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, May 11, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Bryan
Mr. Daane
Mr. Ellis
Mr. Galusha
Mr. Maisel
Mr. Robertson
Mr. Scanlon
Mr. Shepardson

Messrs. Hickman, Clay, 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. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Holland, and Koch, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Molony, Assistant to the Board of Governors
Mr. Cardon, Legislative Counsel, Board of Governors
Messrs. Partee and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Hersey, 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. Hilkert and Patterson, First Vice Presidents of the Federal Reserve Banks of Philadelphia and Atlanta, respectively

Messrs. Eisenmenger, Mann, Jones, Parsons, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Boston, Cleveland, St. Louis, Minneapolis, Kansas City, and Dallas, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Messrs. Fousek and Parthemos, Assistant Vice Presidents of the Federal Reserve Banks of New York and Richmond, respectively
Messrs. Geng and Meek, Managers of the Securities Department, Federal Reserve Bank of New York
Mr. MacLaury, Manager, Foreign Department, Federal Reserve Bank of New York
Mr. Rothwell, Economist, Federal Reserve Bank of Philadelphia

Chairman Martin noted that two new members of the Committee were attending their first meeting today--Sherman J. Maisel, member of the Board of Governors, and Hugh D. Galusha, Jr., President of the Federal Reserve Bank of Minneapolis--and that both had executed their oaths of office as members of the Federal Open Market Committee prior to today's meeting.

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on April 13, 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 April 13 through May 5, 1965, and a supplemental report for May 6 through 10, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury said that the Treasury had not yet decided whether to show a decline in the gold stock this week, but probably would reach a decision today. The last published change was the $150 million drop during the week ended April 14. Since mid-April, however, sales to foreign countries out of the Stabilization Fund's holdings had continued, with the result that the Fund's holdings, which were approximately $150 million at mid-April, were now down to about $45 million. Between now and the end of May, a further drain was anticipated on the Stabilization Fund's gold holdings of more than $100 million, mainly attributable to further sales to Spain ($30 million, for value today), Austria ($12.5 million), and France ($50 million). There was little doubt, therefore, that there would have to be another drop in the gold stock this month; the only question concerned its timing.

On the London gold market, Mr. MacLaury reported, the fixing price reached an April high of about $35.17 at mid-month. Thereafter, the price eased as supplies from new production, together with some sales by disappointed speculators, sufficed to meet the continued moderately active demand. This morning the price was $35.1020, a low figure by recent standards. The gold pool on balance picked up gold during the latter half of April, and for the month as a whole showed a surplus of about $10 million, leaving the cumulative deficit since the beginning of the year at $183 million. That figure had been maintained with minor fluctuations thus far in May.

In the exchange markets, Mr. MacLaury observed, the Committee would recall that sterling began to show a somewhat better tone following the presentation of the British budget on April 6 and particularly after the Prime Minister's speech to the Economic Club of New York on April 14. As the sterling rate strengthened (from about $2.7950 at mid-month to about $2.7975 on April 20) the New York Reserve Bank, with the agreement of the Bank of England, began to sell limited amounts of sterling in the New York market to reduce somewhat System and Treasury balances that had been acquired last fall at the time of the sterling crisis. During the week of April 22-28, $9.1 million equivalent was sold in New York for System account and $7 million for Treasury account. In addition, $1.4 million equivalent and $2.8 million equivalent for the two accounts, respectively, were sold directly to the Bank of England as it picked up dollars on a moderate scale in London. As a result of those sales, the System's sterling position was reduced from about $52 million equivalent to about $41.5 million, while the Treasury's position dropped from $71.5 million equivalent to $61.7 million.

Although the sales, as was the intention, were absorbed by the market without difficulty, Mr. MacLaury continued, it had not seemed wise to press the operations further for the time being. As the Committee was aware, the market for sterling had not been particularly strong in the last couple of weeks. The one exception was at the end of April when the Bank of England, rather than announcing the reduction in Bank rate that had been widely expected by the market, introduced

special deposit requirements for the London clearing banks and Scottish banks. The market reacted favorably to that unexpected tightening of British monetary policy, and the pound moved nearly to parity with the Bank of England taking in some $60 million. That was the largest intake in the recent period. Thereafter, the market moved in a range of about $2.7975-90 without any strong trend; this morning the rate was $2.7986. Sterling eased a week ago today (May 4) when the British authorities announced only a moderate increase of reserves in April (of $22.4 million, to $2,352.1 million). The market had expected a larger increase and was taken aback somewhat by the statement that the Bank of England had had recourse to further central bank credits prior to the budget message, only part of which had subsequently been repaid. During April, the Bank of England drew some $200 million from central banks other than the Federal Reserve System, and on balance repaid $40 million of its drawings on the System. Its indebtedness to foreign central banks after those transactions, therefore, stood at $280 million drawn on the Federal Reserve swap and some $800 million drawn on other central banks.

Although the technical position of sterling remained strong and market sentiment was definitely better than it was a month or so ago, Mr. MacLaury said, there clearly had been no rush by the market to cover forward sterling commitments. However, the strengthening of the forward rate, apart from reflecting speculation on a Bank rate reduction, did indicate that there might be some covering of such commitments going on. The market was still vulnerable to unfavorable

headlines, and probably would remain so as long as the British efforts to reach agreement on an incomes policy remained in a state of flux and uncertainty continued concerning the government's stability, particularly in the light of the steel nationalization discussions. Under the circumstances, it was of great importance that the British authorities continue to have at their disposal resources with which to counter possible speculative pressures. In this connection, Mr. MacLaury noted that all of the hurdles had been cleared for the British International Monetary Fund drawing of $1.4 billion later this month. It was understood that the British would use a good part of the proceeds to pay off their short-term indebtedness. Press reports had indicated that some $700 million would be required for that purpose, but the New York Bank's calculations indicated that $1.1 billion would be required. Accordingly, assuming no large market transactions in the intervening period, about $300 million would remain from the drawing after repayment of short-term debts.

With respect to continental currencies, Mr. MacLaury reported that the System had been able to make some progress during the period in paying off swap drawings. The most notable change was the prepayment of $50 million equivalent of the swap drawings with the Swiss National Bank. The major portion of that repayment ($45 million was made possible by purchases of francs from the Swiss National Bank when difficulties of two small Swiss banks reportedly contributed to market selling of Swiss francs and necessitated heavy offical support of the Swiss franc. That problem was a temporary one, although the Swiss franc

had tended to remain well below its ceiling. There was some possibility that further repayments on that drawing could be made before its maturity on June 1, since the Swiss authorities were now using dollars from their reserves to purchase Italian lire in connection with remittances by Italian workers in Switzerland. Such remittances had previously been used to pay down the $100 million swap between the Swiss National Bank and the Bank of Italy, but that swap now had been fully liquidated.

In addition to repayments on the Swiss drawing, Mr. MacLaury said, early in the period the System paid off the last $5 million equivalent of its drawing on the German Federal Bank, and also $5 million equivalent of its drawing on the Netherlands Bank, bringing the latter to $45 million equivalent. Thus, at the moment, the System's gross debtor position was $525 million and its net debtor position was $245 million. Those figures compared with $580 million and $210 million, respectively, at the time of the last meeting of the Committee.

So far as the situation in the Netherlands was concerned, Mr. MacLaury continued, during the period the System was also able to reduce its forward guilder commitments by $25.3 million equivalent, to the present level of $54.5 million equivalent. The Treasury's guilder obligations were also reduced, by $20.6 million equivalent to $64.1 million equivalent. That meant, in effect, that the series of forward guilder contracts undertaken last December and January had now either been liquidated or rolled over through new sales. The prospects for further reductions in the U.S. guilder obligations were mixed; on the one hand the Account Management had been told that the Dutch money market

was expected to remain tight throughout May; on the other hand, the New York Bank might be able to acquire some guilders, as well as other needed currencies, at the time of the U.K. drawing on the Fund.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period April 13 through May 10, 1965, were approved, ratified, and confirmed.

As he mentioned earlier, Mr. MacLaury said, it was hoped to reduce further the System's drawings on the Swiss National Bank. However, in the event that was not possible, he requested the Committee's approval of a renewal for another three months of the drawing on the Swiss National Bank, now in the amount of $20 million, which matured on June 1. This would be a first renewal.

> Possible renewal of the $20 million drawing on the Swiss National Bank for a further period of three months was noted without objection.

Mr. MacLaury then noted that the $750 million swap arrangement with the Bank of England would mature on May 28, 1965, and recommended its renewal for another twelve months.

Mr. Daane said that in light of the discussions at Paris and Basle last week he thought it was important to support the British by renewing the swap line. Chairman Martin expressed similar views.

> Renewal of the $750 million swap arrangement with the Bank of England for a further period of twelve months was approved unanimously.

Finally, Mr. MacLaury said, the System probably would roll over its $15 million equivalent sterling/guilder swap for another three

months (and the Treasury would do the same). This would be a second renewal.

> Renewal of the $15 million equivalent sterling/guilder swap for a further period of three months was noted without objection.

Chairman Martin then invited Mr. Daane to comment on developments at the meetings he had attended recently in Paris and Basle of Working Party 3, the Group of Ten Deputies, and the Bank for International Settlements.

Mr. Daane said he would report first on the weekend meeting of the BIS at Basle. The tone of the discussion at that meeting was quite mild, for the obvious reason that the substance, relating mainly to the British drawing on the IMF, had already been covered in earlier meetings. Lord Cromer of the Bank of England discussed recent developments in sterling in a little more detail than the British had at the preceding meetings in Paris, and was quite optimistic with respect to the recent strength of the pound. He noted that the British had gained something over $100 million equivalent in spot sterling since announcement of the budget, most of which was acquired since the April 30 announcement of special bank deposit requirements. They had repaid about $100 million of continental central bank advances and added $22 million to their reserves, and their total gain came to about $140 million, taking into account the decrease in Federal Reserve and U.S. Treasury holdings of sterling that Mr. MacLaury had reported. That left them with short-term obligations under the stabilization package of slightly under $1.1 billion--specifically, $1.097 billion. Lord

Cromer also commented at some length on his recent letter to the clearing banks. The spirit of that letter was being relayed to all financial institutions; they would be informed that the budget contemplated an increase of only 5 per cent in bank advances from mid-March 1965 to mid-March 1966. That would represent quite a change from the last two years, when the increase in advances had been 14 and 16 per cent, respectively. Lord Cromer also reported that Britain was experiencing a shortage of mortgage money for house building.

There was general satisfaction expressed with the credit measures now being taken by the British, Mr. Daane said. As the chairman of the Basle meeting put it, 5 per cent was a severe limit. The only critical question raised at Basle was with respect to the method the British used to finance their domestic budget deficit. In effect, through the Exchange Equalization Account they used the proceeds of their sales of foreign exchange for this purpose. That meant that the larger their external deficit the more easily they could finance their domestic deficit. Some of the Basle members noted that that was a rather odd procedure unless it was conceded that domestic deficits always should be financed in an inflationary fashion.

Mr. Blessing, President of the Bundesbank, gave a rather strongly worded statement on conditions in Germany at the Basle meeting, Mr. Daane continued. Mr. Blessing noted that the boom was continuing and that restrictive measures were being taken in both short- and long-term markets. Among other things he expected the rate of house construction to be dampened and considered that a desirable development. The Germans

were making a determined effort to keep prices from rising. Their balance of payments now seemed to be moving into deficit.

