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, August 10, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Balderston
Mr. Daane[1/]
Mr. Galusha
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Shepardson
Mr. Bopp, Alternate for Mr. Ellis
Mr. Irons, Alternate for Mr. Bryan
Mr. Treiber, Alternate for Mr. Hayes

Messrs. Hickman and Clay, 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, Brill, Garvy, Holland, and Taylor, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Molony, Assistant to the Board of Governors
Mr. Partee, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Associate Adviser, Division of International Finance, Board of Governors
Mr. Bernard, Economist, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

1/ Left the meeting at the point indicated in these minutes.

Messrs. Latham and Patterson, First Vice Presidents of the Federal Reserve Banks of Boston and Atlanta, respectively
Messrs. Eastburn, Mann, Ratchford, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Philadelphia, Cleveland, Richmond, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Sternlight, Assistant Vice President, Federal Reserve Bank of New York
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 13, 1965, were approved.

Upon motion duly made and seconded, and by unanimous vote, the actions taken by members of the Federal Open Market Committee on July 28-29, 1965, authorizing negotiations to increase the outstanding swap arrangements with (1) the German Federal Bank from $250 million to $500 million, and (2) the Bank for International Settlements from $150 million to $300 million, on the understanding that the additional facility with the Bank for International Settlements would be used by the System to acquire currencies other than Swiss francs in which the Federal Reserve Bank of New York had been authorized by the Committee to operate, were ratified.

Chairman Martin then invited Mr. Daane to report on the meeting of the Group of Ten Deputies that he had attended in Paris on August 3 and 4.

Mr. Daane remarked that the first afternoon of the meeting had been devoted to a review of the question of the next steps to be taken with respect to future international monetary arrangements, with particular attention given to the feasibility and desirability of an international monetary conference, since Secretary of the Treasury Fowler recently had indicated U.S. willingness to participate in such a conference. Except for the U.S. representatives, the Group was unanimously negative with respect to an international monetary conference at this juncture or in the near future, and they were skeptical for the period beyond that. The consensus was that there were a number of basic differences in view on appropriate international monetary arrangements, but they reflected differences within the Group of Ten itself, and therefore should be worked out by that Group. Thus, the principal conclusion of the Deputies was that their own efforts to prepare for changes in the international monetary system should be intensified without prejudging the question of the urgency of putting any changes into effect.

The Deputies envisaged three phases for future discussions of international monetary arrangements, Mr. Daane said. In the first phase the objective would be to resolve differences among themselves on basic points. They hoped to get a mandate from the Ministers of the Ten at the time of the World Bank-Fund meetings in September that would permit them to move ahead and really come to grips with the problems as they saw them. They considered this phase to be an absolutely essential prelude to the second, negotiating phase; it was necessary, they thought, to see the outcome of phase one before moving on to more formal negotiations on the specific form of monetary arrangements. This left an international conference as a remote possibility for a third phase. From the discussion it was clear that there were serious doubts around the table as to whether such a conference ever would be necessary or even useful.

Two other questions were discussed at the meeting, Mr. Daane continued. One concerned renewal of the General Arrangements to Borrow, on which agreement was required by October 1965, as he had mentioned on earlier occasions. At the previous meeting the Deputies had divided evenly on the issue of duration, with five countries favoring a two-year term and five a four-year term. At this meeting the discussion revolved almost entirely around a compromise British proposal, under which the GAB would be renewed for a four-year term, but with a specific provisio that a review would be made at the end of two years. Reaction was generally favorable, with the only unresolved question that of whether a country would have the advance consent of the others to withdraw from the Arrangements at the end of the two years; under the terms of the present GAB consent to withdraw was necessary. Of course, the whole question of renewal of the GAB was not one for decision by the Deputies, but rather for the Ministers of the Ten, and the matter was left open for decision at the Ministers' meeting in September.

There also was a brief discussion of the measures that Britain had taken recently, Mr. Daane said. Those measures were viewed as a further step in the right direction, and the reactions to them were quite favorable.

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 July 13 through August 4, 1965, and a supplemental report for August 5 through 9, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that the gold stock would remain unchanged this week. The Stabilization Fund still had $83.4 million of gold on hand, with prospective central bank orders this month of roughly $57 million. In addition to such official demands for gold, however, the cost of financing intervention in the London gold market had become heavier From the beginning of the year through the end of July, total intervention by the London Gold Pool amounted to roughly $200 million, of which the U.S. Treasury share was $100 million, or 50 per cent. During the first week of August, the Pool had had to put up an additional $35 million to keep the price under control. Chinese buying continued to be a significant factor in the market, with purchases of $2 million or so occurring every few days. The great bulk of demand for gold, however, seemed to be coming from all over the world and to reflect a fairly general feeling of anxiety; in a sense it reflected all of the troublesome problems of the day, of a political, military, and economic nature. In an effort to relieve the pressure somewhat, the price had been allowed to ride up to just a shade under $35.20, the informal ceiling under the Pool arrangement, at which point some expectation of a price dip might appear. That situation was a potentially dangerous one and had to be watched closely.

On the exchange markets, Mr. Coombs remarked, since the last meeting of the Committee sterling had been hit by recurrent bursts of selling with speculative pressure becoming particularly intense just before the weekends. During July, British reserve losses exceeded $400 million and that compelled the government to announce new policy measures just before the end of the month. As Mr. Daane had reported, those measures were fairly well received among the European governments and central banks, and the initial market reaction to the program also was favorable. However, a new wave of pessimism struck the market last week as a result of a combination of events, including particularly the publication of British reserve figures giving evidence of the magnitude of the July reserve losses. During the first week of August the Bank of England suffered further reserve losses of roughly $225 million.

The market's lack of confidence in sterling was compounded of many things, Mr. Coombs observed, but he did not sense any widespread conviction that British prices and wages at the present moment were so seriously out of line as to render devaluation inevitable. The crisis of confidence seemed, instead, to be rooted in what the market regarded as a basic unwillingness of the present British government to come to grips with the problem. The government had acted in piecemeal fashion, and each set of measures had appeared to the market to be inadequate to the magnitude of the problem. When one considered all of the measures that had been taken they added up to an impressive package and it was possible that relatively little more in the way of either fiscal or credit restraints would be needed. There remained, however, the major risk that the present voluntary program for limiting price and wage increases would prove ineffective and consequently would result in a gradual undermining of the present exchange parity. That, he thought, was what the market most feared.

Perhaps the most urgent need was for some dramatic move designed to demonstrate the Labor Government's determination to hold the price and wage line, Mr. Coombs said. If such a move were made, in view of all the other measures that had been taken there was a reasonable chance of producing a turn in the situation. With sterling so heavily oversold, there was an enormous technical position that could be exploited. The U.K. trade figures for July, just released this morning, showed a considerable narrowing of the deficit--from about £80 million in June to £50 million. There had been a sharp increase in exports, with the rise well distributed by type of commodity. On the whole, the situation appeared to be far from hopeless, the outcome rather depended on whether the British could make a final determined effort.

In other exchange markets, Mr. Coombs continued, there had been continuing flows of funds to Italy, partly reflecting seasonal patterns, and new inflows into Switzerland, the Netherlands, Belgium, and France, reflecting both the sterling crisis and a tightening of credit conditions in certain of those markets. As a result, it had been necessary to make new drawings on the swap lines with the Dutch and the Belgians, and additional drawings of Swiss francs might shortly be required.

Mr. Coombs then referred to the action by members of the Committee on July 28-29 that had been ratified today, approving his request, transmitted by telegram, for authority to negotiate increases in the swap lines with the BIS and the German Federal Bank. He regretted having had to resort to the unusual procedure of asking for such an authorization between meetings of the Committee, but the combination of a prospective Presidential message on Vietnam, the rapid build-up of speculation against the pound sterling, and the heavy pressure on the London gold market all seemed to urge an immediate reinforcement of the country's financial defenses. The increase in the swap line with the BIS had been consummated quickly, and would provide the System with a further source of guilders and Belgian francs in the event of heavy inflows into Amsterdam and Brussels. In that event, drawings would, of course, first be made on the direct swap lines with the central banks of the Netherlands and Belgium. He was disappointed that it had not been possible as yet to consummate the recommended increase in the swap line with the German Federal Bank. Although the senior officials of that Bank would have preferred action earlier, they felt it was desirable to bring the matter before a meeting of their full board of directors, which was scheduled to convene this coming Thursday (August 12). Mr. Coombs was hopeful that he would get an affirmative response at that time and that it would be possible to announce an increase in the swap line with Germany on Thursday afternoon.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period July 13 through August 9, 1965, were approved, ratified, and confirmed.

Mr. Coombs noted that the interest rates applicable to drawings by either party under each of the System's reciprocal currency arrangements had been negotiated on a country-by-country basis and that for the most part it had been possible to secure agreement to employing the U.S. bill rate. In four instances, however, it had been found desirable to acquiesce in the suggestion of the other party that a fixed rate of interest should be employed. In the case of the National Bank of Belgium, for example, a rate of 3-3/4 per cent had been agreed upon under the $50 million standby arrangement, and a rate of 3-7/8 per cent or the fully-drawn arrangement for another $50 million. He thought those rates were roughly appropriate and should be allowed to stand. On the other hand, the rate of 2 per cent on the swap lines with the Bank of Canada and the Bank of England and the 3 per cent rate under the agreement with the Bank of Japan were set when U.S. Treasury bill rates were considerably below their present levels, and had become unrealistic with the passage of time. Therefore, he requested authorization to renegotiate those rates, either securing agreement to use the U.S. bill rate or, if the other party preferred an arbitrary rate, establishing one that approximated the present U.S. bill rate more closely. He had informally sounded out both the Bank of England and the Bank of Canada on the matter and thought they would be agreeable to such a renegotiation.

> Renegotiation of interest rates applicable to drawings on the standby swap lines with the Banks of England, Canada, and Japan, as recommended by Mr. Coombs, was approved.

Mr. Coombs then recommended two revisions in the Committee's continuing authority directive for foreign currency operations.

First, he recommended that the dollar limit on the aggregate amount of foreign currencies that might be held under reciprocal currency arrangements, specified in the first paragraph of the directive, be increased from $2.65 billion to $2.8 billion, in view of the $150 million increase in the swap arrangement with the BIS that had been approved by members last week and ratified today. Such an increase in the aggregate limit would be consistent with the Committee's practice of establishing that limit at an amount equal to the sum of all individual swap arrangements. Secondly, he recommended that the following language be added as a new final paragraph of the directive:

> The Federal Reserve Bank of New York is also authorized and directed to make purchases of sterling on a covered or guaranteed basis in terms of the dollar up to a total of $50 million equivalent.

In connection with the latter recommendation, Mr. Coombs noted that the Account Management now had authority to hold up to $150 million of foreign currencies acquired as a result of outright purchases. At present, $28 million was employed in holdings of sterling, $63 million in German marks, and $10 million in other currencies, for a total of $101 million, leaving an unused margin of $49 million. He would be reluctant to acquire any more sterling outright at this time; in fact, the Account's sterling holdings had been brought down by 50 per cent from the peak of $56 million reached last fall. However, there had been some recent indications that the

British might be prepared, within limits, to provide an exchange guarantee on sterling holdings of the System and the U.S. Treasury. The Treasury had indicated that it would be willing to acquire a moderate amount of sterling on such a basis.

In Mr. Coombs' judgment, an additional limited authority such as he was recommending would be useful on several counts. First, it would enable the System to acquire additional sterling without exchange risk. That sterling could be used to meet any future needs not only for sterling but also for other currencies that might be urgently needed and that could be acquired through sterling swaps. Secondly, a relatively small amount of dollars put through the exchange markets as a result of such covered purchases could have a substantial effect at critical moments. Finally, there was the possibility that such an arrangement could be generalized. For example, the International Bank had a large amount of money placed in dollar assets in New York. If the British government were able to provide a guarantee, it was conceivable that a substantial part of those holdings could be exchanged into sterling.

In response to a question by Chairman Martin, Mr. Coombs said that either of two alternative procedures might be followed in implementing the authority he proposed. Under one possible procedure the System would buy sterling at, say, an exchange rate of $2.79, and simultaneously sell it forward to the Bank of England at a rate of, say, $2.78. For the holding period the funds could be invested in Britain, where they would yield a return higher than the U.S. bill rate. As interest accumulated the original cost of the sterling could be written down to $2.78 and the interest return calculated on the basis of that price. The alternative possibility would be much simpler; instead of arranging for forward cover, the Bank of England would guarantee at par--a rate of $2.80--some specified amount of sterling that the System would acquire. If the Bank of England extended such a guarantee, however, Mr. Coombs suspected that they would be unwilling to see the funds invested in the London market. They might suggest instead that they be placed in a "money-employed" account at the Bank of England at a rate equal to the U.S. bill rate. Whichever procedure was followed, sterling acquired under such an authorization would not be exposed to the risk of devaluation, unlike currencies acquired under the present authorization for holdings of up to $150 million of currencies bought on an outright basis.

Mr. Daane said he would agree that the proposed authority would be useful under present circumstances, although he found the second reason Mr. Coombs had mentioned to be a little more persuasive than the first; there clearly were times when relatively small sums put through the exchange markets could make a great difference. The action would align the System with the Treasury in the effort to be of maximum help to the British, and at the same time would be very much in this country's own interest. There was no risk to the System in the suggested arrangement, and Mr. Coombs was proposing that it be employed on a limited scale. The question of which of the two procedures should be followed was largely a technical matter, but he would expect the British to favor the forward cover alternative. To give a dollar guarantee might imply some reflection on the standing of the pound and might have undesirable implications for other sterling holders.

Mr. Mitchell remarked that the System obviously would be protected against financial loss on sterling acquired under a guarantee by the Bank of England. He noted, however, that it was the policy of the U.S. Treasury not to guarantee outright foreign official holdings of dollars. Under the proposal, therefore, the System would be accepting a guarantee from a foreign central bank of a type the United States was not prepared to offer other countries. Such an act, in his judgment, was likely to expose the U.S. to demands for similar guarantees of foreign official dollar holdings. The kinds of techniques the System presently employed seemed to him to be more consistent with the posture of the U.S. Treasury on the subject of guarantees.

Mr. Coombs commented that he personally was inclined to favor the forward contract procedure. Under that alternative, however, agreement would have to be reached on the forward rate to be employed in each transaction, and operations could become rather cumbersome, particularly if others also entered into such transactions with the Bank of England. Accordingly, the British might feel that limited guarantees were preferable on grounds of simplicity. The magnitude of the risk that Mr. Mitchell saw would depend on the form of the guarantees. If they were made for relatively short periods--say, 6 or 12 months--and for limited amounts of sterling, the transactions would not differ very much in substance from forward contract transactions.

Mr. Daane observed that in principle Mr. Mitchell's point was well taken; if transactions of the type suggested were carried too far they could easily raise questions of guarantees for foreign official dollar holdings. He doubted, however, whether such demands would be provoked by guarantees of System sterling holdings on the limited scale contemplated. On that scale the differences from forward contracts were more of form than substance.

Mr. Wayne said that he would be concerned that the United States might be put in the position Mr. Mitchell feared if the System simply requested the British to guarantee outright sterling holdings. However, he thought a distinction should be drawn between such a request, on the one hand, and acceptance of a proposal by the British, on the other, that the guarantee procedure should be followed as an alternative to the forward contract procedure.

In reply to Mr. Hickman's question concerning the possibility that other central banks might ask for similar guarantees of their sterling holdings, Mr. Coombs commented that continental European central banks now held virtually no sterling. In the past, under the so-called European Monetary Agreement, their sterling holdings had been on a guaranteed basis, for the most part, but the guarantee privilege had been largely withdrawn about two years ago because of concern by the Bank of England that sterling-area countries might ask for similar guarantees. He was not able to predict whether, in an emergency, the British would feel that they could justify restoring such arrangements with the continental central banks. The earlier guarantees had been in terms of dollars, but that was not a necessary element of the arrangements; any new guarantees might be in terms of the currency of the sterling holder.

Chairman Martin commented that Mr. Mitchell's point was well taken. For present purposes, however, he thought the choice between the two alternative procedures was primarily a technical question, and perhaps the opinions of British officials had not yet solidified. On the whole, the proposed additional authorization struck him as a useful precautionary measure, since it offered an additional means for helping to stabilize the market, although it was possible that it might not be used.

Mr. Daane said that if Mr. Coombs' recommendation was approved it would be important, in his judgment, not to give the impression that the arrangement was open-ended and capable of indefinite enlargement. The Chairman concurred in this view.

In response to questions, Mr. Coombs said that he was limiting his proposal now to sterling but might later want to request similar authority in connection with other currencies, and that he had no present intention of increasing the Account's outright holdings of sterling. As he had noted earlier, such holdings had been reduced by half since last autumn.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the continuing authority directive for foreign currency operations was amended to read as follows, effective immediately:

The Federal Reserve Bank of New York is authorized and directed to purchase and sell through spot transactions any or all of the following currencies in accordance with the Guidelines on System Foreign Currency Operations as amended March 23, 1965; provided that the aggregate amount of foreign currencies held under reciprocal currency arrangements shall not exceed $2.8 billion equivalent at any one time, and provided further that the aggregate amount of foreign currencies held as a result of outright purchases shall not exceed $150 million equivalent at any one time:

Pounds sterling
French francs
German marks
Italian lire
Netherlands guilders
Swiss francs
Belgian francs
Canadian dollars
Austrian schillings
Swedish kronor
Japanese yen

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $275 million equivalent, by means of:

(a) purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;

(b) purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;

(c) purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions, for the purpose of influencing interest arbitrage flows of funds and of minimizing speculative disturbances.

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

The Federal Reserve Bank of New York is also authorized and directed to make purchases of sterling on a covered or guaranteed basis in terms of the dollar up to a total of $50 million equivalent.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period July 13 through August 4, 1965, and a supplemental report for August 5 through 9, 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:

Money market developments and a routine Treasury refunding operation in recent weeks have been overshadowed by uncertainties about the interest rate outlook generated primarily by external factors. A foremost source of concern to domestic financial markets has been the outlook for sterling, with U. S. bond market participants now watching for Britain's reserve statistics and trade data with an avid interest previously concentrated on more domestic matters such as business loans, free reserves, or unemployment. The market's concern about sterling rests on a belief that drastic action to aid the pound will quickly put pressure on the dollar, presumably calling for a tighter monetary policy to protect our own currency. Alongside this concern, there has been a growing conviction that stepped-up hostilities in Vietnam will, before long, make greater demands on the U.S. economy in general and on the Treasury in particular. Bond prices have moved significantly lower in this atmosphere, not in a drastic or disorderly fashion, but also without generating much of a feeling that a more "tradable" price level is being reached. Perhaps a little paradoxically, the continuing sizable dealer positions in bonds over five years to maturity help to explain both the heavy feeling of the market, and the moderation of the price decline, as dealers have sought to protect the value of existing positions.

Against this background, the Treasury's August refunding went as well as could be expected. Dealers expressed some dismay at the Treasury's reopening of a 3-1/2 year bond, and they clearly would have preferred a single issue in the 18-month area--a preference that was underlined not only in their comments but also in their very limited participation in the offering. Investors did have some moderate interest in a longer option, however, and about $800 million of the roughly $3 billion of public holdings was exchanged for the reopened bond. Of the remaining public holdings, all but about $200 million was turned in for the 18-month notes, leaving a modest amount of attrition.

Through most of the past four weeks, the Treasury bill market enjoyed a resurgence of demand that carried rates down from the higher levels that had been reached in early July. Demand in mid-July was enlarged in part by dealer purchases in anticipation of increased activity that was expected to be associated with the Treasury's August refunding. By the end of July, however, the bill market turned around and rates tended to back up--partly because the demand related to the refunding fell short of expectations while System buying of bills was also lower than expected by the market. Toward the end of the period, with a generally nervous atmosphere beginning to affect bills as well as coupon issues, the System was able to provide reserves through sizable bill purchases with no significant impact on rates. In yesterday's auction, the three- and six-month issues were sold at average rates of about 3.85 and 3.95 per cent, respectively, compared with a low point in the recent period of 3.80 and 3.87 per cent, respectively (on July 26), and not far different from the rates prevailing in the auction four weeks ago.

System open market operations alternately withdrew and provided reserves over the past four weeks, mirroring the injections and absorptions of reserves by market factors while maintaining fairly persistent firmness in the money market. On balance, operations in Treasury issues added a net of $133 million of reserves on a commitment basis. Large scale use was made of repurchase agreements during the period, both to meet temporary reserve needs and on occasion to avoid adding to the immediate pressure of demand for Treasury bills. While some use was made of the Desk's authority to arrange repurchase agreements against a broader maturity range of issues during financing periods, this authority was used less extensively than in May.

Net borrowed reserves during the period moved in a range from around $100 million to $230 million, while member bank borrowings hovered around the $1/2 billion level. Federal funds traded largely at 4-1/8 per cent, that being the effective rate on three out of five days.

Over the four weeks as a whole, outright System holdings of Treasury bills were increased by $91 million while holdings under repurchase agreements rose a net of $42 million. Outright holdings of coupon issues were unchanged during the period, except for the commitment to exchange the Account's holdings of maturing notes for new notes and reopened bonds.

Looking ahead to the next three weeks, current projections suggest only a modest need for System operations--probably starting with some absorption of reserves as mid-month approaches and then with a net provision toward the end of the month. Given a continuation of the current heavy atmosphere in the bond market, some of that later provision of reserves might appropriately be accomplished through purchases of coupon issues.

Corporate bonds, like Treasury issues, tended to decline in price over the recent period, and the relatively attractive yields available on corporate issues remained a factor tending to divert investors to this area and away from Governments. New issues won mixed receptions, with some higher-yielding offerings moving out quickly and others remaining in underwriters' hands and requiring subsequent price cuts. Tax-exempt issues benefited from a pick-up in bank buying that succeeded in reducing advertised inventories over the interval.

Payment for the current Treasury financing takes place this Friday. The Treasury's next debt operation, apart from routine bill rollovers, is likely to be a cash borrowing in the bill area--possibly not until early autumn.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period July 13 through August 9, 1965, were approved, ratified, and confirmed.

Secretary's Note: On August 2, 1965, the following message had been transmitted to members of the Committee, by telegram to those outside Washington, by Mr. Young:

Referring to current Treasury refunding, System Account holds $3,891,732,000 of notes maturing August 13, 1965, about 53 per cent of total outstanding. Account Management proposes that Account exchange its entire holdings through subscription for $2,891 million, about three-quarters, of the 4 per cent notes maturing February 15, 1967 and $1 billion, one-quarter, into 4 per cent bonds maturing February 15, 1969. System Account already holds $84 million of the bonds. Principal reasons for proposal are avoidance of excessively heavy System holdings of any single Treasury issue, the ample System holdings maturing in one and two years, the relatively short term of the bond offered by the Treasury.

1. Assuming the public subscribes to $1 billion 4's of 1969, the amount of 4's of February 15, 1967 taken by System Account would be about 57 per cent of the new issue, only a slightly larger proportion than the System's present holding of the issue being refunded. If the System's entire holding of the maturing issue were exchanged into 4's of February 15, 1967 it would represent 64 per cent of the issue.

2. The amount of the 4's of February 15, 1969 taken by the System Account would be about the same as the amount expected to be taken by the public, but would represent only 28 per cent of the total issue, including the amount already outstanding.

3. After the exchange 59 per cent of the total System Account will mature in one year and 84 per cent in two years.

Please wire today whether you agree with Manager's proposal.

Advices subsequently were received from all available members of the Committee that they agreed with the Manager's proposal.

Chairman Martin noted that a prospectus for a proposed study of the dealer market in Government securities, dated July 9, 1965, had been distributed to the Committee on August 2, primarily for information purposes at this time. He had discussed the matter with the Secretary of the Treasury, Mr. Fowler, and with Under Secretary Deming, and had found that they were amenable to the proposed study and were anxious to cooperate with the System on it. The thinking was that the study should not be undertaken immediately, but rather sometime this fall. The Chairman thought it would be desirable for all members of the Committee and other Reserve Bank Presidents to review the prospectus carefully and offer any thoughts they had on the matter.

The Chairman then remarked that in light of recent developments in Vietnam and in view of the sterling situation there had been some discussion with the Treasury of problems that might arise in the Government securities market, which he would ask Mr. Young to summarize. He personally did not consider it necessary for the Committee to take any action in this connection today, nor did he anticipate that action would be required later. However, since it was impossible to predict what might happen, he thought it would be desirable for Committee members to have the matter in mind in case a problem should arise suddenly.

Mr. Young said that Messrs. Balderston, Holland, and he had met on Friday (August 6) with Mr. Volcker, Deputy Under Secretary of the Treasury for Monetary Affairs, to discuss informally the nature of possible reactions in the Government securities market if the market was suddenly confronted with a devaluation of sterling or other drastic actions by the U.K. authorities, or if developments in Vietnam should greatly heighten nervousness. It was agreed that the market was particularly sensitive at present because of the large dealer positions in longer-term issues, and that the first question to be faced was whether the dealers should be relieved of those holdings by official purchases. The consensus was that dealer holdings should be lightened by official buying, at prices somewhat under those prevailing at the time, with the System and the Treasury coordinating operations closely in achieving that end. It also was agreed, in light of earlier experience, that the market should be permitted to make downward adjustments, perhaps with some cushioning purchases, but that there should be no massive intervention until it was felt the point had been reached where such intervention could turn market psychology, thus making the market self-supporting.

If the external crisis was only moderate in nature, Mr. Young continued, it would not be likely to have serious repercussions either internally or on other countries abroad. In that event the adjustment in the Government securities market could be expected to be moderate, making it possible to improvise tactics on the basis of market reactions. If, however, the crisis was more serious, it could have extensive repercussions on other countries, and the impact on the Government securities market could be far more serious. Whatever the market intervention problem, the Treasury probably would want to limit its buying to the longer-term sector, leaving the intermediate- and shorter-term sectors to the System. It was thought that little if any intervention would be needed in the market for bills and short-term coupon issues because the short-term sector would be attractive to investors under the circumstances assumed.

Although the discussion did go some distance, Mr. Young concluded, it was, of course, entirely hypothetical. He added that Mr. Holmes would be invited to participate in any future discussions of a similar nature.

Mr. Daane commented that it might be useful to recirculate a basic planning document that had been prepared in 1959 by Charls Walker, then of the Dallas Reserve Bank, Spencer Marsh of the New York Reserve Bank, and himself, then at the Richmond Bank. While the study was concerned with open market operations in the event of an enemy attack, he thought it had some relevance to the present situation, particularly to consequences of possible developments in Vietnam.

Mr. Young noted that additional relevant material was included in the "blue book" containing the Board's Emergency Plan, copies of which were in the possession of all Committee members and other Reserve Bank Presidents. The discussion with the Treasury on which he had reported was, in his judgment, not inconsistent with those documents.

Chairman Martin suggested that the staff bring together any such materials that might be helpful to the Committee for background purposes. It was his hope that such steps would prove to have been needless precautions but it was important for the Committee to be alert to possible developments. The materials in question might, incidentally, be valuable in connection with the proposed study of the dealer market in Government securitites.

Mr. Hickman said he was concerned about the possibility of moving into something close to a pegging operation if the Vietnam situation worsened. Mr. Young replied that it had been agreed in the discussion with the Treasury that the approach to the problem, if one arose, should not be one of reestablishing a peg. The objective would be to provide some general support to the market, but such intervention as might be appropriate would be directed to the stabilization of market psychology, so that the market could settle down to self-reliant functioning.

Chairman Martin commented that this was the kind of question that members of the Committee had to bear in mind in considering how to deal with potential problems of the sort under discussion.

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. Brill made the following statement on economic conditions:

> A first impression of the domestic economic scene, on the part of one returning after a short absence, is that of surprising vigor in both activity and expectations. When I

last reviewed the situation for the Committee, almost two months ago, expectations were generally for a slowing in the rate of economic expansion. The impetus provided by steel inventory accumulation was apparently beginning to lose force, and auto sales had already adjusted down in April, May, and early June from the exceptional winter rates. With considerable new plant coming "on line," and an influx of teenagers into the labor force expected, prospects were for some slackening in the rate of resource utilization.

This prospect may still be ahead, but July data do not suggest that it has already started. Even though inventory accumulation has undoubtedly moderated, industrial production rose in July by at least as much as in each of the preceding three months, and final figures may show an even greater increase. Auto sales picked up in late June and the momentum carried through in July, with domestic car sales for the month rising to a 9.0 million unit rate. Most auto plants are now shut down for model change-over, and maintenance of the July sales pace should permit dealers to reduce their relatively large inventories of new cars to manageable proportions by the time of introduction of the new models.

Strength in consumer spending was not limited to autos last month. Other categories of retail sales, which had shown some lag in June, were up again in July, and total sales rose substantially.

Most heartening of all the July developments was in the youth employment area. The expected flood of teenagers hit the market in July, but this year they found jobs. We finally appear to be making some progress in this hitherto-intractable area. The unemployment rate for young workers declined somewhat, and long-term unemployment also declined, bringing down the total unemployment rate to 4-1/2 per cent, the lowest in nearly eight years.

Does the economy have the momentum to continue to turn in such a performance? To answer this, one must assess a pretty fine balance of forces, and do it blindly for lack of relevant historical experience or adequate current data. On the one hand, we're only 3 weeks from what, hopefully, will be a termination of the long drawn-out steel wage negotiations. Output is likely to suffer whatever the outcome--strike, continuation under a Taft-Hartley injunction, or settlement. There doesn't seem to be a consensus among industry or Government economists as to how adequate or excessive steel stocks have become, but the recent slackening in pace of advance steel ordering suggests that the bulk of steel consumers are pretty well satisfied with their inventories in the context of expected rates of activity. At a minimum, then, we can expect some reduction in steel output after September 1, and the drop could be substantial. A more-than-seasonal drop in auto stocks is also possible this month and next. Reflecting both steel and autos, total inventory accumulation in early fall is likely to be at a much slower rate than in recent months.

But in assessing the outlook for aggregate demand, there are several potential offsets to a slackening in inventory demand to keep in mind. Plant and equipment spending is scheduled to rise further, and the latest (June) data on new orders suggest that spending schedules are likely to be met. Unfilled orders for durable goods continued to expand in June, with most of the rise for the month representing further growth in machinery backlogs, and commercial and industrial construction outlays continued strong through July.

The mailing of checks to Social Security beneficiaries, including both the new higher scale of payments and lump-sum retroactive benefits, will be adding to disposable personal incomes shortly. The amounts involved would about offset the steel payrolls that might be lost in a month-long strike. How rapidly, and for what goods or services, recipients of the benefits will spend their funds is a big unknown; we have very little basis for estimating the consumption function for this older age group. But it's hard to believe that the bulk of it won't get into the spending stream fairly promptly.

Further stimulus to the economy will come from expanded Government procurement for Vietnam hostilities. The recent request for additional appropriation authority is not a good guide to the pace at which actual outlays will be made, particularly since substantial unobligated appropriations exist which could be drawn on promptly. As noted in the staff comments on question 1,[1/] the increases in spending and in the armed forces now proposed do not appear significant enough to touch off widespread commodity or labor shortages or widespread price increases. Nevertheless, the increases will bolster aggregate demand to some extent, and operate to offset the letdown that might follow a steel settlement.

1/ Certain questions suggested for consideration by the Committee, and staff comments on them, are given at a later point in these minutes.

All in all, though I'd be hard pressed to quantify the judgment, the balance of economic forces seems to me to be likely to resolve on the plus side. That is, barring an unusually severe adjustment in steel, I would expect the economy to continue to expand at close to the pace of recent months, perhaps not fast enough to keep up with resource growth over the longer-run, but also not fast enough to create additional upward price pressures in the near-term. If this judgment is right, it would seem premature now to add monetary stimulation to the picture--at least not until the dimension of consumer responses to the Social Security payments becomes more evident or the pace of the defense buildup becomes clearer. It would seem particularly inappropriate to take an easing step on the eve of a major wage settlement, one which might eventuate, as did the aluminum settlement some weeks ago, in an above-guidepost wage increase and an unwarranted price rise.

But uncertainties also argue against any significant move toward monetary restraint. Steel stocks may be much higher than we or most other analysts have estimated, and the adjustment process may be correspondingly more difficult. Moreover, we may have run out the string on favorable automobile years. Consumer tastes are fickle, and in the absence of major innovations even the most sophisticated analysis of demand factors can be frustrated.

While the mild industrial price creep has continued, there are no signs of its turning into a gallop. Stocks of consumer goods are high, and industrial capacity increases already underway should serve to limit the possibility of shortages. The market response to Vietnam developments doesn't suggest any widespread fears of shortages, rationing, or inflation. On balance, then, the domestic evidence isn't clear enough to me to justify a significant policy move in either direction at this juncture.

Mr. Holland made the following statement concerning financial developments:

It seems possible that some days of trial could lie ahead for our financial markets.

Discussion this morning has already reviewed the market's immediate reactions to the stresses to date, and its technical position for withstanding further strains--fairly strong in some sectors, but weak especially in the long Government area. Let me try to assist your deliberations this morning by appraising the trends in underlying financial flows and judging whether they are such as to weaken or strengthen the market's technical ability to weather a financial crisis.

There have been times during this expansion when such an appraisal would have led to a pessimistic conclusion, but--to give my conclusion today in a nutshell--I judge the present status of underlying supplies and demands for funds is such as generally to cushion rather than to aggravate any immediate market shocks.

Such a conclusion cannot be reached, of course, without making a good many assumptions--the more so because our knowledge is still at a stage where judgments have to substitute for tested objective relationships with respect to a good many linkages in the financial process. But the most important caveats I should sound concerning this conclusion are three: it would become unrealistic (a) if our Vietnamese build-up grows rapidly enough to produce a marked expansion of demands for real resources, or (b) if it is expected to do so by businesses and consumers, or (c) if for these or other good reasons monetary policy is tightened significantly.

Let me briefly sketch the main facts that lead me to my conclusion. The market for Treasury coupon issues is demonstrably thin, and has remained in rough balance chiefly because no major group of holders has been led to attempt really large-scale unloading of Treasury notes or bonds in order to accommodate other earning assets. In fact major changes in private supplies and demands for funds have evolved over the past year, but the financial system has fairly well adjusted to these without major pressure on the Government bond market.

The most significant change that took place was the enlarged external financing of the corporate sector, as its over-$50 billion annual rate of spending on capital equipment and inventories outstripped the high but no longer rising flows of internally generated business funds. Somewhat higher rates of return on corporate borrowing have already sweetened its attractiveness to lenders. Given the general preference of banks and insurance companies for such debt, no further big market rate adjustment on corporate instruments seems required unless the net increase in business borrowing grows even bigger, and that eventuality is rendered less likely by the expected imminent shift from steel inventory accumulation to decumulation.

In the municipal market the story may be a little different. More than once before in this expansion, analysts--myself included--have cried "Wolf!" over the municipal market, anticipating a major upward rate movement as the high level of borrowing seemed to be outstripping the buying capacity of a banking system constrained by tightening reserve availability. On each occasion, the worst failed to happen, mainly because banks continued to be able and willing to issue enough time deposits to meet loan demands and buy an impressive amount of municipals besides. With corporate demands for bank funds now strong and dealer inventories of municipals still heavy, some further relative upward yield adjustment in municipals has to be counted a possibility, but the necessity for this action will depend importantly on banks' continued success in attracting time depositors.

The viability of the mortgage market at current rate levels may also be partly dependent on the competitiveness of banks for savings. After some reduction in the net increment of growth last year, demand for housing is showing signs of strengthening. At the same time, banks are again being appreciably more successful in attracting deposit-type savings than are the more specialized mortgage lenders. While banks have also been sizable mortgage lenders in this expansion, the strengthened credit demands of their preferred business customers could lead banks to direct more savings away from mortgages. The consequence could be a mortgage market in which demand is beginning to rise faster than credit supply, with some resultant tendency for a little firming of both credit standards and terms.

You can see that, in my view, the key to a stable set of underlying financial flows in these major markets is a continued large--but not too large--expansion of bank time deposits. That requires, in turn, that banks continue willing to pay the cost of raising time money, rather than stepping up their liquidation of securities as a source of funds; that the nonfinancial sector continue willing to expand its time deposit holdings, even as it goes on borrowing; and that the Federal Reserve continue to supply the reserves to accommodate the consequent bank expansion.

So long as these circumstances obtain--and they still seem to, on the latest reading of the evidence--the network of underlying financial flows should remain reasonably in balance.

I do not see enough strength in this fabric to stabilize the market without official help in any financial crisis, for the expectational shifts in the market could be very sharp and the dealer mechanism, with its exposed long bond position, is peculiarly susceptible. But big expectational shifts do not persist unless sustained by some corresponding shifts in basic flows. For that reason, I think that the rough balance of underlying flows that I have described provides some measure of hope that well-timed official stabilization purchases could calm a crisis market atmosphere effectively.

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

This morning, as Mr. Coombs has mentioned, the United Kingdom announced a 12 per cent jump in exports, seasonally adjusted, in July. This may justify merely a sigh of relief all round, rather than a loud cheer, since the export figures typically zig-zag widely. So far, the market is not quite cheering. Sterling made some gain early in the day immediately after the announcement of the trade figures. The Bank of England reported an hour ago, however, that there was little steam behind the movement, and that the rate had since drifted off a bit.

But averaging July with earlier months shows that there has been a significant improvement in Britain's trade position so far this year. In the first 7 months, exports were up 5 per cent from the average rate for 1964 while imports were down 1 per cent. The trade deficit in this period averaged only half as large (on a balance of payments basis) as during 1964. This suggests that the current account deficit so far this year has been running at only about one-third of last year's swollen $1 billion rate. Substantial further progress is needed, of course, to eliminate the current deficit entirely this year and achieve a surplus in 1966 and later years. Some short-run help in this direction may reasonably be expected later this year from a decline in imports as domestic restraints finally begin to bite.

There are signs that these restraints are beginning to exert some of their intended effects internally. But, of course, it will take a run of good trade figures to demonstrate that resources freed at home can be shifted to exports. Particularly troublesome still, as Mr. Coombs noted, are excessive price and wage increases, and also scattered wildcat strikes.

For the United States, our own merchandise trade position is becoming increasingly worrisome. In June, exports were no higher than last autumn, while imports were up 18 per cent. Steel imports have about doubled in this period, but they account for less than one-third of the total import expansion, other imports are up more than 10 per cent in the 9-month period.

The rise in imports has been sharper than at any time since 1959, and has been spread over a wide variety of goods, excepting only foods. From the second quarter of 1964 to April-May 1965, imports of industrial supplies other than steel--a category that covers nearly half of total imports--rose 12 per cent, compared with only 3 or 4 per cent in each of the preceding 2 years. Imports of consumer goods rose 20 per cent, as they had the year before; this fast-rising group which used to be small now approaches one-fifth of total imports. Imports of capital equipment are up a whopping 43 per cent, compared with 24 per cent a year earlier and only 7 per cent the year before that. By areas, for which we have complete second quarter data, imports are up from a year earlier by 44 per cent from Japan, 29 per cent from continental Europe, 19 per cent from the U.K. (19 per cent being also the increase in total imports), 15 per cent from Canada, 14 per cent from Latin America, and 10 per cent from all other countries except Australia, New Zealand, and South Africa, the latter group having been almost unique in suffering a decline in sales to this country.

I cite this long string of figures because I think they indicate a very wide-ranging boom in U.S. imports. To some extent, no doubt, our imports have been temporarily swollen by heavy inventory demands that will later subside. But the boom in imports of consumer goods and of capital equipment is unlikely to be of this kind. Furthermore, earlier import expansions associated with inventory upswings here have tended to leave a residue of further penetration of U.S. markets, notably in the case of steel.

In short, recent import expansion is a sobering reminder of the adverse effects that rising domestic pressures on capacity can have upon the trade balance, even when broad price averages are not moving adversely. The flattening out of our exports may also owe something to internal U.S. demand pressures, although a leveling off of foreign demands in almost every major area except Canada has probably been much more important.

The National Foreign Trade Council Balance of Payments Group felt able last month to forecast a trade surplus for the full year of $5-1/2 billion, equal to the second-quarter rate that was swollen by favorable, post-strike effects, and well above the $4-1/2 billion rate of the first half-year. For this cheerful forecast to be fulfilled, the trade balance will have to average $400 million a quarter better in the second half year than in the second quarter.

Other elements in the balance of payments seem certain to weaken by more than this amount. Reflows to the United States of U.S. bank credit and of liquid funds exceeded $600 million in the second quarter. These will almost certainly give way to moderate renewed outflows later in the year. The banks have considerable scope for renewed lending within their VFCR targets. Also, foreign borrowing through new security issues here, particularly by Canada, is expected to be larger in the second half.

Finally--a point that overlaps those already noted but is to some extent additive--it seems likely that a return of confidence in sterling, whenever and however it comes, will adversely affect a number of items in our payments accounts. You will recall that in 1962, the Canadian exchange crisis and its subsequent resolution (partly through a devaluation) made our deficit very small in the first half year and very large in the second. Our connections with Britain are less close and direct than with Canada. But, on the other hand, the British crisis has been of much larger dimensions. Canada lost less than $1 billion of reserves in 6 months. Britain has lost some $3-1/2 billion in 10 months. This must have helped our balance of payments almost across the board: on trade, services, and particularly on certain kinds of capital flows. British losses of more than $400 million in July, for example, are likely to have had significant, though not closely identifiable, effects that helped to hold our overall July deficit to less than seasonal proportions.

Thus, the fact that July has now been added to the string of recent months in which there has been an overall surplus on a seasonally adjusted basis does not at all contradict the view Mr. Hersey expressed at the last meeting: that the U.S. balance of payments is likely to be deeper in deficit during the second half year as a whole than it was in the first half.

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 conditions and prices.--What are likely to be the short-term effects of the step-up in U.S. activities in Vietnam on prices, inventories, unemployment, and economic developments generally?

Expenditure plans arising from the latest increase in U.S. military operations in Vietnam have been undergoing almost daily change. Although additional amounts may be appropriated now, the Department of Defense has considerable flexibility in placing orders, because of both unobligated appropriations carried over from fiscal 1965 and plans to request supplementary appropriations in January. Preparations for a much greater degree of mobilization have been under way, moreover, should a still larger military effort be deemed necessary.

The increases in defense spending and the armed forces proposed now, however, appear small--both in relation to recent levels of the defense program and to total spending and the labor force. The President has requested \$1.7 billion in addition to the \$45.2 billion Department of Defense appropriation request for this fiscal year now before Congress. Defense spending was already on the rise, and from the second quarter of 1965 to the second quarter of 1966 the annual rate of expenditures is now expected to increase by about \$4 billion rather than by \$2 billion. These magnitudes must be appraised against the recent annual rate of defense spending of \$55 billion (GNP basis), total GNP of nearly \$660 billion, and quarterly increments to GNP that have averaged about \$10 billion over the last 2 years.

The armed forces will be increased by 340,000 over the next year to a total of 3.0 million. At the time of the Korean outbreak, it may be noted, only 1.5 million men and women were in the armed forces, and more than 2.0 million were added in less than two years. Compared with mid-1950, the labor force currently is 13 million or nearly 20 per cent greater, and the absolute number of unemployed and the rate of unemployment are somewhat higher.

Use of the draft, as opposed to calling up reserves, tends to minimize the impact on labor markets. Most of those to be drafted are in the 20 to 22-year-old group and are among the employed. (Deferments are high for those in school, and rejections are high among the unemployed.) But workers in this age group are generally below average in training and skill and probably can be replaced more easily from among the unemployed and those outside the labor force than would more highly skilled reservists.

Since the extent of the defense expansion as announced is relatively small and is scheduled to come at a time when moderation in the pace of expansion in economic activity was widely anticipated, the increases now contemplated in military requirements, while adding to aggregate demand, should not push it to excessive levels. Moreover, any substantial acceleration or enlargement of the defense build-up would undoubtedly reduce the possibility of a tax cut or other fiscal stimulus next year. Given the manner in which the armed forces will be increased and the nature of procurement, widespread or serious production bottlenecks are unlikely. Commodities now in or close to a tight position, such as copper, may be noticeably affected, but should these or other stockpiled materials threaten to cause serious production bottlenecks and upward price pressures, legislative authority exists for the President to order supplies released from the stockpile "for purpose of the common defense."

The announced program is smaller than was widely expected, and the behavior of commodity and security markets since the announcement does not suggest much public concern over shortages, inflation, or direct economic controls. With business and consumer stocks of many goods already large, no significant move to protective buying has been provoked.

(2) Balance of payments.--What implications do changes in international interest rate relationships over the past several months have for the U.S. balance of payments?

The tightening of Canadian and major European capital markets in recent months increases the likelihood that net outflows from the United States of over-one-year capital other than direct investments will be larger in the second half of 1965 than in the first. Even though the voluntary program for bank and nonbank lenders, and, with lessening force, the Interest Equalization Tax, are restraining major categories of capital outflow, there remains scope for outflows to increase.

European domestic long-term interest rates have risen on the order of 3/8 per cent since March, reflecting increasing market pressures of demand for lendable funds and unremitting efforts of the monetary authorities in all countries but Italy and France to restrain bank credit expansion. Such rate increases have been considerably larger than the rise in new issue yields in the United States.

Further tightening of capital market conditions in Europe does nothing to increase chances for borrowers in less developed countries to obtain long-term funds there, and it is likely that the United States will continue to be their primary source of funds. Moreover, some borrowers subject to the I.E.T. (including British and Australian, and also Japanese borrowers on term loans) have entered into commitments to pay the tax on its present rates.

The claims on foreigners of U.S. banks that are subject to the VFCR are nearly $400 million below the 105 per cent target, so that there is room for a renewed net outflow of bank credit, long- and short-term, in the rest of 1965. The voluntary program for nonbank financial institutions is helping to restrain placements with these institutions of obligations with maturities up to 10 years, and of longer-term continental European securities. However, the nonbank ceilings do not apply to longer-term, IET-exempt, issues by Canadian provinces, municipalities, and corporations.

Weakening of the Canadian balance of payments on current account, partly in response to domestic inflationary pressures, is among the factors that have led the Canadian authorities to permit an advance in Canadian interest rates, both short-term and long-term, on the order of 1/4 per cent since March. These developments will encourage heavier Canadian borrowing through new issues in the United States.

Recent developments in the London market for Euro-dollars have not been such as to induce outflows from the United States through Canada. Euro-dollar interest rates eased off in June and July, partly in consequence of movements out of sterling. Short rates are up less from a year ago than rates for U.S. CDs and Federal funds, and some U.S. banks have again been drawing money from the Euro-dollar market for use in the United States. The longest Euro-dollar rates have not eased much and remain relatively high, perhaps partly because the foreign branches of U.S. banks have continued bidding for longer-term funds to finance transfers of head-office foreign loans to the branches in order to reduce claims subject to the VFCR.

The small recent fluctuations in U.S. Treasury bill rates have been of no significance for the U.S. balance of payments during a period when forward exchange rates for sterling have varied widely under the influence of confidence factors and when liquid flows between the United States and Canada have been dominated by the VFCR.

(3) Bank credit.--What do June-July bank credit developments suggest as to the Underlying strength of loan demands?

Total bank credit in July, adjusted for seasonal influences, probably declined a little, after the sharp expansion of June. This variation in movement over the last two months, however, is due principally to the unusually large end-of-June borrowing by security dealers and finance companies, which was repaid in July. Nonfinancial loans have continued to increase and banks have reduced their security holdings further. On the whole, underlying loan demand has been strong, and appears likely to remain so in the near-term.

Real estate and consumer loans continued to expand in July at about the same rate as during the second quarter. Business loans appear to have increased at an annual rate of about 15 per cent in July, and about 19 per cent in June-July taken together. These growth rates are considerably below the unusually high rate of the first quarter, but considerably above those in 1964 and other recent years.

This strong business loan expansion has occurred despite several months of increased capital market financing. Plant and equipment and inventory experditures by manufacturing corporations appear to have exceeded their internally-generated funds in both the first and second quarters, and this gap is probably persisting in the third quarter. Increasing business capital expenditures may also be reflected in the contraseasonal rise in term loans at New York banks in July, to a near-record high proportion of total business loans outstanding.

Industry data (including figures through July 28) indicate that a large portion of the July increase in loans to business has resulted from demands of public utility firms and the metal and metal products industries. When the steel negotiations are settled--or a strike comes--liquidation of steel stocks will lead to some loan repayments. However, general financing needs arising from the capital goods boom may have become more important than inventory financing in the loan demands of steel producers and users.

(4) Bank reserves.--Assuming no major change in monetary policy or in prevailing economic trends, what are the likely dimensions of bank reserve needs over the remainder of the year and what problems, if any, might arise in meeting these needs through open market operations?

Member bank reserve needs are expected to fluctuate widely during the remainder of the year and should cumulate to seasonal highs by early November. Staff projections of the usual type, plus some allowance for continued deposit growth,[1/] imply that (a) gross open market operations may need to be somewhat larger

1/ These projections, shown in the accompanying table, allow for moderate gold outflow and growth in currency outside banks, consistent with the more detailed projections shown in the reserve memorandum. An additional arbitrary allowance for growth in private deposits at the 1964 rates--13 per cent annual rate for time and 3 per cent for demand deposits--is included in the accompanying table, but not in the regular reserve projections. These trend factors, if appropriate for the months ahead, would cumulate over the period and constitute a permanent absorption of a sizeable portion of the reserves injected to meet peak seasonal needs.

over the rest of this year than in recent months to offset expected wide intra-monthly fluctuations in market factors and required reserves; and (b) operations will need to meet a sharp and partly permanent reserve drain around the end of October and early November. Such operations might give rise to short periods of downward pressure on Treasury bill rates, but probably not of a dimension or duration great enough to pose serious market problems given the offsetting influences that would be present in the market or might be exercised by optional official actions.

Peak reserve needs--about $1.6 billion higher than current levels--are projected for the week ending November 10, largely reflecting a rapid two-week expansion of required reserves and drains from float and currency. A similar peak is projected for the week ending December 8, following intra-monthly swings in float and required reserves which are expected to reduce reserve needs by about $600 million in the two intervening weeks. Cumulative reserve needs are expected to remain above current levels by a minimum of $1.0 billion over the 12 weeks from October 28 to January 19.

Assuming that the System maintains net reserves near recent levels, the above projections call for several sizable concentrations of operations, the largest in the period October 28 - November 10. Such open market operations, if confined to Treasury bills, would exert some downward pressure on bill rates. This pressure might not be great enough to override the usual firming in bill rates that accompanies seasonal shifts in private and public needs for funds over the fall as a whole, but the necessity for concentrated System purchases in some weeks could tend to depress bill rates slightly for brief periods.

As on occasion in the past, such downward rate pressure could be mitigated by several types of official action. