A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, April 13, 1965, at 9:30 a.m.

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

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

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

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Brill, Garvy, Holland, Koch, and Willis, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special 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. Patterson and Strothman, First Vice Presidents of the Federal Reserve Banks of Atlanta and Minneapolis, respectively
Messrs. Eastburn, Mann, Ratchford, Jones, Parsons, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Philadelphis, Cleveland, Richmond, St. Louis, Minneapolis, Kansas City, and Dallas, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Sternlight, Assistant Vice President, Federal Reserve Bank of New York

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 23, 1965, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market operations and on Open Market Account and Treasury operations in foreign currencies for the period March 23 through April 7, 1965, and a supplemental report for April 8 through 12, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs stated that the U.S. gold stock would probably be reduced by $150 million this week in order to replenish the Stabilization Fund. This would bring the total decline to $975 million for the year. During the month of April, he expected that total gold sales would come to about $240 million, offset by purchases totaling about $94 million, including $50 million from the United Kingdom. He anticipated that the Stabilization Fund would end the month with a balance of roughly

$70 million. For May, gold sales of somewhat more than $40 million were already in sight. The total could go to $150 million or more, which would mean a further sizable reduction in the gold stock.

On the London gold market, Mr. Coombs continued, there had been continued private buying in some volume, although less than before. The Chinese Communists still were coming in occasionally; their purchases were now in excess of $50 million this year. On the other hand, there had been a fairly good inflow from new production, and losses of the Gold Pool during March were no more than $26 million. This brought accumulated Gold Pool losses to $206 million against resources of $270 million. But the agreement reached at the time of the March meeting of the Bank for International Settlements to continue Gold Pool selling if necessary, even if the Pool's resources should become exhausted, was reaffirmed at the time of the meeting held this past week end.

On the exchange markets, Mr. Coombs noted that sterling had experienced a number of ups and downs. Prior to the announcement of the British budget, there had been devaluation rumors resulting in speculative pressures. The Bank of England suffered sizable reserve losses in dealing with those pressures in the spot and forward markets. Drawings on the swap with the Federal Reserve were increased to $370 million, and borrowings from other central banks and the Bank for International Settlements to more than $800 million. Since the

announcement of the budget, which was fairly well received in the markets, sterling had recovered, both spot and forward, and the Bank had taken in moderate amounts of dollars. But the March trade figures showed no significant increase in exports and a rise in imports. The sterling rate was immediately affected, and the situation remained highly uncertain.

It had not been possible, Mr. Coombs said, to make any net reduction in the Federal Reserve swap drawings on various central banks, and the total drawings had increased from $515 to $585 million. He suspected that the continuing inflow of dollars to continental central banks was mainly attributable to U.S. direct corporate investments, aggravated by continuing tight money conditions in continental markets.

At the recent Bank for International Settlements meeting, Mr. Coombs said, there were three rather important developments. First, there was a great deal of discussion of the British situation, with more or less general agreement that the British should go to the Monetary Fund for the entire $1.4 billion left in their quota and a general feeling among most of the central bankers that any appearance of dissension should be avoided. There was a feeling on the part of a few of the bankers that the budget was not sufficiently strong, and a rather general view that it was a pity the budget had not been accompanied by further measures on the monetary side. But the budget was a fact, and it was thought essential to make the best of it.

Secondly, there were indications of some softening in the French line, Mr. Coombs continued. Aside from the reduction in the discount rate, there were other evidences of some shifting, which meant that the French might be pressing less harshly than before. Third, there were a number of indications that the European central banks were beginning to respond to the need to ease up somewhat in their monetary policies in order to compensate for the pulling back of U.S. corporate short-term investments and the curtailment in U.S. bank foreign lending. The Bank of Italy had put into the Euro-dollar market a total of $750 million in the last month or so. This was the reason the Euro-dollar rate had been coming down and a disruptive situation averted. He thought that the Bundesbank would shortly institute similar swaps with German banks, and that a number of others, including the French and Dutch, might take actions that would result in a movement of funds into the international credit markets.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period March 23 through April 12, 1965, were approved, ratified, and confirmed.

Mr. Coombs noted that the $100 million swap arrangement with the Bank of France would mature on May 10, and he recommended its renewal for another three months.

Renewal of the swap arrangement with the Bank of France for another three months was approved unanimously.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period March 23 through April 7, 1965, and a supplemental report for April 8 through 12, 1965. Copies have been placed in the files of the Committee.

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

> The money market tone was a bit firmer during the past three weeks. Net borrowed reserves were perceptibly larger, member banks were obliged to borrow in greater volume in order to meet a level of required reserves that ran consistently in excess of our expectations, and Federal funds traded quite frequently above the discount rate. Indeed, the effective rate was 4-1/8 per cent on eight of the past fifteen business days. Nevertheless, bill rates have barely moved from the lower levels reached a few weeks ago. In yesterday's auction the average issuing rates on three- and six-month bills were about 3.94 and 3.99 per cent, respectively. Three weeks earlier the comparable rates were 3.92 and 3.98 per cent.
>
> In conducting System operations during this interval, an effort was made to supply reserves with minimum reliance on Treasury bill purchases in the market. A net of $446 million reserves was supplied, in good part through repurchase agreements; outright holdings of Treasury issues increased by $222 million, including $170 million of bills, the latter largely reflecting purchases from foreign accounts.
>
> In reviewing developments at the last Committee meeting, Mr. Stone suggested that the tendency for bill rates to decline while other short-term rates were steady or rising might be explainable in good part as a result of repatriation of corporate short-term funds from abroad; there seemed to be a tendency for such funds to go initially into the bill market even when this offered a relatively less attractive return than other short-term

instruments. Repatriation flows probably have remained a factor, although it is very difficult to pinpoint the extent or form of such inflows with any precision. An additional factor in recent weeks has been the substantial demand for bills by various public funds, partly with the proceeds of tax receipts, which run heavy at this time of the year. At the same time, commercial bank liquidation of bills, which might have been expected to have been substantial under the sustained condition of firmness in the money market and vigorous loan demand, has occurred to some extent but has apparently been inhibited somewhat by banks' needs to hold Treasury securities for collateral purposes.

In the meantime, other short-term rates have shown little change on balance. Three dealers raised their acceptance rates by 1/8 per cent shortly after the last meeting, as inventories approached record levels, but then rescinded the increase a few days ago as inventories had worked down. Similarly, some commercial paper rates briefly moved higher during the period and then returned to the late March level. New York City bank new CD rates have also changed little--if anything, edging slightly lower as tax date pressures receded. On the whole, therefore, the further slight firming of bank reserve availability seems to have had little noticeable impact beyond the very shortest term area of day-to-day reserve availability.

The bond markets also showed little net change through the interval--exhibiting some hesitancy in the early portion while awaiting the British budget and appraising weekly banking statistics that pointed to strong loan demand and lower reserve availability, and then regaining some confidence in the wake of the British budget proposals and the French bank rate reduction. The publication of a second week's net borrowed reserve level greater than $100 million did generate some caution; most observers now feel that a further modest shift in policy has occurred, but this produced no significant selling pressure and prices were off only 1/32 or 2/32 since Thursday's close.

The corporate and municipal markets have continued rather uneventful. New high-grade corporate issues reached the market in light volume, were priced in the same area as in other recent weeks (roughly 4-1/2 per cent for Aa-rated utility issues), and tended to move out slowly to investors. The supply of new tax-exempt issues continued fairly sizable and these, too, moved out slowly for the most part.

As was mentioned at the last meeting, the next item on the Treasury financing calendar is the refunding of May 15 maturities, of which some $4.1 billion are held by the public. The Treasury will meet with its advisory groups on April 27 and 28, and probably announce the terms of their refinancing on the latter day. A number of market observers expect that the Treasury might offer preemptive rights to holders of the maturing issues, and perhaps sell an intermediate issue as well as a short "anchor" issue in an exchange operation.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period March 23 through April 12, 1965, were approved, ratified, and confirmed.

Chairman Martin then referred to the memorandum dated March 18, 1965, from Mr. Stone, former Manager of the System Open Market Account, which was prepared as the result of a question raised by Mr. Mitchell at the March 2 Committee meeting and held over at the March 23 meeting at Mr. Robertson's request. The memorandum presented a breakdown of the Federal Reserve Bank of New York's holdings, as of end of December 1963 and 1964, and of February 19 and March 12, 1965, either for own account or for foreign accounts, of third-country bankers' acceptances (acceptances created to finance third-country trade, that is, goods stored in or shipped between foreign countries).

The Chairman called for comments, and Mr. Robertson made the following statement:

The question raised by Governor Mitchell as to whether the System should purchase third-country acceptances in view of the low priority assigned them in our voluntary restraint program is a marginal one--and I do not mean that in any depreciatory sense. It is my judgment that System activity in bankers' acceptances is quite marginal to the health of the acceptance market, but this is not the time to argue that on such grounds the System should desist from operations in acceptances. A broad range of questions--dealing with criteria for market performance and desirable characteristics of a free market--would have to be discussed if such were the fundamental issue before us.

We do not really have to deal with so fundamental a problem, though, because System operations in third-country acceptances are also marginal to the success of the voluntary restraint program. Still, I would be reluctant to give up whatever marginal value to the program might be gained from the psychological impact on banks of some limitation on System activity in third-country acceptances. And I do recognize, of course, that the bulk of third-country acceptances involve Japan, a country where application of the program is involved in high diplomacy.

I am not speaking of any written limitation from this Committee, and definitely not of any limitation announced in the market. Rather, I would simply like to see the System make an effort in its transactions to avoid third-country acceptances--which were reported to be about two-fifths of the portfolio on March 12--and emphasize others.

I am not advocating at this time that we necessarily cut down our already limited total activity in acceptances. I would expect that the System would continue to be able to make repurchase agreements or buy outright in volumes not much different from recent experience, but with relatively more emphasis on U.S. import and export paper and relatively less on third-country paper.

The idea, in other words, would be to reduce that two-fifths gradually, and certainly not build it up. In the process, acceptance dealers will find that the System is less willing than formerly to buy third-country paper, even under repurchase agreements. The System would, for instance, tell a dealer that he should make a reasonable effort, in packaging acceptances to be purchased or financed, to hold down the amount of third-country paper involving Japan, Canada, or the underdeveloped countries,

> and to exclude paper financing transactions between other developed countries. Such news should have some psychological benefit in terms of our whole voluntary restraint program--not merely the third-country acceptance part of it. And I do not think that so moderate an action will, as such, hurt the acceptance market. If that market is going to be hurt, it is going to be hurt by the very existence of the voluntary restraint program, given the fact that almost half of outstanding acceptances are third-country acceptances.

Mr. Treiber commented that if he understood Mr. Robertson's proposal correctly it would involve the New York Bank's indicating to the dealers that it had some question about third-country acceptances and therefore they should cut down on such acceptances presented to the Bank. This would quickly permeate the market, and there would be a lesser degree of marketability of that type of acceptance than others. The market would get a clear signal that the System was concerned in this respect. The New York Bank's approach under the voluntary restraint program had been that acceptances, for whatever purpose, were included in the 105 per cent ceiling when created by a bank, and that once the acceptance had been created it still fell within the 105 per cent figure whether the accepting bank held the security in its portfolio or sold it in the market. The Reserve Bank felt that the accepting bank must be the judge under the voluntary restraint program as to whether an acceptance was in accord with the program; and once that judgment was made the acceptance should be able to circulate freely. If that was not true, there would be a cloud on the marketability of

third-country acceptances of even the most scrupulous bank operating within the voluntary program guidelines, and the voluntary nature of the balance of payments program would be vitiated if the Federal Reserve declined to purchase those acceptances. The commercial banks should be relied upon to comply with the guidelines in the creation of acceptances. After this had taken place, there should be no restriction on their free marketability.

Mr. Holmes commented that he did not see how Mr. Robertson's suggestion could be carried out without some announcement to the market, even though informal. Neither did he see how a fine degree of discrimination could be accomplished in the market very easily.