Turning to the preceding meetings in Paris, Mr. Daane said that the two half-day sessions of the Working Party 3 meeting on May 5 and 6 were devoted almost entirely to interrogation of the British and discussion of their situation, leaving only a brief period for review of the U.S. situation. He felt that the tone of the whole discussion was sympathetic and constructive. There was general concern about the narrowness of the margin of safety in the British program. It was felt that the British would manage quite well if all of their projections proved accurate, but that there was no real margin for error. There was general uneasiness about the degree of progress the British were making toward their goal of releasing resources to the export industries. It was thought that their program did not provide for a sufficient cut-back in domestic demand, especially since all of the cut-back called for rested on the private rather than the government sector of the economy. A budget hardly could be considered deflationary or even neutral when it called for a substantial increase in government spending. And there was some feeling that the monetary measures taken still had allowed too great a degree of credit availability, although the April 30 action on bank advances won commendation. Finally, considerable skepticism was expressed about the probable efficacy, at least in the short run, of the government's incomes policy.

The British representatives volunteered the suggestion that the whole British situation be reviewed at Working Party 3 meetings in July, September, and December, Mr. Daane continued. His own judgment was that the willingness of the continental countries to go along with the British rested more on the content of Chancellor Callaghan's letter of intent to the Managing Director of the IMF than on the government's program. In his letter Mr. Callaghan said flatly that the British were determined to take such further action as was necessary, including monetary action. It was hard to quarrel with such a statement.

Discussion of the British situation was continued in the subsequent meeting of the Group of Ten Deputies, Mr. Daane said. That meeting was concerned specifically with the question of activating the General Arrangements to Borrow in connection with the British Fund drawing. Most of the session was devoted to the wording of the communique to be issued; after the earlier meetings there was a clear initial consensus that the GAB should be activated. Only two substantive issues were considered at any length, both of which related to the composition of the proposed drawing. The gold component in the proposal had been raised to $400 million from the figures of $250 million and $350 million that had been discussed earlier. Many of the continental representatives expressed satisfaction over that increase, but a number felt that $400 million was still too low. The American representatives took no part in this discussion on the ground that it basically was a question for the IMF.

There also was some dissatisfaction expressed over the size of the dollar component, $250 million, Mr. Daane observed. The Americans indicated that they thought that amount was sufficiently high, with Under Secretary of the Treasury Deming resting the U.S. case principally on two grounds. The first was that as a matter of basic principle the Fund should not draw on the currency of a deficit country in connection with this sort of operation. Mr. Polak of the Fund endorsed that principle, but it was not accepted by the continental representatives, who pointed out that most of their countries now were in a deficit position. Secondly, Mr. Deming advanced the more pragmatic argument that the exposure of the U.S. after the drawing would be much greater than that of other countries because of the System's swap line with the Bank of England, the Export-Import Bank credit, and the volume of dollar securities in the British portfolio. The continental representatives were unwilling to accept the existence of the swap line or the Export-Import Bank credit as a justification for a low dollar component because those were matters of this country's own bilateral doing. However, they were quite willing to accept the proposition that the U.S. had what, in a sense, was an unwanted responsibility as a result of the dollar securities in the British portfolio. In any case, they agreed to activate the GAB and to go along with the revised package as proposed by the Managing Director.

The Deputies also held a preliminary discussion of the renewal of the General Arrangements to Borrow, Mr. Daane commented. The GAB would expire in October 1966, but renewal was required by October 1965.

From that discussion it seemed to him that most countries did not plan to raise questions about the general structure of the Arrangements. However, some questions probably would be raised about their duration. The original GAB had had a four-year term, but some representatives, including the French, expressed the view that a shorter term, such as two years, would be more desirable on renewal in light of the studies under way on means of improving the international payments mechanism. Mr. Deming indicated that he did not feel there was a link between the studies and the GAB, and expressed a tentative preference for another four-year term.

The final item on the agenda, Mr. Daane said, was a report by Chairman Ossola of the Study Group on Creation of Reserve Assets. Mr. Ossola outlined the Group's planned report and indicated that it would be submitted for study to the Group of Ten Deputies possibly about June 10 or 12. Decisions with respect to procedures for handling the report, as well as with respect to its substance, were left open.

Mr. Ellis asked whether any views had been expressed at the meetings on the progress of the U.S. balance of payments program. Mr. Daane replied there was a feeling that the U.S. program was working, but the continental countries were mainly interested in the way the United States viewed it--what effects were expected, how long it would be carried on, and so forth. There was very little indication of any trepidation on their part with regard to its effects on them. At the Basle meeting, he (Mr. Daane) had given a cautiously optimistic report of progress to date which seemed to have been welcomed.

Chairman Martin noted that the agenda for today's meeting called for a discussion at this point of the possibility of entering into swap arrangements with Mexico, Venezuela, and Peru. He proposed that the discussion be deferred until a later meeting when Mr. Mitchell, who originally had suggested the matter for discussion, would be present. There were no objections to the Chairman's proposal.

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 April 13 through May 5, 1965, and a supplemental report for May 6 through 10, 1965. Copies of both reports have been placed in the files of the Committee.

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

> The money market remained generally steady during the past four weeks, holding firm enough to keep Federal funds generally at 4-1/8 or 4 per cent and member bank borrowing around $400-$500 million, while also accommodating a successful Treasury refunding operation. As in the similar period of other recent years, the major money market banks benefited from temporary Treasury redeposits of April 15 tax receipts. However, the money market as a whole did not ease as it had in similar circumstances in the past, possibly because of the high rate of reserve utilization and the smaller cushion of excess reserves in banks outside the money centers.
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> System operations provided reserves on balance over the period, particularly in the latter part when normal month-end reserve drains were augmented by swap repayments and continuing substantial growth in required reserves. Much of the recent reserve need was met through short-term repurchase agreements with nonbank dealers. In this connection the Committee's recent authorization to permit such agreements against Treasury issues of any maturity, during periods of Treasury refunding, proved

particularly helpful. The System's holding of Treasury issues under repurchase agreements reached a level of $685 million on May 5--the day that subscription books closed for the Treasury's refunding. Of this $685 million, some $501 million were against rights in the refunding and if it were not for the Committee's new authorization, the repurchase agreements against rights would have had to be terminated on May 6 to the extent that dealers turned in those rights for the Treasury's reopened nine-year bond. The dealers did in fact convert their rights mainly into bonds and if the Desk had had to cope with massive repurchase agreement withdrawals a huge offsetting provision of reserves would have been needed--probably in the form of outright bill purchases which would have added to downward pressure on rates. The System also held on May 5 some $11 million of other long-term (i.e., over two-year) issues under repurchase agreements, as permitted under the revised authorization. Holdings of Treasury issues under repurchase agreement declined on May 6, but rose again to $701 million on Friday, May 7, and still included some $501 million against rights and $9 million against issues maturing in over two years.

The Treasury refunding was well received by the market after a bit of initial hesitation, and a useful amount of debt extension has been achieved. The public subscription of about $2 billion of the reopened 4-1/4 per cent bonds of 1974 was somewhat more than most market participants had anticipated. But on the whole the bonds are regarded as reasonably "well placed." Dealers have a sizable job of distribution yet to be done, but the mild market reaction to the large subscriptions to the long bonds indicates that they are approaching the task with confidence.

Treasury bills have continued in demand during recent weeks, with normal refunding demands and other seasonal demands augmented, as indicated in the written reports, by Treasury account purchases. In yesterday's auction, the three-month bill rate edged down slightly further to about 3.89 per cent while the six-month issue was sold at an average rate of about 3.95 per cent. I would see little prospect for higher bill rates on the immediate horizon, given the reduced level of dealer holdings in the wake of the refunding, and the possibility of some demand being generated by attrition from the refunding. Dealers are generally cautious, however, at current rate levels and it may well be that some upward tendency will develop as the next tax date approaches and as the period of seasonal Treasury cash needs draws closer.

There is little to add to the written reports by way of comment on other markets. Tax-exempt issues have been coming to market in good volume at slightly higher rates than prevailed

a few months ago. Today, several large issues are reaching the market, including $100 million State of California bonds. Corporate bond issues have come to market at rates very close to those prevailing earlier, but a number of these issues have been a little sticky in distribution. The sizable overhang of undistributed bonds in both markets has contributed to a certain underlying feeling of caution.

In the bankers' acceptance market, dealers' inventories have declined substantially since dealers raised their rates 1/8 per cent on April 23--partly reflecting particularly heavy purchases by a major New York City bank. During the recent period, repurchase agreements in bankers' acceptances again proved a useful adjunct of open market operations.

As far as third-country acceptances are concerned, we have distributed a new tabulation dated May 6 showing holdings in our portfolio, and propose to distribute similar tabulations at least twice a month in the future. (Note: A copy of this tabulation and of the accompanying memorandum has been placed in the Committee's files.)

Mr. Swan noted that there had been a good deal of comment about the demand for Treasury bills by public funds as one of the factors leading to relatively low bill rates recently. He asked whether such demand was expected to continue. Mr Holmes replied that a reversal was expected; public funds probably would be net sellers of bills in the period ahead, adding to possible upward rate pressures.

Mr. Robertson asked whether Mr. Holmes planned to supplement tabulations on third-country acceptances of the type distributed with a memorandum to the Committee on the desirability and workability of alternative means of reducing the volume of such acceptances in the Bank's portfolio.

Mr. Holmes said that personnel of the Bank had held several discussions of this subject and had concluded that any request to dealers for a smaller volume of third-country acceptances was likely

to produce undesirable reactions in the market and to lead to other problems, as Messrs. Hayes and Treiber had noted at recent meetings. It seemed preferable to deal with any problems in this connection at the point where the acceptances were created, rather than in the secondary market. Mr. Holmes added that he would have a memorandum prepared for the Committee outlining the reasoning underlying these views.

Mr. Balderston asked if Mr. Holmes would analyze briefly for the Committee the factors that had led the Desk to buy a substantial volume of Treasury bills on Friday, April 30, after the Treasury had announced the terms of the current refunding but before the books were open. Mr. Holmes said that as he recalled the transactions in question the System's purchases were made in response to indicated reserve needs. At the same time, the Treasury also was buying bills for its investment accounts. He thought the Treasury probably was concerned about the hesitant reception accorded the 4 per cent notes to be issued, which were priced close to the market. Although the System's purchases were made for a different reason, both sets of operations obviously had effects on the bill market.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period April 13 through May 10, 1965, were approved, ratified, and confirmed.

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. Noyes made the following statement on economic conditions:

> It often seems that the uncertainty which plagues us when we try to look ahead focuses on a particular period, and we feel that once that time has passed, many of our doubts will be resolved.
>
> Early May was such a time this year. Much of the speculation as to the pattern of economic developments in 1965 emphasized that our foresight was clouded by the possibility that by May 1 we might see either a steel strike, or an overly generous settlement, with the impact of one or the other of these alternative possibilities affecting a wide range of business decisions.
>
> As is almost always the case, the passage of time has only partially resolved the doubts that concerned us earlier and has brought its share of new ones. Nevertheless, it does seem to me that the additional knowledge that we now possess is favorable, on balance, to the continuing healthy expansion of the economy. This seems to me to be true whether one was more concerned about the possibility that a sharp curtailment of activity in steel would spread to other lines and precipitate a downturn; or, on the other hand, that the very rapid pace of the first four months would set in motion an inflationary spiral, which would be further aggravated by rising labor costs.
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> As is suggested at several points in the staff comments on the questions suggested for discussion today, we are now moving into a period when demand pressures should be less intense; that is, demands will be rising less rapidly in relation to our expanding capacity. At the same time, the shift now seems likely to be less violent than we feared earlier, partly because of the nature of the interim settlement in steel, and partly because capital expenditure plans are being revised upward. The magnitude of the change in the outlook can be illustrated very roughly with the GNP aggregates. Earlier in the year we speculated about GNP growth in the second quarter only about one-third as large as in the first--say perhaps something like $5 billion, as compared to $15 billion. Now the first quarter expansion looks closer to $14 billion or less, and a gain of $7 billion or more in the second does not seem unreasonable.
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> A more favorable view of the outlook along these lines apparently received nearly unanimous support at the meeting of the Business Council in Hot Springs last week, where both the possibility of a downturn and the danger of "overheating" got short shrift.

Naturally, as a central banker, one must view all this optimism with skepticism and, as usual, one can find some basis for misgivings. While most of the recent rise in wholesale prices is associated with a recovery in farm products from unusually depressed levels, the fact remains that the run-up last summer and fall in prices of sensitive industrial materials, which was associated at the time with transitory supply developments, has not yet been reversed. However, in fairness it would be unreasonable to expect downward price adjustments to have occurred in the period when the economy was running under the forced draft of steel strike anticipations and auto strike make-up. The time when these prices will really be tested lies just ahead.

The increase in plant and equipment expenditure plans deserves special mention, but for the short-run, some further pick-up in this area seems altogether fortunate, as does the rise in housing starts and building permits.

Retail sales hit an extraordinarily high level in February and were off a little in March and again in April. Were it not for the fact that the February figure was so obviously out of line on the high side, two consecutive months of decline in retail sales, in an otherwise booming economy, might be cause for concern. In the circumstances, it is hard to regard what has happened so far as other than a healthy adjustment, especially in the light of the fact that sales for the week ending May 1 seem to be above the normal post-Easter pattern.

Unemployment was up a little in April to 4.9 per cent from the favorable 4.7 per cent in March. Industrial production probably did not change much in April, as some seasonally adjusted decline in autos was perhaps a little more than offset by gains elsewhere. It looks like, if anything, a stronger performance than might have been anticipated on top of recent advances.

I am sure it is apparent by this time that I am straining to find faults in a situation which has generally developed more favorably than it was reasonable to hope.

To summarize, pressures on resources should ease a little as we pass through a period of steel inventory adjustment--and perhaps a lower level of auto demand--but the chances of an actual decline in overall activity now seem quite remote. At the same time, the period of maximum danger of overheating should be behind us for the moment.

Certainly, continued vigilance is needed if monetary policy is to contribute constructively to another year of reasonably stable growth on top of the four just passed, but I see nothing in domestic economic developments which would suggest that the policies of the Committee thus far this year have been inappropriate, or that they are in need of change at this time.

Mr. Holland made the following statement concerning financial developments:

This seems to me to be one of those fortunate occasions when the fog of financial statistics has also lifted a bit, enabling us to perceive a little better the terrain over which we have just come, and thereby to judge better current conditions and prospects.

The most helpful new numbers in this respect are the just-released flow-of-funds data through the first quarter, for they let us view the big bank credit bulge this year against the perspective of broader financial and economic developments. When we do so, we see that the bank credit jump was not simply the most obvious part of a massive credit upsurge, but rather a powerful competitive enlargement of the banking system's share of a total private credit flow that actually grew rather less than past relationships might have suggested.

Ordinarily, periods of vigorous growth in private GNP such as we had in the first quarter generate--and in turn are reinforced by--a relatively even more rapid increase in private borrowing, as individuals and businesses rely heavily upon external sources of funds to supplement their own internal resources. In the first quarter of 1965, however, net funds raised by the domestic nonfinancial sector expanded just about as much percentagewise as did GNP itself, and this is true whether one compares these first quarter results with the preceding quarter or with the average for the year 1964 as a whole. These data, of course, have their weaknesses, but they reflect, if anything, a shade more conservative rather than a more liberal relative use of external debt by the private sector in financing its 1965 bulge in spending. That run-up in spending had its destabilizing potential, but it lay more in the type and concentration of expenditures made than in how they were financed.

Beyond the first quarter, the available data narrow down to descriptions of the banking system and little else, with a corresponding loss of perspective. Nonetheless, one can see signs of change of pace in banking alone that ought to be indicative of some redressing of the enlarged bank share of financial flows that developed late last year. I would judge three factors to be at work dampening bank credit and deposit expansion after the first quarter: (1) some moderation in demands for financing by bank customers, (2) virtual completion of the public's shifts out of stocks of other financial assets and into time accounts in response to the attraction of the latest round of interest rate increases on time deposits;

and (3) a mild further tightening of bank reserves and relative liquidity positions, with Federal Reserve policy chiefly responsible for the former and Treasury debt management actions contributing to the latter.

The effect of these influences is not shown symmetrically in our summary banking statistics. This is in good part because a late surge of bank expansion took place at the very end of March; this rise is captured in the March data in the end-of-month series used to measure bank loans and investments, but is largely carried forward into the April numbers in the average bank deposit series which is based upon an average of the daily figures throughout each month. On an end-of-month basis, total bank loans and investments are now estimated to have risen about $1.8 billion during April. This is only about two-thirds as much as the average for the first three months of 1965, but still a shade higher than last year's pace. Business loan growth appeared down from $1.2 billion in March to $700 million in April. There still exists a vigorous demand for bank loans by business, however, as attested by the $300 million rise (not seasonally adjusted) at New York City reporting banks in the week of May 5. Leading bankers also seem to be expecting good loan demand, for prime-name banks are still pushing CD sales quite vigorously, a source of funds that they have manipulated quite adroitly this year to capture extra funds to loan to businesses when needed.

Other than New York City CDs, time deposit growth has been much slower in March and April than earlier this year, presumably reflecting the wearing out of the impact effect of higher time deposit rates. At the same time, the rate of growth of money supply rebounded in March and April to a 5 per cent annual rate, and the savings flow at mutual savings banks seemed to improve a little relative to seasonal expectations. Presumably the flow of financial savings in the direction of other nonbank intermediaries and direct market securities has also recovered somewhat in the last month or so.

This redirected savings flow can represent a needed cushion for the enlarged supplies of longer-term Federal, corporate and municipal securities now being brought to market. A concentration of these supplies in a few brief weeks, however, does create a potential short-run digestion problem that leaves the capital markets technically vulnerable to upward interest rate pressures at this juncture. This is most true of the municipal and U.S. Government markets, where dealer inventories of longer-term securities are currently large by historical standards.

In these circumstances, the "even keel" constraint on monetary policy might well be construed to extend a few days beyond the May 17 payment date for the Treasury refunding issues, just as sometimes it has been regarded as ending a few days before payment date when the refunding issues were shorter-term, dealer holdings were low, or redistribution to final investors was rapid. Furthermore, after the "even keel" period is presumed over, it might be deemed wise, in the light of the more satisfactory economic outlook described by Mr. Noyes, not to tighten money market conditions in a way that would compound upward rate pressures in the longer-term securities markets as dealers try to speed the redistribution of their current inventories of bonds.

What particular measures of money market and reserve conditions might fit within the definition of "even keel" are, of course, matters of judgment on which reasonable men can differ. The staff's own effort at a consensus in this respect is expressed in its answer to question 6.

Mr. Daane asked whether there was any evidence of pressure on banks to raise the prime rate. Mr. Holland said he had not heard much talk of increasing the prime rate lately. There was evidence of some upward pressure on rates on nonprime loans and on term loans, but there was no sign, as far as he knew, that banks were poised for an increase in the prime rate itself.

Mr. Robertson and Mr. Wayne observed that there seemed to be a tendency to dispense with the prime rate altogether. Mr. Hayes commented that New York banks appeared to be sensitive to the political implications of any change in the prime rate.

Mr. Hersey then presented the following statement on the balance of payments:

On the surface, the balance of payments outcome in March and April can be described as a surplus, without qualifications: a surplus with or without seasonal adjustment, and a surplus on either the Commerce Department definition or the "official settlements" definition. But this outcome was probably heavily influenced by the catching up of exports

after the interruptions of the port strike--as well as by the sharp reduction that has occurred in outflows of bank credit.

Since the Green Book 1/ was put out, we have gotten the March export total, and we now have enough weekly information on the settlement items to allow us to make a fair guess of the April surplus, which looks like about $200 million before seasonal adjustment. While this is much less than the surplus in March, now revised to $433 million, the difference seems to reflect mainly seasonal factors. The result in April was a decline in liabilities to foreign official accounts. And foreign private balances, which usually tend to rise in April, failed to increase.

To get around some of the difficulties of guessing month-to-month seasonal changes and irregularities, I will speak mainly in terms of average monthly figures, comparing the March-April averages with averages for the five preceding months, October through February. I will mention seasonal corrections only when they make an important difference. In the October to February period, as you know, the monthly deficits were very large, and were running at a much higher level than for the year 1964 as a whole. The shift from that 5-month period to March-April, with surpluses suddenly emerging, is very striking.

In round terms, what we have to explain is a change from an average monthly deficit on the Commerce Department definition of nearly $500 million a month in the preceding five months to an average monthly surplus of $300 million in March and April--that is, a shift in level of about $800 million.

On the official settlements basis, the change has been only about half as much. The difference between the two measures of improvement--$800 million per month on the standard calculation, and $400 million on the official settlements calculation--is huge, and I will have to come back to that later.

First we might look at the conventional measure, and inquire what were the increases in receipts and drops in payments that produced so great an improvement in the position, and also try to arrive at some judgment as to how much of the improvement was in some sense or other strictly temporary.

One factor was the reflux of U.S. corporate liquid funds. From confidential Canadian data, we know of about $400 million in March. Even if there was no further reflow in April, this

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

would explain $200 million of the monthly average overall improvement, since the net movement in the preceding 5 months was small. Continued reflows of U.S. liquid funds at that average pace seem unlikely.

Two other main elements are involved: the net outflows of U.S. bank credit, and merchandise trade. In both cases we have data only through March, but I believe that reasonable guesses can be made for April.

The part of the overall improvement that was due to the cut in U.S. bank credit outflow, which was a cut of about $250 million a month, unadjusted, we do not need to think of as strictly temporary. If things go well with the voluntary program, it may be quite a while before the question of "what next?" will have to be faced in this area. There is every reason to think that April's outflow was small, like that of March, and no reason to fear any change for the worse in the near future.

It is very different with the trade surplus. What happened in March was that unadjusted exports nearly doubled, approaching $3 billion. Though imports also jumped, exceeding $2 billion, the statistical trade surplus rose from only $50 million in February to $850 million in March. In the five months October through February, it had averaged a subnormal $400 million.

During the port strike, exports had been held back much more than imports. The catching-up process was in full swing in March, but there was still a long way to go. In April the statistical trade surplus can easily have been about as big as it was in March. By now, in May, there should begin to be a rather sharp tapering off in exports, and by June we ought to be back to a new normal trade surplus.

We will have to wait till July or August for statistics that will allow us to make a judgment of what the new normal level is. In the meantime, a guess in the range of $500 to $600 million a month seems plausible, and allows us to say that of March's $850 million trade surplus, we may have to count as strictly temporary an excess over normal of some $300 million; and something like the same will doubtless apply to April. Furthermore, actual net receipts must have been abnormally large; I find it implausible to suppose that any great amount of the delayed exports had already been paid for. If, then, we take out this strictly temporary element in the trade picture, the balance of payments on the conventional basis was not in surplus by anything like $300 million a month in March and April and may even have been in deficit.

I want to come back now to the question of why the change in the official settlements deficit since the period around the turn of the year has been so much less encouraging than the improvement in the conventional balance. In fact, when

we make a correction for the abnormal trade situation, the change looks very moderate indeed.

What has happened is this. In 1964 foreign private holders, especially commercial banks abroad, were building up their holdings of dollars in the United States--by $1-1/2 billion for the year as a whole. In March and April of this year, however, foreign private balances in the United States appear to have declined by about $250 million. Usually in April there is an increase, sometimes exceeding the usual March decline. This year, there was a sizable draw-down in March, associated with the return flow of U.S. corporate liquid funds from Canada. But our tentative figures indicate that the normal April build-up of foreign private balances failed to develop.

Now you will recall that during the year 1964, the official settlements deficit was $1-1/2 billion, while the conventional deficit was $3 billion, the difference representing the build-up of foreign commercial bank and other private balances. Around the turn of the year, in the October-to-February period, the monthly average deficit on the official settlements basis, seasonally adjusted, was heavy, about $300 million a month. The conventional deficit was heavier still, averaging $500 million a month. In March and April, however, the relationship was completely reversed. The official settlements balance was now a surplus of about $100 million (this allows for some seasonal correction but none for the trade abnormality). The conventional balance, instead of looking the less favorable of the two as it had before, was an even larger surplus, averaging $300 million a month.

In principle, one can't say that either of the two measurements is wrong. Both can be "right," because each measures a different thing. It is important that we understand clearly what we are measuring with either. The large apparent improvement in the U.S. payments situation shown by the standard calculation represents the effects of the export catch-up, plus the effects of the cutback in bank lending, plus the reflux of corporate liquid funds, plus other changes in current transactions and in U.S. capital outflow, but does <u>not</u> count as an adverse factor the apparent shift in the movement of foreign private balances from an inflow to an outflow. At a time when our concern is to halt the accretions of foreign official reserves in order to stop the gold outflow, we need to keep watching <u>all</u> the elements of the situation. One of the elements to watch is the movement of private foreign balances. Perhaps because of the drop in U.S. capital outflow, perhaps also as an effect of the temporarily high level of our exports, foreign commercial bank

balances in the United States have apparently been tending to fall in the past two months.

Our measures to reduce U.S. capital outflow are thus not immediately exerting their full force on foreign official reserves. This does not mean they are useless. The Gore Amendment and the voluntary program for the banks have made a very important change in the situation. Perhaps it was inevitable that last year's build-up of foreign commercial bank balances would slow down greatly this year. If so, the official settlements balance might have increased very sharply in the absence of the new measures. The new measures seem to be accomplishing what could be expected of them. The question remains, whether that is enough.

Mr. Hayes commented that he had found Mr. Hersey's explanation of the differences between the balance of payments figures on the two bases of measurement to be lucid and interesting. He felt that it was vital for the Committee to keep the figures on both bases in view, rather than concentrating on one to the exclusion of the other.

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) Business activity--What does the extension of the steel wage contract suggest as to the near-term outlook for industrial activity, inventories, and prices?

The interim steel agreement has had a stabilizing influence on the near-term outlook. Had settlement of a new steel contract been reached by May 1, steel production probably would be declining sharply now, as it did in 1962 and 1963, while steel consumers were using up excess stocks accumulated as a strike hedge. The interim agreement offers an opportunity for a more orderly adjustment of steel production to final consumption rates. At the same time, the terms of the agreement, and the range of the differences between the union and the companies, suggest that the final settlement is not likely to involve excessive wage and price increases in steel--or in other sectors of the economy where labor settlements in the past have tended to follow the steel pattern.

It is too early to tell how promptly steel inventories will level off or decline. The threat of a steel strike on or after September 1 continues to be a source of some uncertainty. Production is high, and is expected to decline only moderately over the next month or so, even if shipments fall as is expected. Some further increase in steel stocks is likely up to midyear, but at a rate substantially lower than in recent months. The impact of the settlement, therefore, on the near-term outlook for overall economic activity may show mainly in a reduced rate of inventory accumulation without significant repercussions outside the steel industry.

There is no evidence as yet that the 2.6 per cent wage increase provided in the interim agreement will give rise to any appreciable steel price increases. Since 1962, labor costs per ton of steel have been declining. The steel wage increase is well below that granted in the earlier auto settlement, and less than the average rise in manufacturing or the increases provided in the recent can and rubber pacts. Current negotiations in the aluminum industry, and those coming up prior to September 1 in aircraft and shipbuilding, are not expected to produce any breakthrough in the general pattern of recent wage trends.

Even though wage cost increases have on the average been maintained within the economy-wide rate of gain in productivity, some selective price increases may, nevertheless, follow contract settlements. For example, the can industry raised prices by 1 per cent, and some increases have been reported in tire prices. Over all, however, the industrial price level has edged up only slightly so far this year.

(2) Capital spending--What are the implications for sustained economic activity of the higher levels of capital spending now being projected by businessmen?

The higher levels of business fixed-capital spending now being projected for 1965 strengthen prospects for continued economic expansion throughout the year. Results of the McGraw-Hill survey conducted in March-early April indicate a rise in capital spending from the fourth quarter of 1964 to the fourth quarter of 1965 of about 13 per cent,

substantially above the 7.5 per cent gain projected earlier and not far below the large increase (16 per cent) posted over the preceding four-quarter period. The raising of business investment sights provides some offset to the expected slackening in the pace of inventory investment.

Pressures on capacity appear to be a major influence contributing to this year's large planned increases in capital spending. According to the McGraw-Hill report, manufacturers will place much greater emphasis on capacity expansion this year than in the preceding five years. Manufacturers reported that on average they were operating at 88 per cent of capacity at the end of 1964, and nearly one-third were operating at or above preferred capacity utilization rates. Further expansion in factory output in the first quarter probably brought the average capacity utilization rate to 90 per cent, a factor undoubtedly contributing to the recent step-up of investment plans. Manufacturers now plan to expand capacity by 6 per cent this year, as compared with their stated increase of 4 per cent last year. The prospective large increase in capacity is an encouraging element in the outlook for price stability.

(3) Balance of payments--How do the major types of capital flows in the U.S. balance of payments appear to be responding to the program of voluntary restraint?

Judgments about program effects are necessarily still tentative, but the partial information, statistical and other, available on developments since February 10 is moderately encouraging. As noted below, significant declines have occurred in outflows of long-term and short-term bank credit.

There have been some further term-loan commitments by banks to borrowers subject to the IET since the Gore Amendment went into effect, but through April these apparently amounted to less than $60 million. Commitments to borrowers in the less developed countries were large, amounting to about $200 million in this two-and-a-half month period, with the greater part in March and significantly less in April. On an annual rate basis, commitments to the less developed countries were about equal to their 1964 average, though much less than their rate in the latter part of 1964 and first six weeks of 1965. In contrast, the flow

of new commitments to industrial countries was reduced to roughly one-fourth of its 1964 rate.

The actual net outflow of long-term bank credit during March (revised preliminary data from the Treasury's Form B-3) was $43 million--an annual rate (without seasonal correction) of about $0.5 billion, or about one-half the rate in the year 1964. The outflow in April may have been at least as great as in March, since it is known that one very large individual loan committed in March was scheduled for disbursement in April.

Tentative indications (inferred from the Federal Reserve Form 391) are that net bank-reported short-term outflows in March were much less than the $100 million shown in the Green Book, and possibly close to zero. If the figure turns out to be at this lower level, it would represent a drop of about $100 million from the average of the five preceding months. The corresponding drop in 1964 was $54 million. It seems clear that a significant decline has occurred from the rates of these short-term outflows experienced earlier--$1.5 billion in the year 1964 as a whole, and somewhat under a $1 billion annual rate in the five months from October through February.

For direct investment outflows, preliminary quantitative information covering the first quarter will not be available until June. The Department of Commerce has been obtaining single-figure estimates from large corporations with foreign subsidiaries and branches of the planned change between 1964 and 1965 in each company's own "balance of payments" (including its exports to all areas as well as its investment income from and capital outflow to industrial countries, but not including its imports). Assistant Secretary Brimmer stated in a recent speech that these reports indicate a planned $1.2 billion improvement in 1965, occurring principally through export expansion rather than curtailment of new investment.

The remaining major types of identifiable capital flows in the U.S. balance of payments are securities transactions and movements of liquid funds. Securities transactions are affected by the IET where it is applicable, and the program of voluntary restraint for nonbank financial institutions may possibly have some influence on them. However, the sharp drop in purchases of new foreign securities (seasonally adjusted) from $600 million in the fourth quarter of 1964 to about $300 million in the first quarter of

1965 is unrelated to the program, and represents largely the ending of a temporary bulge in Canadian new issues in the United States.

With respect to U.S. corporate liquid funds, the only sizable inflows since mid-February thus far identified are from Canada. Confidential Canadian data show a decline in March in their banks' U.S. dollar liabilities to others than banks in the United States of $375 million. In turn, Canadian banks reduced holdings with their agencies in New York in March by about $320 million. Both of these movements were in good part seasonal.

The reflux of U.S. funds from Canada benefits the U.S. balance of payments as presently computed. However, this reflux is offset by the decline in Canadian bank holdings of U.S. dollars in New York if the balance is calculated on an "official settlements" basis.

(4) Savings flows--What are the implications of the recent abatement in time deposit growth for the overall volume and composition of funds being supplied to credit markets?

Rapid growth of commercial bank time deposits early in 1965 resulted mainly from shifts among existing stocks of financial assets in response to increases in rates on savings deposits and CDs, rather than from a growth in total financial saving. Net acquisitions of all types of financial assets by consumers and corporations together increased only marginally in the first quarter, according to preliminary flow-of-funds estimates. Shifts in asset preferences were reflected in reduced demands for money balances, for claims against nonbank intermediaries (especially savings and loan shares), and also for market securities.

The large first-quarter increase in time deposits, together with the rise in Treasury balances at commercial banks, permitted an enlargement of funds supplied by the banking system at a time of strong demands for credit. Credit demands were heavily concentrated in categories of financing--such as business loans and consumer credit--in which banks participate most actively. Since last fall banks have been able to finance a large customer loan expansion and to increase their purchases of municipal securities without heavy liquidation of Treasury issues. In both the last quarter of 1964 and the first quarter of 1965 the share of total funds supplied by commercial banks was higher than in the first three quarters of 1964.

Slower growth of time deposits during March and April seems principally to have reflected the completion of the adjustment to the higher level of interest rates mentioned earlier. To some extent, however, it probably also reflected larger-than-usual deposit withdrawals for payment of individual income taxes in those two months. Barring further changes in interest rate relationships, the pace of time deposit expansion in the months ahead should continue to be less rapid than in January and February.

Continued growth in economic activity and a likely rise in the ratio of financial saving to income from the rather low first-quarter level probably will increase the volume of total financial saving considerably in the second and third quarters. With slower growth of time deposits expected, the share of the enlarged total savings flow channeled through the banking system should be significantly smaller in the coming months than it was during the first quarter.

(5) Bank credit--What do recent developments suggest as to the pace of business demands for bank credit?

After rising rapidly in the first quarter, growth in business loans at all commercial banks moderated in April, with the abatement of some temporary stimulating factors. Indications are that business loan demands over the next few months will remain relatively strong, but will expand considerably less rapidly than in the first quarter of this year.

The moderation of business loans in April reflected the continued unwinding of temporary factors that raised bank lending so sharply earlier in the year. There was, for example, more than seasonal repayment of the commodity dealer loans built up during the dock strike. In addition, there was probably further abatement of foreign lending as commitments were cleaned up in line with the voluntary credit restraint program.

Continued steel stockpiling in anticipation of a May 1 shutdown, on the other hand, led to a strong contraseasonal increase in borrowings by the metal and metal products industries. April business loans were also probably increased somewhat by the over $500 million of additional corporate tax payments under the revised tax payment schedule.

Beneath the cross-currents induced by these temporary factors a basically strong underlying loan demand is evident. Loan demands in April were particularly strong in miscellaneous manufacturing and mining

and construction, and also showed some strength in trade and textiles. A further sharp increase in business loans took place at New York and Chicago banks in the first week of May.

The industrial distribution of business borrowing thus far in 1965 suggests that bank loans have been used to finance growth in capital spending as well as working capital needs. The impression that recent financing needs of firms have been partly of a long-run nature is reinforced by the increase in the ratio of term loans to total loans to a record high in New York City. Upward revisions of plans for plant and equipment spending implied by the recent McGraw-Hill survey, together with the continuing need for some inventory financing, suggest that business loan expansion will continue vigorous over the next few months, but probably less so than in the first quarter of the year.

(6) Money market relationships--Assuming a continuation of current monetary policy and taking into account the Treasury refunding, what range of money market conditions, interest rates, reserve availability, and reserve utilization by the banking system might prove mutually consistent during coming weeks?

Market activity associated with the current Treasury financing has produced some slight further reduction of bill yields relative to other money market rates. The financing stimulated additional demand for bills from holders of "rights," and this demand was supplemented by official bill purchases in the market in the last statement week totaling about $650 million (about two-thirds of which was for Treasury accounts). Under these conditions the yields on 3- and 6-month bills declined to trading levels of around 3.90 and 3.96 per cent, respectively, despite continued tautness in the Federal funds market and the maintenance of relatively high rates on negotiable CDs, bankers' acceptances, and dealer loans.

Net borrowed reserves of banks in recent weeks have been close to $100 million, somewhat below the average in late March and the first half of April. Borrowings have varied in a wider range, as is usual, but the $465 million average for the last three weeks was only slightly below the preceding 3-week period. In addition to the relatively high level of member bank borrowing, nonborrowed reserves increased rapidly in April, as Government deposits rose sharply and private demand deposit expansion continued brisk. The money supply rose at a 5.3 per cent annual rate, and the

demand deposit component at a 5.8 per cent rate. Time deposit growth, however, slackened further last month.

In coming weeks, conflicting pressures will be at work in the money markets. Downward pressure on bill yields will be exerted by the unusually low current level of short-term bills in dealers' inventories and by the reinvestment demand resulting from attrition in the current refunding. Upward pressure will come from cessation of heavy bill purchases by sellers of "rights" and by official accounts, from expected redistribution of reserves away from money centers, and from continuation of vigorous bank loan demand. On balance, it seems likely that net borrowed reserves in the $100-$150 million range would be associated with some modest net upward pressure on bill yields. In this environment, yields on 3-month bills would be likely to rise above 3.90 per cent again, while other sensitive money market indicators, such as rates on Federal funds and dealer loans, should continue firm.

Private demand deposits may continue to rise fairly rapidly in the next few weeks, particularly if there is a shift of balances out of Treasury accounts. The yield structure specified above is not likely to generate deposits through encouragement of bank acquisitions of bills and other money market instruments. On the other hand, economic expansion is adding to transaction needs for money, and under the reserve and market conditions specified, demand deposit growth appears likely to continue at a rate averaging perhaps around 4 per cent in the next few months.

The immediate outlook for longer term interest rates is greatly dependent upon dealers' success in retailing their more than $500 million awards of the reopened 4-1/4's of 1974. This is a larger position in the 4-1/4's, by almost $100 million, than they took when the same issue was offered at this time last year, and dealers' total position in over-5-year issues is now about $500 million above last year. Also, financing costs are now much closer to the 4-1/4 per cent coupon than last year. If dealers encounter difficulty in distributing their holdings of the 4-1/4's, long-term markets may be vulnerable to some upward interest rate pressures. Also contributing to this vulnerability is the relatively full calendar of corporate and tax-exempt bond offerings, and the continuing heavy dealer inventories of the latter. Nevertheless, investor confidence in

current market rate levels is shown by the sizable ($2 billion) public exchange for the 4-1/4's in the Treasury refunding.

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

Business activity. The business situation is strong, and there continue to be confirming signs that the outlook for the balance of the year is brighter than was thought likely several months ago. The postponement of the strike deadline in the steel industry should lead to some downward adjustment in production in that industry, but not so much as might have occurred if a final settlement had been reached--some users will doubtless continue to build up stockpiles. After we make due allowance for some upward bias in the McGraw-Hill survey of business spending on plant and equipment, the latest survey still suggests that the advance during 1965 is likely to exceed earlier expectations. High levels of capacity utilization and of corporate profits and cash flows provide a firm backing for expanded capital spending. It is also good to note accumulating evidence that residential construction activity is bottoming out. These and other data raise the possibility that overall economic activity will show both a higher level and a steeper growth rate than seemed probable a few months ago.

Prices. While the terms of the ultimate steel settlement are of course a continuing major uncertainty, there is some ground for encouragement in the moderate nature of the interim agreement and, with respect to industry in general, in the tendency for wage settlements so far this year to be about in line with the guideposts. However, I find cause for concern in the fact that producers in several areas continue to test markets with higher prices, in some cases successfully, as evidenced most recently by the price increases for copper and tires (and, I might add, aluminum) and by the mild upward drift in raw commodity prices and industrial wholesale prices. Even if various upcoming labor negotiations are settled on reasonable terms, they may offer an excuse for higher prices in the present buoyant business atmosphere. Fortunately, there still is little evidence that upward price pressures are substantial enought to be having any appreciable effect on businessmen's inventory decisions--but we must keep a close eye on this area for possible adverse tendencies in the coming months.

Balance of payments. The President's balance of payments program has been an important factor in the sharp improvement in the balance of payments figures in March and April. It has contributed to a large-scale repatriation of short-term funds from abroad and is responsible for keeping the rise in outstanding bank loans to relatively moderate proportions. An analysis of the performance of Second District banks reveals that they have made a determined effort to comply with the guidelines. In the corporate sector the program's principal effect appears to have been the repatriation of short-term funds. I am troubled by the fact that we have had no indications of significant deferments or cancellations of direct investment projects in the sensitive Common Market area. Besides the effects of the President's program, there were two other significant factors behind the recent payments improvement. As usual, U.S. corporations repatriated large amounts in March to meet regular tax and dividend needs; and the end of the dock strike in early March led to a very sharp rise in exports and in our export surplus.

Although the balance of payments outlook for the second quarter is clearly favorable, it would be very unwise to let this lead to any feeling of complacency over the payments problem. Since the President's program represents a temporary line of attack designed to give time for more basic improvements, we must do all we can over the coming year or so to contribute to that basic betterment.

Bank credit and money. Following the record bank credit expansion of the first quarter, at an annual rate of nearly 13 per cent, the preliminary estimates for April suggest tentatively a reversion to a growth rate about in line with that of the past few years--a rate which has appeared generous and perhaps excessive in relation to the real growth of the economy. Loans continue to account for most of the total bank credit increase, and business loans remain strong. Total reserves and required reserves grew in April at a rate exceeding even the substantial pace of the first quarter--but the April figures were almost certainly influenced by a change in the mix of the deposit expansion. This change in mix probably reflects largely the completion of adjustments to the late-November Regulation Q liberalization. The annual rate of growth of the money supply and time deposits combined in the first four months of 1965 was 8.6 per cent, well above the 6.1 per cent for the corresponding period of 1964. Whereas some of this steep gain had earlier seemed to reflect the strengthened competitive position of the commercial banks--in the credit market because of the unchanged prime rate, and in the deposit market because

of the change in Regulation Q--it is interesting to note that the public's total nonbank liquid assets grew in the first quarter at a rate of 8.6 per cent, i.e., in effect just as rapidly as money supply and time deposits combined.

Monetary policy. It would seem appropriate to try to maintain even keel conditions in the money market during the coming two weeks, since the new Treasury securities will not be delivered until next Monday, and particularly in view of the heavy subscription to the longer 4-1/4s, which may make for a relatively sensitive "after-market." Thus I believe monetary policy should not be changed in the period in question. Because of significant temporary influences in the bill market, we probably must resign ourselves to continuance, for a time, of the current relatively low level of bill rates, even though net borrowed reserves are maintained in the $100-200 million range. No change in the directive is needed at this time, apart from an updating of the reference to the Treasury financing. The draft directive prepared by the staff appears acceptable, with a slight change in the wording of the statement with respect to the balance of payments. 1/ In place of the phrase of the first sentence which reads "and some apparent improvement in our international payments position," I would suggest "and a beginning toward improvement in the U.S. international balance of payments."

Looking a little further ahead, I think it likely that we shall have to take some further steps to check the recent growth of bank credit. A slower pace would clearly be desirable in view of the latent price threat and the over-riding importance of improving our international payments position. Some further tightening would seem to carry little risk in view of the evident very considerable strength of the economy.

Mr. Shuford remarked that, as had been fully pointed out this morning, from all indications the domestic economy was continuing a strong and widely-based expansion. Recent surveys suggested no reversals in the immediate future and, for the present, the interim steel settlement had avoided a strike and its accompanying adverse economic effects.

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

Economic activity in the Eighth District had generally kept pace with the national advance, Mr. Shuford said. Measures of production, employment, spending, and bank credit had all risen markedly since last fall, although there had been some slowing in recent weeks.

While there still was little evidence that price movements had departed from the patterns of the past several years, there was some indication of increases and Mr. Shuford was inclined to believe that the economy might be approaching a point at which significant price increases were imminent. In his judgment the Committee should be prepared to foster a moderating monetary environment if excessive demand appeared.

With respect to the international situation, while basic problems remained, the most recent data suggested some moderate improvements to Mr. Shuford. The voluntary credit restraint program had been reasonably effective; whether the improvements would continue or could be maintained, of course, remained to be seen.

