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, August 18, 1964, at 9:30 a.m.

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

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

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

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

Mr. Molony, Assistant to the Board of Governors
Mr. Cardon, Legislative Counsel, Board of Governors
Messrs. Partee and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Associate Adviser, Division of International Finance, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Mr. Coldwell, First Vice President of the Federal Reserve Bank of Dallas

Messrs. Eastburn, Taylor, Fossum, and Tow, Vice Presidents of the Federal Reserve Banks of Philadelphia, Atlanta, Minneapolis, and Kansas City, respectively
Mr. Sternlight, Assistant Vice President of the Federal Reserve Bank of New York
Mr. Meek, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Stiles, Senior Economist, Federal Reserve Bank of Chicago
Mr. Arena, Financial Economist, Federal Reserve Bank of Boston

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 28, 1964, were approved.

Under date of July 31, 1964, there had been distributed to the members of the Federal Open Market Committee copies of the report of audit of the System Open Market Account and of the report of audit of foreign currency holdings, both made by the Board's Division of Examinations as at the close of business May 22, 1964, and submitted by the Chief Federal Reserve Examiner under date of June 26, 1964. Copies of these reports have been placed in the files of the Committee.

Upon motion duly made and seconded, and by unanimous vote, the audit reports were accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period July 28 through August 12, 1964, and a supplementary report covering the period

August 13 through August 17, 1964. Copies of these reports have been placed in the files of the Committee.

Supplementing the written reports, Mr. Coombs said the gold stock would remain unchanged again this week. The Stabilization Fund now had $188 million on hand, with prospective drains between now and the end of the month of about $38 million, leaving a prospective month-end balance of $150 million. Partly owing to the Viet Nam and Cyprus disturbances, the Gold Pool had taken in only $6 million so far this month. The Russians had remained out of the market and, if recent reports of a much improved Russian wheat harvest were borne out, there might be much less of a windfall from Russian gold sales this coming fall and winter.

The Viet Nam and Cyprus situations had created a certain amount of tension on the exchange markets, Mr. Coombs said, but with the exception of some buying pressure on the Swiss franc the markets remained in reasonably good balance. During this period the New York Bank was, of course, constantly prepared to intervene against any speculative development and, as on previous occasions, it consulted with the foreign central banks as to appropriate tactics. Meanwhile, market knowledge that the central banks and governments were working together to maintain stable market conditions had tended to suppress speculation at its source.

Sterling had become subject to some selling pressure during the past two days, Mr. Coombs said, after getting through the first two weeks of the month in good order. As far as he could tell, the recent selling pressure seemed to emanate from Germany and France and might reflect rumors of a further deterioration in British trade figures as well as expectations that the election date might be announced within the next week or so. The Bank of England continued to pursue its tactics of yielding to pressure on the spot rate and, as in July, this had resulted in some tendency for the forwards to tighten as the floor level of $2.78 was approached. The strength of the forward sterling rate was a gratifying indication of the underlying strength of market confidence in the determination of the British Government, backed up if necessary by massive credits, to maintain the sterling parity. On the other hand, just as in July, the tightening of the forward discount as the spot rate declined might open up an arbitrage margin in favor of London. Mr. Coombs thought that if a risk of such arbitrage developed, it might be well to move into the market again to buy sterling spot and sell it forward with the objective of forestalling private arbitrage flows. This was a tricky operation, since it was necessary to be extremely careful not to exert undue downward pressure on the forward sterling rate and touch off any speculative reactions.

In addition to the continuing credit squeeze in Europe, Mr. Coombs said, some tightening of credit conditions in Canada was now evident. On the past four tenders, the Canadian bill rate had moved steadily up from 3.60 per cent to 3.82 per cent. Commercial bank liquidity ratios were down, while rates on U. S. dollar deposits, Canadian dollar deposits, and finance paper had all tended to move up. Meanwhile, however, the forward Canadian dollar had moved from a premium to a discount and, at the present moment, there was no arbitrage margin favoring Canada on the bill rate comparison. On the other hand, he had the impression of continuing flows of U. S. corporate funds into U. S. dollar deposits at Canadian banks as well as uncovered placements in Canada by U. S. corporations anticipating investment outlays.

Mr. Coombs commented that at the last meeting he had mentioned that the dollar holdings of the Swiss National Bank were roughly $200 million above their traditional ceiling of $175 million. Since that meeting, a combination of a new Swiss franc bond issued by the Treasury to the Swiss National Bank and some payoff on maturing Treasury forward contracts had reduced the surplus dollar holdings of the Swiss National Bank to about $170 million.

Finally, Mr. Coombs said, the worsening of the U. S. balance of payments situation had so far gone largely unnoticed on the exchange markets. Although the dollar remained strong, reports of the deterioration were now beginning to leak out, however, and if the deficit was allowed to proceed unchecked the situation could become potentially dangerous. For the past six months or so, the dollar had been riding a wave of renewed confidence. Market disillusionment could produce some strong speculative reactions in the market and greater resistance from the Continental central banks to accumulating U. S. dollars.

In response to a question by Mr. Hickman, Mr. Coombs said it might be desirable for the System to buy spot sterling in addition to any spot purchases made concurrently with forward sales. If the pound came under attack and the British authorities chose to defend it, the System, by stepping into the market itself, could help reinforce confidence and nip the speculative movement in the bud. Such operations might also give the System a freer hand with respect to swaps between spot and forward sterling.

Mr. Hickman then commented that some Canadian banks were inviting nonbank corporations in the Fourth District to invest in dollar-denominated time deposits in Canada at interest rates 15-25 basis points above the U. S. rate on certificates of deposit. He asked what, if anything, the System could do to alleviate this situation. Mr. Coombs replied that Canadian agencies were offering a rate of 4.25 per cent, as compared with 3.9 per cent currently being quoted on CDs by U. S. banks. In his judgment, a rise in the U. S. rate to 4 per cent, the maximum permitted by Regulation Q, would have little effect on these outflows. Thus, the Regulation was limiting the ability of U. S. banks to compete effectively with Canadian banks for the funds in question.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System Open Market transactions in foreign currencies during the period July 28 through August 17, 1964, were approved, ratified, and confirmed.

Mr. Coombs noted that the System had outstanding with the Bank for International Settlements a $13 million swap of sterling against Swiss francs, which would mature on September 10. At the moment he did not see any possibilities, aside from selling gold to the Swiss, of reversing this swap before the next maturity. Consequently, he requested Committee approval of its renewal for another three months. He noted that this would be the fifth renewal of the swap in question.

Mr. Mitchell asked what the objections were to paying off the sterling-franc swap with gold. Mr. Coombs replied that there was a question of priorities in liquidating various liabilities to the Swiss. He understood from conversations with them that their main objective was to reduce their outright dollar holdings. Accordingly, he thought they would much prefer to have any gold sales used for this purpose rather than to close out the sterling-franc swap, which they regarded simply as a means for moving from one currency to another. In any case, Mr. Coombs said, in his judgment the principle of early reversibility that the Committee followed did not apply as forcibly to this kind of transaction as it did to drawings under reciprocal currency arrangements.

Renewal for another three months of the $13 million swap of sterling against Swiss francs was approved.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U. S. Government securities and bankers' acceptances for the period July 28 through August 12, 1964, and a supplementary report covering the period August 13 through August 17, 1964. Copies of these reports have been placed in the files of the Committee.

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

> Financial markets came through the recent three-week period displaying the underlying stability that has become customary in the face of crisis or near-crisis developments. The Treasury's sale of about $4 billion of 18-month notes, to replace the August 15 maturities not turned in during

last month's advance refunding, proceeded smoothly, and dealers made further progress in distributing the large holdings of bonds taken on during the advance refunding. The market had a jittery moment or two when news from Cyprus came closely on the heels of Southeast Asian developments, and when this was followed up by market advisory letters making reference to adverse payments developments and possible inflationary pressures, but no sizable selling was pressed into the market and a feeling of confidence in current rate levels has remained.

Indeed, the confidence during the past three weeks has been such that dealers have been in no particular hurry to work down their holdings of longer term issues taken in the advance refunding. Progress in distributing their holdings has been most noticeable in the 5-to-10 year maturity area where dealer positions have worked down from over $800 million after the advance refunding books closed to just under $500 million last Friday. Holdings of over-20 year maturities have moved down irregularly from about $360 million to around $300 million. Dealers also hold a sizable block of the new 18-month notes that were paid for yesterday--although, of course, the potential exposure on an issue of this maturity is much less than in the case of longer term holdings.

As described in the written reports, the condition of the money market varied from day to day during the past three weeks, but generally remained within the range of variation prevailing in recent months. In the early part of the recent period the money market was fairly comfortable as dealer financing needs were light and some of the major money market banks tended to be underinvested. Practically all Federal funds trading was at 3-1/2 per cent, but the flow was large and member bank borrowings were modest. As the period progressed and market supplies of securities increased--in good part reflecting additional bill sales by the Treasury--the dealers turned with their enlarged financing needs to the money market banks. The availability of Federal funds contracted and a larger portion of bank reserve needs had to be met at the discount window, but there were no signs of undue strain.

On balance System operations provided $295 million reserves during the period, with sizable injections in the early part of the interval partly offset later on as the usual midmonth factors came into play. Temporary reserve needs were met in part through the extensive use of short-term repurchase agreements, while the more lasting reserve needs were met through outright purchases of both bills and coupon issues--the latter being undertaken once the books were closed on the Treasury's note offering.

Treasury bill rates edged a little higher during the recent period, continuing the upward movement from the low point touched just before the Treasury's announcement of a $1 billion bill strip on July 20. The rise seems to have reflected not only the enlargement of supplies offered by the Treasury but also a let-up in investor demand once the advance refunding was over and a firmer tendency developed in the money market. In the period immediately ahead, the bill market may face some of the same influences as in the past few weeks, since the Treasury plans to raise about $1 billion quite shortly through the sale of a March tax anticipation bill, while investor demand may be seasonally light. On the other hand, the large seasonal reserve needs associated with the month-end and with Labor Day lie just ahead and presumably the bulk of these reserves will be supplied through System bill purchases. Moreover, it will probably not be long before the continued generation of corporate liquidity injects increased demand for short-term money market instruments.

