance with established procedure. In the meantime, Mr. Sproul said that he did not think that the Committee could or would wish to deny such a request as that made by Senator Douglas. However, he thought the Committee would wish to guard against individual members of the Congress using such visits as a means of obtaining information which should come to them through official channels in a manner already well established.

Mr. Vardaman said that he agreed that the Committee should welcome the Senator's visit but that he questioned the propriety of his bringing

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with him an economist. Rather, Mr. Vardaman thought, it might be suggested that the System designate one of its economists to assist Senator Douglas during his visit in whatever way he wanted so as to avoid any question of having an individual other than the Senator himself observing the open market operations.

Mr. Ralph Young stated that he had received a call from Mr. Ensley, Chief of Staff on the Joint Committee on the Economic Report, which might be related to Senator Douglas' call. Mr. Ensley had asked that he (Mr. Young) meet with Senator Douglas, Mr. Ensley, and Mr. Wallace, Director of Staff of the Senate Banking and Currency Committee, to discuss monetary and banking statistics. It was Mr. Young's thought that this invitation, which he had accepted, might be related to the other proposal of which he had not previously known.

There was further discussion of Senator Douglas' request and it was agreed that Mr. Szymczak would talk further with the Senator, assuring him that the Committee and the New York Bank would be glad to have him observe the operations. In the discussion, Mr. Szymczak would also present the question whether Senator Douglas felt it would be desirable under all the circumstances that he be accompanied by an economist from the Committee's staff or whether he might find a System economist adequate for his purpose. It was understood that Mr. Szymczak would report his conversation to the Committee.

Mr. Sproul noted Chairman Martin had been authorized at the meeting on July 12, 1955 to appoint a subcommittee to review plans for carrying out

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the operations of the Federal Open Market Committee in the event of an emergency. He noted that Mr. Robertson had a special interest in this subject in connection with the reviews being made of Federal Reserve plans for emergency operations, and he stated that in the absence of appointment of a subcommittee he hoped that Governor Robertson could do some work on existing plans with the view of expediting Committee consideration and action.

Mr. Sproul stated that he had one other matter that he would like to discuss concerning both the procedure for getting matters before the Committee for its consideration and the substance of the discussion regarding discount rate policy at the meeting on August 23, 1955. He then made a statement substantially as follows:

1. I would like to make some tentative comments on the suggestions with respect to discount rate policy which were made at the last meeting of the Committee, first as to matters of form and then as to substance.

2. As to form or procedure it has always seemed to me that, if at all possible, statements such as those presented by Mr. Riefler and Mr. Young should be distributed to members of the Committee--and to the other Presidents--sufficiently in advance of a meeting so that they would have time to consider the complex problems involved and thus be better able to contribute to their discussion. Otherwise the record is likely to have a lopsided appearance, perhaps adequately presenting only those views held by the writers of the papers. In this case the Board members may have had time to study the memoranda, as suggested by Governor Mills' statement, but the Presidents had to rely on immediate reactions to an oral presentation.

Advance distribution of such papers, in addition to contributing to discussion, would also mitigate the dilemma as to how widely such papers should be distributed. So long as they were not part of the records of the Federal Open Market Committee, but merely provocative papers dealing with a System problem, the confidential character of the records of the Federal Open Market Committee would not be in question. This would appear to be particularly so in the case of documents having to do so largely with the discount rate.

3. As to substance, I have several observations which may need to be considered or reconsidered after further study, but which I feel I should mention now. There is no real question, it seems to me, about the desirability of exploring new or different methods of using our weapons of credit policy, in the light of present day conditions in the banking system and the money market, if we remember that our experiments are not of the laboratory but are experiments with the economic blood stream.

4. Now to some of the specific questions with which I have difficulty.

(a) It is said that "the basic tradition of central banking is that the discount rate in boom times ought to be a penalty rate." In my opinion this is not the basic tradition of central banking in the United States as it has evolved since 1914. It is the basic tradition of central banking in the United Kingdom on which we tried to pattern ourselves without complete success because of differences in the banking system and the discount mechanism. The discount mechanism in the United States serves a purpose which is almost absent in the United Kingdom in that it supplements reserve averaging so as to enable a large number of relatively small individual banks to adjust their reserve positions to their individual and often temporary needs. This is quite apart from differences in the discount mechanism which have been found essential to maintain the penalty rate apparatus in the United Kingdom and which do not exist in the United States.

(b) Second, I have difficulty with the argument that the vast difference between "then" and "now" makes the "penalty rate" tradition more acceptable now than it was in the twenties, and that this is largely because there is now one single pivotal or strategic or dominant rate in the short-term money market, namely, the Treasury bill rate. It seems to me that in recent months and years, the Treasury bill rate has become less a part of the money market structure, reflecting the availability of reserve funds at the banks, and more a reflection of the availability of corporate and state or municipal short-term funds. So long as the economy continues to include large nonbank investors who acquire and require increasing holdings of liquid assets, and so long as the payment of interest on demand deposits is prohibited, there will be an increasing special influence in the market for Treasury bills, and the bill rate will often move out of relation to other rates in the sensitive money markets. I doubt if we are much closer than we were to having a single short-term market rate against which a penalty discount rate could be uniformly set.

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(c) In fact I have difficulty with the whole "penalty rate" concept under our conditions. What is to be penalized? It is suggested that we penalize any bank that attempts to borrow from us and use the funds to buy highly liquid paper at a profit, and to remove any incentive for member banks to adjust reserve deficiencies through discounting rather than through disposal of securities in the market. I have difficulty in seeing how that kind of penalty can be enforced by relating the discount rate to the bill rate. In the broadest sense it is still true that the basic reason for member bank borrowing is to obtain reserves to meet heavy demands for loans, which are made at rates well above the discount rate. In a narrower sense, even if the so-called penalty rate were designed to affect bank investments, it would have to be related to the rates on Government securities stretching out well beyond the 90 day bill.

(d) I have difficulty also with the actual role of open market operations under the policy suggested. As I understand it open market operations would be used to maintain a volume of negative free reserves sufficient to make market rates of interest highly responsive to the discount rate, but not in such large volume as to raise the bill rate above the discount rate. Does this mean that the System should maintain a formal penalty rate situation by easing up on reserve pressure whenever the bill rate tends to rise above the discount rate, or does it mean that the discount rate should be raised again and again, say in a period of increased seasonal demand for credit, to keep it in the proper position with respect to the bill rate? If the first course is followed we are likely to lose rather than gain control of the credit situation and if the second course is followed we would seem to have acquired a built in device for shoving the discount rate up, during periods of credit restraint, with real risk of creating disorderly conditions in the capital markets. The only time in recent years when the bill rate went substantially above the discount rate was in the spring of 1953. Such increases in the discount rate at that time might have created conditions which would have brought the capital markets to more of a standstill than was actually the case.

(e) This leads me to another difficulty. The discount rate has been above the bill rate most of the time during the past two years, and the existing relationship is now about what has been suggested as the appropriate one. We have not needed a timeless or rigid formula to achieve this result. It may be said that it has come about in the wrong way, that the discount rate has followed open market operations instead of leading, but I think that is more a matter

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of terms and definitions than of unchanging fact. We have had a situation in which bank borrowing has increased but in which most banks are still swayed by their reluctance to borrow over long periods, and we have had a situation in which there has been large scale adjustment of individual bank portfolios as they sold Government securities to accommodate loans. That, I would say, is what we wanted. If more severe "penalty rates" than have obtained during this period are now envisaged and, if we want to get the discount rate up faster and higher in order to force the banks to sell whatever Government securities they have of whatever maturities, we are really talking about discount rate action and discount rates which could have a demoralizing effect on all capital markets.

(f) I also have some difficulty with a formula which implies that the discount rate should be set uniformly by all Federal Reserve Banks, even though in the past I have been doubtful whether this could be avoided. It may be that recent experience suggests certain tactical advantages, at times, in staggered increases in discount rates. It would seem unfortunate, in any case, unless the grounds were very clear, to adopt a "penalty rate" formula which would further reduce the role of the directors of the individual banks in setting discount rates.

5. What this may all boil down to is the question in my mind as to whether we should contemplate tying ourselves down to one course of action with respect to the discount rate at all times of credit restraint. This is not necessarily the same thing as exploring and using all possible methods of making the discount rate effective under a variety of conditions. There are times and circumstances when the discount rate should lead more than it has, but in attempting to substitute a formula for judgment we have to beware of abandoning responsibility.

6. These are some of the thoughts which have occurred to me. I think they suggest that the proposals put forward at the last meeting need further study and clarification before we can weigh them properly, and that is why I wished to make these tentative comments today.

Mr. Williams stated that Mr. Bopp, Vice President of the Federal Reserve Bank of Philadelphia, had prepared a statement with respect to discount rate policy which related to the subject discussed by Mr. Sproul, and he then read the statement as follows:

***MONEY MARKET IMPLICATIONS OF NEGATIVE FREE RESERVES**

"I. The discount rate, market rates, free reserves and member bank borrowing

"Since free reserves are defined as excess reserves minus member bank borrowings from the Federal Reserve Banks, they can be negative only if borrowings exceed excess reserves. Furthermore, since excess reserves rarely fall below $\$ \frac{1}{2}$ billion, free reserves do not reach a negative level until borrowing exceeds that figure. In other words, negative free reserves mean that the money market is dependent directly on the Reserve Banks to a considerable degree.

"Attempts of member banks to reduce this dependence, either because of tradition possibly reenforced by moral suasion or because it is made more expensive, will tend to tighten the money market in terms of both availability and cost of credit.

"But these attempts to reduce dependence will be frustrated if a specified level of negative free reserves continues to be the goal. A primary effect will be a further rise in market rates. If the discount rate is to continue to be a penalty rate or to lead the market, it will have to be increased again.

"We may begin with member bank borrowing of, say, \$700-800 million and negative free reserves of \$100-200 million. The discount rate is raised to lead the market--or to make it a penalty rate. But this penalty rate will not reduce borrowing so long as open market operations are designed to maintain negative free reserves at the original level. Market rates, however, may be expected to rise because credit has become more expensive at one of its important sources (Federal Reserve Bank discount windows). If the new discount rate is to be kept above market rates, it will have to be increased again.

"The point is that the periodic upward adjustments of rates could be very rapid. Too rapid an upward adjustment could create a liquidity crisis.

"An ultimate purpose of tightening the market is, of course, to curb demand, but the question of policy is the speed with which the brakes should be applied. Although the central bank operates in the money market, its ultimate purpose is to influence the flow of purchases throughout the economy. If the existing tone of the money market is judged to be appropriate to the state of the economy, the discount rate should not be changed for the purpose of assuring that it will continue to "lead" rather than to "follow" market rates.

"II. Anticipations and the rate structure

"Although many factors influence the time structure of interest rates, a pervasive influence is the market's expectations as to rates in the future. If the market expects rates to rise, the slope will tend to be positive (rates on short maturities will be lower than those on longer maturities). The basic reason is that borrowers will wish to issue long terms before the expected rise takes place, and

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the lenders will hesitate to invest in long issues until after the expected rise has taken place. In other words, the expecta-tion tends to increase the demand for and to reduce the supply of long-term funds. At the same time, lenders, not wishing to keep funds idle, will tend to invest in short terms, whereas borrowers will borrow on short term only if they secure a rate concession. The expectation of a rise tends to increase the supply of and reduce the demand for short-term funds.


"If the market expects rates to rise, it may be difficult to force up short-term rates without "drying up" the long-term capital market to a greater extent than may appear desirable."

In the ensuing discussion Mr. Vardaman requested that copies of the statements presented by Messrs. Sproul and Williams be made available to the Committee along with the statements by Messrs. Young and Riefler on August 23. Mr. Riefler said that he assumed that further comments by others could be included and it was agreed that the papers referred to should be made available for further study and discussion by the Committee.

Mr. Sproul stated that he did not intend his remarks to be critical of Mr. Riefler or Mr. Young but that his purpose in presenting the comments he had made this morning was to stimulate thought regarding discount rate policy in the hope that at a subsequent meeting there could be a discussion of the problem and its various aspects on the broadest possible basis.

It was agreed that the next meeting of the Committee would be held on October 4, 1955, at which time a meeting of the Conference of Presidents of the Federal Reserve Banks would also be held in Washington.

Thereupon the meeting adjourned.


Secretary