Mr. Robertson said that even if the word got out to the market--and he thought it would rather quickly--he did not think it was going to occasion any cloud on the acceptance market. He thought the impact would be almost entirely psychological. The Federal Reserve would continue to acquire acceptances in the ordinary course; it would just give a little push to the desirability of holding down third-country acceptances, without eliminating the Japanese paper.

Mr. Wayne observed that while he was quite sympathetic to the views Mr. Robertson had expressed, he hoped the Committee would be slow in implementing Mr. Robertson's suggestion. Not only would it permeate the market rather quickly but also, as he was sure all members of the Committee were aware, some of the spokesmen and writers for

the New York City banks, particularly those most outspoken in pressing for a greater reliance on restrictive monetary policy, had alleged in recent weeks that the Federal Reserve was likely to act through the discount window to support the voluntary restraint program. In other words, the idea was spreading through the banking community that the voluntary program was likely to become something less than voluntary through denial of access to the discount window to banks that failed to cooperate. He hoped the Committee would not make a move that would appear to validate any such idea. Implementation of Mr. Robertson's suggestion no doubt would be interpreted by those who had been pressing strongly and continuously for more reliance on a restrictive monetary policy as the first move. He was sympathetic to Mr. Robertson's views; he would not like the System to appear as saying restraint was good for others but not for itself. For the time being, however, he saw merit in Mr. Treiber's position. He would hope for restraint at the point of creation of acceptances and wait a little longer before making any move, even "quietly."

Mr. Mitchell said he had examined Mr. Stone's report and noted that less than a third of the third-country acceptances in the New York Bank's portfolio were held for its own account, two-thirds being held for foreign accounts. He would be reasonably well satisfied if continuing analysis indicated that such acceptances were not being unloaded on the System; that the System was not getting the type of

acceptances it was trying to discourage commercial banks from making. If the New York Bank was not, in these operations, adding to its portfolio and also getting a different mix, namely, a larger proportion of third-country paper, he would be satisfied. If the Bank, however, appeared to be getting an unusually large proportion of third-country paper or a larger portfolio, he would take this to be evidence that the Federal Reserve was doing the sort of thing it was requesting the commercial banks not to do.

Mr. Daane commented that the System had had an active interest in the growth of the acceptance market over a period of time. He would not want to see the System interrupt its posture of general concern for that market unless this was really essential. The comment had been made that restraint should be exercised under the voluntary program at the point of inception, and with this he agreed. He concurred generally with Mr. Mitchell's position; he would not like to see a growth of third-country paper in the portfolio. He suggested keeping a close look at the figures in the light of the whole voluntary restraint effort.

Chairman Martin commented that he, too, thought the point of inception was the place to work on this. He had one real conviction on this matter, which was the System should not say anything "quietly" to anybody. This type of thing was certain to go right through the

market, to be misconstrued, and to be self-defeating. If the Committee was going to change its pattern of activities in the acceptance market, it should do so openly.

Mr. Robertson said he would not object to a formal statement if that was the best way to go about it. He then inquired whether the best way to approach the matter might not be to ask the Desk to analyze the situation over the next few weeks and report back to the Committee.

Mr. Wayne commented that it might be appropriate also to try to determine what effect the voluntary program was having on acceptances at the point of inception.

Chairman Martin then suggested that the matter be carried over until another meeting, on the basis indicated, and no disagreement with this suggestion was expressed.

Chairman Martin called at this point 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 made the following statement on economic conditions:

> Business activity thus far this year has been exceptionally good, better than expected by most of us. Not only have the data on March developments been very strong but many estimates of activity in January and February have been revised upward substantially. Moreover, the expansion has been broadly based, although the

high rates of activity in autos and steel are no doubt having secondary expansionary effects on other industries. The index of industrial production for March, to be released Thursday, stands at 140.1, as against 138.9 for February. The March figure represents about an 8 per cent increase from a year ago.

We have also made some progress with our sticky unemployment problem. The increase in employment, particularly in manufacturing and among production workers as well as nonproduction workers, has been striking in recent months. The first quarter's average unemployment rate of 4.8 per cent reflects real improvement rather than a temporary fluctuation around the 5 per cent level that prevailed in the second half of last year. Further progress in reducing the unemployment rate after the next month or two will be more difficult, however, as the high current rate of overall expansion inevitably slows down somewhat and as an expected more rapid growth of the labor force occurs.

There remains the need to assess the relevance of the great first quarter strength in overall economic activity to the two basic questions that have been plaguing us for some time: first, the possible overheating of the economy in the near-term future and, second, its possible slowdown after the steel strike threat has passed.

The likelihood of the economy overheating in the near-term future can, I think, be discounted a bit more now that we have gotten through several months of unsustainably rapid rate of economic expansion with few additional outward signs of inflation. We are, of course, using our resources more intensively now than earlier, but the expansion of plant capacity in many lines is likely to equal or even to exceed that of output over the next few quarters, and the potential supply of both employed and unemployed labor susceptible of training to meet shortages of higher skills remains large.

In the price area, at first glance it seems difficult to reconcile the list of specific increases that have been announced recently with the exceptional stability of the overall indices, particularly the important industrial wholesale price index. This development, however, illustrates again the limited and selective nature of the increases and the lack of publicity given to offsetting price declines. The recent renewed strength in nonferrous

metals prices, at a time when supplies are being augmented by withdrawals from the stockpiles, is a cause for concern, although it may be due in large part to special temporary factors.

In the area of business costs, the big question, namely, the wage settlement in steel, remains unanswered. The steel industry costs the initial demands of the union at a 7.5 per cent annual rate of increase for the 3-year period of the proposed contract, but this was an asking price that is reportedly already being reduced by the union. An eventual settlement not far from the 3-1/2 per cent increase recently achieved in the can industry is still a real possibility. A wage increase of this magnitude might involve some steel price increases, but they would probably be selective and not well publicized. The can companies have announced small price increases following their wage settlement.

With regard to the relevance of the recent pickup in the rate of overall economic expansion to its likely sustainability, the dependence of the expansion on very high auto sales and heavy inventory accumulation does raise doubts as to its likely duration. Consumer spending on new autos declined 8 per cent to a seasonally adjusted rate of about 9-1/4 million units (including imports) in March, but this rate is still no doubt unsustainable for a long period of time.

In the area of business inventory accumulation, available data on production and shipments certainly suggest that accumulation of steel since last spring has been substantially greater than the direct dollar inventory figures suggest. If this is so, settlement of the steel wage dispute will no doubt mean a sharp reduction in steel output, and probably also a significant decline, at least temporarily, in the rate of growth of total industrial production and the GNP.

Total business inventory accumulation has also no doubt been proceeding at an unsustainably high rate in recent months. The seasonally adjusted annual rate approximated $10 billion or more in the 3 months ending with January. After falling off in February according to preliminary figures, which may very well be revised upward later as have been those of earlier months, accumulation no doubt rose sharply again in March if available production and sales figures are correct.

In conclusion, although the recent sharper rate of overall economic expansion is welcome as a step toward a more satisfactory level of employment, it warrants careful watch. This is because the current long-lived expansion is beginning to show signs of imbalances which have in the past often been preludes of slowdowns or recessions.

A further burst of activity is possible, particularly if extension of the period of steel wage negotiations engenders even more inventory build-up. But this would only accentuate the imbalances that threaten maintenance of satisfactory growth later this year and in 1966. Meanwhile, the current less easy monetary posture adopted at the Committee's last meeting might well be maintained for the next few weeks pending a clearer view of prospects in the steel industry.

There followed comments by Mr. Koch, in response to a question by Mr. Mitchell, concerning the degree of significance that it would seem appropriate to attach to the decline to 4.7 per cent in the unemployment rate in March. The purport of Mr. Koch's comments was to the effect that he would not be inclined to overemphasize the March figure taken by itself. Instead, he would base a judgment more on the March figure's relationship to developments in the employment and unemployment statistics over a period of months, which indicated steady improvement in employment and a break away from the unemployment rate plateau that had persisted earlier. He added a note of caution concerning anticipated labor force developments later this year that would militate against further reduction or even maintenance of the current unemployment rate.

Mr. Noyes made the following statement concerning financial developments:

We are accustomed to some difference between the rate of growth in total deposits, on the one hand, and total loans and investments on the other, because of problems of seasonal adjustment and because we generally use daily average figures to measure deposit changes and end-of-month figures when we look at bank credit. But we expect to see them move in the same direction and by roughly the same order of magnitude.

In February, for example, total deposits increased at a seasonally adjusted annual rate of $2.6 billion, and bank credit at $2.4 billion--a reasonable and understandable sort of difference. But in March the rate of deposit expansion dropped to $1.3 billion, and the rate of credit growth soared to $3.5 billion.

If we look at the first quarter as a whole, I think we get a better picture of what has been going on. For the quarter the annual rate of increase in the money supply was 1 per cent; time deposits rose at an 18.7 per cent rate; and money supply plus time deposits was up 8.8 per cent. This latter figure is almost the same as the rate in the fourth quarter of 1964, and only moderately above the 7.7 per cent for all of last year.

For the first quarter the rise in total bank credit was at a 12.8 per cent annual rate--up considerably from either the 6.6 per cent in the fourth quarter or the 7.9 per cent for the year 1964.

But it was in loans--and especially business loans--that the rise has been most spectacular. In March, loans rose by a record $3.9 billion. This brought the quarterly annual rate to almost 20 per cent, and the rate for business loans for the quarter was a whopping 28 per cent.

Some of this credit growth at banks was undoubtedly at the expense of competing institutions. It will be quite a while before we have any reliable estimates of total credit flows for the first quarter, but it is interesting that the annual rate of expansion in total liquid assets for the first two months was only 6.5 per cent, as compared to 6.9 per cent for last year. Hence, we may find that the rise in total funds raised in the first quarter was not nearly so spectacular as the bank credit figures.

It is also important to keep in mind that the rise in real output was unusually large in the quarter. The increase in real GNP that is now generally anticipated translates into an annual rate of over 8 per cent, as compared to a 4.1 per cent increase over the year 1964. Thus, the rise in bank credit in relation to GNP was not as large in comparison to earlier periods as the credit figures alone might suggest.

It is hard to account for the strength of credit demand solely in terms of transitory factors. Certainly, some of the demand can be related to steel inventory accumulation and some to the belated build-up in dealers' auto stocks. But both the expansion of the economy and the size and structure of bank credit extensions suggest a broader basis for the surge in demand for bank loans. There is no prima facie reason why it should subside quickly even if the steel inventory build-up slows or reverses.

As one would expect in a period of strong credit demand, the rate of increase in total reserves has been high during the quarter (over 8 per cent), despite progressively tauter money market conditions. In the first quarter free/net borrowed reserves averaged $240 million less than the preceding quarter, and the increase in nonborrowed reserves was down to only a 3.5 per cent annual rate.

In the last few weeks most money market interest rates have remained close to their recent highs and the bill rate has edged up a little from its "out of line" position. Long-term yields have moved back and forth in response to day-to-day developments and are generally a few basis points above the levels prevailing at the time of the last meeting.

In summary, we see a fairly clear picture of strong credit demand pulling out a near record volume of bank credit in the face of more reluctant reserve provision at the System's initiative and, of course, a corresponding rise in member bank borrowing.

As the Manager has indicated, the Treasury will be engaged in a major refunding in about two weeks. Therefore, an "even keel" is almost inescapable. Especially in light of the fact that the change in policy at the last meeting may not yet be fully reflected in market yields, the precise meaning of this term in the circumstances would seem to be the major question at issue today.

Mr. Swan referred to the strength of business loan demand and earlier discussions about a firming of credit terms and lessening significance of the prime rate. This did not seem to square with the March quarterly interest rate survey, which showed a reduction in the average

rate on short-term business loans and an increased dollar volume of loans made at the prime rate.