The markets in corporate and tax-exempt securities have been uneventful recently--as is usual in the midsummer period. The small volume of new corporate offerings reaching the market was fairly aggressively bid for but was taken up rather slowly by final investors, and dealers have been willing to hold on to their positions in view of the light calendar. State and local issues have been in good supply and at one point during the recent period the dealers' "Blue List" of advertised inventories worked up above $700 million but underwriter bidding has been restrained and progress has been made in moving bonds into investors' hands--in some cases at small price concessions. A major test faces this market next week with the scheduled sale of $320 million Columbia Storage Power project bonds.

At the moment, no major Treasury financing operation is in immediate prospect. As noted above, the Treasury plans to sell about $1 billion of March tax bills in the near future and several auctions of tax bills of roughly similar size are tentatively scheduled for the balance of this year, but operations of this scope should present no problem for the absorptive powers of the market. The dealers continue, of course, to hold a sizable block of securities taken in the recent refunding operations but good progress is being made in distributing these issues and progress can be expected to continue, barring a drastic change in the interest rate outlook.

Mr. Mills noted, as background to a question in his mind, that the Committee had before it a staff draft of a proposed directive of the conventional type and also a prototype of the kind of directive that would be used if the Committee adopted the reasoning and the philosophy that had been set out for further study. It seemed from the closing paragraphs of both directives that the Desk was being asked to keep an attitude which really was tied to the rate of interest. In supplying and withdrawing reserves, the Desk would allow some oscillations in rates, but in the final result it would produce rates approximately at a level that was predetermined. His questions were whether in the course of its operations the Desk was working toward some magnitude of free reserves, and what emphasis it put on the tone of the market. His concern was based on a feeling that the reactions of dealers and other participants in the market had been deadened by the nature of operations over a protracted period of time, and that the consequences of any sudden change in interest rates resulting from a change in the directive would be more far-reaching and disturbing than if a freer market was permitted.

Mr. Sternlight said that the Desk considered various factors in association--the tone of the market, statistical measures of reserve availability, and rough ranges of money market interest rates. In day-to-day operations the Desk was guided mainly by the aim of maintaining some level of reserve availability. It also was attentive to the factors summed up by the word "tone," because reserve estimates might be off for one reason or another and because there frequently were changes in reserve distribution. The Desk did not aim specifically at any given pattern of interest rates, but tried to achieve the degree of reserve availability and the conditions in the market that were associated with the general range of interest rates that the Committee had indicated it desired.

With respect to the matter of the market's being upset by a substantial change in rates, Mr. Sternlight said, some readjustments would be called for whenever the Committee made a major change in policy, whatever guideline was used. There had been such periods of readjustment in the past, most recently a year ago when the discount rate was raised. In his judgment the market was able to cope with such developments.

Mr. Daane asked what range of free reserves Mr. Sternlight thought would be consistent with the recent behavior of interest rates and other money market variables. Mr. Sternlight replied that the Desk's recent operations had been aimed at a free reserve figure of $100 million, with fluctuations of perhaps $50 million on either side. At times the figure might fall outside of that range due to circumstances beyond the control of the Desk.

Mr. Mitchell asked whether additions to the supply of Treasury bills, such as would occur shortly with the sale of the tax anticipation bill that Mr. Sternlight had mentioned, might not alter the relations previously existing among bill rates, free reserves, and other variables. If it did, could the Desk manage operations in such a way as to maintain the existing consistency among the guides mentioned while achieving the same monetary results?

Mr. Sternlight replied he would not expect that a sale of bills in the volume the Treasury planned would produce any great problem for the Desk. The market was expecting a sale of tax bills, and the increase in supply would tend to be offset by the kind of broad investment demand that had been exhibited more or less regularly. There might be some problem in the very short run, and some day-to-day accommodation might be necessary while the market was taking up the new supply of bills. But this would be only a temporary accommodation.

Mr. Mitchell commented that the immediate effect would be to provide additional reserves, although they might be withdrawn subsequently. Mr. Sternlight agreed.

Mr. Ellis noted that Mr. Sternlight had explained the factors at work in the last three weeks which led, among other things, to a rise of about 6 basis points in the bill rate. In Mr. Ellis' judgment this rise was within the context and scope of the present directive. He asked whether in Mr. Sternlight's view a further rise of 5 or 6 points, perhaps resulting from further bill issues, also would be within the context of the directive, or whether the Desk would feel constrained to supply enough reserves to moderate such a rise.

Mr. Sternlight replied that the bill rate had fluctuated recently within the 3.45-3.55 per cent range, and currently it was about 3.50 per cent. Thus, even with a further rise of 5 basis points or so the rate would still be within the recent range. There would be another set of circumstances, however, if as a result of a new supply of bills the rate moved significantly above 3.55. However, he regarded the directive to the Desk as geared primarily to reserve availability. In his judgment the Committee met frequently enough to reset its guides if it was dissatisfied with the bill rate.

Mr. Hayes said he thought it important to avoid putting too much emphasis on the bill rate as such; the general tone of the money market was of greater significance. There could be wide swings in the bill rate at times when the tone of the money market was reasonably steady.

Mr. Balderston referred to Mr. Sternlight's comments that increased corporate demand for money market instruments was expected, and noted that he had understood some corporations, particularly in the auto industry, were faced with financing needs. He asked whether corporations were expected to be buying or selling short-term instruments on balance in the near future.

Mr. Sternlight replied that the next few weeks were likely to be a period of seasonally light corporate demand for short-term securities, particularly because the auto companies would be letting up on their purchases, but in September corporate demand was apt to be heavy again. Even during the next few weeks he did not expect the sort of turnaround from buying to selling by auto companies that typically had occurred a few years ago. They had reorganized their financing operations so that they ordinarily did not have to sell bills in any volume; they made adjustments by modifying their rate of buying.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period July 28 through August 17, 1964, were approved, ratified, and confirmed.

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

Mr. Noyes presented a statement on economic conditions as follows:

While it is true that the economy has continued on its impressive upward course, with little change in the rate of advance and no spectacular movement in the broad price indexes, it would be wrong to say that there has not been some shift in the economic climate. There has been a subtle, but basic, change in attitude, and too much movement in sensitive industrial commodity prices to dismiss lightly.

The Board's index of industrial production rose another full point in July--up seven points, or 5-1/2 per cent, from a year ago, and an even more impressive 5 points, or about 4 per cent, from January.

Capacity is an illusive concept, but no matter how one conceives of it or attempts to measure it, there can be no doubt that, with production increasing at an annual rate of over 8 per cent, the rate of use of our physical resources moved up in the first seven months of the year.

Similarly, there undoubtedly has been an improvement in our use of human resources. The sharp decline in unemployment from June to July to 4.9 per cent may be suspect, but the downdrift from figures which were averaging around 5-1/2 per cent last winter, to something in the 5 per cent range this summer, is unmistakable. In terms of the so-called gap between actual and potential GNP, as set forth in recent reports of the Council of Economic Advisers, there was a reduction in the gap, from 4.3 per cent of potential GNP at the end of 1963, to 3.8 per cent in the second quarter of 1964. Thus, we have made real inroads into our unutilized backlog of both manpower and plant capacity so far in 1964.

On the average, wholesale prices increased 4/10ths of one per cent from June to July. Despite a 1 per cent month-to-month rise, farm products and foods were still well below both a year ago and the 1957-59 average. On the other hand, the 2/10ths of a per cent rise in industrial commodities put them 3/10ths of a per cent above a year ago, and 1.1 per cent above the 1957-59 average.

These are small differences, and it now appears unlikely that there will be much further increase in the wholesale price index from July to August. The weekly index, based on a smaller sample, declined a little after mid-July, and then rose only moderately in early August. Thus, there is very little basis, even taking into account the latest data, for modifying the generalization that the broad average of wholesale prices is still well within the narrow range in which it has moved since the late 1950's.

Only when we turn to a daily index of market-traded commodities do we find any dramatic changes in the recent period. For example, the 13 industrial materials in the BLS daily spot index averaged 101.4 per cent of the 1957-59 average in June. This index had risen 1 per cent by mid-July--specifically to 102.5 on July 15. It gained another percentage point by July 31, when it stood at 103.6. It jumped to 106.3 by August 10, and has drifted down very slightly since then. Thus, we do see in the narrow area of market-traded industrial commodities an impressive upward price movement, extending over several months and accelerating in early August.

This movement in the BLS spot index, and in similar privately-compiled indexes of market-traded commodities, has undoubtedly contributed to the enhanced concern about the possibility of inflation, which has been reflected in quite a number of newspaper stories and market comments. Widespread discussion of the possibility of an across-the-board increase in steel prices, and speculation about the effect of the high first-half profits of auto companies on the wage settlement in that industry, are also cited as reasons for growing concern about the continuance of price stability.

I have tried to set forth the facts about recent price movements as fully and fairly as I could. They do not lend themselves readily to brief summarization, but one might say that the broad measures are still quite stable, while market-traded commodities, notably copper and steel scrap, have moved up sharply, with some accompanying increase in inflationary sentiment.

More generally, confidence in the continuation of rising levels of output and employment, with or without rising prices, seems to have increased. I have been exposed recently, for the first time, to analyses by two careful students of the building industry, who feel that construction in the months ahead will be limited by supply rather than demand factors. Sources within the automobile industry seem, almost incredibly, to be expecting another very good year, encouraged perhaps by what they regard as strong current performance.

Speculation, which seemed to be gaining some ground a month or so ago, that we might see an upper turning point early in 1965, has all but completely vanished.

It is hard to be critical of the recent performance of the economy--it has been little short of magnificent. By the same token, it is hard to argue that some lessening of credit ease, either to moderate the rate of monetary and credit expansion or for balance of payments reasons, would have serious adverse effects on domestic output and employment in the present circumstances.

Mr. Holland made the following statement concerning financial developments:

Economic expansion in recent months has been accompanied by large and growing financial flows. The sustaining influence of such flows into the central financial markets undoubtedly helps to explain the resilience of these markets in the face of the large Treasury advance refunding and the succession of international uncertainties.

Bank credit and deposit expansion has played a large role in these recent financial movements. On an average daily basis, total bank credit and deposits expanded at about an 8 per cent annual rate during the June-July period, and further expansion, although perhaps at a somewhat more moderate rate, appears underway in August. Money supply climbed $2.2 billion from the last half of May through the first half of July; it fell back $200 million in the last half of July, and we now estimate it rose again by a more moderate $400 million in the first half of August. Taken together, the increases in this measure since the second half of May have been at a seven and one-half per cent annual rate. This expansion, of course, comes on the heels of rather small money supply additions earlier in 1964, and the annual rate of growth over the year to date is only about 4 per cent. Nonetheless, this has been the strongest surge of money supply increases since last fall.

I should point out that the summer's addition to the money stock has not been idle. Debits to checking accounts have risen just as fast as deposits, holding the July rate of money turnover outside New York City at the advanced 35.5 annual rate of the second quarter. GNP is apparently rising at a rate almost as fast. Clearly, there has been more money work to be done.

Undergirding this growth in money supply, and reflecting the general business advance, has been a fairly steady growth in bank loans extended to nonfinancial customers, that is, to businesses, consumers, farmers, and on real estate. July's $900 million growth in such loans was a little below the first-half average, but it brought the annual rate of growth for such loans thus far in 1964 to over 10 per cent, compared with 9 per cent in the similar months in 1963.

Other kinds of bank earning assets, however, were undergoing sharp fluctuations over the past six weeks, making comparisons of aggregate single-date figures quite confusing. Bank holdings of Governments have been particularly volatile, as banks first sold large amounts of securities in the favorable atmosphere created by the Treasury's July advance refunding, moved temporarily into very liquid positions, then bought sizable blocks of the bill strip and one-year bill offerings, and bid heavily for the 3-7/8 per cent, 18-month cash refunding offering for which payment was made yesterday.

The consequences of such bank maneuverings were reflected in the easy money market atmosphere that developed in middle and late July and that was only erased in the past two weeks as banks picked up the weight of their own and dealer participations in the latest Treasury financings. Now we are back with a money market in a snug but more balanced position. In fact, the readings of most money market indicators are quite similar to those as we approached the fall season a year ago, with the chief exceptions being that the three-month bill rate is about 15 basis points higher today and free reserves fractionally lower.

Last fall, however, as well as the year before, you will remember that the reinforcement of cyclical with seasonal demand forces resulted in several months of strong money and credit expansion. How much of a repetition of that pattern we can expect this year is a matter of conjecture at this moment, but it seems to me reasonable to expect that the objective of moderate further credit and monetary expansion in the period ahead would more likely be served by maintenance of the slightly firmer money market conditions that have emerged in these past two weeks, rather than the fluctuating but on average somewhat easier climate of money market conditions and marginal reserve availability that has prevailed since last spring.

It would be well to expect that a policy aimed at preserving recent money market snugness would on occasion lead to tighter readings in one or two areas. For example, bank borrowings might be expected to move up further on occasion, for during the fall's heightened financing activity reserve needs and reserve flows do not always mesh as well as in more tranquil times. Moreover, the Treasury bill rate could move up a little further in the weeks ahead, for reasons already outlined by Mr. Sternlight.

I am compelled to emphasize, however, the narrowness of the range within which current monetary policy could be altered without risk of producing sharp and substantial reactions within the financial system.

In the capital markets, dealers have heavy inventories of both long-term Government and municipal securities. Right now they feel assured that there will be no substantial change in monetary policy. But a rise in the bill rate of more than a very few basis points, or a few weeks of low reserve figures, could easily upset that assurance and produce a significant upward move in long-term interest rates.

In the money market, Federal funds flows, already reduced from their July bulge, would be likely to dwindle further as bill rates rise. Reduced Federal funds flows would pinch New York City banks particularly, and again risk the generation of a cumulative spiral of money market pressures.

Here the feedback into the CD market becomes a cause for concern. Market reports suggest that most big CD's are now being initially issued at no less than a 4 per cent rate, even by prime-name banks, with the only variable being the number of months to maturity. In this circumstance, second- and third-line banks, even good ones, are likely to have some of their customers pre-empted by money market banks as the latter come under greater pressure. With some uncertainties about CD's already prevalent because of a handful of problem cases, the ingredients for a serious contraction, or at least a centralization, of CD demand exist.

Finally, there is the broader question of impinging upon local bank credit availability. Without reciting all the details, let me simply point out that bank liquidity ratios have been worked down low enough to imply that at least a fraction of the banks are approaching the point where some reconsideration of lending policies will occur. That point cannot be defined with precision, but it is one to be approached very gingerly.

To sum up, the robustness of money and credit demand seems to give some grounds for reconsideration of the proper monetary policy at this juncture, but the room for prudent maneuver is limited indeed. I myself do not read the financial signs as yet being so definitive as to impel a change in monetary policy at this point, but I think they are such as to be compatible with a mild change, if that should be regarded as desirable because of either domestic business or balance of payments developments.

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

The U. S. payments deficit remains uncomfortably large. The preliminary unadjusted July figure of $612 million is, after seasonal adjustment, certainly no larger and probably smaller than the April deficit of $484 million. But whereas last spring the deficit nearly vanished again in the following month of May, the tentative data for the first two weeks of August suggest for this month another substantial deficit. Unless the second half of the month brings substantial improvement, the deficit for the two months, July and August, would be at least as large as the deficit for the entire second quarter.

And as you know, the figures for the second quarter were themselves disappointing. In consequence of a revision in the estimate of "special" receipts and in the seasonal adjustment factor, the seasonally adjusted deficit for that quarter is now put at $740 million, and the seasonally adjusted deficit for the first half of the year at $960 million.

The increase in the deficit between the first and the second quarter was due to three items: the trade surplus was reduced by $270 million, as exports declined slightly and imports rose; domestic issues of foreign, largely Canadian, securities rose by $130 million; and the deficit on transactions other than merchandise trade and flows of financial capital--i.e., services, direct investments, and government expenditures abroad, as well as errors and omissions--rose by $170 million. The outflow of short-term bank credit and liquid funds remained at near-record levels but long-term bank lending to foreigners declined.

We should remember, however, that the deficit figures appear so large only because of the peculiar way in which we compute the payments balance. A recent study undertaken by Mr. Lederer, the payments expert of the Department of Commerce, confirms the view frequently expressed by San Francisco's Mr. Grove that commercial banks often tend to make their loans to foreigners equal to the volume of their foreign deposits. Obviously, if a U. S. bank receives a deposit from abroad and relends the same amount to a foreigner, this transaction cannot in any meaningful sense be considered to hurt the net liquidity position or the balance of payments of the United States. And the same applies to the converse case, in which a foreign bank receives a deposit from a U. S. resident and reinvests it in the U. S. money or credit market. It should not be beyond the ingenuity of U. S. statisticians to present our payments data in a way that gives recognition to these relations.

Such a reform would be important because, for instance, in the second quarter the rise in U. S. bank credit to foreigners and the movement of U. S. money-market funds abroad was practically equal to the entire U. S. deficit--$600 million as compared with a seasonally unadjusted deficit of $623 million; and as much as one-fourth of these movements should probably be considered as cancelling out a corresponding rise in foreign deposits with U. S. banks and foreign investments in U. S. money and credit markets.

Data on movements of U. S. bank loans and deposits abroad are not yet available for the first six weeks of the current quarter. But in this latest period, the larger part of the deficit--$600 million out of an unadjusted total of $820 million--represented an increase in foreign private dollar holdings. No doubt a substantial part of that amount should again be cancelled out by corresponding increases in U. S. private liquid claims on foreigners. On the so-called "official settlement" basis--which is also subject to serious weaknesses but which, on balance, is ordinarily less misleading than the conventional basis of our payments calculation--the U. S. payments position in the current quarter so far would actually be much less unfavorable than in the second quarter, although still much less favorable than in the first quarter or in the first half of the year as a whole.

But while our conventional method overstates the economically significant size of the deficit, the existence (or rather the reappearance) of a serious payments gap is confirmed by all alternative methods.

Three possible explanations for this deterioration come to our mind. First, it would be surprising indeed if the political uncertainties of the forthcoming election, together with the higher tension in the Mediterranean and the Far East, were not reflected in some capital flows, including especially "leads and lags" in commercial and financial payments. And, indeed, for the first time in several years, relatively sizable funds have been reported moving uncovered into sterling--presumably because the holders feel certain that a sterling devaluation will neither precede nor immediately follow the British elections due in October.

Second, there have been rumors that some banks were shifting funds to Europe in order to be able to expand their lending through the Euro-dollar market in case the interest equalization tax should be extended to bank loans.

And third, the restrictive policies of many European countries, which in June had already led to a sharp decline in imports from the United States, are bound further to reduce U. S. exports; and they are increasingly compelling a withdrawal of funds from the United States. The latest example: the Netherlands authorities have based the publicity for their anti-inflationary program primarily on the deterioration in the Netherlands payments balance. But in July and August, the Netherlands Bank experienced such a rapid inflow of dollars that it requested the Federal Reserve to draw $30 million in guilders under our swap arrangements.

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

For several months now we have watched events unfold both at home and abroad, and some of us have had the uneasy feeling that the time might be approaching when a moderate change of policy would be required if the signs of deterioration in the U. S. balance of payments received further confirmation. Our hands were tied while the Treasury was carrying out its major advance refunding program and taking care of the remaining August maturities, and while the market was given time to digest the large volume of new securities offered in these programs. That period is now past, and we are free to move if we believe a move is desirable. To my mind, the worsening of the payments deficit in the second quarter, followed by a dramatic further deterioration since mid-year, and coupled with the further evidence of vigor in the domestic economy, points clearly to the need for a reduction in the present degree of monetary ease.

The strength of the domestic economy and the brightness of its prospects are highlighted by the sizable July increases in industrial production and retail sales, continued low inventories in relation to sales, reports of enlarged capital spending plans associated with higher corporate profits and increased manufacturing capacity utilization, and the consumer spending potential resulting from the tax cut. Retail sales so far this year have exceeded those of a year earlier by 5 per cent, double the rise in the comparable months last year. In this context, the recent slight softness in residential construction is not disturbing.

The reduction in unemployment is highly encouraging. While the new low rate for July involves but one month, comparisons of longer periods are also encouraging. In the period between the last quarter of 1963 and the months of May, June, and July, 1964, 1.4 million more persons were employed, while the civilian labor force rose by 1.1 million. On the other hand, between the last quarter of 1962 and the three-month period May-June-July 1963, employment rose by only 900 thousand while the labor force rose by 1 million.

We have been fortunate in the last several years in having a relatively stable price situation, but questions are now arising as to whether that situation will continue. It is too early to know whether the rise in sensitive raw industrial prices in early August by 3-1/2 per cent above the June average is due mainly to temporary factors. Trial balloons for higher prices are appearing from time to time, notably from the steel industry. While announcements of specific price changes continue to be mixed in direction, more are on the up side than on the down side. The outcome of the current labor negotiations in the auto industry could have an important effect on prices; while the auto companies could probably absorb substantial wage increases without an increase in auto prices, a too generous settlement could set the stage for pervasive wage and price pressures.

Developments in the international area are most disturbing. The second-quarter balance of payments deficit was at a seasonally adjusted annual rate of $3 billion, up sharply from the first quarter, and considerably in excess of the $1.6 billion (annual rate) deficit recorded in the second half of 1963. The deficit for July, as indicated by the "flash" figures, was very bad. While some of the bad July showing was due to seasonal and other special factors, the size of the deficit is appalling, especially when we reflect on our national record of large annual deficits for some six years, despite the great effort expended in recent years to reduce the deficit.

The second quarter of 1964 was marked by deterioration in the trade accounts--both exports and imports; in the service accounts; and in certain Government accounts. As for the remainder of 1964, it is apparent that the cyclical trend is against us as regards imports of goods and services; we are not likely to have the benefit of extraordinarily high agricultural exports; and direct investments have been rising. At the same time, there is little evidence that there will be areas where receipts will rise or outflows will decline in sufficient volume to offset the probable losses.

Recorded short-term capital outflows have been running at an annual rate of $2.5 billion in the first half of this year. Little solace can be gained from the fact that these outflows declined slightly between the first and second quarters--that decline is altogether trivial in the light of the heavy total for the first half as a whole. It is striking that actual recorded outflows in the first half of this year were roughly twice as large as in _all_ of 1963, or _all_ of 1962. Thus, the potential for bringing about some favorable balance of payments effects through efforts to dampen down short-term capital outflows is large. It should be noted that interest rates have been rising abroad, and that interest rate differentials, both covered and uncovered, have been moving against us this year, although they may now be reaching a level from which further advances are much less likely.

The money supply so far this year has risen at about the same rate as over the same period last year, after a distinct slowing down during the first four months. Although the money supply plus time deposits has not grown as rapidly this year as last, the growth has been substantial. I am impressed by the fact that despite relatively high and rising loan-deposit ratios the banks as a group are still prepared to lend money rather generously both here and abroad. There is no evidence that the economy is not obtaining an adequate supply of credit, including bank credit.

The firmer tone in the money market since completion of the most recent Treasury financing has been helpful, but in my judgment open market operations should now be employed to bring about a further firming of short-term interest rates. I have in mind a gradual and cautious move leading to a three-month bill rate of perhaps 3-3/4 per cent, with due consideration of the impact on the longer term capital markets. This would probably entail continuation of the Federal funds rate consistently at the discount rate, an increase in member bank borrowing, and free reserves in a range fluctuating around or somewhat below zero.

After such a change has been brought about by open market operations, an increase in the discount rate will undoubtedly be advisable. However, I would not favor an anticipatory discount rate increase at this time but would envisage use of the discount rate later to confirm our action in the open market area.

While the proposed policy change would clearly entail a higher level of short-term interest rates and some upward pressure on rates generally, it does not envision any sharp cutback in the flow of bank credit to the economy. In this connection, we should bear in mind that the shift in policy last July had only minor effects in slowing the growth of bank deposits and nonbank liquidity. Over the past year, money supply plus time deposits has advanced 7-1/2 per cent, only slightly below the 8 per cent rise in the previous year. Nonbank liquidity has risen 6-1/2 per cent, as compared with 7-1/2 per cent in the previous year.

The robust domestic economy should be able to take such a policy change in stride without adverse effects. There is not sufficient evidence of incipient inflationary pressures to suggest a positive need for reduced ease on domestic grounds, but this might become an important supplementary consideration some time in the coming months.

A reduction in monetary ease should be helpful not only in its direct effect on short-term capital flows but also as a signal to the world of the United States' determination to take affirmative steps to defend the dollar. Failure to act promptly to protect the dollar in the light of recent payments developments could easily lead to an erosion of confidence which in turn would make the dollar more vulnerable to speculative attacks. The impending annual meeting of the International Monetary Fund and the International Bank in Tokyo will tend to focus attention of the payments positions and policies on the major countries. In these

> days of international incidents, and of questioning and testing this country's political and military leadership in the world, a strong dollar is a particularly vital element of national strength.
>
> The directive should be revised substantially to reflect the further deterioration in the balance of payments, the fact that Treasury financing operations are no longer a policy consideration, and the change to a policy of reduced monetary ease. I have specific language to suggest at the appropriate time.

Mr. Shuford reported that production and employment in the St. Louis District had shown little change this year. After expanding steadily through 1962 and 1963, total payroll employment had remained unchanged since January. Industrial production in the District, as indicated by electric power use, had risen only slightly since January. This continuation of activity on a high plateau was shown in St. Louis, Little Rock, and Memphis.

Mr. Shuford commented that there were some indications of a rise in spending in the District in recent months. After virtual stability from August 1963 through April of this year, check payments had risen rather markedly. Business loans had risen at about a 5 per cent annual rate since April, in contrast to the stability shown from January to April.

Despite the apparent limited strength in the District economy, banking developments resembled what might be expected in a strong economic expansion. Loan-deposit ratios had risen since January, continuing a rise that began in 1961. Most categories of loans had expanded, Mr. Shuford noted. The investment portfolios of District banks had declined relative to deposits, largely reflecting decreases in holdings of Treasury securities. Bank deposits rose from January to July at a seasonally adjusted annual rate of 10 per cent, primarily as a result of growth of time deposits. While there had not been any appreciable increase in borrowing from the Reserve Bank in recent weeks, it was significant that there recently had been inquiries by two of the District's larger commercial banks regarding the mechanics of borrowing against eligible paper.

Nationally, Mr. Shuford said, the economy appeared to be continuing a strong expansion. Industrial production, employment, and retail sales continued to show substantial gains in July, and there was further improvement in the unemployment situation. While the economic expansion was reasonably balanced and had not shown any clear inflationary tendencies, some upward pressure on prices had emerged.

The salient monetary developments, Mr. Shuford said, were the continued rapid increases in bank reserves, loans, and deposits, and, in recent months, sharp increases in money. These developments had occurred within an environment of continued stability in interest rates.

Recently, Mr. Shuford noted, there had been some concern about the ability of banks to accommodate further loan expansion. Since early 1962 bank loans had risen relative to deposits and since early 1963 bank investments had declined. Bank holdings of Governments had dropped sharply. This situation might mean that if credit and money expansion were to be kept within reasonable limits demand for credit might push interest rates up markedly.

As to policy, Mr. Shuford favored moderate expansion in money, at a rate similar to the average rate of expansion since the beginning of the year. This would mean some reduction from the recent rate of increase. From December to July money increased at a 4 per cent annual rate and reserves behind private demand deposits rose at a 3.7 per cent rate. However, from May to July these rates of increase were 8.5 per cent and 10 per cent, respectively. A moderation from the recent high rates of expansion of reserves and money might result in somewhat less ease in money market conditions, but in the context of the domestic and international situations this would not appear to be undesirable. Therefore, Mr. Shuford said, he would not be disappointed if somewhat lower free reserves and somewhat higher short-term rates were required to moderate the recent rapid monetary expansion. Also, this undoubtedly would result in increased borrowings from the Federal Reserve Banks, which should be expected and accepted.

Mr. Shuford said that these aims perhaps could be accomplished under the existing directive, but he was inclined to agree with Mr. Hayes that some revision in the directive was appropriate in order to reflect somewhat less ease in money market conditions. He thought the first paragraph of the staff draft was satisfactory, but he would suggest the following alternative language for the second paragraph: "To implement this policy, System open market operations shall be conducted with a view to accommodating moderate expansion in aggregate bank reserves, while maintaining orderly conditions in the money market." The principal aim was to place primary emphasis on the expansion of reserves and the money supply, rather than specifically on recent conditions in the money market. Mr. Shuford said he would be glad to see Mr. Hayes' suggested draft, which he suspected he would find also acceptable.

Mr. Bryan remarked that the available figures for the Sixth District continued to indicate a robust economic expansion. As he had mentioned before, new plant and equipment announcements seemed to be running at record levels.

On the national scene, Mr. Bryan said, he had been pleased by the expansion in the economy. At the same time he was somewhat alarmed by recent price developments, which Mr. Noyes had described so well. He disliked making predictions, but he suspected that the economy presently was at a stage where further price increases could be expected, since marginal work forces were now being combined with marginal plant. He also was concerned by the fact that the money supply, however defined, seemed to have increased in the last 90 days at a rate greater than the economy reasonably could be expected to absorb if this rate of expansion were to continue.

With this situation in mind, Mr. Bryan said, he had come to the conclusion that the Committee ought to move toward reducing the level of free reserves. While he was somewhat reluctant to mention a specific figure, he would concur in Mr. Hayes' suggestion that the target be moved from the $100 million level down to zero, sometimes producing net borrowed reserves and sometimes net free reserves.

Mr. Bopp said business continued to be favorable in the Third District with labor demand showing the greatest strength. In July, unemployment decreased substantially in most areas; Scranton had been reclassified from "E" to "D", leaving the District with no major areas of considerable labor surplus for the first time since the series began in 1955. Department store sales and new car registrations continued to show gains in year-ago comparisons.

Unemployment claims in Pennsylvania and Delaware remained favorable, Mr. Bopp commented. In July, insured unemployment rates dropped considerably in a majority of labor market areas. In recent weeks the Northeast Coast steel index had increased at a better than national rate.

On the financial front, the basic reserve position of reserve city banks continued on the deficit side, averaging about $49 million for the three-week period ending August 12. Although the reserve city banks borrowed for the first time in a month, borrowing at the discount window continued to be light.

Net loans adjusted at weekly reporting member banks increased by $123 million compared to a year-ago increase of only $12 million, Mr. Bopp said. The cumulative increase in net loans since January was substantially higher than it was during the comparable period last year. Business loans rose by $11 million and investments were $6 million higher in the three weeks ending August 12. Both business loans and investments, on a cumulative basis, were running well above last year.

Mr. Bopp continued to be impressed by the steady upward pace and the broad strength of economic activity. He was equally impressed by the lack of any pronounced pressure on prices and resources. Despite developments in the Far East and scattered price hikes and talk of hikes, domestic supplies remained ample and unit costs stable.

The unemployment picture, on the other hand, provided less cause for optimism than might at first appear warranted. To a considerable extent, the July decline in unemployment was associated with withdrawals from the labor force and perhaps with difficulties in timing of the survey week. Moreover, the percentage of those unemployed 15 months or over remained uncomfortably high.

In view of the price and employment developments, Mr. Bopp felt that about the same degree of ease that had prevailed in recent weeks continued to be appropriate to domestic conditions in the coming three-week period.

On the international front, the sizable second-quarter deficit and the contribution of short-term capital outflows to that deficit could not be ignored. The substantial July deficit added to his concern. He believed, however, that the evidence to support a general tightening of monetary policy should be conclusive before such a move was made. Given the tight liquidity position already prevailing, the banking system was likely to respond rapidly to Federal Reserve action, and there was a real danger that sudden tightening for balance of payments reasons could dampen the forward momentum in domestic business. For these reasons, he would avoid a general move toward restriction. However, he would like to see short-term rates move more consistently around the 3.5 per cent level or slightly above. If this required operations in coupon issues to supply reserves, Mr. Bopp would favor such action. Also, he said, the Board might wish to give consideration to a change in reserve requirements as a method of meeting the coming seasonal need for reserves while avoiding downward pressure on short-term rates.

Mr. Bopp added that the staff's proposed directive appeared appropriate.

Mr. Hickman said that information on the general business situation that had become available since the last meeting had not altered his impression that the pace of economic activity was moderate and sustainable. Production and distribution had continued to expand, as had the money supply. The most recent report on the labor force was heartening, but should be interpreted with caution, particularly since the sharp decline in unemployment was associated with a decline in the labor force and little gain in employment.

Steel output in July, on an unadjusted basis, remained virtually unchanged from June; however, allowing for the normal seasonal and for the number of working days, steel output rose, according to the Cleveland Bank's estimates, to an annual rate of about 130 million ingot tons, an increase of 6 million tons from June. There was more and more talk of steel production of at least 120 million ingot tons for 1964, an increase of 2 or 3 million tons from the earlier projections of the Bank's staff.

Domestic new car sales in the first ten days of August, Mr. Hickman noted, were 22 per cent higher than a year earlier, the best showing since 1955. Auto production would be off sharply in August, as expected, and inventories would decline rapidly. It was, of course, even more difficult than usual to interpret auto figures at this time of the year.

In the Fourth District, recent production and employment trends were also difficult to interpret because of model changeovers, plant shutdowns, vacations, and the like. In a number of areas in the District, the seasonally adjusted rate of insured unemployment had increased. This was most pronounced in the Lorain-Elyria area where the temporary layoff of Ford employees had caused unemployment claims to triple, a situation that had occurred last year, but two weeks later. In contrast, a return to normal operating schedules in other areas had brought the unemployment rate down from previously reported high levels, notably in Toledo. Data for the most recent three weeks, through the first week of August, indicated that unemployment patterns in major labor market areas were less favorable than at the time of the Committee's last meeting, with the seasonally adjusted rate of insured unemployment up in nine areas, down in three, and unchanged in two. On the other hand, the Labor Department's July ratings of major labor market areas showed a number of improvements in the District. Three of the areas moved from Group C to Group B; two from D to C; and one from E to D. Only two of the centers remained in Group E, namely, Pittsburgh and Wheeling.

Another development in the Fourth District might be of interest to the Committee, Mr. Hickman said. The Reserve Bank's most recent semi-annual survey of municipal bonds held by District reporting banks revealed that in the first half of this year there was a noticeable lengthening in average maturity, reflecting primarily an increase in issues due to mature in over ten years. In addition, the survey showed that reporting banks held proportionately more issues rated Baa or lower.

Mr. Hickman observed that the news of the sharp deterioration in the second quarter balance of payments had been received with concern by bankers and industrialists in the District. At the directors' meeting last Thursday, the view was expressed that the U. S. balance of payments problems had not been solved in any fundamental sense. About all that had been accomplished was to buy time through the use of various palliatives.

A member of the Cleveland Reserve Bank board, who was serving on the President's Advisory Committee for the General Agreement on Tariffs and Trade (GATT) Negotiations, was rather discouraged about the state of these negotiations. He reported that so far the ground rules had not been established as to what was to be negotiated, primarily because of disagreements among European nations. There seemed to be generally some sentiment among the board members that American industry was at a competitive disadvantage with respect to tariff and nontariff barriers, and that U. S. antidumping legislation was in need of a general updating.

Mr. Hickman said he had been puzzling over recent reports on the U. S. balance of payments, and had tried to compare these movements with changes in covered yield differentials. From observations for a very short period, he though he could detect a rough inverse relationship between payments flows and the Canadian differential, with some tendency for flows to lag behind yields. Although his examination of these relationships was cursory, the problem might warrant further study. Specifically, it might be useful to relate short-term capital flows, gross and net, to different countries (particularly Canada) to the corresponding yield differentials.

Insofar as monetary policy was concerned, Mr. Hickman said, in his judgment the Committee should continue to provide sufficient credit to support economic growth without inflation. Against the background of the most recent balance of payments developments, however, he again felt compelled to recommend that the Committee think in terms of slightly less ease. He was not suggesting that the Committee fail to provide the credit needed to support sustainable domestic expansion. But he did believe that a moderate firming of rates and a moderate reduction in credit availability would help the balance of payments, without constraining business expansion. He added that he was thinking in terms of a slightly more modest approach than those recommended by Mr. Hayes and Mr. Bryan. He would favor free reserves in the neighborhood of $50 million and a bill rate of around 3.60 per cent.

Mr. Daane said he had a great deal of sympathy for the view that the Committee might have overstayed a bit on the side of ease. If the Committee could be in a posture of slightly less ease without the difficulty of getting there, he would have considerably more sympathy for this view. He also shared the concern others had expressed about the balance of payments, and he agreed that recent developments would argue for a less easy policy, particularly if it could be demonstrated clearly that such a policy would be helpful in overcoming the deficit.

On the other hand, Mr. Daane said, he felt that Committee policy had been appropriate in light of domestic economic conditions and also in light of Treasury financing considerations. The operations of the Desk, he thought, had been most helpful to the Treasury and at the same time had been consistent with the intentions of the Committee.

In his judgment, Mr. Daane continued, moving the free reserve figure down a few million dollars would not accomplish very much, if it accomplished anything. If free reserves were reduced still further, as Mr. Hayes had suggested, Mr. Daane thought the Committee would be up against the problem that Mr. Holland had mentioned; there was only a narrow range within which to operate without risking adverse effects on the financial markets and consequently on the domestic economy.

Mr. Daane said he came out about where Mr. Bopp did, believing that the Committee would not be justified in taking a decisive step toward less ease at this time. Pressure on prices was not yet evident, and the factors underlying the deterioration in the balance of payments were still hazy.

Mr. Daane concluded that the Committee should not make a change in policy, and that it should avoid any move toward real restriction. He pointed out in this connection the unusual situation with respect to Treasury financing--there was a period from now until November in which there would be no financing. The timing of a policy shift was still very much in the hands of the Committee, Mr. Daane said, and he would favor deferring such a shift, possibly until about a month from now. The Committee then would have more information on the balance of payments and would be in a better position to determine whether a policy change would be helpful; and it could see whether the domestic economy was continuing to demonstrate vitality and strength.

Within this general framework of no change in policy, Mr. Daane would leave the Desk latitude to operate in terms of a free reserve target range of zero to $100 million. His conception was that doubts should be resolved on the side of somewhat less ease. In fact, the most recent developments in the market anticipated to some extent those he would like to see continued for the next three weeks, and he favored maintaining prevailing conditions, taking care to insure that free reserves did not fall below zero. Accordingly, he would change the second paragraph of the staff's proposed directive to read "To implement this policy, System open market operations shall be conducted with a view to maintaining the somewhat firmer conditions in the money market that have prevailed in the most recent week, while accommodating moderate expansion in aggregate bank reserves."

Mr. Mitchell said he would make three comments on the domestic situation. First, the economy undoubtedly was performing better recently, in good part as a consequence of appropriate fiscal and monetary policies. Secondly, the economy was not characterized by any significant excesses. It was surprising that anyone should think that something must be done to an economy that was functioning so well. In connection with Mr. Noyes' comments on recent price movements, price changes were necessary to make a free enterprise economy work efficiently, and they were a matter of concern only when they become pervasive in the same direction. There was no indication that this was the case at present. The economy was now moving ahead toward the national economic objectives endorsed in the recent tax cut legislation, and it was doing so without significant excesses.

His third point, Mr. Mitchell said, related to the recent increase in the growth rate of the money supply. The Committee had not called for such a money supply increase; it had occurred, but not as a result of any decision specifically made by the Committee. This indicated to him that the Committee did not have close enough control over the money supply to make it respond sensitively in the short run; the Committee did not know enough about linkages in this area. Money supply changes had tended to be lumpy, although to some extent the uneven growth might be a consequence of poor seasonal adjustment factors. In any case, he was satisfied with the growth rate over the past seven or eight months and he would not now want to take steps to alter it.

On the problem of the balance of payments, Mr. Mitchell said, after hearing Mr. Furth's statement, he felt that it would be unfortunate if the Committee were to rely on an old mythology to do something at this time. He believed it was not the policy of this nation to admit that the dollar was overvalued and that it was national policy that the dollar would be defended to the last ditch. It certainly would not be desirable for the Committee to use monetary policy to achieve the equivalent effect of devaluation, i.e., by shrinking the domestic price level.

Also, Mr. Mitchell continued, it was said that the Committee could use monetary policy to influence short-term and long-term capital flows. But Mr. Furth's analysis suggested that there were statistical and analytical deficiencies in the way that capital flows were treated, and that if these were corrected a large component of the deficit would disappear. If the Committee were not in a position to bring its excellent analytical resources to bear on the problem, it might be justified in taking a naive policy action. But since the Committee was informed as to the shortcomings of the balance of payments data and analysis he thought that it would be a serious mistake to uncritically use the balance of payments conventional wisdom as a reason for a policy change at this time, either to deal with the basic balance or with capital flows.

It seemed to Mr. Mitchell that the Committee needed to exercise great caution at this time because of the possible impact of a policy change on financial market psychology. Even a small change might be misconstrued as an initial step toward larger changes. He had no objections to the targets Mr. Hickman had mentioned except for the danger of exciting an adverse psychological reaction, which might be extremely difficult to check once underway.

In sum, Mr. Mitchell said, the economy was well on the road to achieving the goals sought for it, and there were no excesses requiring action. The balance of payments problem was still present, but in part it apparently was illusory and in part it was subject to attack by special techniques, such as including bank lending to foreigners under the interest equalization tax. He concluded, therefore, that no change should be made in policy at this time. He would be agreeable to the directive as submitted by the staff, and also to the amendment suggested by Mr. Daane.

Mr. Robertson said that he agreed with most of the conclusions of Messrs. Bopp, Daane, and Mitchell. He then made the following statement:

> The kind of business and financial developments we have been hearing about recently are the most likely precursors of a need to change monetary policy that we have had in the past three years. But I use the word "precursor" deliberately, for I think it is not at today's meeting but at the meetings lying ahead of us this fall that policy ought to be adapted to these developments, provided that by then they have ripened into trends.
>
> Among the developments I have in mind are the recent drop in unemployment, the strong bank credit and money expansion in June and July, and the large July balance of payments deficit. But it is also true that these statistics bounce around a good deal. To put it bluntly, they fluctuate a good deal more than we are prepared to have monetary policy fluctuate, and therefore we are well advised to keep watch over these developments until we are fairly sure they are going to persist before we decide to shift monetary policy accordingly.
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> The very latest evidence in each of these areas seems somewhat more moderate in nature than the early July figures suggested. If we rush in with a policy change, we could be embarrassingly off in our timing. Any appreciable change in policy at this juncture runs some real hazards of generating sharp adverse reactions in the banking system and the financial markets. Furthermore, I would not want to see any alteration of monetary policy that could serve as an excuse for not pursuing more pointed and effective means of dealing with what ails our balance of payments, and I have here particularly in mind the lending activities of a few of our largest banks.
>
> Fortunately, I think we are in a position to be able to wait and see whether what we are seeing are simply fluctuations or more underlying trends. Our price structure is still fundamentally stable, and we have still a sizable margin of unutilized resources. With a real economy whose reflexes have been demonstrably more phlegmatic in this expansion than earlier, I see no reason to fear that events will run away from us if we continue our "watchful waiting" a few weeks longer.

Mr. Robertson said he would accept the directive as prepared by the staff but, like Mr. Mitchell, he also would have no qualms about accepting Mr. Daane's suggested amendment.

Mr. Mills commented that in the light of domestic economic developments and international financial developments, and taking into account the lag between the time of inception of a policy action and the accomplishment of the results sought, he was persuaded that the Committee should move to a moderately less easy monetary and credit policy. The approach, however, should be gentle and cautious; the Committee should probe carefully to discover the responses of the financial and business community to such a change. The reason for caution focused on a concern about the over-all position of the commercial banks and the trend toward ever-lessening liquidity. A policy that would reduce the bank's capacity to lend could have unfortunate effects under these conditions. Although there was no great reason to anticipate an increased demand for credit this fall, even the seasonal demand on the banking system that would certainly eventuate was bound to have interest rate and credit effects of importance.

In that connection, Mr. Mills said, there was the likelihood of a peculiar assist that the Committee could expect on the balance of payments problem. If the Committee had a slightly less easy credit policy and the commercial banks found themselves less able to meet the credit demands that would be made on them, their first reflex, in his judgment, would be to curtail foreign lending. In other words, Mr. Mills said, banks have looked upon their domestic loan activity as their primary responsibility, and when a requirement for exercising selectivity arose, he would anticipate a withdrawal of foreign credits. The favorable effect this would have on the balance of payments would be in addition to whatever effect resulted from some stiffening of interest rates in this country.

Mr. Mills repeated that he was persuaded that the Committee should move to a moderately less easy monetary policy, but on a provisional and probationary basis, to determine what the over-all reaction would be. He would accept Mr. Hickman's formula of free reserves around the $50 million level and a bill rate of around 3.60 per cent, even though he recognized that a bill rate of 3.60 per cent might create a temptation for banks to make greater use of the discount window for arbitrage purposes.

Mr. Wayne reported that Fifth District business was apparently continuing the moderate and orderly advance of recent months. Business sentiment as measured by responses to the Richmond Bank's survey was slightly improved and indications were that unemployment had declined a little. The textile industry was prosperous and production was up somewhat. There had been very few price reductions in finished goods since the equalization payments were initiated last April and this should mean a larger margin of profit. The U. S. Department of Agriculture forecasts for the coming year were for the largest domestic consumption of cotton since 1950-51. These conditions caused almost half of the normally pessimistic textile respondents to report improved profits prospects for the period just ahead. It should be noted, however, that pressures for increased wages were building up. Cigarette production continued to recover and in July was slightly above the level of a year earlier. Construction activity remained at a high level in most parts of the District. Retail sales, off somewhat during July, apparently had picked up a bit at the beginning of this month. Recent rains had improved farm crop prospects in all five States.

Although the national economy at midsummer seemed to be maintaining its moderate advance, Mr. Wayne said, there were numerous cross-currents. Employment gained significantly in the first seven months of 1964, suggest-ing that the tax cut helped to achieve at least one of its major aims. Yet the only sector of the economy that exhibited any strong momentum was new plant and equipment expenditures. Gains in retail sales had been modest compared to increases in disposable income, inventory accumulations had been remarkably low, and prices generally had been quite stable. Construction expenditures had been almost stationary for several months, and manufacturers' new orders had shown small declines for two successive months. These diverse developments and the behavior of the leading indicators suggested that a considerable part of the stimulus provided by the tax cut was required to offset declining tendencies which were normally present after more than three years of business expansion. The important question at the moment appeared to be whether business capital outlays and consumer spending could carry the economy forward while new momentum was being generated in other important sectors.

Mr. Wayne said it seemed to him that the Committee's present posture was appropriate to prevailing conditions and he would not change it. The suggestion that somewhat less ease would not do violent damage to the economy was not enough--such a risk could be justified only by compelling pressures elsewhere, which he did not yet see. Significantly more ease would not be suitable in the light of international conditions. On the other hand, Mr. Wayne said, he would not like to see appreciably less ease, first, because in his estimation conditions in the domestic economy did not require it and, second, because the market and the banking system were likely at this point to react more strongly than usual to any tightening move. This position seemed to be in accord with the views expressed by Mr. Holland and others. There were indications, such as the recent successes of Treasury financing, that the market had with some reluctance come to the conclusion that interest rates were likely to remain stable for some time. Any distinct move on the part of the Committee toward less ease might change that opinion and trigger readjustments of holdings which would push interest rates upward considerably. The banking system would soon be faced with a large seasonal increase in demand for accommodations. The loan ratio was quite high and holdings of short-term Governments were low, Mr. Wayne noted. Any move toward reduced availability of reserves could produce a substantial tightening by the banking system.

Mr. Wayne favored no change in the discount rate, no change in policy at this time, and a directive essentially similar to the present one. The draft directive submitted by the staff, with the amendment proposed by Mr. Daane, would be acceptable to him.

Mr. Clay said the domestic economy's performance was generally quite good. Yet, there continued to be room for expansion within the framework of orderly and sustainable economic developments. In fact, despite some improvement in unemployment over the past year, unemployment still remained a problem. What needed to be underscored was that the problem existed even though economic activity had increased substantially. The rapid growth in manpower and other resources and the increase in productive efficiency afforded the explanation. The expansive trends in output potential were continuing with manpower of working age growing at an increasing pace. What was apparent, then, was that the unemployment problem remained of tolerable proportions only within a growing volume of economic activity and that any deceleration in the pace of economic advance would rapidly accentuate the problem.

The international balance of payments deficit remained a matter of concern, Mr. Clay commented. Recognition must be given, however, to the substantial improvement that had occurred despite the less favorable recent developments. Moreover, the most recent data did not provide adequate information for judging fully the sources of the adverse developments and the nature of the problem. It was apparent, however, that the Committee would need to observe future developments closely and analyze carefully what was taking place in the international payments area.

Mr. Clay thought that the domestic economy did not call for any movement toward monetary restraint. Rather, it needed an expansive monetary policy designed to foster further growth in economic activity. A continuation of the monetary policy of recent months would be in line with the needs of the domestic economy, in his judgment. Despite the recent unfavorable developments in international payments, on balance it appeared preferable to continue monetary policy without any basic change at this time.

Pursuit of such a policy, Mr. Clay continued, should aim to provide sufficient reserves to the banking system to permit commercial bank credit to expand at about the same rate that it had thus far this year. In carrying out this program, money market conditions should be maintained essentially within the pattern of the last three weeks, with the 90-day Treasury bill rate generally within the range of that period. Mr. Clay felt the staff draft of the economic policy directive would serve well for the period ahead. He would make no change in the Federal Reserve Bank discount rate.

Mr. Scanlon reported that businessmen and bankers in the Seventh District were generally agreed that the current business expansion would maintain its momentum through the remainder of the year. The main basis for longer run optimism in the District was found in the trend of investment expenditures. Midwest producers of various types of capital goods informed the Chicago Bank that incoming business either was setting new records or was the largest since 1957 or some earlier period. Farm equipment shipments continued to run 8-10 per cent above last year's level and this margin was expected to continue through the year, although at the beginning of this year most analysts had forecast a level or declining trend of farm equipment sales. Although there was considerable concern over a possible slowdown in total construction, Dodge contracts in the Midwest were 18 per cent above last year in the first half compared with a rise of 8 per cent for the nation and there was reported to be a huge volume of heavy construction projects in the planning stage.

In July, Mr. Scanlon said, District department store sales were 13 per cent above last year and were at a record high after seasonal adjustment. Preliminary evidence for August suggested a continuance of high level department store sales. Employment continued to rise and unemployment continued to decline in the District, although changes were modest in both cases. At present, 10 of the 25 major labor markets classified in the B group--40 per cent--were in the Seventh District, although only 15 per cent of all major labor markets were in the region.

Business loans of weekly reporting banks had declined less than usual since midyear, Mr. Scanlon said, and early August figures suggested a seasonal upswing in credit demand similar to that which occurred last year. Recent strength was due mainly to increased borrowing by firms in retail trade and extractive industries. Growth in consumer loans had remained modest.

On the whole, Mr. Scanlon commented, District banks had been able to handle their reserve positions without difficulty. Although dealer loans had been reduced, they remained at a relatively high level. Bank holdings of both Governments and other securities also had declined.

Large Chicago banks had maintained rather comfortable reserve positions. One reported a substantial decline in CDs outstanding early this month, and another had been a rather steady net seller of Federal funds. Borrowing at the discount window had remained low.

As to policy, Mr. Scanlon said it seemed to him that once again the Committee was concerned with matters of timing. He believed that for reasons mentioned by Mr. Wayne and others the Committee must move cautiously in making any policy changes. For the same reasons, he shared the views expressed by Mr. Daane. The directive prepared by the staff was acceptable to him, with the changes in the second paragraph proposed by Mr. Daane. Mr. Scanlon would not change the discount rate.

Mr. Deming commented that recent economic developments in the Ninth District differed little from those he had reported earlier. However, he would like to mention one significant item. He had referred at previous meetings to a survey which the Minneapolis Bank conducted at six-week intervals of about 20 large corporations with headquarters in the District that operated nationally and in some cases internationally. This sample was surveyed twice each quarter--once at the beginning and again about half way through the quarter--on prospects for employment, production, prices, and so forth. The returns had been generally optimistic recently, and they continued to be so in a survey completed just within the past few days. This last survey, however, gave a much greater indication than earlier ones of expectations of price advances. In earlier surveys typically one or two firms would report that they expected their own prices to go up, and one or two would indicate that their prices probably would go down. In the latest survey five of the 20 respondents reported that they had already made some price increases in the quarter, and only two reported declines. For the balance of the quarter, six respondents expected increases and only one a decline.

This pattern, of course, might be partly seasonal, but there was a stronger indication than earlier of upward price movements.

With respect to policy, Mr. Deming said, he concurred in the statement of Mr. Noyes that the economy seemed to be able to take somewhat more monetary snugness; in Mr. Holland's statement that the room for maneuver was not great; and in Mr. Daane's observation that the Committee had a fair amount of time in which to make a policy change. He was concerned about recent balance of payments developments, even after allowances for the statistical illusions to which Mr. Mitchell had referred, and for the fact that monetary policy by itself could not resolve all of the difficulty. It seemed to Mr. Deming that an upward movement in short-term interest rates could hardly injure the balance of payments situation and it might conceivably do some good; it could be viewed as a type of insurance.

Also, Mr. Deming said, as Mr. Hayes had suggested the Board might want to give some consideration to a reduction in reserve requirements. The staff memorandum indicated that it would be necessary to provide about $1.5 billion of reserves on balance until early in December, and approximately $650 million during the next three weeks. A volume of reserves roughly equivalent to the latter figure would be released by a 1/2 point reduction in reserve requirements for either demand or time deposits. It might be possible to take care of reserve needs during the next three weeks by a reduction in reserve requirements, and to absorb reserves in the following three weeks by selling bills in the market, in the process inducing more borrowing and raising the bill rate by about 10 basis points

It would be consistent with this kind of policy to let free reserves go down to about $50 million on average, Mr. Deming said. He thought this could be accomplished under the proposed staff directive with the modification suggested by Mr. Daane. It would not involve any significant change in policy at this time, but would put the Committee in a better position to move in either direction later. He would not change the discount rate at present.

Mr. Swan reported that in California and Washington, the only States in the Twelfth District for which July employment figures were available, total employment increased more than seasonally in that month. However, the increase was largely in agricultural employment and followed an abnormal decline in June. Nonfarm employment showed very little change. In California, moderate increases in government, service, and construction employment were offset by a decline in manufacturing employment, which reflected another drop in defense- and space-related industries. On the other hand, in Washington there was a slight increase in aircraft manufacturing employment; defense-space employment in that State now had gained slightly for two successive months. Western steel production rose in the first part of August and demand for nonferrous materials was strong. Department store sales in July showed substantial gains on a year-to-year basis, although less than the gain nationally.

Mr. Swan said that District banks had continued under considerable reserve pressure in recent weeks. In the three weeks ending August 12 borrowing from the Reserve Bank rose substantially, and in the week ending August 12 District banks accounted for about one-quarter of the total member bank borrowing in the country. It had been some time since major banks in the District had been net sellers of Federal funds on a large scale. The flow of savings into savings and loan associations picked up a little in June but for the second quarter as a whole the increases were less than in either the first quarter of 1964 or the second quarter of 1963.

Mr. Swan said he found himself in substantial agreement with Mr. Wayne on policy. It seemed to him that the domestic situation was going along quite well and offered no basis at this point for changing policy. The international situation, of course, concerned him as it did everyone else. He had the uncomfortable feeling, however, that if it became necessary to act on account of that situation--and this was a real possibility--a slight tightening would have little effect; that an overt move, including a change in the discount rate, would be needed to have a real impact on the flows of funds. He was not prepared to recommend such a move at this point, considering both the international and the domestic situations together. Therefore, he would favor no change in policy now, although he did think that the question might well simply be one of timing. Mr. Swan would accept the directive as drafted by the staff. He would not object to the amendment suggested by Mr. Daane, although he did not think the language proposed necessarily implied the somewhat lower level of free reserves that Mr. Daane had mentioned.

Mr. Coldwell commented that Eleventh District conditions remained about as they had been during the past several months. Industrial production, construction, retail trade, and general business conditions were all advancing and now were at record levels. The agricultural outlook had been brightened considerably by widespread rains over the past few weeks. Prospects of improved pastures might have reduced pressure for forced marketings of cattle at present prices, which were 9 per cent below a year ago.

Mr. Coldwell said banking conditions in the District showed evidences of summer doldrums. Loan demand had weakened slightly while investments increased. There had been two bank failures tied to ownership changes and brokerage of CDs, and these seemed to be the main centers of controversy in the District. New bank charters were also under considerable fire, raising talk about branch banking in Texas, where banks were limited to one office by the constitution. Banking conditions, however, were not substantially different from those of recent weeks. Major banks in the reserve cities seemed to have all the loan demand they could take care of at the moment, and were attempting to farm out participations. At the same time, agricultural loan demand was exceptionally high, and the agricultural banks were trying to send some of their loans back to the city banks.

Mr. Ellis commented that the recent cool weather in New England seemed to have helped department store sales, which in the most recent four weeks had averaged 8 per cent ahead of last year. Demand balances at all types of savings institutions also had been rising. At mutual savings banks in the District balances had expanded by almost 1 per cent in June alone. Other trends in the region continued to show the pattern of strength that he had reported at recent meetings.

With respect to policy, Mr. Ellis said that the steady expansion in the rates of production, distribution, and consumption, as described in the staff reports, was so nearly ideal that the burden of proof rested on anyone who sought a realignment of the underlying financial supports of present trends. He knew of nothing that approached proof of a need to change monetary policy, but there were some disturbing indications that a change would be wise. If domestic and international considerations were not divorced, one would have to conclude that there were excesses in the economy--including excessive bank lending to foreigners, excessive capital outflows, and an excessive deficit, all of which contributed to the monetary policy problem.

In his judgment, Mr. Ellis continued, the Committee had to satisfy itself on the answers to three questions: ( ) Was the worsening in the U.S. balance of payments significantly attributable to long- and short-term capital flows that were materially influenced by excessive availability of funds responding to attractive rate differentials? (2) Was it reasonable to expect that a modest modification in monetary policy, such as a 10-point rise in short-term rates and somewhat lessened availability of reserves, would have any appreciable effect on these capital flows? (3) Would such a modification in monetary policy be consistent with the long-term needs of the domestic economy?

Mr. Ellis said his own answers to these questions were tentative. With regard to the first question, the staff reports indicated that short-term capital flows were up sharply in June, with two-thirds of the outflow representing movements of liquid funds; and that the outflow of short-term bank credit was up somewhat from the moderate level that had prevailed since February. Obviously, data for more than one or two months had to be analyzed for long-run trends, but the present evidence of the trend was disturbing. On the second question, Mr. Ellis felt that expectations about the eventual impact of monetary policy actions had to take account of their possible effects on principal trading partners abroad. Abrupt action in substantially increasing the discount rate might well draw retaliation. A more modest move probably would not, but of course it might also have much less effect on flows. As to the third question--whether a modest policy move might be consistent with long-term needs of the domestic economy--Mr. Ellis noted that reserves, bank credit, and the money supply had been expanding sharply over the past two and one-half months, at rates that probably were not compatible with sustained growth without inflation. It seemed to him fair to conclude that the financial stimulus had been doing more than its share in recent months. And, as Mr. Noyes had said, the economy appeared to have the strength to withstand lessened ease.

