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, December 15, 1964, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Balderston
Mr. Hickman
Mr. Mills
Mr. Mitchell
Mr. Robertson
Mr. Shepardson
Mr. Shuford
Mr. Swan
Mr. Wayne
Mr. Treiber, Alternate for Mr. Hayes

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

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

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

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

Messrs. Sanford, Eastburn, Baughman, Parsons, Tow, and Green, Vice Presidents of the Federal Reserve Banks of New York, Philadelphia, Chicago, Minneapolis, Kansas City, and Dallas, respectively
Messrs. Sternlight and Brandt, Assistant Vice Presidents of the Federal Reserve Banks of New York and Atlanta, respectively
Mr. Eisenmenger, Director of Research, 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 November 24, 1964, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market operations and on Open Market Account and Treasury operations in foreign currencies for the period December 1 through December 9, 1964, and a supplemental report for December 10 through 14, 1964. Copies of these reports have been placed in the files of the Committee.

Supplementing the written reports, Mr. Sanford said that the published gold stock figure would remain unchanged this week. Treasury sales of gold to foreign central banks this month would be larger than first anticipated--some $125 million, as compared with $75 million reported at the Committee's December 1 meeting. The Swiss National Bank, which bought $26 million last week in connection with the liquidation of the Treasury's and System's sterling-Swiss franc swaps of June 1963, purchased another $25 million yesterday (December 14) and was scheduled to purchase $25 million in January. In addition, the first of seven monthly $30 million sales of gold to Spain would occur this month. Barring offsetting increases, the Stabilization Fund's gold holdings would amount to no more than $30 million by year end.

Eventual disclosure of renewed U.S. gold losses, Mr. Sanford said, might reinforce the current uneasiness in various world financial markets. It might also increase further the recently stepped-up activity in the London gold market, where the fixing price had advanced from $35.1002 to $35.1216, and where the gold pool reserve was being whittled away. The gold price was reduced slightly to $35.1179 yesterday, and to $35.1138 today, to counter the market effect of a recommendation by the National Planning Association for an increase in the price of gold.

Turning to the foreign exchange market, Mr. Sanford reported that the pound sterling's performance had been less than robust. The market remained extremely cautious, and the good reaction that followed the Bank of England's request last Tuesday (December 8) for credit restraint petered out quickly as pre-weekend selling once again took hold of the market. Over the first two weeks of December as a whole the spot rate had drifted downward from $2.7931 to $2.7900 or a trifle more. As a result, the Bank of England had intervened on various occasions either to support the rate or to bid it up, in the process losing some $280 million in spot operations so far this month. In order to bolster its reserves, the Bank of England had made net drawings since December 3 of $150 million under its swap facility with the System, thus raising its System swap commitments to $325 million. During the period beginning November 30, the United Kingdom drew $1 billion from the International Monetary Fund and $155 million from other countries participating in the $3 billion assistance package. Of the total, $80 million had been used to bolster reserves and the balance to repay short-term credits.

In the forward sterling market, Mr. Sanford continued, rates also had been under pressure with the discount for three-month forward sterling at one time having been slightly more than 3 per cent per annum. Here also there had been official British intervention to firm the rate and thus to avoid any possible movement of covered funds out of London. Intervention in the forward market in part had taken the form of swap operations, in which the Bank of England simultaneously bought forward sterling and sold spot sterling (acquired spot dollars). Some $170 million of swap transactions had been undertaken in this process, and by their very nature these operations had served temporarily to offset reserve losses. However, at times they also had depressed the spot rate, and consequently had necessitated use of the alternative technique of outright purchases of forward sterling, which had amounted to some $120 million.

With sterling having just weathered a strong attack, Mr. Sanford commented, it was going to take a certain amount of time for the market to quiet down. Sterling was expected to improve after the year-end pressures had passed. The main problem was one of leads and lags, and the immediate task of those who managed the market was to hold a determined, firm line until the leads and lags began to operate in favor of the United Kingdom. He understood that, at the week-end meeting at Basle, satisfaction with the United Kingdom's short-run program had been expressed while indications of the needed longer-range policies were awaited.

As to the continental currencies, Mr. Sanford reported that the intake of dollars by the central banks so far in December had been less than in November. Exchange rates, however, had remained at or near the respective ceilings.

Mr. Swan referred to Mr. Sanford's statement that sterling should strengthen after the year end, and asked whether the expected shifts in seasonal forces were of sufficient significance to cause improvement. Mr. Sanford replied that there would be considerable pressure on sterling until the end of the year because of the need on the part of people holding pounds for funds to be used in various kinds of overseas operations. Once those needs had been met the seasonal pressures would evaporate. This in itself would be a matter of some consequence and would constitute an element of strength.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period December 1 through 14, 1964, were approved, ratified, and confirmed.

Mr. Sanford recommended renewal for another 12 months of the $250 million standby swap arrangement with the Bank of Canada, which matured on December 28, 1964.

> Renewal of the swap arrangement with Bank of Canada for a further period of 12 months, as recommended by Mr. Sanford, was approved.

Mr. Sanford then noted that two $150 million standby swap arrangements, with the Swiss National Bank and with the Bank for International Settlements, would mature on January 20, 1965. The facility with the BIS had been used to the extent of $100 million to absorb previous dollar accumulations of the Swiss National Bank. He recommended renewal of both of these arrangements for a further period of six months.

> Renewal of the swap arrangement with the Swiss National Bank and the Bank for International Settlements for further periods of six months, as recommended by Mr. Sanford, was approved.

Mr. Sanford then reported that two identical $10 million equivalent three-month sterling-Dutch guilder swaps with the BIS, of which one was for System account and one for Treasury account, would mature for the first time on December 28. He did not at this time envisage the possibility of acquiring in the market the Netherlands' guilders needed to liquidate these swaps, and consequently he thought they probably would have to be renewed. Also, it was probable that another System guilder commitment, a $5 million equivalent drawing of guilders under the swap arrangement with the Netherlands Bank falling due January 18, 1965, would have to be renewed.

> Renewal of the System's sterling-guilder swap with the BIS, and of the drawing on the swap with the Netherlands Bank, were noted without objection.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period December 1 through December 14, 1964. A copy of this report has been placed in the files of the Committee.

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

> At the time the Committee last met the market had undergone an orderly adjustment of prices and rates in the wake of the dramatic events of the preceding week. As I reported then, rates on Treasury bills were in the neighborhood of 30 basis points above the levels of mid-November, while intermediate and long-term rates were up by around 12 and 5 basis points, respectively.

The market was still in a highly uncertain state, however, and it seemed possible that a new round of expectational rate increases might get underway. Given the Committee's decision on that day, and given also the prospective withdrawal of $0.5 billion of reserves the next day because of the Bank of England's repayment on its swap drawing, we moved into the market in size on December 1 and 2, making heavy purchases of Treasury bills and lesser purchases of coupon issues. By the close of business on December 2, the rate on three-month Treasury bills was 3.84 per cent, down 5 basis points from the high two days earlier, while prices of Treasury bonds were up by 1/4 point or more. Furthermore, by that time the $65 million Pacific Gas and Electric issue, which investors had resisted the day before at 4.50 per cent, had been sold out; and a $40 million utility issue offered on the morning of December 2 at 4.49 per cent had also been sold out by the close of that day.

The improvement in market atmosphere that followed the System's operations of December 1 and 2 was strongly reinforced by the statement of the President regarding bank lending rates that appeared in the press the next morning, and by the action of the First National Bank of Boston, and later of other banks, in rescinding their posted increases in the prime rate. Prices of bonds continued to move higher through much of the period as investment demand developed, and a number of issues reached price levels that equalled or even exceeded those prevailing before the British move. In the bill market, rates moved still lower after the President's statement, reaching the neighborhood of 3.75 per cent as increased investment demand pressed against short supplies of many issues.

With the close approach of the tax and dividend dates, however, rates turned around and moved back up. In the auction of December 7, a week ago yesterday, the average issuing rate for three- and six-month bills turned out to be 3.82 and 3.94 per cent, but with corporate and bank demand having diminished in the face of the dividend and tax dates, dealers found themselves taking up record awards of almost $1.1 billion bills at rates that scaled all the way up to 3.87 per cent for the three-month issue and 3.97 per cent for the six-month bills. The unsold portion of these bills would, of course, have to be paid for the following Thursday, which happened to be a heavy corporate dividend date--on which dealers would have to refinance up to $0.5 billion of securities coming back to them from corporations that had earlier acquired the securities under repurchase agreements. The market also would have to face another auction the following Monday (yesterday), and in addition would have to refinance yet another $0.5 billion or thereabouts of securities due to come back to them from corporate repurchase agreements today, the tax date. It was against this background of heavy seasonal pressures, and the prospect that those pressures would have pushed bill rates well into the 3.90's (with consequent upward movements in intermediate and long rates), that we made repurchase agreements at 3.85 per cent last Thursday. Even so, the average rate for three-month bills came out at 3.86 in yesterday's auction, with some awards being made at rates as high as 3.88 per cent.

Once the current seasonal pressures have passed, investors may well regard these rate levels as quite attractive; and, as I suggested at the last meeting, the market might settle down with the three-month bill moving around in the 3.80's.

It is perhaps well that the Committee de-emphasized free reserves at the last meeting, since the figures would have proved virtually uncontrollable even if we had sought to conduct operations in terms of that statistic. The figures will very likely continue to behave erratically, since the estimation of reserve factors is always particularly difficult over the four weeks that are ahead.

As indicated in our written reports, Federal funds have been readily available at the discount rate and frequently below. Member bank borrowings have been on the low side. The relatively low level of borrowings is attributable in part, as the staff's comment on question 6 1/ indicates, to the level of the bill rate in relation to

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

the discount rate. Also important in this regard, however, is the somewhat higher level of aggregate free reserves last week, the lower level of country bank excess reserves during the past two weeks, and particularly the significant recent improvement in the basic reserve position of the New York banks. This improvement occurred in good part through a reduction in their loans to dealers as the latter liquidated a substantial part of their bill positions in the days following November 23. The New York banks generally have been sellers of Federal funds over the past two weeks instead of large buyers, as they customarily are. This of course had reduced the need for discount window accommodation both in New York and elsewhere. How long it will be before these banks move back into their usual basic deficiency position remains to be seen. But activity at the discount window is likely to remain relatively light until they do; and even then, for the reason the staff points to in its answer to question 6, borrowings may not move to their former levels.

Treasury financing prospects for the next several weeks include the necessitous borrowing of perhaps $1 billion to $2 billion cash and the active possibility of an advance refunding operation. As matters now appear, the Treasury is likely to raise cash through the sale of additional June tax anticipation bills, probably announcing this operation just before year end--at the same time that they may announce an advance refunding. The sale of additional bills would tend to offset any downward tendency in bill rates that might result from the depletion in supply of short-term coupon issues through the advance refunding. It also appears likely that the Treasury will raise some additional cash after the turn of the year by continuing to sell $2.2 billion of three- and six-month bills each week as against weekly maturities of $2.1 billion.

Mr. Mills remarked that in following the operations of the Account and in interpreting market developments in the period since the Committee's previous meeting, at which he had not been present, it seemed to him that operations had been aimed largely at producing an interest rate structure that would instill confidence in the financial community. This course had been followed despite the fact that there typically was a tightening of interest rates in December. The question in his mind was whether by interfering to prevent such a tightening this year the Committee was creating an unnatural situation that would require correction at some early date. By and large, and within reason, some tightening of interest rates and some effort to limit the reserve supply would have been preferable, in his opinion, to supplying reserves at a rate that created a surplus and that led to almost a sloppy market. In addition, as the new year began, if economic developments were as had been indicated, a more drastic reversal of operations might be required than would have been the case if seasonal developments had been allowed to produce their usual effects.

Mr. Stone responded that the instructions of the Committee at the previous meeting, as he understood them, were to focus on interest rates, particularly the bill rate, in the conduct of operations; and to keep the rate on three-month Treasury bills roughly in the 3.75-3.90 per cent range. As he had indicated in his statement, shortly after that meeting the bill rate moved down to about 3.75 per cent, but it then rose from that level in response to seasonal pressures. Accordingly, there had been some reflection of seasonal forces in the market.

Mr. Mills observed that bill rates would have been higher than they were if free reserves had been lower. As he read the directive issued at the previous meeting--and this brought up the whole question of the Committee's directives--it called for accommodating moderate growth in reserves and for maintaining certain conditions of stability in the money market, but it made no direct mention of a target for bill rates such as might have come up in casual discussion around the table.

Mr. Stone replied that he had operated on the understanding that it was the Committee's intent that a bill rate target should be used. With respect to the suggestion that unnatural market conditions might have been created by the Desk's operations, Mr. Stone noted that, as mentioned in his statement, he had suggested at the previous meeting that the three-month bill rate probably would settle down in the 3.80 per cent range after the period of seasonal pressures had passed if the Committee made no substantial change in its reserve posture. The bill rate was in that range now, and in his judgment its current level was quite compatible with the kind of reserve posture the Committee had been maintaining recently. On the whole, he thought there was nothing artificial in current money market conditions.

Nor did he think conditions in the long-term market were artificial, Mr. Stone continued. The market was confident that the economy would continue to generate a substantial flow of savings and that the demand for long-term funds in 1965 was not likely to be substantially greater than in 1964 and might possibly be smaller. The expectation for long-term interest rates was that, if anything, they were likely to go down in 1965.

Recently, Mr. Stone said, the Federal funds rate frequently had been below the discount rate. This was closely related to the low level of borrowings, and both of these developments, in turn, were partly a consequence of the level of the bill rate relative to the discount rate. Also, the New York banks, which typically borrowed $400 to $600 million net every day, had a basic reserve excess and had been net sellers of Federal funds in the past two weeks. Commercial banks in New York, as well as some other banks, had worked themselves into a basic reserve surplus position in order to be able to accommodate the expected heavy demands for funds over the tax and dividend dates. In other recent years they had done this by selling assets, beginning about two weeks in advance of those dates. This year, however, they did not have to sell assets because they lost dealer loans as dealers worked down their trading positions. Dealers had sold a tremendous volume of bills to the private sector recently, in addition to their sales to the System Account.

In reply to a question by Mr. Swan, Mr. Stone said this situation had been reversed in the past few days as dealers re-acquired inventories in recent auctions and borrowed from the New York banks in considerable volume.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period December 1 through 14, 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. Koch presented the following statement on economic conditions:

Domestic economic activity has rebounded sharply from the effects of the work stoppages in the auto industry. The November industrial production index was almost a full point above the record September high, despite some impact of the Ford strike early in the month. The index is no doubt showing a further rise in December and is about 7 per cent above a year ago. The manufacturing workweek rose to 40.9 hours in November, due in part to heavy overtime in autos, but also reflecting some further increases in overtime in quite a few other industries, particularly in the durable goods area. Because of the temporary curtailment of activity in October, the fourth-quarter increase in GNP is likely to be only about half as large as in earlier quarters this year, but chances are very good that this shortfall will be made up in the first quarter of the new year.

One dramatic aspect of recent demand developments has been the step-up in inventory accumulation by manufacturers. Stocks of manufacturers rose $600 million in the third quarter, following increases that averaged only $125 million per quarter in the first half of 1964. They are anticipated to increase $1.2 billion in the fourth quarter. The greater accumulation since midyear has been due in large part to resumption of accumulation of inventories of steel and other materials, although accumulation of goods in process and finished goods has also stepped up since midyear.

Manufacturers anticipate a further rise in stocks of $600 million in the first quarter of 1965. In viewing longer-run prospects for inventory accumulation, two points are relevant: first, much of the current step-up in manufacturers' inventory demands represents a hedge against a possible steel strike; and, second, businesses have now had several years of satisfactory experience in operating with relatively low stock-sales ratios and most of them still report that their present ratios are "about right."

Turning to the price area, the weekly wholesale industrial price figures in November and early December suggest a continuation of the October rise, although at less than half the rate. The rise continues to be focused in the nonferrous metals area, with price changes outside this area continuing to be selective and largely offsetting in their effects on the general price indexes.

Prospects are improving, moreover, that pressures will abate in some nonferrous markets. In copper, for example, world production has been recovering from last summer's strikes and current output is higher than last spring when inventories apparently were being accumulated. The gap between tin production and consumption is being filled by increased sales from the stockpile, and tin prices have dropped sharply from the very high levels reached in October.

On the labor front, the decline in the over-all unemployment rate from 5.2 to 5.0 per cent from October to November cannot be considered highly significant. The rate remains in the relatively narrow range in which it has varied since late spring, as increases in employment have only matched increases in the labor force. Unit labor costs in manufacturing rose in September and October, but this movement, like those in many other statistics recently, was no doubt materially affected by the work stoppages in the auto industry. In November, unit labor costs may have returned to about their September level.

Although labor unrest appears to be increasing and dock and rail strikes are threatening, concern about the spreading of wage increases continues to focus on the steel industry. Here there are some factors suggesting a large settlement and others suggesting a more modest one. Those suggesting a large settlement include the struggle for political power within the union, the relatively large earlier auto settlement, the high current demands for steel, and the small settlements in steel in 1962 and 1963, settlements that consisted only of fringe benefits. Factors suggesting the possibility of a more moderate settlement are the changed attitudes of both management and labor in the industry regarding the likelihood of being able to pass on cost and price increases to buyers in the current competitive market environment, and the importance to the administration and the general public of a settlement near the guidepost and without a strike.

Settlements in steel as well as in other industries have appeared in recent years to be strongly influenced by longer-term competitive aspects and by concern over the threat of substitution from other sources of supply, both domestic and foreign. Sales of Japanese steel in the U.S. market, for example, are still on the rise, and Japanese producers are likely to intensify rather than diminish their sales efforts here in the months ahead. Union demands in collective bargaining have emphasized increases in fringe benefits rather than in money wages, reflecting a heightened desire to protect job security and future income rather than just current income. On balance, these developments suggest a fairly generous steel settlement but one far less costly than the disruptive ones in the mid- and late-1950s.

In sum, economic activity in the near-term future is likely to be brisk, as auto restocking and precautionary steel buying continue and as business capital expenditures rise further. The current vigorous expansion still poses the potential threat of a destabilizing thrust on the upside, but this threat may well lessen sharply with a steel settlement, unless it is a large one. Prospective declines in auto production following the current stock rebuilding and in steel production following the wage settlement could well lead to a slowdown in the expansion, although at this juncture one cannot see what new elements may have entered the picture by then.

The most common current economic forecast is that 1965 will be a prosperous year, but not good enough to absorb the increase in the labor force, expected to be larger than in 1964, let alone reduce the present number of unemployed unless more stimulus than is currently anticipated comes from either the private sectors of the economy or the Government. With this possible outlook in mind and recognizing the inevitable lags in the impacts of monetary policy, domestic economic considerations still seem to me to call for a continuation of the existing degree of credit availability and of approximately current costs of longer-term credit and capital.

Chairman Martin noted that a memorandum dated December 7, 1964, entitled "Proposal for Obtaining Financial Statements from Nonbank Dealers in U.S. Government Securities," had been addressed to the Committee by the Steering Group of the Government Securities Market Study, of which Mr. Koch was a member. (A copy of this memorandum, together with certain attachments, has been placed in the files of the Committee.) The Chairman suggested that the Committee discuss this memorandum before proceeding to the report on financial developments, and he invited Mr. Koch to comment.

Mr. Koch observed that the proposal, which was summarized in the first five pages of the memorandum, grew out of the 1959-1960 study of the Government securities market by the Treasury and the Federal Reserve that followed the 1958 episode of speculative boom and collapse. The recommendation of that study for collection of better information on dealer positions, transactions, and financing already had been implemented. The Steering Group then had turned to a second recommendation, that more uniform balance sheet and income statements be obtained from nonbank dealers, and it had developed the proposal for financial statements described in the memorandum.

Mr. Koch described the proposal as a first and exploratory step in meeting the problem. He said the Steering Group had encountered considerable difficulty in taking even this first step; that it hoped to learn more about the problem as experience under the new program was accumulated; and that this might well result in further recommendations.

The proposed financial statements would serve several objectives, Mr Koch said. First, it was hoped that improved and more uniform financial statements would encourage sounder financial reporting and practices by dealers. Their financial reports at present generally were skeletal and disparate in nature. It was difficult to achieve uniformity in statements because of the wide differences in the scope of activities in which the various dealers engaged and because some dealer organizations were partnerships and some were corporations.

Good accounting practices were particularly important in this industry, Mr. Koch observed, because dealers typically operated with small capital and narrow equity margins. At the same time, the smooth and sound functioning of the Government securities market was vital both to the financing operations of the Treasury and to the open market operations of the Federal

Reserve. Although great reliance in ensuring the financial solvency of dealers still would have to be placed on the integrity of the dealers themselves, the Steering Group felt that the development of uniform financial reports could play an important contributory role. Initially, the proposal called for annual statements, but later the statements might be requested more frequently. It might also be appropriate to institute surprise audits at some future date.

A second purpose of the program was to provide better aggregate statistical information of a financial-statement type for the industry. There had been many requests for such information from interested groups, including committees of Congress. Finally, some dealers have complained recently that various System operations and Treasury debt management techniques had been impairing the functioning of the market and their ability to earn adequate profits. Better information on dealer capital, incomes, and expenses would be useful in evaluating such complaints.

Mr. Koch observed that the program proposed had been discussed with the Secretary of the Treasury, and Mr. Dillon had made two suggestions. First, he thought it would be desirable to have a letter to the dealers announcing the inauguration of the program from Chairman Martin and himself as well as one from Mr. Hayes as proposed in the memorandum. Secondly, he strongly urged that the program be started with financial reports as of the end of the current calendar year.

In response to an invitation to comment by Chairman Martin, Mr. Stone said that he fully endorsed the proposal. He observed that dealers were agreeing to supply the information requested with a certain amount of reluctance, but he would expect this reluctance to be overcome once the program was under way and the dealers could see its value.

In the ensuing discussion Mr. Robertson remarked that he thought the proposal was a real step forward. Mr. Mitchell commented that while he did not disapprove of the program proposed he considered it inadequate for the purpose and regretted that it was not more responsive to the problem.

Thereupon, the recommendations of the Steering Group for obtaining financial statements from nonbank Government security dealers, as set forth in the memorandum of December 7, 1964, were approved.

Secretary's Note: The following letter was sent to nonbank dealers in Government securities over the signatures of Secretary Dillon and Chairman Martin on December 24, 1964:

Dear Mr. ____________:

The Treasury-Federal Reserve program for improving the available information on the Government securities market has now been underway for nearly five years. You will recall that in January 1960 Chairman Martin and then Secretary of the Treasury Anderson wrote you to initiate a program for "collection of data covering transactions volume, dealer positions and borrowing, including financing under repurchase agreements, and balance sheet and income statement information."

The data on transactions volume, dealer positions and dealer borrowing collected since 1960 have proved to be of real value to the Treasury and the Federal Reserve, as well as to interested students. We want to express our appreciation for your cooperation and public-spiritedness in providing these data which have proved so useful.

Now the time has come to move ahead on the second stage of the information program, the collection of nonbank dealer financial reports, including both balance sheets and income statements. We expect that this additional information, to be collected on a confidential basis but with the prospect of publication in consolidated summary form after some reasonable trial period, will be of significant benefit to us in appraising developments in the Government securities market. The accompanying letter from Mr. Hayes and its attachments give the details of the projected program and our staffs will of course be available to work with you in implementing it.

Chairman Martin observed that it might be desirable to institute meetings with the dealers early next year to give them another opportunity to discuss their problems directly with System people.

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

Domestic financial markets appear now to have settled down in the wake of the official rate actions of November 23. Sensitive yields have declined in both short- and long-term markets, and in the latter case are back to about where they were just before the discount rate increase. Partly this readjustment has been in response to official pronouncements, to market estimates of Federal Reserve policy, and to the failure of any prime bank rate increase to carry through. But the resilience of long-term markets also reflects basic supply-demand relationships, including particularly the absence of any significant current or prospective rise in financing volume.

In shorter-term markets, despite some backing down in the past two weeks, yields remain appreciably above the November 20 level--generally 15 to 20 basis points higher. As a result, the yield curve is even flatter than before; taking bills on an investment yield basis, the Government list is essentially flat in yield from 6 months on out at about 4.10 per cent. The question is, how sustainable is such a yield curve?

Under present circumstances, it seems to me that there is a good chance that long-term yields will hold where they are, or even drift lower, despite the upward adjustment we have had in short-term rates. Basic to this proposition is the expectation that aggregate long-term financing demands will not rise in the period ahead. There could well be some increase in corporate financing as capital expenditures continue upward, although no such tendency is yet evidenced by the new issue calendar, which is seasonally slack over the turn of the year. But the net expansion of mortgage debt has already fallen off somewhat this year from its late 1963 peak, and a further decline is to be expected as the drop in housing starts last spring is reflected more fully in the mortgage figures.

The flow of savings available for long-term investment has continued large throughout this expansion, and most market observers expect such flows to remain high in the period ahead. The prospects for this have been enhanced by the Regulation Q action, which both improves the ability of banks to compete for time deposits and savings funds and virtually eliminates any possibility of a move toward lower rates by savings institutions generally at the turn of the year. The potential for larger savings flows, especially to banks, appears to underlie the recent marked decline in municipal yields to the lowest levels since the spring of 1963. Any developing slack between supplies of and demands for longer-term funds, of course, could be taken up by Treasury debt-lengthening; a decision to undertake an advance refunding in January would present a near-term test of the absorptive capacity of the capital markets.

The sustainability of the present flat yield curve is also enhanced by uncertainties about the course of the economy in 1965. If we are at or close to a cyclical peak in interest rates, borrowers would not want to accelerate their long-term financing needs, nor would lenders want to do much shortening of their investment portfolios.

Growing investor uncertainty about the strength of economic prospects may be indicated by the recent behavior of the stock market, which has declined 3-1/2 per cent over the last three weeks. International financial uncertainties and the increase in official rates here and abroad may have triggered the decline, but a more basic factor probably is the growing awareness that corporate profits appear to be leveling out. Manufacturers' profit margins, in fact, have inched downward quarter by quarter this year on a seasonally adjusted basis, although there will be fillip to after-tax earnings with the second two-point cut in the corporate tax rate in January. This has long been discounted in the market, however, and the new indications of an essentially flat earnings performance, despite a possibile uptick stemming from near-term inventory accumulation, may well not be bullish enough to sustain the relatively high price-earnings ratio of 19 reached in mid-November.

Turning to recent credit market developments, the figures now confirm that total bank credit expansion in November was exceptionally large, both on a daily average and month-end basis. Much of the unusual size of the increase was accounted for by Treasury financings, which had the effect of boosting both Government portfolios and security loans more than seasonally toward month-end. Business lending also picked up, but only to a pace about in line with the year as a whole, and other loans, except for those to security dealers, continued to expand at the rate of recent months. In the first two weeks of December, judging from reports for New York City, business loan demands strengthened significantly, partly due to hedging against possible prime rate action, but the rise in total credit was considerably less than in other recent years.

Most of the increase in lendable funds in November resulted from a contraseasonal expansion in Treasury balances, and also from an acceleration in time and savings deposit growth. The former reflected the Treasury cash financing, unusual for November, and the latter a continued enlargement of savings inflows, related in large part to the shortfall in new car sales in both October and November. Demand deposits rose only moderately on balance, expanding in the first half and contracting in the second, and the money supply increased $500 million, at the lower end of the $500-$800 million range of increases over the past 4 months. Very tentative indications are that there was only a moderate further rise in the first half of December. The November expansion brought the growth rate of the money supply for the year to date to 4.2 per cent, with currency up 6 per cent and demand deposits 3.8 per cent. (The last figure is slightly revised from the 3.5 per cent reported in element 3 of the trial directive.)

Meanwhile, the banking system has reacted to the higher discount rate in a predictable manner. In the first two weeks of December, both excess reserves and borrowings declined from the averages of earlier two-week settlement periods, with a little larger decline in the latter contributing to somewhat higher average free reserves. Banks have been pressing to utilize excess reserves, and the flow of Federal funds has been large, often at rates below 4 per cent. So long as rates on both bills and Federal funds remain well below the discount rate, banks will tend to make marginal reserve adjustments through these markets and borrowings will be restricted. This, of course, means that a higher free reserve figure on average is likely to continue to be associated with current market rates. Maintenance of these rates, in turn, depends basically on the availability of nonborrowed reserves as required to support current bank credit expansion.

In summary, there has been an orderly, and on the whole balanced, adjustment to the November official rate actions. The yield structure which has evolved seems sustainable in the current context, although the adjustments in investor attitudes and in initial allocations of funds are still provisional and tentative. Expansion in bank credit and in money appears to be continuing, and there is no evidence of any significant change in earlier trends as yet. Under the circumstances, domestic market conditions would appear to call for a policy of continuing open market operations aimed at stabilization of rates and flows. With seasonal fluctuations in funds flows so large at this time of the year, and with the balance of pressures on short-term rates about to reverse, it would seem that such policy must be couched primarily in terms of desired market conditions rather than in terms of either a specific marginal reserve target or any precise yield expectation for 3-month bills.

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

The year end is typically a period of large seasonal and erratic movements in international transactions. This year, the difficulties of interpreting the data are compounded by uncertainties about the effects of Britain's problems, related policy actions, and the threat of a U.S. port strike. Also, we have just encountered a purely statistical puzzle: the "flash" report by large banks on their foreign liabilities in November indicates a considerably larger over-all payments deficit in that month than has been suggested by weekly reports.

In the circumstances, there seems to be little point in speculating in detail on the fourth-quarter outcome. It seems clear that the seasonally adjusted deficit will be larger than it was in the third quarter, and that this result will be mainly explained by the bulge in new foreign security issues. Whether Britain's difficulties have temporarily been producing an improvement in our figures is hard to tell; to the extent that uncertainty about sterling has generated wider uneasiness about the whole exchange rate structure, it may have produced adverse as well as favorable capital flows.

The deficit for the full year will probably work out at about $2-1/2 billion on "regular transactions" and perhaps $1 billion on "official settlements"--about $1 billion smaller on either measure than in 1963.

These guesses do not allow for the possibility that Britain may request a waiver of $138 million of year-end debt service payments to the United States.

Perhaps the most striking data that have become available in the past two weeks are the merchandise trade figures for October. You will recall that a surge of exports in September was tentatively ascribed to anticipation of the port strike, which was then postponed. But now it turns out that exports did not fall back very much in October, and for September-October combined, they were 7 per cent above the first half-year's rate and 12 per cent higher than a year earlier. Even if some of this gain reflects chance or anticipatory bunching of shipments, it seems clear that exports were rising again in the autumn, after a dip in the spring that had reflected the ending of unusually large grain shipments, a decline in exports to Japan, and some temporary leveling off in Western European demand, notably in Italy. The renewed autumn advance shows up in shipments to all areas except the U.K. Imports, meanwhile, did not change in October, and were only a little higher than last spring.

Over the two years to September-October, imports rose--rather unevenly--by 12 per cent, or about as much as GNP. Exports over the same 2-year period increased by an extraordinary 28 per cent. The resulting improvement in the trade surplus has been a major element of strength in our balance of payments position.

Two main forces have been at work here: an unusually favorable cyclical position abroad, and a basic improvement in the U.S. competitive position. The cyclical upswing has been unusual both in its strength and in its world-wide character. Taking the 2-year period as a whole, activity has been expanding vigorously in all industrial countries--the United States and Canada as well as Europe and Japan. As in 1955-57, the boom has lifted the earnings of non-industrial countries as well, and after some lag they have sharply increased their imports.

The European economies have generally been at full stretch in this period. Their wholesale price levels are now generally 10 to 20 per cent higher than they were in 1960, whereas ours has not changed significantly. In recent months, prices have continued to rise in Europe. Only Italy and France have succeeded in slowing their price-cost advances, although Germany continues to hold hers to modest proportions, and most other countries feel that they are beginning to bring the advance under control. Thus, basic competitive trends have continued to move in our favor, although they may not move as rapidly in this direction from now on.

Prospects for short-run demand changes are more difficult to assess. It seems most unlikely that the nonindustrial countries as a group can continue to increase their imports at recent rates. Australia, for instance, had a 50 per cent increase in imports over the past year, and is now trying to rein in; so is South Africa. Some major Latin American countries are now encountering renewed balance of payments difficulties. In Europe, the shift in British policy towards internal restraint, and the import surcharges, will have major dampening effects. Against this, there may be some acceleration of demand expansion in the months ahead in some continental European countries, notably Italy; and German business conditions continue buoyant as before. Outside Europe, Japan is apparently increasing its imports again, and Canadian demand continues to expand. On balance, I would expect further expansion in U.S. exports during 1965 at a rate that will be fairly satisfactory by historical standards but considerably less rapid than during the past two years.

U.S. imports seem likely to be swollen in the next few months by strong inventory demand, notably for steel. Therefore, we should probably not expect further gains in the trade surplus early in 1965. (And the threatened dock strike will, of course, distort the monthly figures.) But some improvement in the trade surplus for the year 1965 as a whole over the year 1964 now seems more likely than it did a short time ago. And if price stability can be maintained in this country, the longer-run trade prospects are also favorable, in my view.

Mr. Deming asked what the pattern of the balance of payments deficit for 1964 would be when figured on an official settlements basis. Mr. Reynolds replied that for the first three quarters of the year it had been running at an annual rate of about $1 billion, and there was no obvious reason to expect a substantial change in the fourth quarter. But any fourth-quarter estimate now could be only a guess since current figures were not collected on that basis. The weekly reports would have provided a clue to developments under ordinary circumstances, but as he had noted the November flash report by large banks, which gave no breakdown of liabilities as between official and private foreigners, appeared inconsistent with the weekly reports. Also, large shifts between foreign private and official holdings of dollars might have been occurring because of uneasiness about the pound sterling. Accordingly, it was necessary to await the more detailed fourth-quarter figures before estimating the deficit for that quarter on an official settlements basis.

Mr. Shepardson referred to Mr. Reynolds' comments on the outlook for U.S. exports, and asked whether allowance had been made for a possible decline in agricultural exports. These had been high this year, Mr. Shepardson noted, partly because of drought conditions abroad. Also, if he correctly read the indications of current negotiations on Common Market farm policy, they implied a significant reduction in U.S. agricultural exports to Europe.

Mr. Reynolds replied that in assessing the outlook he had assumed that the decline in farm exports as a result of the ending of the drought abroad and the lack of further Russian purchases of grain had run its course. He had not allowed for any further drop in connection with policy decisions by the Common Market on the ground that the nature and effects of the decisions that would be taken were still uncertain.

Mr. Mitchell commented that Mr. Reynolds' expectations for U.S. foreign trade seemed somewhat different from those implied in the staff statement made in response to question 4. Mr. Reynolds agreed that he saw some prospects for improvement that were not suggested by the staff statement. In part this reflected the fact that his own views were toward the optimistic end of the range of staff opinion. But perhaps the more important explanation was that he and other members of the staff had not fully absorbed the implications of the figures for October when the response to the question on the balance of payments was prepared. On the whole, however, his current expectations did not differ greatly from those implied by the staff statement.

Chairman Martin then called for the go-around of comments and views on economic conditions and monetary policy, beginning with Mr. Treiber. He noted that, in accordance with the understanding the members had reached in the afternoon following the December 1 meeting, the Committee would adopt a new procedure in the go-around today; members were invited to address their remarks at least in part to some or all of the questions and responses that had been prepared by the staff and distributed before this meeting.

The staff materials to which the Chairman referred were as follows:

(1) Production, sales, and inventories--Taking into account the effects of recent and threatened work stoppages, is the strength of current economic activity showing any signs of diminishing or increasing?

After being dampened by work stoppages earlier in the fall, economic activity currently is receiving a temporary stimulus from strenuous efforts on the part of auto producers to bring retail inventories back to a level commensurate with the record level of sales and by apparently widespread efforts on the part of steel consumers to build up their stocks of steel in anticipation of a possible strike next May. These two influences are augmenting business inventory accumulation now and will probably continue to encourage inventory investment into early months of 1965, although strikes threatened by longshoremen and railroad workers might prove to be a disruptive factor.

Aside from these temporary influences, trends in other sectors of economic activity have shown little change from earlier months. On balance, the underlying economic situation appears to be one of continuing moderate growth. As the year ends, business and consumer confidence remains at a high level, with recent surveys showing both groups anticipating rising levels of spending in the months ahead.

(2) Employment--Can the economy achieve a significant further reduction in the margin of underutilized manpower in the near-term future without strong upward pressures on prices generally?

The current prospect for further expansion in activity at about the same rate as in the past year does not suggest any great likelihood of a significant further reduction in the margin of unutilized resources in the near future, because resources of manpower and industrial equipment also are continuing to expand. Employment gains since May have been matched by increases in the labor force, and the unemployment rate has fluctuated in the narrow range of 4.9 to 5.3 per cent.

Significant near-term reduction in unemployment would require one or more of the following developments:

(1) a more rapid expansion in employment than has been taking place recently. This could occur temporarily early next year because of the inventory buildups related to recent and threatened strikes. But in autos and steel, employment in November and December already is very high and overtime work has been increased to meet what may be a temporary peak load. In construction, notwithstanding an unusual seasonal rise in November, employment appears to have leveled off. In trade and in public and private services, employment gains have been strong but steady;

(2) a less than expected increase in the labor force. But expectations are likely to be realized if demands continue strong because the labor force tends to respond positively to job opportunities;

(3) a decline in the rate of productivity advance. This could occur but there is no evidence as yet of any moderation in what has been a high and sustained rate of advance. Substantial further additions to plant capacity will be an important factor tending to maintain the advance in productivity.

So far, the supply of labor has been adequate to meet expanding demands without any strong general upward pressure on prices. In some industries, strong demands have required considerable overtime work and active recruiting and training programs. The balance of forces affecting bargaining has been such that in some cases, notably in the auto industry, settlements have been larger than the general rate of productivity advance in the private economy. In September and October, labor costs per unit of output in manufacturing rose, but only to the level of December 1963, and a significant share of the rise is believed to reflect the work stoppages in autos. The critical question, not yet resolved, is whether the wage patterns developing in industries showing high productivity increases, such as autos, will spread to industries showing lower productivity increases.

(3) Price developments--Have upward price pressures been getting stronger and more pervasive?

High rates of economic activity in the United States and abroad have maintained strong upward price pressures in markets for nonferrous metals. In some cases upward pressures have been intensified by political disturbances or strikes that have limited production. There are reasonably good prospects, however, that pressures in some of these markets will ease in the near future.

Outside the nonferrous metal markets, price changes continue to be selective. Industrial commodities as a group rose only slightly further in November and early December, following the October advance.

With prices of industrial materials increasing little, and with labor costs per unit of output in manufacturing no higher than a year ago, prices of finished goods have not been subject to pervasive upward cost pressures. Wholesale and retail prices of consumer goods (other than foods) have been stable all this year. Prices of producers' equipment, on the average, have been stable since spring, following a rise of 1 per cent over the preceding 6 to 8 months. A general steel price increase, of course, would seriously threaten this pattern of over-all stability.

(4) Balance of payments--Have underlying influences recently been tending to strengthen or to weaken the position of the dollar internationally?

Continuing uneasiness about the pound sterling is tending temporarily to strengthen the dollar in some ways and to weaken it in others. U.S. trade figures are being distorted to an unknown extent by anticipations of a possible port strike. Underneath all this churning, however, it is possible to discern some of the underlying forces that are likely to be of decisive importance over the period ahead.

Basic trends in the competitive position for merchandise trade have been favorable for five years. But efforts to slow down price-cost advances in Europe are beginning to take effect. Therefore, continuation of favorable competitive trends hinges increasingly upon the continued maintenance of price stability in the United States.

Changing demand conditions may limit further improvement in the trade surplus in the short run. The large increase in exports during the past two years resulted partly from favorable cyclical forces. Growth in U.S. exports now will be slowed by recent U.K. policy actions, less buoyant expansion in some other industrial countries (e.g., France), and less rapid growth in the imports of some nonindustrial countries. Meanwhile, U.S. imports, after increasing in line with GNP for two years, may rise more briskly in coming months, especially if inventory demands are strong.

Income from foreign investments remains on a strongly rising trend. But the increase in receipts will be smaller in 1965 than in 1964, mainly because tax factors shifted some dividends from 1963 to 1964.

Relative credit conditions shifted adversely in 1963-64 as credit tightened in Europe and Japan and remained readily available here. While covered interest rate relationships affecting movements of liquid funds have not changed significantly, both short- and long-term rates have generally risen more abroad than here. Also, U.S. banks have been eager to expand their foreign lending. Outflows of U.S. private capital will have risen to a new high of more than $5 billion in 1964, including about $2 billion of direct investments, $1 billion of new foreign security issues, and $1-1/2 billion of total bank lending. If any large balance of payments improvement is to occur during 1965 in a context of continuing U.S. economic expansion, most of the improvement must take place in capital flows. No early easing of credit conditions abroad can be counted upon to help.

Continuing erosion of the U.S. international reserve position points to a need for showing significant further improvement in the payments position fairly soon, or at least for policies that would ensure continuation of favorable basic trends. Questions arise, however, about the rate of improvement that is needed and feasible in the light of other objectives, and about the mix of Government policies most likely to achieve desired results.

(5) <u>Money supply and liquidity</u>--What interpretation should be placed on recent fluctuations in the rate of expansion in bank credit and the money supply?

Fluctuations in the rate of growth of total bank credit in recent months have reflected in large part the unusual pattern of Treasury financing operations. This was particularly true of the July decline and August increase in credit and the unusually large increase in November. A major factor in the disparate changes in September and October was the fact that the last-Wednesday reporting date for September was the last day of the month. This resulted in the recording of the large end-of-month credit increase in September rather than, as is more usual, in October. Since midyear the rate of growth in bank credit has been about 8 per cent, the same as over the first half of this year.

Within the aggregate of recent credit expansion, however, there has been some change in composition. Expansion in total loans since midyear has been somewhat slower than earlier this year while holdings of investments have increased somewhat faster. The rate of growth of business loans, on the other hand, has continued in recent months at an annual rate of close to 10 per cent, the same as earlier in the year.

The seasonally adjusted money supply rose $500 million in November, at the lower end of the $500-$800 million range of monthly increases which has prevailed since July. Over this period, the annual rate of growth has been 4.6 per cent, considerably above the 2 per cent average for the first five months of this year but considerably below the 8-1/2 per cent rate of June and July.

Short-run fluctuations in money supply growth such as these do not represent a departure from earlier experience in this series. A certain degree of lumpiness in money expansion results from short-run shifts between private and Government deposits and from attempts by the public to bring money balances into line with desired levels after temporary departures from those levels. Factors which might have contributed to such fluctuations this year would include: (1) heavy consumer buying in anticipation of a tax cut and large acquisitions of securities by the consumer sector in the early months of this year; and (2) a restoration of previously reduced balances, together with a lag in the adjustment of expenditures and savings flows to the increase in disposable personal income stemming from the tax cut, in June and July. The growth rate in money balances since July, while somewhat more rapid than the 3.9 per cent rate for the first seven months of this year, is not out of line with the recent rapid rise in GNP, both in current and in constant dollars.

The emergence of a substantial uptrend in seasonally adjusted demand deposits at city banks since spring, after a period of several years of little change, suggests that businesses as well as consumers now may be increasing their money holdings more closely in line with transactions needs. The recent decline in the rate of growth in CDs would be consistent with such a development.

(6) Money and credit markets--Are the adjustments to the discount rate increase in money and capital markets and in bank reserve positions completed, or are they continuing?

It appears that the adjustments in yield relationships to the discount rate actions *per se* have been substantially completed, although some consequent changes in financial flows may still be in process and day-to-day rate fluctuations may continue for a time to be wider than usual. However, basic yield relationships are still subject to stress from the seasonal reversal of pressures in short-term markets after mid-December as well as from possible shifts in underlying supply-demand relations in both short- and longer-term markets.

Following the initial adjustments, bond yields returned to levels close to those obtaining at the time the official actions were taken. This resulted in part from market interpretations of official statements and also from continuing expectations that the flow of long-term savings to investing institutions would continue large--and perhaps be enhanced by the recent amendments to Regulation Q--while long-term credit demands would remain relatively moderate. Municipal and corporate security flotations have been well received recently, but the basic strength of the long-term market will be further tested in January if the Treasury undertakes longer-term financing operations at that time, as it has in the past several years.

Upward adjustments of short-term rates have amounted to as much as 25 basis points, resulting in further flattening of the yield curve in the shorter maturity range. Rates on Treasury bills have settled down somewhat below the highs reached in the initial adjustment, while rates on other short-term instruments generally have held at the levels reached in early December.

Banks appear to have adapted to the new discount rate in management of their reserve positions, although current seasonal pressures tend to obscure basic trends. So long as the 3-month Treasury bill rate does not rise closer to the discount rate, the tendency which emerged in the past three weeks for banks to want to keep borrowings at somewhat lower levels is likely to persist.

(7) Monetary policy--In light of these and other considerations, what policy with respect to bank reserves

and money market conditions would be appropriate for the next four weeks?

Mr. Treiber commented that at past meetings the statement of the New York Bank member usually had focused on the areas of a number of these questions, and his statement today would be concerned with all of them. Mr. Treiber then made the following statement:

1. Domestic economic activity. The domestic economy continues to be basically strong despite some distortion of current statistics because of the auto strikes in October and November. Economic activity may be expected to continue to increase. There are, however, uncertainties over labor-management problems including threatened strikes of railroad workers and longshoremen within the week, and possibly steel workers in the spring.

Retailers are generally highly optimistic about Christmas sales, and longer-run strength in the consumer area is suggested by the October Census survey of consumer buying intentions.

Business confidence is high. There is further indication of strength in capital spending. The November Commerce-SEC survey of plant and equipment spending plans indicates an upgrading for the second half of 1964, and a further advance in the first half of 1965. The new survey is consistent with the view that 1965 will see another sizeable advance in plant and equipment spending, though perhaps not as large as in 1964.

While both inventory and sales figures have been distorted by the auto strike, it seems likely that there has been some basic accumulation of inventory. So far the building of steel inventory has been moderate, but a big push in steel inventory accumulation is expected in the first quarter of 1965.

2. Employment. The November decline in the unemployment rate to 5.0 per cent from 5.2 per cent in October is encouraging, even though some of the improvement is due to the unusually favorable weather

conditions which permitted more workers than usual to engage in construction and other outdoor work. The unemployment rate for married men is the lowest it has been in more than seven years. There are shortages in various types of skilled labor. The unemployment problem is most severe among the unskilled, particularly teenagers.

To cope with the problem of unemployment, greater stress will have to be placed on measures to raise the general level of education, to improve and expand particular types of technical training, to induce young people to take full advantage of educational and training opportunities, and to enhance labor mobility as well as equality of access to job opportunities. While adequate credit is important to a dynamic and expanding economy and helps to provide job opportunities, merely increasing over-all demand by expanding credit will not solve the unemployment problem stemming from lack of education and training. There is great risk that pressing to increase over-all demand will push up prices generally without substantially reducing unemployment.

3. Prices. There has been no clear change in the price picture. The consumer price index continues its relatively mild upward drift. Industrial wholesale prices appear to have risen a bit more than seasonally. Specific price announcements continue to be predominantly on the up side. On the other hand, there still continue to be some announcements of price reductions. It is too early to assess the impact on the general price level of recent wage agreements. Yet it is apparent that general price tendencies are upward.

4. Balance of payments. The latest balance of payments figures indicate a large deficit--$272 million--for November. Little can be said on the outlook for December, since many cross-currents are at work. There is the possibility of a deferment of $138 million of year-end interest and amortization payments by the British. Our deficit for 1964 is likely to be between $2 and $2-1/2 billion; this is too large. A much larger proportion of the deficit is reflected in a buildup of private balances than in other recent years. If, however, private holders of U.S. dollars become nervous, there could be a large transfer of those dollars to official bodies with the resultant potential drain on our gold supply.

The outflow of U.S. private capital in 1964 will probably exceed $5 billion; this is $1 billion more than in 1963. The outflow this year is at about the same rate that existed in the first half of 1963 before the mid-summer increase in United States interest rates and the proposal of the interest equalization tax. A large part of the increased outflow in 1964 has occurred in the short-term area; there have been continuous increases throughout the year in short-term bank credits and holdings of U.S. dollar deposits and money market assets abroad. We cannot tell at this time to what extent the recent increase in our discount rate and in maximum permissible rates under Regulation Q may tend to reverse the previous outflows.

The British situation is still very serious. Any threat to sterling as a reserve currency is a threat to the whole international financial structure including the U.S. dollar and its role as a reserve currency. Even though the United States may have an inflow as a result of Britain's unfortunate experience, such an inflow is not a sign of fundamental U.S. strength. So long as sterling is under pressure we cannot say that the position of the dollar is really stronger internationally.

5 and 6. Credit conditions. Month to month fluctuations in total bank credit have been unusually erratic in the last few months. There have also been substantial fluctuations over the year in the rate of expansion in the money supply. In the longer run, however, growth has been continuous and substantial.

Bank reserves, bank credit, and the money supply have continued to grow in 1964 at about the same substantial pace as in 1961, 1962, and 1963. Over that period aggregate bank credit has advanced almost steadily at about 8 per cent each year. The money supply has risen about 3 per cent a year on average and in the last two years at about 4 per cent a year. It is significant that other forms of liquid assets have also kept growing. The ratio of total liquid assets of the nonbank public to gross national product is now higher than at the recession trough of 1961; in previous expansions the ratio has declined as the economy expanded.

As the demand for bank credit has expanded with the expansion of the economy over the last few years, the System has accommodated those demands by providing an expanding volume of reserves. The cost of the additional reserves and short-term interest rates have risen and the tone of the money market has firmed as free reserves have declined; but the additional reserves have been provided to support the credit expansion.

The banks have pressed to expand their loans. Reserves have been sufficiently available to enable them to meet the demands of their domestic customers and to seek aggressively and successfully to increase their foreign loans unconnected with exports.

Savings appear to be readily available for long-term capital purposes. Two large issues of utility bonds were publicly offered at yields which were about the same as the yields on similar issues offered before the recent discount rate increase.

7. Monetary policy. Over the longer run the continuing large deficit in the U.S. balance of payments requires, and the generally strong domestic business outlook counsels, some reduction in credit availability. A reduction in availability would be helpful in restraining lending by banks to foreigners. Such a reduction would be reflected in a somewhat slower rate of growth of bank credit. The time has not yet come, however, to take overt steps in that direction; rather the System should aim at maintaining relatively stable money market conditions in the coming weeks and at observing the effect of the higher rate structure on the growth of bank credit. The possibility of an early advance refunding by the Treasury also counsels market stability at this time.

The money market has adjusted well to the recent increase in the discount rate. But the effects of the policy change have not fully worked their way through the market. The banks' needs for reserves are at a seasonal peak; normal market forces put Treasury bill rates under considerable pressure at this time.

The tone of the money market would appear to be the most important guide over the next four weeks; the amount of free reserves should be subordinated. A three-month Treasury bill rate within the range of 3.75-3.90 per cent would seem appropriate. There should be maximum flexibility to respond to market developments.

Mr. Treiber then referred to the draft directives that had been submitted by the staff, and indicated that he preferred alternative B for the second paragraph because it placed primary emphasis on money market conditions.[1/]

Mr. Shuford said that he had considered the questions and responses that had been prepared by the staff and had made a few notes regarding them. However, since his views did not differ in basic respects from those set forth in the staff statements he would not comment on details, but instead would offer some brief general observations.

It appeared that the domestic economy was continuing to expand, Mr. Shuford said, although the automobile strikes were continuing to blur the analysis. Most recent statistics, such as those on employment, production, and total construction, had been favorable. Over the longer periods that perhaps were more relevant for purposes of policy formulation, most indicators of economic activity had been increasing, after allowance was made for the effects of strikes. Prices in some sensitive areas had risen but the over-all indexes remained relatively stable.

It seemed to Mr. Shuford that it was still too early to make a completely satisfactory evaluation of the effect on the domestic economy of the recent increase in the discount rate and the accompanying rise in short-term market rates. These events

1/ The staff's draft directives are appended to these minutes as Attachment A.

might have some dampening effect, but the economy was strong and should not turn down or slow unduly as a result of them. Activity had been moving ahead with considerable momentum, and monetary actions had been relatively stimulative from May to November.

The most recent data on rates of expansion in reserves and money seemed to Mr. Shuford to have shown some appropriate moderation from summer and early autumn rates. Since September, total reserves of member banks had risen at less than a 2 per cent annual rate. This was down significantly from the 5 per cent rate that had prevailed since November 1963. However, the contraction in the growth rate in total reserves had been about matched by a reduction in Treasury tax and loan account balances at commercial banks, freeing reserves for the support of private deposits. The money supply had risen at a 4.2 per cent annual rate since September, a rate which was much lower than that of last summer but about double the average since 1951.

Mr. Shuford noted that the present turn-of-the-year period typically was characterized by considerable churning in the money market. He thought it would be advisable, in view of both the international and domestic situations, for the Committee to mark time for this period, attempting to keep money market conditions relatively stable. He agreed with Mr. Treiber's suggestions with respect to the general approach that might be taken. Certainly, the level of free reserves should be an incidental consideration during the next few weeks. He would not favor having the Desk operate entirely on the basis of the tone and feel of the market; some statistical measure should be used as a guide to operations. In his opinion the bill rate continued to be the best guide for the time being, and the 3.75-3.90 per cent bill rate range discussed at the preceding meeting remained appropriate for the next few weeks.

Mr. Bryan commented that recent statistics for the Sixth District did not seem to reflect developments that were of particular significance for, or predictive of, national economic trends. Therefore, he would turn to the questions submitted by the staff. On a number of these questions he had little to contribute beyond the staff's analysis. For example, he would accept the staff reply to question 1, concerning production, sales, and inventories. On the second question, whether a significant further reduction in unemployment was possible without strong upward price pressures, there was a problem in his mind relating to the word "significant." He would expect that some reduction in unemployment could be achieved if the economy continued to expand, but in view of the expected large increases in the labor force he was not sure that there could be a significant reduction.

There was some limiting factor in any expansion, and in the present situation this factor might take the form of difficulty in matching the skills of available labor with those required, at wage rates that were satisfactory to the unemployed.

Regarding question 3 on prices, it seemed to Mr. Bryan that there was no clear indication that the country was undergoing an inflationary development at present. However, on the average, whoesale industrial commodity prices had moved up a bit recently. Also, the upward movement continued in the consumer price index and in some of its elements. While these movements might have been matched by improvements in quality of consumer goods, there also were a considerable number of "hidden" price increases--that is, increases that were inadequately reflected in the index. Whether average retail prices of consumer goods (other than foods) actually had been stable thus seemed to him to be uncertain.

On question 4, which called for an evaluation of the direction of "underlying influences recently" on the international position of the dollar, there was a problem associated with the meaning of the word "recently." Perhaps the intention was to refer to recent weeks. Over a somewhat longer period the U.S. balance of payments position had improved, and the country might be about to make great further "progress" by revising its bookkeeping methods, which would be a commendable step. But it seemed to Mr. Bryan that the deficit was going to be huge over a period of years however it was calculated. The country seemed to be bleeding to death through these deficits.

Mr. Bryan said he was not sure what interpretation should be placed on the recent fluctuations in the growth rates of bank credit and the money supply, referred to in question 5. He would agree that money supply growth on a year-to-year basis had been within a reasonable range. But he also felt that money supply expansion in the past four months had been greater than the country could absorb readily without setting the stage for inflationary developments, and that in the same period reserve growth by any measure had been at a rate that was not sustainable in the long run.

A free market always was in process of adjustment, Mr. Bryan said, so his answer to question 6 would be that the adjustments t the discount rate increase were continuing. The real issue was whether a reasonable degree of market stability now could be expected. In his judgment this would depend on whether the rescue operation for the pound sterling proved to be successful, or whether the imbalances were so great that the operation would not succeed.

Mr. Bryan favored an essentially unchanged monetary policy. He agreed that an objective formulated in terms of bill rates was appropriate for the next four weeks and thought that the range of 3.75-3.90 per cent in the three-month bill rate that had been suggested would give the Manager ample latitude. In his opinion the Committee could not rely on any reserve figure for target purposes at present; as Mr. Stone had pointed out, it would be necessary to deal with complex patterns of developments over the coming period.

Mr. Bopp observed that although the course of production, sales, and inventories at this time was clouded by the effects of the past and possible future labor difficulties, on balance the economy appeared to be continuing along a moderate growth trend, with more room to go before problems arose of labor and resource availability. It always was important to look ahead, however, especially at a time such as the present when the economy might be approaching a cyclical turning point.

Looking ahead, Mr. Bopp continued, there was the strong possibility that some slackening would develop because of a decumulation of inventories, a reduced rate of increase in capital and housing expenditures, and a shift to a surplus position in the Federal budget. This longer-run view seemed to him one of the most important aspects of the economy to bear in mind. He did not feel that price increases, thus far, posed a particularly disturbing problem for economic stability. The human and material resources were available. Much depended on industrial relations developments in the railroad and steel industries and on the attitude of the administration toward any settlements. The recent rates of expansion in money and credit appeared appropriate to the domestic business envircnmnnt.

As for the balance of payments, Mr. Bopp thought the deficit was a continuing and difficult problem, but one that had to be kept in proper perspective within the context of a possibly weakening business environment. For the time being he would be inclined to sit tight and watch developments closely.

Mr. Bopp said he would make no change in the current posture of monetary policy, although he would be inclined to let short-term rates approach the lower limits of recent levels if necessary to maintain about the same growth in money and credit as had prevailed in recent months and if necessary to maintain longer-term interest rates substantially unchanged.

Mr. Bopp reported that at a meeting last Thursday (December 10) of economists representing various firms and industries in the Third District, the consensus had been that the economy would continue to expand throughout 1965, although at a slower rate during the second half of the year. The median forecast of the group was for a 3.8 per cent increase in GNP at an annual rate in current dollars from the fourth quarter of 1964 to June of 1965, and another 1.2 per cent increase from June to December. The group expected plant and equipment expenditures to be somewhat higher than McGraw-Hill's 5 per cent projected increase. Residential construction was expected to provide neither a lift nor a drag on the economy. With some living off of inventory, steel production was expected to decline from an expected 124 million ingot tons in 1964 to 115 million in 1965. Auto and truck output was expected to be 9.1 million units in 1965 compared to 9.3 million units in 1964.

Mr. Bopp concluded by noting that he preferred alternative B of the staff's drafts for the second paragraph of the directive.

Mr. Hickman observed that with the auto strikes finally out of the way, the domestic economy was getting back into full stride. Production and consumer takings were both moving forward. Except for the possibility of dock or rail strikes, the near-term prospect all were on the side of continuing expansion at high rates.

There had been only one recent development in the Fourth District that had differed significantly from national trends, Mr. Hickman said, and that occurred in the area of construction. Earlier this year, construction contracts in F. W. Dodge's Region IV (roughly the Fourth Federal Reserve District) had been lagging behind those in the nation, but this pattern was reversed in September and October because of a clustering of several very large building contracts in Ohio. This development was a reflection of the strength of heavy industries at this stage of the business expansion.

As he had noted earlier in these meetings, Mr. Hickman continued, a disturbing factor in the current business situation was the stockpiling of steel as a hedge against a possible strike in 1965. Events were now moving into the full-fledged accumulation stage. The steel mills were running briskly, but some of their business, in effect, was being borrowed from next year.

Mr. Hickman reported that at the end of 1964, steel users would have on hand an estimated 17 million tons of finished steel. By May 1, barring an early settlement, steel users would have about 21 million tons on hand, as compared with a normal range of 12 to 14 million tons. While this would not be as large as the steel inventory peak of 26-1/2 million tons reached in the accumulation phase preceding the long 1959 strike, it would be appreciably larger than amounts stocked in 1962 and 1963. If all other factors were equal, the cut-back of production following the settlement could be absorbed by the economy. The danger was, however, that other things might not be equal. He referred specifically to the prospects of a smaller deficit, or possible surplus, in the Federal budget in the spring of 1965. It was at least conceivable that on these and other grounds the economy might be in for a serious adjustment around the middle of next year.

In this context, Mr. Hickman remarked, an attempt at present to further stimulate aggregate demand through a stepped-up rate of expansion of money and credit would make the adjustment more difficult. No growth at all would be equally upsetting, and would be untenable politically. He thought the Committee should, therefore, continue to strive for modest, sustainable growth, on the order of 3 to 4 per cent for the money supply and of about 6 to 8 per cent for bank credit. In his judgment, except for a brief period of sloppy ease last summer the Committee had held fairly well to the appropriate course, and it should continue along the same path as best it could.

Mr. Hickman said the present state of the money market, and to a lesser extent of the capital market, was stable but nervous, and it required unusually close attention to prevent its running off in either direction. He would, therefore, continue the policy adopted at the last meeting, attempting as a primary objective to hold the 91-day bill rate in a range of

3.75-3.90 per cent on the bid side, and as a secondary objective to provide average free reserves of about $50 million, plus or minus $100 million. For these reasons he preferred alternative B of the drafts for the second paragraph of the policy directive

Mr. Hickman said that his reactions to the staff's questions, prepared largely before receiving the staff's answers, could be summarized as follows:

(1) Although up-to-date figures were not available, the current growth rates of production, sales, and inventories appeared to him to be very high, and probably not sustainable beyond 4 or 5 months. In this connection it seemed to him that the first paragraph of the staff analysis, which described the temporary influences augmenting inventory accumulation, was quite satisfactory. The second paragraph, however, seemed to him to be inappropriate, because it tended to brush off the significance of what had already been said in the first paragraph. The opening phrase, "Aside from these temporary influences," marked the path of the brush-off. The second sentence ("On balance, the underlying economic situation appears to be one of continuing moderate growth") then completed the brush-off.

Some definite unbalancing forces obviously were at work in the economy, Mr. Hickman said. It was an artificial device to distinguish between "underlying" factors, on the one hand, and "temporary" or "special" factors on the other, in a situation where the unbalancing forces were so deeply woven into the economy as was the case with the present steel inventory situation and with other inventories.

(2) In Mr. Hickman's opinion the economy could achieve a reduction in the margin of underutilized man power (or rather teen power and woman power) without upward price pressures, provided it was done largely through specific structural measures rather than entirely through additional aggregate demand. Mr. Treiber's comments on this question were nearer to his own thinking than were the staff's.

(3) In the price area, the various diffusion indexes that Mr. Hickman watched had been above 50 per cent for many months, with the National Association of Purchasing Agents' diffusion index showing an increase in November for the fifth consecutive month.

(4) With reference to the balance of payments, Mr. Hickman commented that outpayments from Government programs and private capital flows obviously were still larger than net earnings on current account. Despite much discussion of the balance of payments problem, no one appeared to be able to foresee what the future held in store.

(5) As he had indicated earlier, Mr. Hickman felt recent changes in the money supply and liquidity had been appropriate and had been roughly in line with what he considered to be sustainable trends in measures of real economic activity.

(6) From the impressions he had gained on the daily telephone conference call during the past two weeks, the money and capital markets appeared to be stable but nervous.

(7) In light of these considerations Mr. Hickman would continue for the present to pay primary attention to market tone, with secondary emphasis on bank reserves and the money supply.

Mr. Mitchell remarked that in considering the real alternatives for monetary policy today the Committee had to recognize that the System had made a trade-off between the balance of payments constraint and domestic needs when the discount rate was raised, and in effect had announced this to the world. At the same time, the System had said in effect that it was going to minister to the needs of the domestic economy by continuing to make funds available. Subsequently, these statements were reinforced by the operations of the Desk. The market had accepted the feasibility of the kind of trade-off that had been announced, and Mr. Mitchell did not think it was realistic at present for the Committee to consider a departure from the described policy. Since the System had convinced the market that such a policy could be implemented, the only questions confronting the Committee today were how to continue to implement it, and how to avoid arousing expectations that it would not be possible to do so.

Mr. Mitchell said he would accept the Manager's judgment that it would not be feasible now to follow a free reserve target. He noted that Mr. Partee had recommended an instruction in terms of desired market conditions, but he had not offered any specific language for such an instruction. Mr. Mitchell would accept a bill rate target, but would prefer a range of 3.65-3.85 per cent, to give rates a chance to flex a little in accordance with seasonal changes.

All things considered, Mr. Mitchell did not think the short-run posture of monetary policy could be very different from this at the present time. However, it was necessary to recognize that monetary policy operated with a lag, and the Committee also should be thinking in terms of the longer run; in particular, it should be taking account of the possibility that the pace of activity might slacken in the coming year. Perhaps the most the Committee could do was to keep expectations out of unrealistic channels. Expectations on the business outlook ranged from boom to a leveling off or decline in activity, and it was desirable to avoid prejudicing any one of these views by a prejudged monetary policy. Mr. Partee had raised a question about the sustainability of the present flat yield curve, and had concluded it was reasonable to expect from market forces that long-term rates would remain at about their present levels. The Committee ought to avoid discouraging such an expectation, based as it was on an analysis of market forces.

Mr. Mitchell said that, by and large, he thought the staff's questions and answers made up a good document. He agreed in general with the analyses presented and he was especially impressed with those on financial subjects. He was unhappy, however, with the staff response to question 2, on employment. The analysis seemed to him to be quite unrealistic, and he was sympathetic with Mr. Treiber's views on this subject. He disagreed with Mr. Hickman's criticism of the reply to the first question; it seemed to him that if monetary policy created an environment conducive to rising investment, which he thought it should do, it could not prevent people from hoarding steel or from increasing their inventories of autos. As he read the paragraph Mr. Hickman had criticized, it implied that the special factors leading to accumulation of steel and autos had not spread to the rest of the economy. In his judgment such accumulation should not be choked off by monetary policy; rather, it should be accommodated, unless it became pervasive.

Mr. Hickman said that Mr. Mitchell evidently had misunderstood his comment, because he had not meant to suggest that the current inventory accumulations should be choked off. As he had indicated, he did not think that the Committee should attempt to stimulate aggregate demand further, but at the same time he would consider no growth in money and credit to be untenable. In short, he preferred to continue the present policy. His objection to the paragraph in question was that it implied that, apart from temporary factors, the prospects were for continued economic growth. In his judgment the more likely development was a letdown in activity after the inventory build-up had run its course.

Mr. Brill commented that the staff had had a relatively short time horizon in mind when it prepared the paragraph in question. It was the staff's view that, aside from the temporary inventory accumulation, underlying forces suggested continued growth in the short run. The staff had not intended to imply a judgment that growth would continue through the balance of 1965.

Mr. Swan commented that in his view the most important question with regard to the current steel and auto inventory accumulations was whether there would be some reaction on the rest of the economy when they came to an end. Mr. Mitchell agreed, and Mr. Hickman noted that such a development might well occur at a time when the Federal budget was shifting to a surplus position, thus compounding the problem.

Mr. Shepardson said that he thought the staff's responses to the questions on the whole were good, and in general he agreed with them. It was important, in his judgment, to distinguish between two possible reasons for the inventory developments that had just been discussed. If steel inventories were being accumulated as a hedge against anticipated price rises, that definitely would be something to be deplored, and the Committee should do what it could to discourage it. But as he understood the situation, larger steel stocks were desired primarily as a hedge against a possible stoppage of supply. He doubted if the Committee could do anything to stop such a development despite the fact that it might result in a letdown later unless there was a long strike in the steel industry, which would be equally unfortunate.

Mr. Shepardson remarked that he had some questions about the staff's analysis on employment, particularly in connection with the list of alternatives given. He would have put more stress on the need for efforts toward structural improvement, at the same time recognizing that monetary policy could not do much in this respect. He also questioned the implication that growth in the labor force would be adequate to meet the demand occur at a time when the Federal budget was shifting to a surplus position, thus compounding the problem.

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