Mr. Shuford noted that the strong demands being generated by the domestic economy had tightened financial conditions somewhat since last autumn. The structure of interest rates had moved up more in the five-month period from November to April than it had in the preceding year. The increase occurred despite seasonal forces tending to push interest rates down. The money supply had expanded 3.6 per cent in the year ending last November and, according to weekly data, the average growth in money had continued at a rate near that from

November to date. Although the rise in bank credit, particularly loans, had accelerated in recent months, part of that rise probably represented an expansion in the banking system's share of credit rather than net additions to credit in the economy.

On considering those factors--the strength in the domestic economy, reasonable price stability, and the absence of a compelling reason to take restrictive actions on account of international considerations--and in view of the Treasury financing, Mr. Shuford favored no change in policy today. In this connection he noted that the Committee would meet again in two weeks. The staff's draft directive was acceptable to him.

Mr. Bryan reported that the performance of the Sixth District economy seemed to be good by the usual statistical measures. In fact, on the basis of employment in particular and some other measures, the District was doing better than the nation. The one development that gave him some concern was that the value of new construction contracts in the District had been a sixth less during the first quarter than a year ago.

Mr. Bryan said he had little comment on the staff questions. Postponement of the steel strike, under the announced terms, seemed to him to set a minimum for the prospective settlement, and probably more could be expected. It allowed more time for steel stockpiling, and for a developing hedging against the expectation of selective price increases.

Capital spending plans were encouraging and all to the good, Mr. Bryan remarked, subject only to the recognition that capital plans, until they were far committed with cash outlays, were subject to rapid cancellation. There was nothing in the Sixth District in the way of hard facts that gave an independent judgment on the balance of payments figures or on the voluntary credit restraint program. His opinion was simply that it was undoubtedly having a favorable effect; but other factors were having an unfavorable effect, and the net balance of forces was unclear at the moment. On the savings question, he would merely note that of the gains in savings accruing to commercial banks in the first quarter not all had been at the expense of the savings and loan associations and mutual savings banks. The time deposit growth, therefore, was in part "for real." While this savings growth rate in commercial banks was now coming down out of orbit, the savings flows outside the commercial banks were again picking up.

As Mr. Bryan looked at the figures, except for the Federal funds rate, the behavior of other money market rates had been essentially easy. Longer rates had been easy to steady. He would again draw attention to the growth in reserves. From January through March (seasonally adjusted at an annual rate), total reserves had gone up by more than 9 per cent, nonborrowed reserves by just under 6 per cent, and total required reserves by 8 per cent. Under those circumstances he could do no more than repeat the suggestion he had

made heretofore--if the Committee was going to give instructions essentially in terms of free reserves, its target should move further into a net borrowed reserve figure. As soon as the Treasury refunding was out of the way, Mr. Bryan thought the Committee should move toward a $150 million target rather than the figure of $100 million that had been characteristic of recent weeks.

Mr. Bryan believed it was clear that the Committee had to halt what he regarded as a completely excessive reserve expansion. He took no comfort in the behavior of prices. He thought the System would need to make its discount rate effective by keeping the banks, in the absence of untoward developments in the money market and money market rates, more heavily in debt at the discount window than had generally been the case in recent weeks. He advocated no change in the discount rate at this time. Some change in the directive seemed desirable, but he had no specific suggestions.

Mr. Hilkert observed that economic advances had been common for over a year now in the Third District. Recently--since December--those advances ceased in a number of the District's major economic areas, but since March the tempo had picked up again. Unemployment rates again had stabilized or had begun to drop; output was increasing; and store sales were strong, but as usual were not keeping up with national increases.

Unemployment claims remained at very favorable levels relative to similar periods of recent years both in Pennsylvania and Delaware,

Mr. Hilkert said. Unemployment rates (insured rates, seasonally adjusted) were down or stable in April in all but one major labor market. Electric power consumption by manufacturing industries in the District retained an unusually favorable position relative to national output measures, and increases in manufacturing employment confirmed the strength in output.

Capital spending plans in the District, as in the nation, had been raised substantially since earlier estimates, Mr. Hilkert continued. Manufacturers in the Philadelphia Metropolitan Area now planned to spend $526 million on plant and equipment in 1965. That represented an upward revision of nearly 17 per cent since previous estimates made in October 1964, and, if realized, would be an increase in capital expenditures of almost 35 per cent over last year's figures. Most other areas in the District also showed sizable upward revisions. This spring's findings for the Philadelphia Metropolitan Area continued an upward trend which began in 1962. Since then, Philadelphia manufacturers each spring had raised their fall estimates, and also had increased the actual amount spent on plant and equipment each year.

On the financial front, Mr. Hilkert reported that business loans in the District had lagged behind those in the nation. Since the beginning of the year, for example, business loans at District weekly reporting member banks had increased by less than 1 per cent, while national business loans were up by almost 6 per cent.

As for the steel outlook, Mr. Hilkert continued, a brief discussion with the largest producer in the District revealed that that company's shipments since the contract extension agreement were less than in other recent months, but only slightly so, and that there had been very few order cancellations. That producer expected orders to pick up in August, with the pickup perhaps related more to anticipations of rising prices than to anticipations of a strike.

Mr. Hickman said that events of the past few weeks had altered his appraisal of the near-term outlook for business only with respect to timing. Thus, in response to the staff's first question, the interim steel contract suggested to him the following changes in the outlook: (1) improved prospects for steel production, possibly through August, which would contribute to a larger total tonnage for 1965 than had been previously thought likely; (2) deferral and enlargement of the inventory liquidation to come when final settlement was reached; and (3) a possible carry-over of the steel adjustment problem late into 1966.

In view of a continued, but slackening, rate of inventory accumulation of steel, Mr. Hickman continued, the iron and steel component of the production index would probably change little in months immediately ahead. At the same time, the auto component, although continuing at high levels, would probably trend slightly downward. When the steel liquidation phase began, it might be expected to exert a drag on the production index of as much as 1-1/2 points from current levels, stretched over a period of six to nine months.

So far as the steel wage-price question was concerned, Mr. Hickman believed that the final settlement would be close to the guidelines on the wage side and would not involve a general steel price increase. While "selective" advances in isolated product lines were possible, they were unlikely to hit the big-tonnage items of the flat-rolled group, where product differentiation was minimal. Recently, there seemed to have been a renewed flurry of price increases in other industrial items, including aluminum, copper, tires, and trucks. While the weights of those items were small in the broad price averages, upward movement was again discernible in the diffusion indexes, which suggested the need for continuing close attention to price developments.

With reference to the staff's second question, Mr. Hickman said, the expected continuation of strong forward movement in capital spending this year was all the more important because of developments to which he had just referred. Also, the Cleveland Reserve Bank's spring survey of capital spending plans in the Cleveland area showed a substantial gain for 1965 over 1964, like the Philadelphia plans reported by Mr. Hilkert. The improvement was concentrated in the second half of the year. In addition, he noted that the McGraw-Hill survey suggested continued strength in capital spending next year. Such strength might be crucial for the economy in light of the presently expected additional fiscal drag in early 1966, resulting from higher social security taxes, if not corrected by appropriate adjustments in timing of tax payments.

In regard to the balance of payments situation, Mr. Hickman remarked that there was very little that could be added to the staff's

comments in the green book. It was gratifying that banks and corporations were apparently responding favorably to the voluntary credit restraint program. While reports from Fourth District banks suggested some difficulty in meeting the guidelines, there were indications of progress, and it was only a matter of time before appropriate adjustments were made. Reports from large District corporations confirmed that efforts were being made to cooperate with the President's program.

On the matters of savings flows and bank credit (questions 4 and 5), Mr. Hickman commented that the recent abatement in the growth of time deposits should have only a limited effect on the volume of credit available for investment. Against the background of System policy and relatively large savings flows, there should be little difficulty in meeting demands for credit, short of an unexpectedly large run-up in capital spending. Special factors that sparked a marked expansion in business loans earlier this year had passed, except that the deferral of the steel adjustment might extend business borrowing in that area temporarily.

Insofar as policy over the next two weeks was concerned, Mr. Hickman thought that the Committee had no alternative, given the current Treasury refinancing operation, but to maintain an even keel within the policy directive adopted at the last meeting (or the one recommended by the staff for this meeting, since the two were substantially the same). Since such a directive would call for no change in money market conditions, he again 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--within, say, a range of $50 to $150 million. Since the 91-day bill rate had been somewhat below the desired range, and since covered differentials were moving slightly against the United States, he would like to see the Treasury either issue a strip of bills or add to the existing supply of bills through the regular weekly auction, if and when such action was feasible.

Mr. Maisel said he had nothing to add to the staff materials and preceding comments of members nor did he have any changes to propose in the directive.

Mr. Daane remarked that he had little to add to what had been said. He agreed that the securities issued in the Treasury financing still had to be fully digested, and that an even keel policy therefore was called for until the Committee met again in two weeks. With regard to the balance of payments reference in the directive, he thought it would be desirable to avoid the evaluations implicit both in the use of the word "apparent" to qualify "improvement" as proposed by the staff and in the alternative phrase that Mr. Hayes had suggested. Moreover, he would not favor another minor change proposed by the staff--from the "balance of payments" to "payments position"--particularly since the Committee presumably would not change its policy today. He saw no purpose in changing words for the sake of change itself. Accordingly, he recommended that the phrase read "and some improvement in our international balance of payments."

Mr. Shepardson said that he also had little to add. He thought the staff reports indicated a generally favorable economic situation, although he was concerned that too optimistic an attitude was taken with respect to some indicators. He shared the concern Mr. Bryan had expressed; the recent rate of credit expansion was very high and in his judgment the Committee should be looking toward some tempering of that rate. In view of the Treasury financing, he agreed that it was appropriate for the Committee to make no change in policy during the coming two weeks, but he hoped that the Committee might be able to move to a little lower rate of credit expansion subsequently.

With regard to the directive, Mr. Shepardson shared Mr. Daane's view that the word "apparent" should be omitted from the reference to the balance of payments improvement. He also questioned the proposed insertion of the word "further" before "growth in the reserve base, bank credit, and the money supply." The addition of that word implied to him that higher growth rates were desired; if anything the Committee should be leaning toward lower rates of growth. Accordingly, he would omit the word "further."

Mr. Robertson then made the following statement:

> It seems to me that the weight of the evidence before us this morning calls for no change in monetary policy during the next two weeks.
>
> With regard to the business situation, I find my view neatly summed up by the first sentence appearing in the Green Book, which says: "Changes reported in the domestic economic scene since early March have been of a kind generally conducive to further expansion in activity over the near-term without widespread price advances." A moderate slowing down in the pace of business expansion is taking place, but for reasons that do not call for a prompt response on the part of monetary policy.

On the financial side, too, some signs of moderation and readjustment are showing. Bank loan demand is not so unremittingly strong, and the latest money supply and time deposit figures seem to be explainable as readjustments from their unusual January-February performance. Bill rates have drifted down a bit in connection with the Treasury refunding, and I am not happy about the extent to which that may have been deliberately brought about by heavy official purchases of bills instigated by the Treasury for purposes of sweetening the refunding. But I am not concerned about the lower level of the three-month bill rate per se. I think fluctuations in yields, dowrward as well as upward, ought to be expected and allowed to occur as part of the regular functioning of the market. In addition, I do not believe this, or even an appreciably lower, bill rate would constitute any threat to the balance of payments improvement we are seeking to achieve. Short-term interest-sensitive fund flows seem to be fairly well in hand and we should concentrate our general economic and monetary policies on our more fundamental objectives.

I am concerned about one aspect of the securities markets: the possibility that some upward adjustment of longer-term interest yields might take place under the weight of current Federal, state, local, and corporate bond marketings. I would not want to try to tinker with the long market to interfere with some temporary yield fluctuations that might occur as part of the process of digestion, but I also would want to be careful not to have our monetary policy either trigger or aggravate such a development. Accordingly, I would favor having the Desk aim at keeping money market and reserve conditions unchanged between now and the next meeting of the Committee.

I would vote to approve the current directive to the Manager as drafted by the staff. I would prefer, however, as I mentioned last time, to substitute "support" for "reinforce" in the last sentence of the first paragraph, in order to avoid any connotation that further tightening is needed or desired.

Mr. Robertson added that he agreed that the word "apparent" should be deleted since the facts certainly indicated some improvement in the balance of payments, and he would also delete the word "position" after "international payments." However, he did not favor omitting the word "further," as suggested by Mr. Shepardson.

Mr. Wayne reported that the steady advance of Fifth District business continued with strength evident in almost every sector. Over half of the respondents in the Bank's latest business survey anticipated further gains in the weeks immediately ahead, and the others were confident that current strength would be sustained. Rates of insured unemployment declined more than seasonally over the first four months of the year. The outlook for the District's agricultural sector, however, was somewhat less favorable than for the rest of the economy. Last week the new acreage-poundage program for flue-cured tobacco was approved by growers. Even if that new program spurred tobacco farmers to produce a better-quality, higher-priced product, as was anticipated, the net effect might be to reduce income from this year's marketings by as much as 10 or 15 per cent, from $718 million to $650 million or perhaps even to $600 million.

The outlook for general business continued favorable, Mr. Wayne said. While the interim steel settlement had not eliminated the uncertainty surrounding that industry, it had at least pushed the critical point four months into the future. Steel consumption remained strong and, given the political situation in steel labor, it appeared likely that contract negotiations this summer would provide steel users with a continuing incentive to maintain inventories at high, if not rising, levels. For the near term, the diminished urgency of strike-hedge buying and the possibility of some slackening in automobiles and durable goods output might lead to somewhat lower steel production figures. It was too early to assess the impact on prices of the current steel negotiations, but he was not optimistic on that score.

Considering the longer-term prospect, Mr. Wayne said, it now seemed clear that business plant and equipment spending would continue to be a stimulating factor for the remainder of the year. Coupled with probable increases in Federal Government spending for defense and perhaps also for welfare, those outlays might well insure a continuation of the present expansion even in the face of a major interruption in steel in the second half. The latest Newsweek survey, however, showed a significant reduction in manufacturers' capital appropriations in 1964's fourth quarter and was a reminder that businessmen's stated investment intentions were not always matched by their actual investment performance.

In the international area, Mr. Wayne observed, there seemed to be substantial evidence that the voluntary restraint program had reduced, at least temporarily, all major types of capital outflows. The program appeared to have been especially effective in curtailing bank term loans to foreigners and, judging from the behavior of short rates, in promoting return flows of liquid capital. He also was encouraged by reports of postponement of foreign investment plans and of stepped-up borrowing abroad by U.S. corporations. At the present juncture, however, the magnitude of the improvement, as well as its permanency, was uncertain. In the absence of more supporting data than had been provided to date, the estimated $1.2 billion improvement indicated for this year in the reports by U.S. corporations to the Department of Commerce seemed optimistic to him.

Mr. Wayne recalled that at the last meeting he had suggested the possibility that the demand for bank loans might ease, and there were indications that that might be happening. During the four weeks ended April 28, commercial and industrial loans made by weekly reporting banks declined slightly, probably reflecting the receding effects of the dock strike, the reduction in foreign lending, and some small slowdown in automobile sales. Further, some slowing in consumer credit loans seemed possible in the immediate future. During the first quarter of 1965 the monthly increase in outstanding instalment credit was about 40 per cent above the average monthly increase for last year. Commercial banks increased their holdings of instalment loans by almost 60 per cent more than last year's average rise. Such sharp increases as those, coming after a long and sustained rise in consumer credit, were usually followed by a much slower growth. On the other hand, expanding outlays for plant and equipment were being financed to some extent by term loans from banks and that might help sustain loan demand.

In the policy area, it seemed to Mr. Wayne that the Committee had realized little in the way of results from its last two moves to firmer conditions. It was true that marginal reserve availability had declined substantially as free reserves of $32 million in February gave way to net borrowed reserves of about $140 million in April, but the impact of that change on the rate structure had been small indeed. Long-term rates had held steady or declined very slightly while some

short-term rates had risen slightly and others had barely moved. He was aware that in recent weeks the repatriation of funds from abroad, heavy institutional demand for bills, and the current Treasury refunding might have distorted the relationship between the Committee's policy posture and some money rates. Some of the effects of those factors might diminish soon and perhaps some rate adjustments would be seen, but in the face of the Committee's tightening moves, total reserves, nonborrowed reserves, and bank credit had increased at rates well above the average for last year. The behavior of those indicators made Mr. Wayne doubt whether the Committee had in fact tightened. In any event, if loan demand eased off and if there was some slowdown in the automobile and steel industries, there might be no need for firmer credit conditions. In view of that possibility and because of the Treasury refunding and the early date of the next meeting, Mr. Wayne favored no change in policy at this time. The directive as prepared and submitted by the staff with such changes in wording as the Committee might be able to arrive at was satisfactory to him. He thought the substance of the draft directive was appropriate.

Mr. Clay observed that recent developments in the domestic economy suggested a moderation in the pace of economic activity from the unsustainable rate of growth of the first quarter. It was evident that automobile sales were adjusting to a more reasonable pattern. While the interim steel agreement avoided the abrupt adjustment of a strike or a final settlement, it probably would have some moderating influence on output. Those adjustments were taking place in an

environment of general economic expansion. In that connection, the economic outlook was bolstered substantially by the latest projections on business capital outlays. Moreover, the prospective extension of industrial capacity should be an important factor in maintaining relative stability of prices.

Bank credit developments also appeared to be moderating, Mr. Clay said, as several temporary factors requiring a larger volume of business loans earlier in the year had abated. The underlying demand for credit remained strong, however. Continued expansion in economic activity, including business capital outlays, required a larger volume of financing.

The staff statement indicated that the international balance of payments developments were on the encouraging side, Mr. Clay commented, but it obviously was too early to know the magnitude of the improvement and the ultimate impact of the Administration program.

The domestic situation as well as international payments developments suggested to Mr. Clay that monetary policy should be continued unchanged. The period of digestion following the Treasury refunding also indicated a continuation of the present monetary policy during the next interval between Committee meetings. In carrying out such a policy, Mr. Clay said, it should be the aim of the Committee to maintain money market conditions essentially unchanged. No special effort should be made to move the Treasury bill rate upward, and reserve availability should not be reduced for that purpose. Neither should monetary policy action be permitted to put pressure on longer-term

interest rates. In his opinion no change should be made in the Federal Reserve discount rate. The draft economic policy directive appeared satisfactory to him.

Mr. Scanlon reported that economic activity in the Seventh District remained strong. Shortages of skilled labor were evident in additional areas. Durable goods producers continued to receive a good flow of new orders and were optimistic that those would continue. The Chicago Reserve Bank continued to receive reports of new expansion programs as firms encountered continued strong demand for their products.

The Bank's contacts in the steel industry indicated that output was expected to decline only slightly through the remainder of the second quarter, Mr. Scanlon said. There had been surprisingly few order cancellations or postponements following the four-month extension of the strike deadline. While there was some evidence that production of goods containing steel had been accelerated because of strike fears, adjustments would be confined largely to the steel industry itself. Local experts in the industry now anticipated a first half-second half decline in steel production of 22 per cent compared to declines of 19 per cent and 15 per cent in the second halves of 1962 and 1963 when strike threats boosted first half output. It was believed that the total buildup of steel inventories from September 1964 through June 1965 would amount to 9 million tons. A working estimate used by steel analysts was that 1 million tons of steel would be liquidated in the third quarter of 1965 and another 4 million in the fourth quarter. That estimate envisaged production of 8.8 to 9.0 million passenger cars this year and an FRB production index of 141 in the fourth quarter.

With respect to capital spending, Mr. Scanlon continued, information obtained from contacts with business firms, announcements of new projects, and statistics on new orders for various types of machinery and equipment--including such components as gears, bearings, and fluid power drives--all suggested further expansion of plans, consistent with the recently reported McGraw-Hill survey. Overall, the rise in capital spending appeared to be proceeding at a vigorous, but orderly, pace. From a District standpoint increases in activity in firms producing those goods would help to offset expected second half declines in autos and steel.

He had little to add to the staff comments on the balance of payments, Mr. Scanlon said, other than that the voluntary credit restraint program was working very well thus far with banks in the Seventh District. All of the major banks were within their base. There continued to be concern, however, that the program for nonfinancial establishments was lacking in clearly defined goals. Bankers were fearful that anything they might accomplish toward improving the balance of payments would be offset by continued large outflows of direct investment.

On savings flows, Mr. Scanlon noted that the recent abatement in time deposit growth seemed due largely to a sharp reduction in month-to-month gains in corporate deposits outside New York. The recent slowing in corporate time deposit growth at small banks appeared related in part to a narrowing in the spread between CD rates at small and large banks. Since smaller banks had to offer somewhat higher rates

on CDs than large banks, the CD rate ceiling apparently had made it more difficult for the smaller banks to roll over maturing CDs and to attract new funds. Unfavorable publicity resulting from investigations of bank failures also had contributed to the decline in corporate time deposits at small banks. In addition, the typically small corporate customers of the smaller banks had sizable fractions of their total liquid asset holdings in bank accounts; thus, the impact on time accounts of quarterly tax and dividend payments probably was somewhat greater than it was for larger firms able to raise cash from a wider variety of sources.

For the first four months as a whole, Mr. Scanlon continued, it seemed that some of the reduction in corporate holdings of time deposits (and other liquid assets) was associated with the climb in capital spending, including the buildup of inventories. That such factors were important during the period in corporate financial management showed up also in the sharp rise in business borrowing from banks. If the recent slackening in time deposit growth was to be attributed mainly to reduction in corporate holdings, due to increased disbursements of cash, the likelihood was that corporations would have a smaller volume of funds to supply to the market in coming weeks.

On bank credit, demand factors still appeared to Mr. Scanlon to be sufficiently strong so that business loan expansion during the summer might be as large or larger than usual. The estimated step-up in capital expenditures could be expected to strengthen the demand for bank loans so long as the cost of bank borrowing remained low

relative to capital market financing. In addition, postponment of the steel settlement would probably encourage some further inventory building, and increased credit needs, by steel users.

With respect to money market developments, District banks had increased their holdings of Governments from the low end-of-March level. They had done very little borrowing lately. Chicago banks as a group had been reporting very moderate net purchases of Federal funds, but their CDs had risen by about $50 million over the past month. Mr. Scanlon concurred in the staff analysis relative to the outlook for bill rates.

As to policy, Mr. Scanlon agreed with those who favored no change today and certainly would not recommend any easier position. He shared Mr. Wayne's views on the directive.

Mr. Galusha said that the weather, as usual, had dominated recent developments in the agricultural sector of the Ninth District; the past winter had been the most severe in history in many parts of the District. However, the area was now emerging from its effects. The livestock situation had improved markedly recently. A fundamental change in habits apparently was in process, with people eating more beef.

The nonagricultural sector of the District was prospering, Mr. Galusha continued. There had been some evidence of an inventory buildup, especially in the Twin Cities area. Because of the recent disasters, the prospective demand for new construction in the District was heavy. It was estimated that in Minnesota, and in the Twin Cities

area particularly, the floods did $80-$90 million of damage, and last week's tornadoes $20-$30 million. Those were not unmixed tragedies because the rebuilt plants would be better than the old ones.

In the area of personal expenditures, Mr. Galusha noted that requests for reservations at Western national parks were high. It appeared that travel to those parks would be at an unprecedented level this summer.

As to banking, Mr. Galusha continued, information from weekly reporting banks suggested that District loan demand, like that of the nation, slackened somewhat in April. Although total credit at weekly reporting banks increased slightly more in April than March, it increased less on a seasonally adjusted basis. The average loan-deposit ratio of District reporting banks presently was higher than at any time since early 1960 and net Federal funds purchases were high through April, so he would not suggest that District banks were now wallowing in funds. In fact, District banks might have some problems in coming months, in view of the pressure that would be put on them in connection with reconstruction.

In a concluding remark, Mr. Galusha said that he agreed with the consensus expressed so far on the directive.

Mr. Swan commented there had not been much change recently in the Twelfth District economy. In March, employment rose somewhat more slowly than earlier in the year and there was no change in the rate of unemployment. Preliminary California figures for April, however, showed

some increase in the unemployment rate there. The farm labor situation still seemed to be generating more heat than light. The special panel appointed by Secretary of Labor Wirtz had recommended current use of 2,500 foreign workers, including 1,500 from Mexico. That recommendation dissatisfied people at both extremes; it was a considerably smaller number than the growers had requested, and there were those who felt that no foreign workers should be brought in at all.

Mr. Swan said that business loans at reporting banks in the District decreased slightly in the four weeks ending April 23, in contrast to earlier gains and to an increase in April 1964. Also, the decline in savings deposits during April was considerably less than a year ago, although virtually all of the decline in savings accounts at reporting banks nationally was accounted for by banks in the Twelfth District. Despite the business loan decrease and the strength in savings deposits, District banks seemed to come under somewhat more pressure during April, and were borrowing more from the Reserve Bank than earlier in the year. The increase in real estate loans in April was larger than that of the entire first quarter, but because the first quarter rise had been much less than in 1964 and because the April increase was concentrated in one week it was too early to say whether the rise reflected any change in bank attitudes toward mortgages.

Mr. Swan remarked that he had little to add, or to differ with, with respect to the staff comments on the questions. He agreed that the extension of the steel contract did have a stabilizing influence on the near-term outlook, and it seemed to him that the announced capital

spending plans were related to capacity pressures and were not out of line with the rest of activity.

In light of domestic developments, the situation with respect to the foreign loan program, and the current Treasury financing, Mr. Swan agreed that there should be no change in policy today. That decision would seem to call for about the same level of member bank borrowing and net borrowed reserves as had been experienced recently. In view of the general tightness of Federal funds and other areas of the money market besides Treasury bills he certainly would not favor efforts to raise the bill rate within a generally unchanged posture of policy. It would be one thing if market forces led to some increase; but if they did not he would not do anything about it in the next two weeks.

The draft directive was acceptable to Mr. Swan. However, he also would suggest that the word "apparent" be deleted.

Mr. Irons reported that conditions in the Eleventh District continued generally favorable. Some preliminary figures suggested that there might have been a slight slip off in April--certainly not a large one. There had been a minor decline in District industrial production recently and construction also had slipped off somewhat. Unemployment was up a bit in the last month but was still running under the national rate. Purchases of new cars had slackened somewhat but total retail sales were holding up well.

The agricultural situation was somewhat mixed, Mr. Irons noted. Conditions in the eastern half or two-thirds of the District continued quite favorable but in the western part they were quite dry.

On the financial front, Mr. Irons continued, bank credit and bank loans increased in April but less than previously, as in the nation as a whole. District banks had been active users of Federal funds, with purchases recently running about $275 million in excess of sales. Bank holdings of Treasury bills were down a bit. Borrowings from the Reserve Bank were little changed and discounting activity had not been unduly high.

Mr. Irons said he would omit the detailed comments he had planned to make on the national situation since others had already made similar points. He recommended that there be no change in policy at this time. Such a conclusion was indicated by the economic situation, which in his judgment continued to show strength and also signs of somewhat greater stability in movement than the Committee might have anticipated. For example, the inventory situation appeared less unmanageable than earlier, and the interim steel settlement also worked in that direction. The fact that the Treasury financing would be in the process of being concluded in the period before the next meeting also argued for no change in policy.

Specifically, Mr. Irons said, he favored net borrowed reserves of something above $100 million--perhaps in the range of $100-$125 million. He would expect the Federal funds rate to be in the 4 to 4-1/8 per cent area, more frequently at the latter figure than the former. He was not overly concerned about a bill rate level of around 3.90 per cent. Perhaps a 3.94 or 3.95 per cent rate would be better, and he would not object if it moved to that level, but he certainly would not favor deliberate, positive actions to force the rate up.

The staff draft of the directive seemed satisfactory to Mr. Irons. He was prepared to leave the semantic questions to others at the meeting.

Mr. Ellis commented that New England continued to illustrate that substantial and widespread expansion in aggregate demand and production could not be relied upon to resolve structural unemployment, at least within a single region such as New England. Both manufacturing and nonmanufacturing employment rose more than seasonally in March, and total nonfarm employment reached a new peak, with each State in the District registering year-to-year gains. The regional unemployment rate for March was 4.4 per cent, below the 4.7 per cent national rate. The insured unemployment level as of mid-April had declined 24 per cent in twelve months.

Supporting those statistics, Mr. Ellis said, were the many pages of employment advertisements in the daily press as well as testimony from a large Connecticut employer that Boston employers were trying to dissuade Boston newspapers from carrying ads for employment in Connecticut. The same Connecticut employer claimed that the Pennsylvania Employment Office was withholding its services to potential recruiters. A spokesman for one of the larger private shipyards used personal appeals to oust a Seattle recruiting officer who was offering moving costs and tempting wages to draw trained workers to the West Coast. At yesterday's meeting of the directors of the Boston Reserve Bank two directors complained of the lack of skilled labor, and one

observed that he could expand employment by 2,000 if he could find the right workers. Those directors would not accept the notion that New England suffered from distress unemployment at present.

Despite such evidences of over-full employment, Mr. Ellis continued, New England continued to account for eight of the nation's 29 major labor areas classified as having a substantial labor surplus. Nevertheless, the dominant tone of the region was one of prosperous expansion. Last minute telephone confirmations indicated current upward revisions in the 1965 capital spending plans of New England manufacturers, which presently tallied out as an expected gain of 19 per cent. For three years, the reporting manufacturers had used borrowing to a greater extent than they had planned in advance. Last spring they foresaw financing 9 per cent of 1964 outlays by borrowing but they actually financed 14 per cent in that manner. This year they reported intentions to borrow 6 per cent of their 19 per cent higher outlays.

Mr. Ellis saw no reason to disagree with the standard expectations expressed in the staff memorandum resulting from the steel negotiations or the capital spending surveys. Both the extension of the steel wage contract and the further upward revision of capital spending served to strengthen the near-term outlook for business. With respect to international capital flows, he could only report that of the ten New England banks reporting monthly progress under the guidelines, only four were above year-end levels at all. Two banks exceeded the target, by 26 per cent and 57 per cent, respectively, the group averaged a 4 per cent growth from December to March.

The principal implication Mr. Ellis associated with the current rate of time deposit growth was that it probably represented a less excessive situation than prevailed in January and February. Growth in those two months quite clearly represented shifting from one type of account holding to another in response to the higher time deposit rates allowed under Regulation Q. Recent liquid asset growth had exceeded the true rate of saving out of income so in part it had to represent one-time switching of assets.

Mr. Ellis remarked that the steel moratorium, slower auto sales, a moderation in the balance of payments crises, and slower expansion of retail sales all suggested that some of the pressure at the margin on bank loans to business might diminish. The current reports on business loans, however, gave a contrary indication.

Mr. Ellis noted that the staff memorandum listed several factors that would be operating in money markets in the next few weeks, even within the framework of even keel. He would single out two that might operate to avoid further weakening of bill rates. First, the Treasury would not need to continue operations at the short end of the market to render its anchor issue more attractive. Secondly, reserve projections indicated that instead of injecting substantial funds to achieve reserve objectives, the System Account might be able to make net sales in meeting the objectives for the next two weeks. Thus, within the framework of even keel, Mr. Ellis hoped and anticipated that there would be a rise of a few points in short bill rates and continued firmness in the money market, with member bank borrowing averaging $450 million and net borrowed reserves in the $100-$150 million range.

On the draft directive, Mr. Ellis favored dropping the word "apparent." On reflection he also would endorse Mr. Shepardson's suggestion to drop the word "further"; he was not sure what the word implied but on his interpretation it conflicted with the preceding phrase regarding avoiding the emergence of inflationary pressures. He did not think the Committee could continue for long to characterize a nine per cent growth rate in the reserve base as "moderate," or to permit such a rate to be maintained without recognizing that it was promoting inflationary pressures.

Mr. Balderston commented that since the next meeting of the Committee would be held in only two weeks he would favor the status quo with respect to policy. He thought that in the interval before the next meeting Committee members might well consider carefully the points Mr. Bryan had made today. He (Mr. Balderston) was impressed not only by the fact that total reserves had been growing at a 9 per cent rate since the beginning of the year but also by the fact that demand deposit turnover at reporting centers outside New York was about 8 per cent higher in March than six months earlier.

Mr. Balderston subscribed to the changes in the draft directive suggested by Mr. Ellis; he would delete the words "apparent" and "further."

Chairman Martin remarked that there seemed to be general agreement today with respect to policy, although some differences of opinion existed as to the best wording of certain phrases in the first paragraph of the directive. There ensued some further discussion of the directive language to be employed.

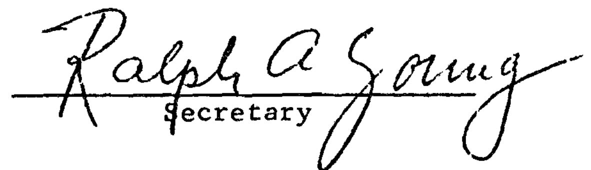
Thereupon, upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy and some improvement in our international balance of payments, but with gold outflows continuing. 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, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, while taking into account the current Treasury financing, System open market operations over the next two weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 25, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

Attachment A

CONFIDENTIAL (FR) May 10, 1965

Draft of Current Economic Policy Directive
for Consideration by the Federal Open Market Committee
at its Meeting on May 11, 1965

The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy and some apparent improvement in our international payments position, but with gold outflows continuing. 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, while accommodating moderate further growth in the reserve base, bank credit, and the money supply.

To implement this policy, while taking into account the current Treasury financing, System open market operations over the next two weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.