Mr. Ellis concluded, therefore, that monetary policy should be shifted slightly to a position of lessened ease. In effect, he said, he was prepared to accept some of the "mythology" to which Mr. Mitchell had referred of the impact of monetary policy on the balance of payments. He favored a free reserve target of around $50 million, with the expectation that short-term rates might move up gradually to the 3.55-3.65 per cent range. Mr. Ellis thought the directive approach suggested by Mr. Hickman came closest to what he preferred. He noted that he had been attracted by Mr. Deming's analysis.

Mr. Balderston remarked that at the last meeting of the Committee he had urged some slight adjustment of the current posture of monetary policy with a view to minimizing foreign lending, in light of the prospect for an adverse balance of payments for the year as a whole. This step was proposed as a contribution to the protection of the U.S. gold supply. To the same end he also had suggested a reduction in reserve requirements as a means for supplying seasonal reserve needs this fall. The broad reasons he had advanced were that bank loans and investments had been growing at an annual rate of about 8 per cent since early 1961; that big corporations possessed liquid funds in increasing amounts; that in most European countries other than Germany, both short- and long-term rates had advanced during the past year; and that the incentive to place funds abroad should not be allowed to strengthen. It should now be added, Mr. Balderston said, that since these comments were made three weeks ago, the worsening of international payments had become even more disquieting.

The proposal he had made at the last meeting, Mr. Balderston recalled, involved a modest shift in monetary policy to nudge bill rates upward gradually, with a target of about 3.60 per cent for the three-month bill but with an upper limit of 3.75 per cent for the six-month bill. He had favored then, and he continued to favor, permitting a larger portion of expansion in bank reserves to be financed from advances by the Federal Reserve Banks to member banks. To achieve these ends would require letting free reserves drop experimentally, close to zero and perhaps even below if monetary policy was to assume a slightly different posture without setting off such a shrinkage of negotiable CDs as to create a problem.

Mr. Balderston then turned to the possibility of substituting a reduction in reserve requirements for open market operations in meeting seasonal reserve needs. According to estimates of the Board's Research Division, he said, during the seven weeks from October 22 to December 9 it would be necessary to provide about $1.9 billion in reserves, net, assuming that there was not an outflow of gold to be compensated for. If required reserves were to expand at a 3 per cent rate over that interval an additional $80 million would be necessary, bringing the aggregate reserve need for the period to nearly $2 billion. If this need were met by reductions in reserve requirements, appropriately timed, the resulting gold cover would be less than otherwise by about $1/2 billion, and the volume of "free gold" would be higher by that amount. Mr. Balderston noted that $1/2 billion represented about one-fifth of the existing stock of "free gold," and about one-fourth of the "free gold" that might otherwise remain at the year-end seasonal trough. This amount also would be equivalent to the net gold loss of the U. S. since January 1963.

As to the directive, Mr. Balderston said, he would want to hear Mr. Hayes' suggestion, but he was not averse to the staff draft with Mr. Daane's amendment.

Chairman Martin commented that the discussion of policy today turned on the questions of degree and timing. He had been debating the best course of action in his own mind, and he felt that good cases could be made for and against a policy change at this time, as in fact they had been made at this meeting. In his judgment the burden of proof probably was on those who wanted to make a change in policy.

The question that concerned him most, the Chairman continued, was whether the Committee could operate in so delicate a manner as not to disturb the market. Even a small shift could have a psychological impact. With respect to timing, the Committee had until the middle of November to act on policy as far as Treasury operations were concerned. One could take the position that the Committee should begin now to move in a gradual manner, or the alternative position that action should be postponed until it could be seen whether a more significant move was called for.

Chairman Martin said that if he were doing this on his own his inclination would be toward the kind of policy change that Mr. Mills had aptly termed "provisional and probatiorary." He thought that the Committee's policy up to this point had been appropriate. The degree of ease that had been maintained had been helpful to the economy, and, incidentally, to the Treasury. Now he would favor letting free reserves trend down to a zero to $50 million range. However, if the Committee thought it could not take such action without having an unfortunate psychological impact, it might be best to wait until more significant action was clearly appropriate. The matter could be argued either way.

In sum, Chairman Martin said, he did not think a substantial policy change was called for at present; the choice was between a modest move now and perhaps a more significant move later. He felt personally that the balance of considerations was in favor of a modest move now. If this was the sense of a majority of the Committee, there remained the question of how to formulate an appropriate directive. He then invited Mr. Hayes to distribute the proposed directive the latter had referred to earlier, the second paragraph of which read: "To implement this policy, System open market operations shall be conducted with a view to maintaining somewhat firmer conditions in the money market than have prevailed, on average, during recent months."

Mr. Hayes remarked that a majority of members seemed to lean toward moving toward a slight firming of conditions, although there were differences in degree within the majority and other members favored no change. In his judgment, the second paragraph of the staff draft as amended by Mr. Daane would be inconsistent with what he took to be the consensus of the Committee. In particular, to call for maintaining recently firmer conditions seemed to imply a continuation of the bill rate at its current level of about 3.50 per cent, whereas he understood the consensus to favor having the bill rate climb a bit further. With respect to his own proposal, he would now suggest use of the word "slightly" rather than "somewhat" in qualifying "firmer conditions."

Mr. Hayes added that he would like to comment on some observations that had been made in the go-around. He did not think the Committee could conjure away the balance of payments problem by references to "mythology."

The problem was real and, if he understood Mr. Furth correctly, it was serious whatever definition of the deficit one might favor. It certainly existed in the minds of foreigners who read the figures published on the U.S. payments balance. He also disagreed with the argument that this problem should be dealt with primarily by means other than monetary policy. Other approaches, such as moral suasion and the interest equalization tax, might also be helpful, but monetary policy certainly had a role to play in the attack on the problem, particularly since capital flows had been so important in the deficit.

Also, Mr. Hayes said, he would like to point out that no one had suggested shrinking the domestic economy in the effort to deal with the balance of payments problem. In his judgment the economy was robust and not fragile. What he thought the Committee had in mind was some slight slowing of the rate of credit expansion. Even that was uncertain; he would hope that the effect on the domestic economy would be negligible. Finally, on the question whether the Committee had to refrain from all policy moves because of possible psychological market reactions, Mr. Hayes' feeling was that the longer the Committee permitted the freezing of interest rates to persist the worse its position became for taking action later.

Mr. Daane said, in reference to Mr. Hayes' comment on his (Mr. Daane's) proposal for the directive, that it had been his intention to call for a continuation of the present firmer money market conditions with the clear understanding that somewhat higher bill rates might eventuate, particularly since the Treasury would be coming into the market and corporate demand for bills was expected to be light. In his judgment the language he had suggested would not be inconsistent with a slightly higher bill rate. As he conceived it, however, this language would be inconsistent with negative free reserves. He felt strongly that negative figures would produce major expectational effects in the market. He had suggested a target range of zero to $100 million rather than zero to $50 million in order to reduce the probability that a negative figure would be produced inadvertently.

Mr. Hayes noted that the Committee's previous directive had called for "maintaining about the same conditions in the money market" and that there had been some small changes within the context of that directive. In his opinion, if the consensus favored a modest further firming the directive issued at this meeting should say so explicitly.

Mr. Mitchell concurred in this view. He noted that what was at issue was the question of a change in policy. To sharpen the focus on this question, he said, the alternatives posed might best be the original staff draft and the language proposed by Mr. Hayes.

Mr. Robertson suggested that the Committee might best resolve the issue by considering the following language: "To implement this policy, System open market operations shall be conducted with a view to maintaining slightly firmer conditions in the money market, while accommodating moderate expansion in aggregate bank reserves."

Mr. Swan commented that this language still left a great deal of uncertainty with regard to the targets implied. Chairman Martin remarked that this problem was unavoidable. He thought it was the intent to suggest trending, in a modest and gradual fashion, toward zero but not negative free reserves, giving due consideration to the tone and feel of the market. The objective was to achieve a very modest firming.

Mr. Hayes said the Committee must recognize that once free reserves were brought close to the zero level, human skill was not adequate to guarantee that negative reserves might not result inadvertently. He agreed that it clearly was the intent to avoid negative figures if possible.

Mr. Daane said he would not subscribe to the conclusion that the Committee was prepared to accept the possibility that negative free reserves might inadvertently result in, say, two or three successive statement weeks, because he would expect such a development to produce an adverse reaction in the market. In his judgment it would be hard to trend down from a level of free reserves that already was near $60 million. Mr. Hayes replied that Mr. Daane evidently did not want to change policy from what it was now. Mr. Daane agreed, saying that within the present policy posture he was willing to accept the slightly firmer conditions that had come about.

After further discussion, Chairman Martin suggested that the Committee vote on a directive with a first paragraph as proposed by the staff and with a second paragraph as suggested by Mr. Robertson.

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

It is the Federal Open Market Committee's current policy to accommodate moderate growth in the reserve base, bank credit, and the money supply for the purpose of facilitating continued expansion of the economy, while fostering improvement in the capital account of U.S. international payments, and seeking to avoid the emergence of inflationary pressures. This policy takes into account the continued orderly expansion in economic activity, and essential stability in interest rates, unit labor costs, and commodity price averages, including the moderate reactions in markets generally to military incidents in the Far East and Mediterranean. It also gives consideration to the recent improvement in rates of unemployment and industrial capacity utilization, the substantial increases in the money supply in June and July, and the large U.S. balance of payments deficit in July.

To implement this policy, System open market operations shall be conducted with a view to maintaining slightly firmer conditions in the money market, while accommodating moderate expansion in aggregate bank reserves.

Votes for this action: Messrs. Martin, Hayes, Balderston, Hickman, Mills, and Shuford. Votes against this action: Messrs. Daane, Mitchell, Robertson, Swan, and Wayne.

Chairman Martin commented that he knew everyone present appreciated the importance of preserving the confidentiality of Open Market Committee deliberations and decisions.

It was agreed the next meeting of the Committee would be held on Tuesday, September 8, 1964.

Thereupon the meeting adjourned.

Ralph A Young

Secretary