In discussion of this point it was noted that there was no doubt some volume of borrowing around the tax date on the part of prime borrowers that may not have been otherwise active in the market. If there was increased loan demand by larger corporations that were eligible for the prime rate, with perhaps some drop-off in less desirable credits for which the rates were necessarily higher, this would have the effect of lowering the overall rate.

Mr. Daane recalled that at the recent Princeton meeting sponsored by the American Bankers Association there had been some comments by bankers about giving the prime rate to parties who never before would have gotten it. The reason was not entirely clear, given the existing credit demand, but it appeared to reflect strong competition for loans.

Mr. Balderston remarked that with a Treasury financing in the near offing the Committee might conclude that an even keel posture was indicated for that reason. He suggested that perhaps the central issue this morning had to do with what was meant by an even keel in the present circumstances.

Mr. Noyes replied that it was not entirely clear whether the current rate structure reflected full market understanding of the present posture of monetary policy. The question, then, was whether an

even keel posture was one that would allow market adjustments to continue to take place or one in which an attempt would be made to hold at bay any further adjustments. While it was only a guess, he rather felt that there would be a tendency for yields to adjust upward somewhat further in light of the present reserve position of the banks and the present levels of borrowing and net borrowed reserves. The question was whether such a further adjustment should be allowed to take place during a period of Treasury financing.

Mr. Reynolds then presented the following statement:

> The large U.S. payments surplus recorded in March seems to have persisted into early April, in contrast with last year when there was a sharp March-April reversal. Thus the new balance of payments program apparently continues to bite into capital outflows. Also, exports are no doubt still rebounding in the wake of the port strikes.
>
> Little new information on our payments position has become available since the "Green Book" was written. 1/ Therefore I shall direct my remarks this morning to what seems to me the most important international financial news of the past few weeks--the British budget. Mr. Coombs has already commented on its early, mildly favorable, effects on foreign exchange markets. I should like to consider it in the context of economic developments in the United Kingdom, and of other U.K. policies.
>
> An American analyzing British developments must always guard against two opposite dangers. First, there is a temptation to assume more similarity between the two countries than actually exists. We are both reserve-currency countries, we both have payments problems, and we both use the same language, including much of the same economic language. Yet our circumstances and institutions are in many ways very different. In particular, a budget deficit can mean different things in one country than in the other.

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

Secondly, however, it would be wrong to treat Britain as a wholly unique case, beset by structual problems unknown elsewhere, and uniquely bedevilled by the gnomes of Zurich (or of London). There has been some tendency in the press to do this, and to forget that mundane things like inventory cycles and plant and equipment outlays are as important in Britain as they are here.

The U.K. economic context in which the budget was announced last week was one of rapid economic expansion and of strong inflationary pressures. Real GNP in Britian rose 5 per cent from late 1963 to late 1964, despite very slow growth in the labor force. The advance both in plant and equipment spending and in residential construction, again after allowance for price increases, was 12 per cent. Expansion continued into the first quarter of 1965, and plant and equipment spending plans surveyed as of December--after the emergency policy actions connected with the sterling crisis--indicated a further 10 per cent increase this year.

Inflationary pressures have been evident on every hand. Wholesale and retail price indexes have been rising at a rate of 4-1/2 per cent a year. The unemployment rate has fallen to less than 1-1/2 per cent, with labor shortages widespread, particularly in the heavy engineering industries and in construction. The pressure of demand against supply in the engineering sector has been particularly important for the balance of payments. Export order backlogs in this sector, which accounts for about one-third of British exports, have risen 20 per cent over the past year, but export deliveries have risen only 7 per cent. Britain's ability to sell has been hampered by inability to deliver.

Thus, in framing the budget the Government did not face any conflict between internal and external economic objectives, even though it took courage for a Labor Government to recognize and act upon this fact. There was a clear need, on both counts, for a policy of restraint. The need was widely recognized by British economic analysts; it was not peculiarly the recommendation of "international financiers."

It seems to me that the budget does provide some considerable new measure of restraint. It had earlier been announced, last November, that an increase in the standard rate of income tax, and in social security contributions,

would finance an equal increase in welfare pensions. Also in November, taxes on motor fuel were significantly increased. Last week's budget imposed an additional 200 million pounds of new taxation on consumption--on tobacco, alcholic beverages, auto registration fees, and postal rates. In U.S. terms, the equivalent for our economy would have been $3 billion to $4 billion of new taxes and fees The intent is to dampen consumer demand without unduly dampening the rate of investment, since investment is thought needed to insure continued growth and improved competitiveness.

Some analysts, including several of my colleagues here at the Board, are rather skeptical about the budget because they notice that the overall budget deficit is expected to be as large this year as last, even apart from that portion of this year's expenditure which represents a mere shifting of local authority financing from the market to the central government. Other analysts, notably the London Economist, focus on the above-the-line surplus, which is to be the largest for 15 years, and regard this budget as very severe indeed.

It seems to me that the truth lies somewhere in between. The character of the below-the-line expenditure matters a good deal here. A large increase is provided for investment outlays by the nationalized industries, particularly electricity. In the United States, such expenditure would not be in the government sector at all, but would instead represent private plant and equipment spending. Allowing for this, and striking the balance on the sort of items that would be included in a U.S. Federal cash budget, there is to be a significant reduction in the U.K. budget deficit--by roughly 200 million pounds.

It is always difficult to say exactly how much restraint is needed to cure an inflation, particularly one in which psychological uncertainties have played as large a role as they have in Britain. The amount of new taxation announced in the budget is about what had been recommended by commentators of as diverse leanings as Professor Paish of London and Professor Kahn of Cambridge, and was perhaps a little more than had been generally expected by the British press. It may be some time before we know whether the budget has done the full job required. The Chancellor recognized this in two ways: first, by asking renewal of his authority to use "regulator" taxes, i.e., to increase

purchase taxes if more fiscal restraint should prove needed; and second, by stating that monetary policy would be used to the extent required. This last implies, to me, that no early relaxation of credit policy should be looked for, certainly not before the trade and payments figures show a decisive turn for the better.

There are several indications that the credit squeeze in Britain is having a useful restraining effect. There was no significant net expansion of bank loans during the first quarter, whereas earlier expansion had been very rapid--20 per cent a year. Inventory accumulation slowed some in the fourth quarter. Mortgage money is reportedly in much tighter supply than before, which is important since the residential construction boom has been an important element in the inflation in Britain.

My summary impression of Britain's present financial policies is that they represent significantly more restraint than the policies of six months ago. While the question remains open whether the British have done enough, they have moved a long way in the right direction. And what they have done may well prove to be enough, particularly if they have any success at all with their longer-run policies of moderating wage demands and increasing the flexibility of the economy.

Prior to this meeting the staff had prepared and distributed certain questions suggested for consideration by the Committee, and comments thereon. These materials were as follows:

(1) <u>Business activity</u>--What do recent developments with respect to production, sales, and inventories in steel, steel-using, and other key industries suggest for the sustainability of overall economic activity?

The economy continues to be characterized by vigorous and broadly based expansion, with extraordinarily high rates of production in the auto and steel industries. Whether expansion can be maintained at close to the average pace of recent quarters depends not only on the timing and extent of the inevitable readjustments in these industries but also on such factors as the developing strength in business capital spending and prospective changes in Federal fiscal stimulation.

Short-run prospects in the automobile industry appear to be somewhat clearer than those for steel. Auto production in March rose to a new high, even though sales failed to show the usual large seasonal increase. (A downward readjustment in consumer auto purchases from the exceptionally high January-February level was suggested by the Buying Intentions Survey conducted by the Census Bureau earlier in the year.) While dealers' inventories consequently increased further, their stocks are still low relative to sales, and production is scheduled to remain at record levels throughout the second quarter. Automobile producers are reportedly sufficiently well stocked with steel to maintain output at advanced levels until about midyear even if a steel strike occurs May 1.

If consumer purchases continue to lag behind output, however, it is likely that production of this year's models will be cut back sharply early in the summer (unless an excise tax reduction rekindles consumer demands). It seems likely, though, that automobile production will continue to contribute to high levels of economic activity over the next few months.

The steel situation hinges on the wage negotiations now under way, the outcome of which cannot be predicted. Building of steel stocks continues, with data on physical volume of production and shipments suggesting much more accumulation than is indicated in the dollar value figures. Current steel consumption rates are high, for in addition to the record volume of auto production, output of business equipment has been rising. Also, production of household metal goods has been maintained at the advanced rates reached in late 1964, even though retail sales of these goods have leveled off this year.

An early settlement of the steel wage negotiations, while steel-using industries are operating at such high levels, would permit relatively orderly liquidation of inventories. But it would likely be accompanied by a sharp reduction in steel output, as in 1962 and 1963, when settlements were reached without strikes. Such a cutback in steel would obviously slow the rate of economic growth, but expansionary forces in the rest of the economy appear sufficiently strong at this time to maintain a general upward trend in overall activity.

Extension of the contract beyond the May 1 termination date would permit further inventory accumulation. While it would tend to maintain the recent pace of business for

some time, it raises the disturbing prospect of concomitant and substantial cutbacks in production of steel, autos, and household durable goods later in the spring or summer.

(2) Prices and costs--To what extent has the step-up in industrial output and the strengthening in the labor market in recent months been reflected in unit labor costs and prices?

Since the October-November auto strikes, industrial output has increased sharply and has maintained a margin of 8 per cent over year-earlier levels. The recent rise has been accompanied by a substantial increase in employment, a considerable lengthening of the average factory workweek through increased overtime, and a decrease in the unemployment rate. Nevertheless, total labor costs per unit of output in manufacturing have remained essentially stable; the first quarter level was down nearly 1 per cent from a year earlier and more than 2 per cent from two years earlier. The industrial commodity price level, after having risen three quarters of 1 per cent in late 1964, leveled off in the first quarter.

Most recently, increases have been reported for some sensitive commodities. Upward price pressures still are confined mainly to markets for nonferrous metals and products, however. Within most other commodity categories, price increases have been selective and of moderate size or have been balanced by decreases. Over the past two years of rapid expansion in output, discounts from list prices no doubt have been reduced or eliminated, but increases in list prices have been neither large nor widespread.

On the cost side, an important feature of the response to expanding demand and output is the continued rise in productivity. Although less rapid than earlier, the rise in manufacturing productivity in recent months has continued to be great enough to offset the gradual increase in hourly rates of pay, including the wage costs of overtime and also the costs of fringe benefits.

Whether output and employment now have reached a range where further expansion is likely to be accompanied by significantly greater upward pressures on prices and labor costs depends for the most part on the rate of growth in the labor force and its adaptability, on the rate of

expansion in plant facilities, and on expectations for market conditions. For some occupational groups, unemployment rates have reached what might be considered frictional levels. Therefore, further expansion in demands could result in some labor bottlenecks and selective upward wage pressures. With the overall unemployment rate still as high as 4.7 per cent, however, and with the labor force now increasing 1.2 million persons a year, further significant gains in employment could be achieved without widespread labor cost pressures, assuming a reasonable settlement of the current steel negotiations.

Continued growth in industrial capacity and prospects of further large increases also have tended to restrain upward price and cost pressures. One feature that distinguishes this from earlier postwar business expansions is that capital outlays reached advanced levels long before the development of pressures on existing resources, and then outlays continued to increase. The increase in actual and potential supplies has helped maintain expectations of competition within markets and between products. At the same time, the new facilities are holding down costs by continuing the advance in productivity.

(3) Balance of payments--What significance is to be attached to preliminary payments data for the first quarter of 1965?

Preliminary payments data for the first quarter appear encouraging. The restraint program has cut back bank lending from the high rates reached late last year and in the first six weeks of 1965. But too little is known about other elements of payments and receipts to permit a judgment as to how much and how lasting an improvement in the balance is being achieved in comparison with the 1964 average.

The deficit on "regular" transactions appears to have been roughly $2-1/2 billion, at a seasonally adjusted annual rate, somewhat below the average rate for 1964 and well below the fourth quarter rate. However, foreign commercial banks made much smaller net additions to their balances here than they usually do in the first quarter. Consequently, on the "official settlements" basis the first quarter deficit was very large--perhaps $3 billion, annual rate, against last year's average of $1-1/2 billion.

There have been additional indications that net outflows of U.S. private capital diminished sharply after

the new balance of payments program was announced. February statistics on long-term bank loans show a net outflow of about $200 million, but the sharp drop in new bank loan commitments after February 10 suggests that most if not all of this net outflow occurred in the first part of the month. Also, we have learned of the cancellation or postponement of several nonbank loans and investments earlier planned. A number of large corporations are reported to be letting their money market investments abroad run off at maturity and to have told their European subsidiaries that the latter must seek funds locally and rely less upon United States financing. But no comprehensive data beyond February are yet available on foreign lending by banks, and none beyond January on liquid asset holdings abroad of U.S. corporations. Data on direct investment transactions during the first quarter will not begin to become available for another month or two. New foreign security issues sold here during the quarter were at about the average rate for 1964.

The effects of the longshoremen's strike on merchandise trade greatly complicate analysis of the first quarter payments results. Exports slumped much more sharply than imports in January-February, and the trade surplus in those months was zero. Even though exports are likely to have jumped up in March, the trade surplus for the quarter must have been much below the $7 billion annual rate of the fourth quarter, on the trade statistics basis. On an actual payments basis, too, the trade surplus was probably reduced, but it is impossible to say by how much.

(4) <u>Bank credit and money</u>.

A. What do recent developments in the major categories of bank loans suggest for the future course of lending activity?

The rapid bank loan expansion of recent months is attributable not only to temporary factors--some of which are still operative--but also to strong and continuing underlying demands. While demands could slacken somewhat--as a result of inventory liquidation following a steel strike or settlement, for example--bank loan activity over the next few months might still be expected to rise at or above the late 1964 rates.

The dominant factor in recent bank loan developments has been the sharp increase in business loans. Earlier

this year, the accelerated growth was due in large part to temporary influences, particularly the dock strike, the surge of foreign lending, and anticipation of a steel strike. The first two of these factors receded in late February and early March, and this was reflected in some slackening in the business loan expansion.

Since then, loan growth has accelerated again. Several of the industry groups recently showing the strongest demand for bank loans also are markedly increasing their plant and equipment expenditures (e.g., food processors, chemicals companies, and certain metals-using industries). Since such expenditure programs will be in process for many months, continued bank borrowing by these industries may be in prospect. Also contributing to near-term strength of loan demand is the need for corporations to make partial payment on estimated 1965 tax liabilities in mid-April. On the other hand, borrowing for steel inventory accumulation, which may have accounted for close to one-fourth of the $1.1 billion rise in business loans in March, could terminate after a few more weeks. Borrowing by trade concerns, which also have been making large additions to inventories, could also slacken later in the spring.

Bank lending to consumers has been at a relatively advanced rate in recent months, mainly reflecting high rates of car sales. As the surge in auto sales abates and after borrowing by individuals for income tax payments is completed, some slackening from recent very high rates of consumer credit growth at banks and elsewhere is indicated.

City bank holdings of real estate mortgages have increased at a considerably reduced pace so far this year compared with 1964. Less bank interest in mortgages and a leveling off in such financing demands appear to be factors in this decline. A continuation of the recent slower rate of acquisitions of mortgages appears to be a reasonable assumption for the period ahead, particularly in view of the strength of competing business credit demands.

B. What factors have been mainly responsible for the changing relationships among the rates of expansion of total commercial bank credit, time and savings deposits, and the money supply in February and March?

In recent weeks, time and savings deposit growth has slackened substantially from the high rate of increase earlier in the year, while the money supply, though fluctuating, apparently has begun to rise again. Bank credit has continued to increase at an advanced rate.

Following the initial sharp inflow of time and savings deposits in response to the introduction of higher rates and new savings instruments around the beginning of the year, the recent slackening was not unexpected, as one-time transfers to time deposits from other assets were completed. The slowing occurred somewhat earlier this year than in 1957 and 1962--two previous periods of substantial rate advances--probably because banks adjusted their rates more promptly this time. In addition, the advance in market rates of interest in January and February may have created difficulties for some banks in attracting CD funds even under the new ceilings. Adverse publicity regarding CD losses in recent bank failures also may have been a factor in limiting net CD sales by smaller banks.

Accompanying the sharp rise in time and savings deposits, the money supply declined from early January through late February, but since then has moved higher on balance. Temporary downward pressure on the money supply, which was evident also early in 1957 and 1962, would normally be expected to accompany transfers of funds from other assets, including demand deposits, into time deposits. But rapid growth in transactions needs associated with the accelerated pace of economic activity has helped stimulate a resumption of monetary expansion.

The first quarter increase in the private money supply and time deposits combined, at an 8.8 per cent annual rate, was about the same as in the fourth quarter of last year. On the other side of the ledger, bank credit expansion accelerated in the first quarter. The difference in behavior is explainable in large part by the sharp buildup in U.S. Government deposits in this period.

The bank credit figures have reflected unusually strong loan demands. Banks have been under moderately increased reserve pressure, and have reduced their holdings of Governments and cut back on their acquisitions of municipals and agency issues to help meet strong loan demand. Nevertheless, a substantial increment of reserves has been needed to accommodate growth in demands for bank

credit and deposits. About half of the reserve rise has been provided through increased member bank borrowing, and the remainder through a continued expansion in nonborrowed reserves.

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

Over the last week of March and the first week of April, member bank borrowings at the Federal Reserve rose to an average of more than $500 million and net borrowed reserves averaged $130 million, as required reserves showed more than usual strength. The Federal funds market continued taut, and there was a slight firming of bill rates in the early part of the period. But a resurgence of bill demand in recent days has kept the three-month bill rate in the 3.92-3.94 range. This demand has been highlighted by seasonal buying on the part of public funds, and also may have been enhanced by corporate demand.

With net borrowed reserves above $100 million for two successive statement weeks, the market is now beginning to focus on the question of whether the Federal Reserve has firmed policy somewhat further. This question is being raised following some strengthening of the bond market in reaction to the British budget and the reduction in the French discount rate. The U.S. Government bond market is in a fairly good technical position, however, so that upward rate adjustments from a modest change in expectations are likely to be minor. In the municipal market the level of unsold inventories continues large, but the calendar of new offerings is relatively light.

In coming weeks, continuation of net borrowed reserves in the $100 to $150 million range would appear consistent with Federal funds trading frequently at 4-1/8 per cent and with the emergence of some upward pressure on bill rates. Such upward pressure depends importantly on continued strong bank loan expansion and abatement of some of the recent special demands for bills, since bill rates tend to be seasonally low at this time of year. Firmness in money market conditions of this order is unlikely to produce any appreciable upward rate adjustments in the capital markets.

In March, private demand deposits rose at a 6.7 per cent annual rate, but these deposits seem likely to grow more slowly in April. Slowing appears especially likely if tax collections from individuals (and to a minor extent from corporations) are significantly larger than in earlier years, although continued strong loan demand could be an offsetting influence. While month-to-month variability will undoubtedly continue to characterize demand deposit growth, the money market conditions postulated above would appear consistent with a rate of increase over the next few months averaging around the 3.7 per cent rate of 1964.

Chairman Martin called next for the go-around of comments and views on economic conditions and monetary policy, beginning with Mr. Treiber, who made the following statement:

Business activity. The current business situation is very strong. The first quarter of 1965 will probably show one of the largest gains in overall output on record. Even after allowing for some cutback in auto and steel activity from the very high current levels, the outlook is for high and rising economic activity.

Reports from the steel industry suggest that lead times for filling orders are now extended into June and July, and that barring a quick wage settlement, the present high levels of production should be sustained at least through April and possibly May. While there inevitably will be some downward adjustment in production levels--but not necessarily in employment--in the steel and auto industries, the latest indications suggest a somewhat longer sustained period of strength than had been thought possible a month or so ago. Any weakening that might develop seems more likely to occur in the third quarter rather than in the second quarter. There is good reason to believe that the economy may turn in even a better performance over the year than has generally been projected.

Prices and costs. The step-up in industrial output has helped to bring unemployment to the lowest level since October 1957. There are more reports of shortages

of skilled workers in various occupations. Demands of labor unions in current bargaining sessions are high, but terms of settlement are customarily less than demands. There has not yet been an increase in overall unit labor costs in manufacturing. Profits have been well maintained.

Industrial wholesale prices continue their modest upward creep. Producers are testing markets on a selective basis. In the area of administered prices there continue to be more increases than decreases.

The prospect of price increases is more imminent, and the problem of keeping down unit costs is more precarious, than they have been for several years.

Balance of payments. There has been a dramatic improvement in the recent balance of payments figures, which can be traced clearly to the voluntary restraint program. The March figures will probably show a large surplus; yet that surplus is a good deal less than the heavy outflows of February and January. In addition, seasonal factors are customarily favorable in the first quarter of a year; after allowing for them there is a large deficit for the first quarter.

Much of the good showing in recent weeks is due to large declines in the balances held by Canadian banks with their New York agencies. Surpluses attributable to a decline in short-term investments here by Canadian banks in response to a loss of corporate time deposits of U.S. concerns are not as important to the international position of the dollar as surpluses resulting from transactions with Continental Europe.

So far this year the United States has lost more than $900 million in gold; and we expect to lose more.

It is too early to evaluate fully the effect of the new United Kingdom budget on sterling. Generally the market response to the budget has been favorable; this is all to the good. But, even if the budget proposals are considered adequate, the longer-term position of the pound depends heavily on further efforts to restrain cost and price increases and to improve the competitive position of the British economy. Hence sterling may remain quite vulnerable in the short run and may be subject to repeated periods of pressure.

Bank credit and money. In recent months, banks have accounted for a larger share of total credit expansion

than previously. Liquid assets held by the public have continued to advance more rapidly than economic activity.

Bank credit continues its rapid advance. The pace of advance in March exceeded that in January and February. As in previous months, a broad-based business loan expansion has been the major contributor to the current strength of bank credit. Figures for the first quarter of 1965 will probably show the largest advance in bank credit, in both absolute and percentage terms, since early 1958. The annual growth rate for the quarter just ended was 13 per cent compared with the 8 per cent rate that had been characteristic of most of the current expansion. Loan-deposit ratios have risen further, reaching post-1931 highs.

Loan officers of the New York City banks are impressed with the strength of the loan demand. Two factors are cited: first, after several years of financing investment essentially from internal sources, more corporate treasurers are now concerned with the need for cash for capital spending plans; and second, bank loans are readily available and relatively cheap. The present seems to be a good time to borrow from banks, even as a protection against future needs; there may be some expectation of lesser availability and higher rates.

Recent surveys by the Federal Reserve Bank of New York indicate a fairly widespread tightening of loan terms, including firmer rates, while at the same time there has been a decline in the average interest rate on both short-term loans and long-term loans. Apparently prime-rate borrowers have been obtaining a larger proportion of total loans.

The banks appear to be capturing an especially large share of the total credit and deposit market. The banks have been able to improve their competitive position, aided by rapid reserve growth. Total member bank reserves grew at an annual rate of 8 per cent in the first quarter of 1965 compared with 4.3 per cent in the first quarter of 1964 and 4.2 per cent during all of 1964. The rapid reserve growth has been accomplished in part by increased borrowing from the Reserve Banks.

Money market and reserve conditions. Money market conditions have been firm. The growth in bank credit and deposits has been especially rapid in the light of these

money market conditions. The rapid growth has necessitated frequent upward revisions in our estimates of required reserves. Despite the heavy demands for funds by the public and despite a general firmness in other money market rates, the demand for U.S. Treasury bills has been strong and rates on the three-month bill have remained several basis points below the discount rate. We do not have a complete explanation for the strength of the bill market. But it does seem to be due in some measure to the investment demand by business concerns that have withdrawn deposits from abroad and by public bodies seeking the temporary investment of tax monies.

On or about Wednesday, April 28, the U.S. Treasury will probably be announcing the terms of its proposed financial operations to refund the Treasury issues that mature May 15, about $4 billion of which are held by the public.

Credit policy. The current financial situation--both international and domestic--counsels some reduction in the rate of growth of bank credit and some upward pressure on the Treasury bill rate. To meet these objectives might require net borrowed reserves in a range of $50-$200 million.

While in recent weeks net borrowed reserves were higher than expected, they were not inappropriate in the light of the large expansion in bank credit. I would suggest that our objective in the next four weeks, until the next meeting of the Committee, be to maintain about the same degree of firmness in the money market as has existed in recent weeks.

I like the draft of directive prepared by the Staff.1/

Mr. Ellis remarked that perhaps the most notable aspect of economic strength in New England was its generality. Manufacturing employment in almost all industries was strong, as were output and capital spending plans. Service employment, while slackening in

1/ The draft directive is appended to these minutes as Attachment A.

February, had been a steady source of expansion; and construction activity, paced by accelerated housing construction, especially of apartments, had continued to provide strength. With hours of work rising, construction contracts rising, and new orders exceeding output, the evidence was persuasive that the region was participating widely in the national prosperity.

The same might reasonably be said of the First District banks also. Business loan demand remained strong, with District banks reporting greater strength currently than the national pattern. Perhaps the evaluation by those banks of prospective loan demand reflected their tighter position. In spite of deposit growth that paralleled the nation, the average loan-deposit ratio for weekly reporting First District banks stood at 72.9 per cent compared with 68.4 per cent for the nation. Except for two weeks in January, New England reporting banks had been net borrowers in the Federal funds market since early December, and borrowings from the Reserve Bank had averaged slightly higher in recent weeks, in the national pattern. The two banks using unsecured notes had gradually expanded their outstandings to a total of $68 million.

Turning to monetary policy and the questions proposed by the staff for discussion, Mr. Ellis noted the first question posed was what recent developments suggested in terms of future developments. Given the major impacts of the auto strike last fall, the dock strike

in January, and the expectation of a steel strike, his reaction was that the underlying strength of the economy must have been and continued to be substantial to withstand the effects without spinning off into inflation or tipping into recession. That underlying strength was reflected in the breadth of industries expanding output and capital outlays and in the breadth of business loan demand. This basic attitude led him to expect continuation of strong business conditions throughout 1965, with an expected dip traceable to the steel settlement whether or not there was a strike.

The second question, Mr. Ellis observed, related to prices and costs. He agreed with the staff response, to which he would add that there did not seem to be much evidence that rising labor costs were having sufficient upward pressure to force upward price adjustments. However, the strength of demand kept producers looking to see if they could make price increases stick were they to announce them. In short, the situation was very competitive, as it should be.

As to the question on bank credit and money, particularly the changing relationships between bank credit expansion rates and deposit trends, Mr. Ellis thought the staff memorandum fell short on explaining why a pickup in credit expansion could be associated with no change in the rate of growth of total deposits. He suspected that an explanation on a short-term basis was bound to be frustrating because what was known about such relationships suggested multiple causations of variable

consistency and strength. He was inclined to look at a single month's figures as being merely confirmatory of previous trends or as a first indication that a previous trend was changing. From this viewpoint, March data substantially confirmed the pre-existing trend of sharp expansion in bank credit. The numbers seemed to say that the first quarter bank credit expansion averaged 13 per cent, annual rate, compared with 7 per cent for the fourth quarter of 1964 and perhaps 9 per cent for the year. March data also confirmed that loan demand was strong enough for such expansion to take place in spite of a lessened availability of reserves. The over-riding question was whether the Committee was prepared to continue feeding in reserves to support such a trend.

The last question, Mr. Ellis continued, asked the Committee to postulate what range of money market conditions, interest rates, reserve availability, and reserve utilization might prove mutually consistent if the Committee were to continue the monetary policy adopted at the last meeting. Without knowing the exact strength and duration of the factors that were causing the divergence between bill rates and what might ordinarily have been expected in their trend in relation to other money market measures, it would seem appropriate to move slowly though probing actions to test out the effect of the Committee's moves toward attaining higher bill rates. Unless the bill rate were to move to perhaps 4.05-4.10 per cent, an upward move would not be likely to produce

disturbing changes in the long-term market, nor should it lead to expectations of a change in the discount rate. If reflow-of-funds pressure continued, net borrowed reserves near $150 million or more might be required. This would increase the frequency with which Federal funds traded at 4-1/8 per cent, along with continuation of the relatively high dealer loan rates and member bank borrowings at about $450 million or above. At the same time, probing toward $150 million net borrowed reserves would help slow the expansion of bank credit.

With this objective in mind, Mr. Ellis favored continuation of the monetary policy adopted at the last meeting of the Committee. He would renew the existing directive, with its instruction to conduct operations "with a view to attaining slightly firmer conditions in the money market," and he would probe toward net borrowed reserves of around $150 million. If the short-term bill rate tended to push above 4.05 per cent, he would be prepared to reverse direction as necessary to forestall an abrupt cumulative effect of lowered reserve availability if the supply of repatriated funds were to dry up suddenly.

Mr. Irons said that Eleventh District economic conditions continued very strong and followed generally the pattern in effect over the nation. There had been little change from the conditions of three weeks ago except that the expansion had continued and the figures were at higher levels. It seemed to him that prospects were favorable for

further expansion and for a high level of business activity throughout the year. With perhaps a little dip, the steel and auto situation might well iron itself out.

In view of the high level of activity experienced and the indications of further increase, it seemed strange that the imbalances were so minor. Prices, according to the indices, seemed to have shown a rather high degree of stability. There had been substantial inventory accumulation, but probably not as substantial or damaging as might have been anticipated in view of the dragging out of the steel wage negotiations. The steel and auto problems were still ahead, but he was inclined to feel that the steel settlement might not be as upsetting as had been thought. He was not sure about the sustainable level of auto consumption; it seemed to move up from level to level. People liked automobiles and had the money to buy them, and a much higher level might prove sustainable than many would have believed a year ago. Certainly the production of all goods and services was running very high, and consumption was also high.

Mr. Irons observed that the demand for credit was exceptionally strong. Banks were reaching for funds and deposits in any way they could. Some banks seemed to be operating on a "planned deficit basis," presumably with the idea of coming to the discount window temporarily if they got caught. Many member banks in the Eleventh District were less liquid than they were not too long ago.

Mr. Irons got the impression in talking with bankers that there had been a change in the quality of credit. He was told that while they had not changed their rates per se, they were negotiating rates upward with individual customers wherever possible. In their judgment the quality of credit, all things considered, was not as high as a year ago. He understood that this question was considered informally at the recent meeting of the Reserve City Bankers Association, with general agreement that there had been some degree of deterioration in credit quality.

As far as the international payments situation was concerned, Mr. Irons noted that apparently there had been some improvement. However, the available figures were scattered and hard to interpret in the light of various developments, so he did not think one could be sure just what was happening that might lead toward a basic improvement in the balance of payments. It might be two or three months before a solid appraisal could be made.

During the past three weeks, Mr. Irons pointed out, there had been a moderate firming in money market conditions, and he would be inclined to continue the conditions that had prevailed. It would seem well to watch closely what went on over the next four weeks and maintain policy as it was. With considerable leeway for a margin of error, he would be inclined to think that if net borrowed reserves fluctuated around $100 million, this would probably be in order, with Federal

funds more often at 4-1/8 per cent. A Treasury bill rate under 4 per cent would not worry him. As long as the bill rate caused no more trouble than it had caused over the past month, he did not know why there should be a particular objective of getting it up. A range from around 3.95 to 4.05 would seem satisfactory. He would expect borrowings to average around the $450 million figure, and at certain times rise higher. He would want to avoid any change in conditions that would put pressure on the discount rate, which he would not like to see increased at this time.

On the directive, Mr. Irons did not favor the staff draft. He preferred that the Committee not change policy but maintain the degree of firmness of the past few weeks. Therefore, he would use the first paragraph of the current policy directive, which he found more understandable than the staff draft, while changing the second paragraph of the draft directive so as to call for open market operations over the next four weeks to be conducted with a view to "maintaining the slightly firmer conditions in the money market that have prevailed in recent weeks."

Mr. Swan reported the general tone in the Twelfth District seemed to be one of underlying strength, apart from the continuing question of the course of defense and space-related employment, lack of strength in residential building, and concern about some aspects of agriculture. In the lumber industry, which was affected by the

residential building picture and the weather in other parts of the country, orders were up in the last half of March but were still somewhat slow, and prices remained soft. On the other hand, heavy construction was strong indeed in the District.

Mr. Swan remarked that he had been going to comment on the dividend rate changes announced by some Southern California savings and loan associations, but that had been covered in the green book. Strength in loan demand was evident at Twelfth District banks, although the major banks still were not under marked pressure. They continued to be net suppliers of funds to banks and securities dealers. Although borrowings from the Reserve Bank were up a little in the week of April 7, they still were not large. On the other hand, one of the larger banks had indicated that inquiries from smaller and newer banks regarding the purchase of loans had risen considerably. To some extent this might be a result of depositors' reaction to the special situation in the Twelfth District; to some extent it might reflect real tightness apart from losses of deposits.

Mr. Swan said he was in general agreement with the staff comments on the economic and financial questions. In terms of policy, he doubted whether he could do better than to say that he agreed with the remarks made by Mr. Irons. In view of the strength of the current situation he would continue present policy, but in view of the uncertainties he would not like to see any further tightening or any probing in that direction

for the next four weeks. In terms of a definition of continuation of the same policy, he agreed with the figures Mr. Irons had given. He favored putting no pressure on the discount rate, and he would be happy if the bill rate did not go above 4 per cent at all. He still thought it possible that there would be a little increase in the bill rate; in fact, he was surprised that there had not been more upward pressure in the past three weeks given the lesser degree of reserve availability.

Mr. Swan said he had the same comments on the directive as Mr. Irons. When he read the first paragraph of the draft directive, he thought it was going to lead into a move toward a tighter position in the second paragraph. He did not think the two paragraphs matched up well, and therefore he would go back to the first paragraph of the existing directive.

Mr. Strothman, on commenting on developments in the Ninth District, said it was necessary to distinguish between the agricultural and the nonagricultural sectors. The agricultural economy seemed to be doing rather poorly and prospects were not encouraging. Farm prices were still low, and in addition a particularly severe winter had hit some parts of the agricultural economy very hard, raising costs and reducing the prospective calf crop. Nor could it be expected that agricultural business would prosper this spring. The most recent Reserve Bank survey indicated that businessmen in rural areas were expecting a less-than-normal spring expansion.

However, expectations as to the District's nonagricultural economy were for a better-than-average spring. This was what survey respondents reported, and what preliminary labor market and output statistics strongly confirmed. Strong increases in construction activity and retail sales, held back by a decidedly wet and cold March, would help appreciably.

If there was any real bleakness in the Ninth District outlook, it was for the longer term, Mr. Strothman continued. There was the possibility that the rate of economic expansion currently being enjoyed would not be continued in the second half of 1965. Present inventory positions, for the most part of finished goods, were suggestive of this. And a high enough level of spending for business plants was becoming somewhat less certain.

Loan expansion at District member banks continued to be impressive. Among weekly reporting banks the January-March 1965 increase in loans was far greater than seasonal, and so was the March increase taken by itself. Moreover, increases in commercial and industrial loans had continued to lead the way.

Of course, Mr. Strothman said, the March increase in total credit of weekly reporting banks, still stronger than seasonal, was not as impressive as the increase in loans outstanding, for those banks reduced their investments rather sharply, as did the nonweekly reporters. The latter also appeared to have been faced in recent months with

heavy loan demands. Their loans outstanding increased through March and over the first quarter of 1965 much more than seasonally. It appeared, however, that country bank loan demand had differed some, at least in motive, from city bank loan demand. Continuing high-level country bank loan demand had to be explained, in some considerable measure, by an unfavorable agricultural situation.

In closing, Mr. Strothman noted that the largest banks in the Twin Cities area reported a firming in the loan market. Whether for good or bad, the cost of business loans had evidently increased slightly in recent months.

Mr. Scanlon said he concurred with the staff judgment that an upward trend in overall activity was likely to be maintained even though important sectors might experience substantial setbacks.

Steel producers in the Chicago and Detroit areas had been unable to increase output appreciably since the start of the year, Mr. Scanlon commented. Mill inventories of finished steel were now declining; at the manufacturing level, however, steel inventories were rising rapidly. His observations regarding the steel and auto industries were similar to those that had already been made. Overall, it did not appear that declines in output of steel and autos would do more than slow the advance of aggregate economic activity in the months ahead.

Measures of employment and unemployment had continued to show improvement in recent weeks in the Seventh District. Unemployment

rates in all District states continued well below the national average. The volume of help-wanted ads for the Chicago area, seasonally adjusted, had risen sharply in recent months and had now passed the level for January 1957, which was the previous high on record. Overtime had increased in many industries since last year, and employment increases had been fairly general. Those developments were indicative of greater pressure on the labor market and doubtless tended to increase unit labor costs. As the staff had noted, what lay ahead might be determined largely by the adaptability of the labor force.

Doubtless there had been some moderate strengthening of upward price pressures in recent weeks, Mr. Scanlon said. Increases had occurred for a number of commodities, although a number of declines had been posted also.

On the balance of payments, Mr. Scanlon agreed with the comment that too little was known to attach great significance to data for the first quarter. Even a complete set of figures on the performance of the first quarter could not be taken as significant and fully indicative of U.S progress. More time must be allowed for a reversal of what had been a long-run trend in some of the accounts, and for a sorting out and evaluation of the several unusual and nonrecurring factors.

The Chicago Reserve Bank's analysis of probable loan trends came out essentially at the same place as the staff analysis,

Mr. Scanlon commented. On balance, he felt that loan demand might ease substantially after mid-April.

While he had little to add to the staff's explanation of the changing relationships among bank credit, money, and time deposits in recent months, Mr. Scanlon found it disconcerting to note the very strong role attributed to changes in Regulation Q. He thought the changes had been effective, but not to the extent some apparently believed.

On money market and reserve conditions, Mr. Scanlon observed that present policy was directed toward achieving slightly firmer money market conditions than had existed before the last Open Market Committee meeting. While free reserves had declined and borrowings rose, most money market rates changed only slightly in this period of continued strong credit demand. This seemed to him to leave open the question whether the somewhat firmer money market conditions specified in the directive had been achieved. While he did not mean to imply that the Desk had not done everything it should, he found it difficult to reconcile the absence of more rate changes.

Chicago banks, Mr. Scanlon noted, remained in a relatively comfortable reserve position for this time of year. While New York banks had continued to build up their outstanding certificates of deposit rapidly, after adjusting for tax runoffs, those of Chicago banks were still below their pretax date level. Accommodation of

the heavy credit demand at near-stable interest rates in March resulted in continued rapid increases in total reserves, bank credit, and total deposits.

As to policy, Mr. Scanlon favored striving to maintain the slightly firmer conditions that had recently prevailed. He would not back away from the position the Committee had attained. The positive statement in the draft directive about an improvement in the balance of payments seemed to him a bit premature. He would be satisfied with the present directive as revised by Mr. Irons, also making reference in the second paragraph to the impending Treasury financing.

Mr. Clay commented that the most noteworthy aspect of the domestic economy was its impressive performance in absorbing the strong surge of demand resulting from the automobile and steel contract disputes and the rather broadly based general demand for goods and services. When consideration was given to the advanced stage of the business upswing, the predominantly orderly developments in prices, manpower. and industrial capacity were worthy of more than passing notice.

The economy continued to be faced with important uncertainties, Mr. Clay added, concerning some sectors of the economy, notably steel and autos, and their impact on the aggregate level of economic activity, as the staff statement analyzed effectively. There was no way of foreseeing the shape of those developments, but it was apparent the

economy would need to absorb reductions of uncertain magnitude in those sectors. The economy did have substantial underlying strength and its advance was broadly based, however. While the trend of productivity in the manufacturing sector was favorable, the labor contract settlements and commodity pricing resulting therefrom remained the most serious threat on the price level front.

Obviously, it could not be known with any high degree of accuracy what was happening to the international balance of payments in view of several factors distorting the data and the incompleteness of the more recent data. The limited evidence available was on the encouraging side, however. So far as the payments balance was concerned, it was only reasonable to give time for the effects of the present program to unfold within the existing framework of monetary assistance.

Reserve availability had shifted considerably in recent weeks, Mr. Clay noted. While bank credit growth was still rapid, the role of borrowed reserves had increased substantially. The level of interest rates had not changed much recently, but interest rates already were high by historical comparison.

While judgments might differ as to the appropriateness of moving toward a tightening of monetary policy, judgments presumably did not differ as to the desirability of avoiding abrupt tightening action. System experience certainly demonstrated the importance

of that position. In view of the fact that interest rates were, as already indicated, high by historical standards, it became particularly important to be mindful of the degree and pace of reduction in credit availability. This was especially true inasmuch as the domestic economy continued to grow in productive potential, which would permit further orderly expansion in real output, assuming a satisfactory settlement of the crucial steel labor contract negotiations. In view of the recent actions taken in the balance of payments area, it would seem logical to await further observations of their effects, while maintaining a monetary policy conducive to domestic economic growth.

For the period ahead, Mr. Clay felt that money market conditions generally should continue essentially unchanged. While the Treasury bill rate should be permitted to rise toward the discount rate if market forces brought that about, reserve availability should not be further reduced in an effort to produce that result. He favored no change in the discount rate.

Mr. Clay agreed with those who felt it desirable to retain a directive similar in the first paragraph to the outstanding directive, with changes such as suggested by Mr. Irons in the second paragraph.

Mr. Wayne reported that business developments in the Fifth District had approximately paralleled those in the nation. In banking, commercial and industrial loans in the District since the first of the year had followed the recent seasonal pattern closely, whereas

in the country as a whole they had been much above that pattern. This was probably accounted for by the lesser importance of steel and automobile production and foreign lending in the District.

Turning to the staff questions, Mr. Wayne said he would incorporate comments without referring directly to each question. Business activity in the nation seemed to be following the same trends that were evident three weeks ago. Inventory accumulation, especially in steel and related industries, seemed to be restrained by limits of productive capacity and unusually high consumption. This meant that if there was no steel strike the period of adjustment might be shortened because the amount of inventories to be liquidated would be smaller except to the extent that the present high level of consumption was due to the anticipation of a strike. If there was a strike, the fact that inventories were less than had been planned would mean that steel-using industries would have to curtail activity sooner as their supplies of steel were exhausted. Such a slowdown would cause a more rapid spread of the effects of the strike and might well strengthen demands for political action to bring the strike to an end.

Mr. Wayne noted that as the level of industrial production had moved up in recent months, unit labor costs had declined somewhat despite a rise in overtime with its higher labor costs. Whether the decline would continue in the face of a growing scarcity of skilled

labor remained to be seen. On the other hand, the prices of industrial raw materials, which had drifted downward or held steady between the end of October and the middle of February, had again been moving up. In the past two months the raw materials component of the daily index had risen about 5 per cent. Thus, the effects of those two items seemed to have partially offset each other, the extent depending on the cost structure of a given industry.

It seemed to Mr. Wayne that it was much too early to assess the significance of balance of payments data for the first quarter of 1965, which at this stage were quite fragmentary. Even if complete and detailed data were available, a careful and extended analysis would be necessary to determine their significance in view of the dock strike, the heavy outflow of funds before February 10, and the voluntary restraint program since then. In the meantime, there might be some small basis for optimism in the continuing good progress of the voluntary restraint program, the absence of covered flows of funds to or from Europe, and some easing of credit conditions in France and Italy.

Several factors suggested to Mr. Wayne that the unusually rapid rise in bank loans might come to an end before long. The effects of the dock strike were receding, foreign lending had been greatly reduced, the accumulation of steel inventories would reach a peak soon, and the growth of automobile inventories would likely slow

down. The combined effect of all those factors should soon be apparent in a slower rate of growth, or even a temporary decline in bank loans.

Higher rates on time and savings deposits, Mr. Wayne observed, especially on certificates of deposit, had been a major factor in changing the relationship between bank credit and the money supply in recent months. Those higher rates had apparently enabled commercial banks to divert substantial amounts of new savings away from savings and loan associations and the funds so obtained had been used to make loans.

In the policy area, Mr. Wayne said, the indicators told that money market conditions showed only minor changes from three weeks ago despite progressively larger net borrowed reserves. The growth rates of total and nonborrowed reserves declined a little in March but in both cases the absolute amount continued to rise. The bill rate had risen a little in the past three weeks, probably due in part to an increased supply, but was still well below the discount rate. If it were not for impending Treasury refundings, the nature of loan demand, and a good probability of its easing within the next month, a further distinct move toward less ease might seem advisable. As it was, however, he believed that the Committee should retain its present posture and keep the market steadily firm at about its present level. No change in the discount rate seemed appropriate now. The

draft directive, including the first paragraph, appeared satisfactory to him.

Mr. Robertson made the following statement:

Business activity is continuing at a very high rate, with gratifying large recent increases in employment and as yet no inflationary break-out of price increases, but also with some clearly unsustainable rates of output in a couple of major industries.

I remain optimistic that we can move through this period without need for any major change in monetary policy. But a key factor shaping the future course of business will be the outcome of the steel wage negotiations. A reasonable settlement ought to add to the longevity of this already record period of non-inflationary peacetime expansion. On the other hand, there is no gainsaying the possibility that an outsize steel wage contract and accompanying price increase might give rise to ramifying wage and price advances in numerous other sectors of the economy where activity is already high. The formal contract termination date is now only 2-1/2 weeks away. Either a strike or a settlement by that date would halt or reverse the pressure of steel inventory accumulation. A temporary contract extension would delay and perhaps even aggravate the adjustment, but I see no substitute for simply waiting to see how the issue is resolved.

Fortunately, a "wait and see" attitude also seems quite appropriate to the international financial situation. That there has been an improvement in our situation since mid-February is undeniable; the real imponderable is how long-lasting that improvement will be. Here, too, only time will tell.

It does seem to me that the domestic credit expansion accompanying these developments has been rather large. Although a variety of factors help to explain this credit rise, I do not want to be overly critical of the size of the net borrowed reserve figures that developed these past few weeks as banks kept putting more reserves to work than we were expecting. Having moved to a more restrictive policy at our last meeting--and believing it unwise to shift back and forth too frequently--I

> would not object to a directive holding to the degree of tightness achieved since the last meeting, so long as the pressure of bank loan expansion continues very strong. Such a posture should also suffice as an "even keel" during the Treasury financing period that will occupy about half the time between this meeting and next.
>
> I would caution, however, against giving any special attention to the three-month bill rate as a policy target at this time. I cited my reasons for this feeling at the last meeting, and I will not take time to reiterate them here, but I feel them every bit as strongly today as I did three weeks ago.
>
> With these views, I would vote to approve the current directive to the Manager as drafted by the staff if the last sentence of the first paragraph were altered to substitute "support" for "reinforce," and the last two lines were left as they were. The changes suggested by the staff seem to contemplate a further move toward "reinforcing" or "moderating" that is not in accord with a policy of "no change" as set forth in the proposed last paragraph.

Mr. Shepardson remarked that the reports and comments so far all seemed to agree that there was a high level of economic activity, rather broadly based, recognizing the disturbances that might come from the steel situation at some point in the near future. The expansion of credit seemed to go on at a higher rate than could be justified over a long period of time. The international situation, as several had commented, seemed to be improving, but because of many conflicting factors there was no definite answer as yet.

With all these things in mind, it seemed to Mr. Shepardson that the policy the Committee adopted at the last meeting continued to be appropriate. In his judgment the Committee should press for

slightly firmer money market conditions. The actions of the past three weeks had been constructive, but he did not think the Committee had probed as far as it might. He was not in favor of any drastic change, but he would favor probing toward a somewhat firmer position. He agreed with the comments made about the draft directive as written, for it seemed to him that the first and second paragraphs were not consistent. The first paragraph seemed to lead up to a continuation of the attempt to achieve slightly firmer conditions, which he would support. If the impending Treasury financing would be impaired, however, by not assuming an even-keel posture, then the maintaining of present conditions might be required. His personal preference would be for the staff directive as written, with one minor change in the first paragraph, unless that was inconsistent with the Committee's usual policy of even keel during periods of Treasury financing. If it was inconsistent, he would be willing to go along with a directive that called for maintaining the firmer money market conditions that had prevailed in recent weeks.

Mr. Mitchell made the following statement:

> At the last meeting I raised the question whether we should, in light of the voluntary foreign credit restraint program, regard a widening of the differential between foreign and domestic interest rates brought on by rising interest rates abroad as a reason for monetary tightening by this Committee.
>
> Fundamentally, I seriously doubt that, in the environment of the mid-20th century, one is justified

in assuming that capital flows between reserve currency countries and their major trading partners and the attendant balance of payments surpluses and deficits which they generate can be adequately regulated by adjustments in the monetary policies of the countries involved.

The "stop-go" experience of the U.K. and the recent reaction of exchange markets and their participants to the "crisis" bank rate in the U.K. and the bank credit squeeze there add to the accumulating bulk of evidence that the creation of artificial monetary stringency is neither a sound nor practical way to curtail capital outflow.

There is some logic in the presumption that a country that is enjoying a surplus on current account might benefit domestically from a somewhat easier monetary policy, and that a country that is suffering from a deficit on current account might be encountering internal developments which would call for a tighter monetary policy. Unless there are chronic maladjustments of exchange rates, it is reasonable to assume that the deficit country is erring on the side of ease and/or the surplus country is erring on the side of tightness, and that an appropriate adjustment by one or the other, or both, would redound to everyone's benefit. There are important exceptions to this logical sequence, even when it is related only to the current account. When it is extended, as it too often is, to the overall balance including capital account transactions, it loses all realistic logic.

It simply is not true that the capital exporter, when his current account is in surplus or balance, would necessarily benefit from the tighter monetary policy which would be needed to bring his overall account into balance--and there is no prima facie reason to believe that the capital importer, when his current account is in deficit, would be better off with an easier monetary policy. This would only be a valid logical conclusion if capital were employed with the same intensity in all countries in the first instance, and if the rates of saving were approximately equal thereafter. That this is not the case in the world today, even among the so-called developed or industrialized countries, is obvious.

The conclusion is also inescapable. Overall restriction of credit growth is not a desirable or even a feasible way to deal with our capital outflow problem. It is not, as is often said, a fundamental or basic approach.

The determination of the precise response of saving in the U.S. to changes in interest rates is not presently within our analytical capacity. But we do know one thing. In recent years the flow of financial saving here appears to have been significantly responsive to the rate paid to savers. Hence, any effort to reduce the flow in credit markets by more restrictive monetary policies is offset, in part, by a diversion of the flow of current income away from consumption and durable goods expenditures into credit markets. Hence, we have every reason to expect that the restrictive impact of a "tight money" policy would be to reduce the relative profitability of investment in the U.S., slow up the rate of domestic expansion, and not curtail substantially the flow of funds seeking investment outlets abroad. Only by bringing domestic activity to a virtual standstill for a good many years could we hope to produce changes in the basic rate of return on investment which would "naturally" stem the outflow of capital. These are the hard, basic facts that people are reluctant to face. Tight money is not the "traditional" solution to a capital outflow occasioned by intensive capital application in one area, as compared to another. It is no solution at all.

Then what can we do? In the longer run, we must establish controls over capital outflows that do not have to be "backed up" or "reinforced" by tight or tighter money. Interest rate differentials are bound to persist for some time between the U.S. and other areas which are not as intensively capitalized, and which have much lower savings rates than we do. We simply must control this capital outflow so that we can "feed out" capital to the rest of the world at a reasonable, sustainable rate, compatible with our current account surplus and foreigners' willingness to hold dollars. This mechanism of control must be such as not to interfere with the availability of credit for continued expansion in the United States.

The program we are now following for reducing the U.S. balance of payments deficit relies on restricting

the supply of dollars flowing abroad in various capital transactions. The Federal Reserve's task is to cut the outflow of bank loans. The Commerce Department aims at corporate investment--both liquid and fixed; that program may well be involving not only a slowdown in the rate of outflow of U.S. funds but actual repatriation of liquid balances by American corporations.

The entire program is a conscious attempt to reduce the supply of dollars to the rest of the world by means other than raising interest rates in the United States. It rests on the soundly based fact that the advance in interest rates necessary to eliminate that balance of payments deficit would have had to have been so large as to seriously injure domestic prosperity. A second good reason for avoiding an increase in U.S. interest rates as the instrument for reducing capital outflow is that such action was much more likely to lead to an escalation of interest rates throughout the industrialized world.

Whatever the technique we use to reduce capital outflow, the result will be a tendency for interest rates abroad to rise. This is a natural reaction to a reduction in the supply of funds going from the United States to the rest of the world. In fact, if rates abroad did not tend to rise, we would have reason to doubt that our program was being effective.

Now, if we had adopted the technique of raising rates here--and assuming this action were successful in cutting the outflow of capital--the consequent advance in rates abroad would tend to undo the effect of our initial increase in rates. Thus we would feel an incentive to raise rates here again in order to maintain the inducement for reducing capital outflows. In light of our experience thus far in trying to cope with the balance of payments deficit, it is easy to imagine an upward ratcheting of interest rates back and forth between the United States and Europe, to levels far above those appropriate for a healthy domestic economy.

The great virtue of our present program is that the natural reaction abroad--a tendency for rates to rise--does not weaken the force of our own measures, as would happen if we had used the interest rate weapon in the first place.

The increase in rates abroad has appeared mainly in the Euro-dollar market. This impact should be

recognized as a favorable indication that our program is biting. In view of the nature of our program, this rise in Euro-dollar rates in no way requires a rise in interest rates in the United States.

What we should look for are the further reactions in Europe to this advance in Euro-dollar rates. In the Euro-dollar market, our program is leading to a reduced supply of U.S. funds and an increased demand by foreigners who might otherwise have borrowed in the United States. How will this help our balance of payments and, in particular, how will it reduce official dollar holdings in Europe?

There are various ways in which the higher Euro-dollar rates can act to reduce official dollar balances. One way would be direct placement of dollars in that market by European central banks. A second way would be a diversion by European commercial banks of dollar accretions into the Euro-dollar market instead of to their own central banks. A third way would be that European borrowers who had been tapping the Euro-dollar market will now borrow at home. If they need dollars, they will acquire them in their own markets, reducing the flow of dollars to their central banks; if their need is for their own currency, their switching from the Euro-dollar market to domestic sources of funds will shut off a flow of dollars that previously went to their central banks. (This is what is happening in the U.K. to the extent that local authorities are repaying Euro-dollar loans and refinancing in sterling.)

By these and other channels, our program will tend to reduce the dollar buildup in foreign official holdings. And, it should be noted, none of these channels requires an increase in interest rates in the United States. Each type of reaction results from the cut in the supply of U.S. funds. As long as our program is effective in reducing this supply, there is no case, from the balance of payments side, for also raising rates here.

Turning to the domestic situation, Mr. Mitchell said he was disturbed about the effect on the economy generally of the beginning of steel inventory liquidation. He thought there was a tendency to

underestimate the shock effect of this operation and that the economy was a little more exposed to a cessation of growth, if not a small downturn, than might be assumed. The economy had only just now achieved a reduction in the unemployment rate to 4.7 per cent, and he thought the U.S. ought to be able to achieve a higher utilization of resources while absorbing a balance of payments constraint. He agreed with what Mr. Irons and others had said about not giving too much attention to the bill rate and felt that the Committee ought to be giving more attention to the level of total reserves. The longer-term market may not have assimilated the change in policy at the Committee's last meeting, he added, and in this sensitive area the adjustment might have still some way to go.

Mr. Mitchell preferred the first paragraph of the existing directive and a second paragraph along the lines suggested by Mr. Irons.

Mr. Daane said he felt that the Committee's present policy posture was clearly appropriate on both domestic and international grounds and in terms of prospective developments, even if one made the assumption that the economy possibly had passed the overheating point. In short, he was pleased that the Committee stood where it did in its firming of money market conditions and its general policy stance. His general predilection against quantification and being too precise as to targets had been reinforced in recent weeks by

consideration of the problems encountered and dealt with successfully by the Account Manager, so he would not want to set a precise reserve target for the next month. Nor would he want to make a special effort to bring the bill rate up to any higher level, although he would be happy if it were to rise a few basis points. The imminence of Treasury financing reinforced the idea of a steady course in policy and open market operations. The Committee could not be oblivious to the fact that there would be a Treasury financing of substantial magnitude during the period prior to the next meeting. In summary. he would try to stay steady in terms of the tone and feel of the market, recognizing that this might be difficult in light of the growing market feeling that the Committee was in process of effecting a change in policy.

On the directive, Mr. Daane said he shared the dissatisfaction of those who did not like the suggested new first paragraph. He would prefer to retain the first paragraph of the present directive, and he would accept Mr. Irons' suggestion for the second paragraph, which would call for maintaining the slightly firmer money market conditions that had prevailed in recent weeks.

Mr. Hickman said that in considering his answers to the questions suggested by the staff he had drawn heavily on views expressed at a Fourth District Economists Round Table held at the Cleveland Bank on March 26, in which 23 economists participated.

With reference to the first question, recent developments in steel, autos, rubber, and aluminum reemphasized the reasons for doubting the sustainability of the current level of industrial production. Some declines in the monthly index of industrial production were expected within the next six months, accompanied by a slower rate of gain of GNP. In forecasting the industrial production index, only 6 of the 23 economists participating in the recent round table expected the index to be higher in the fourth quarter of 1965 than in the first quarter.

Auto production was scheduled to decline in April, and auto sales had trended downward from extremely high levels since late January. On a seasonally adjusted basis, a cumulative drop could be noted of 20 per cent in sales between the last ten-day period in January and the last ten-day period in March. Adjusted monthly sales had also declined since January, and were expected to drop further in April.

In steel, Mr. Hickman noted that the strike-hedge buildup of inventories continued, but there were wide variations in estimates of the extent of the accumulation. On the basis of estimates by steel industry analysts, it appeared that the current buildup would fall somewhere between the moderate accumulations of 1962 and 1963 and the high of 1959, with the amount varying directly with the length of time required to reach a labor settlement. One of the

Cleveland Bank's directors, a major executive in the industry, believed that the contract deadline would be postponed for a month or two and that current levels of production could be maintained throughout much or all of the second quarter. Once a settlement was reached, steel shipments might decline by as much as 25 per cent from current levels and hold at that reduced level for two or three quarters.

Other key industries affected by the same or similar developments included aluminum and rubber. Labor negotiations in aluminum had a strike deadline falling one month after that of steel. An economist for a major aluminum producer in the Fourth District expected that shipments of ingots and mill products during the second half of this year would average some 9 per cent below the first half. Representatives of three major rubber companies attending the recent meeting of the Economists Round Table agreed that tire sales were being borrowed from the future, and that there would be a second half slowdown, the extent depending on autos.

So far as the question of prices and costs was concerned, Mr. Hickman said, the consensus of the meeting of the economists was that the high rates of output achieved thus far this year had not led to serious inflationary pressures, although occasional price increases were reported. An _a priori_ explanation was that expanded output had lowered unit labor costs and raised profit margins.

With respect to the balance of payments, Mr. Hickman believed the preliminary data for the first quarter to be too fragmentary for firm conclusions. Indications that the deficit was less than one-half that of the fourth quarter, after seasonal adjustment, and that the March surplus was larger than usual were encouraging, but the dock strike settlement robbed the figures of much of their glow. A return of corporate funds formerly held overseas was reported at the recent meeting by several Fourth District business economists, and this response was presumably nationwide. Some, however, were puzzled by seeming inconsistencies in the groundrules being used by the Department of Commerce.

As to the fourth question, the behavior of bank credit and deposits thus far in 1965 was basically what should be expected in a period of strong business expansion, following a change in Regulation Q. In this connection, comparisons between the first quarter of 1965 and the first quarter of 1962 were striking. In the earlier period the money supply increased at an annual rate of 1.4 per cent, while time deposits rose at a rate of 14 per cent; more recently the money supply growth had been at an annual rate of one per cent, and time deposits had increased at an annual rate of nearly 19 per cent. The correspondence would have been even closer if it had not been for the fact that Government deposits declined by $100 million in the first quarter of 1962 and rose by $600 million in the first quarter of 1965.

The business readjustments referred to earlier would be associated with inventory liquidation and lower sales of consumer durables, Mr. Hickman continued, and these in turn would restrain bank loan expansion. Such a development would be reinforced by the return flow of funds from abroad under the voluntary credit restraint program.

In this environment Mr. Hickman recommended a continuation of the monetary policy adopted at the last meeting, in order to sop up a redundant liquidity that might otherwise press interest rates down and offset some of the favorable effects of the President's balance of payments program. In any event, the forthcoming Treasury financing called for no change in money market conditions over the next four weeks. He therefore recommended a bill rate in the range of 3.95-4.05 per cent, borrowings above $400 million on average, and net borrowed reserves at whatever level was required to maintain those objectives, say $50 to $150 million. Because of his appraisal of the domestic business outlook, Mr. Hickman preferred to see figures at the lower, or less restrictive, end of the range.

For that reason also, Mr. Hickman said, he would prefer the words "while accommodating moderate growth" (in the reserve base, bank credit, and the money supply) at the end of the first paragraph of the current economic policy directive to the words "by moderating growth" suggested in the staff draft. The money supply was now barely

back to where it was two months ago, and he would not like to "moderate" that rate of growth further. On the other hand, he thought the Committee should refer to the forthcoming Treasury financing, as the staff suggested in the second paragraph. On the whole, perhaps the first paragraph of the present directive and the second paragraph of the suggested revision could best be used.

Mr. Bopp said discussions with a dozen large business firms in the Third District suggested that the larger-than-usual March balance of payments surplus might indeed be associated with the voluntary restraint program. Each of the corporations with whom the Philadelphia Reserve Bank spoke indicated a thorough awareness of the President's program, and nine out of the twelve reported that a "plus" payments position would be achieved in 1965. Of those nine, five indicated with a good degree of certainty that 1965 would be "more plus" than 1964. A very large chemical company, for example, reported plans to achieve a 15 per cent improvement over 1964's favorable balance. As for how the balance was to be improved, four firms were making no new portfolio investments abroad and were pulling down existing portfolio investments; four planned to finance expansion abroad either from foreign borrowing or from earnings of subsidiaries; three planned to repatriate additional earnings; and two had plans to defer direct investment abroad.

Turning to the steel situation, Mr. Bopp reported that a survey of producers in the Third District indicated that the mills were running as close to capacity as possible, that they were selling all they could produce, and that they had added little inventory at the mill. The producers estimated that consumers had built up a three to four week supply of steel in addition to their normal stocks as a strike hedge. They felt, however, that only a short strike would occur, if there was a strike at all. Hence the greatest economic dislocation would probably come from a situation of protracted negotiations during which further additions to inventory would be made, with greater reductions of orders when a settlement was reached. The producers expected that the final settlement would result in some increase in labor costs and perhaps some pressures on profits.

With respect to policy, Mr. Bopp commented that the economy continued to exhibit basic strength, although some slowdown might result from curtailed production in autos and steel. He was pleased with the improved employment picture, with the apparent response to the voluntary restraint program, and with the continued stability in prices and unit labor costs. He saw no reason to depart from the present posture of monetary policy. Hence, he recommended using the first paragraph of the existing directive and the second paragraph of the proposed directive.

Mr. Bryan reported that the economy of the Sixth District seemed to be expanding vigorously. In two States, Georgia and Florida, the insured unemployment rate was now down to 2 per cent. So far this year the District's weekly reporting member banks had shown loan expansion three times greater than in the corresponding period last year.

As to the staff questions, Mr. Bryan found the comments on them thus far, including the staff comments, quite satisfactory. He did feel there was a tendency to lay a little too much emphasis on the unit labor cost as a statistic. This was a figure that, if he recalled correctly, covered only about a 30 per cent sample of total nonfarm employment in this country.

As far as monetary policy was concerned, it seemed to Mr. Bryan that barring strikes or the unexpected the economic news was reassuring, with no adverse reaction, thus far at least, to the mildly firmer credit policy that the Committee presumably had been following. Indeed, there was some question in his mind whether the Committee had really been following a much firmer policy. Total reserves in March, as well as the first quarter as a whole, were up contraseasonally, and by a large amount; required reserves were up contraseasonally, and by a large amount; nonborrowed reserves were up contraseasonally, and by a large amount. Short-term rates had been somewhat firmer, to be sure, and in the two weeks ended April 7 net borrowed reserves had been over $100

million. Yet there had also been a startling acceleration in the growth of bank credit.

It seemed to Mr. Bryan, therefore, that the Committee had been influencing the bank credit situation only marginally, although it had moved into a position of net borrowed reserves. In response to strong loan demands, member banks apparently had been willing to borrow enough to more than offset the modification in reserve availability stemming from System operations and market forces. If loan demands continued to be as strong as they were in March and the Committee was guided largely by the net borrowed reserve figure, it was likely to be trapped into supplying more reserves than the country could tolerate. Under conditions of strong credit demand, a given net borrowed figure exerted less effect on reserve expansion than at other times. Therefore, if the Committee was going to continue to use a net borrowed reserve target and expect to allow only a moderate increase in bank reserves, it was going to have to bring the banks into a further net borrowed reserve position. Just how large that should be, he did not know, but he believed the Committee should be feeling its way toward a further increase in net borrowed reserves and a further increase in the use of the discount window. It seemed to him there should be an average of net borrowed reserves of around $150 million, fluctuating between $100 and $200 million. He would not consider this to be a further tightening of policy but merely an effort to implement the policy already decided upon.

Having said this, Mr. Bryan commented, he must recognize the fact of the imminent Treasury financing and on that account vote for an even-keel policy in the period ahead. Certainly he would not favor a change in the discount rate. He preferred the existing directive, with the second paragraph changed along the lines suggested in the staff draft.

Mr. Shuford commented that, as had been pointed out by others around the table, economic activity was at a high level and was continuing to rise rapidly. Most measures had gone up sharply in the past three months, and aggregate demand appeared to be exerting some upward pressure on prices, especially sensitive prices. In the Eighth District the economy had risen at an exceptional rate since last fall.

Thus far, Mr. Shuford continued, the economic expansion appeared to have been accomplished without creation of sizable imbalances, but at the same time he had a feeling that a slowing down of the rate of economic advance would be a healthy development. Continued increases in the demands for goods and services at recent rapid rates could soon become excessive.

With respect to the international situation, Mr. Shuford said the evidence, limited and uncertain as it was, indicated that the voluntary restraint program had been reasonably effective, at least in its initial stages, but some of those early gains had been partly the result of a one-time reflux of corporate funds and a possible

catching up of exports in the wake of the port strike settlement. Whether the improvement in the balance of payments could be maintained remained to be seen.

Mr. Shuford went on to say that he had been considering whether Committee policy had been restrictive enough or whether it should become a bit more restrictive. In view of the strength of the domestic economy, more monetary restraint was needed now than a year ago, but it appeared to him that the Committee had been achieving somewhat greater restraint during the past four months than previously. During most of last year the three-month bill rate was about 3.5 per cent, and recently it had been near 4 per cent. While total member bank reserves, time deposits, and bank credit had continued to rise markedly, this did not necessarily indicate a lack of restraint. The time deposit growth reflected the high level of liquid saving accompanying the economic expansion and the aggressiveness of banks in seeking those funds. Most of the reserves furnished to the banking system in recent months had been used to support those time deposits. Growth in bank credit had in large part also been a reflection of the large share of funds being attracted by commercial banks.

The money supply rose at a 4 per cent rate last year, Mr. Shuford pointed out, and such a rate was appropriate then. But now, with economic activity pressing capacity, some moderation seemed to be called for. Since mid-December the money stock had been about

unchanged on balance. In view of the changes in Regulation Q and other factors, this short-run situation had probably been appropriate. The spurt in time deposits, utilizing the reserves furnished, was apparently temporary. From February to March, time deposit growth returned to the rate of last year, and the money supply rose.

With respect to policy, Mr. Shuford felt that the economic situation called for continuation of some restraining influence. He favored maintaining the tighter money market conditions that now existed, with the bill rate around 3.90-4.05 per cent and Federal funds in the 4 to 4-1/8 per cent range. This would necessitate net borrowed reserves, of course, and he favored whatever magnitude was necessary in order to reach the other objectives. He hoped that over a period of time, say four to six months, there would be a money supply growth averaging around a 2 per cent rate. He would leave the discount rate unchanged at this time.

With respect to the directive, Mr. Shuford said there were several alternatives with which he could agree. The majority seemed to favor the first paragraph of the current directive and essentially the second paragraph of the draft directive, and he would accept such a solution.

Mr. Balderston favored use of the first paragraph of the existing directive and the second paragraph of the staff draft. He was concerned, in view of the increase in bank credit in the first quarter, that

holding an even-keel during the next four weeks not mean retrogression. In other words, he would not want the Committee to perpetuate rates at the long end or relax the slightly tighter stance that it adopted three weeks ago.

Chairman Martin remarked that at the last meeting he had commented on the absence this year of the usual references to the February doldrums, and it seemed clear that there were no March doldrums either.

As to the directive, the Chairman said it appeared that a majority favored the use of the first paragraph of the present directive and the second paragraph of the staff draft He inquired whether anyone felt strongly enough to dissent.

There followed a discussion of some of the specific wording of the proposed directive, at the conclusion of which Chairman Martin remarked, as he had on previous occasions, that words meant different things to different people. With this observation, he suggested that the Committee vote on a directive in the form that had been suggested.

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

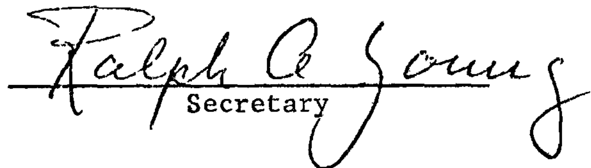
The economic and financial developments reviewed at this meeting indicate a generally strong further expansion

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

To implement this policy, while taking into account the forthcoming Treasury financing, System open market operations over the next four weeks shall be conducted with a view to maintaining the firmer conditions in the money market that have recently prevailed.

It was understood that the next meeting of the Committee would be held on Tuesday, May 11, 1965, with the following meeting scheduled for Tuesday, May 25.

The meeting then adjourned.



Secretary

Attachment A

CONFIDENTIAL (FR)

April 12, 1965

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on April 13, 1965

The economic and financial developments reviewed at this meeting indicate a continued rapid expansion of the domestic economy, reflecting broad underlying strength as well as extraordinary demands for steel and autos. At the same time, with the persisting drain in our gold stock, there is need to consolidate the recent improvement in our international balance of payments. In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, by moderating growth in the reserve base, bank credit, and the money supply.

To implement this policy, while taking into account the forthcoming Treasury financing, System open market operations over the next four weeks shall be conducted with a view to maintaining the firmer conditions in the money market that have recently prevailed.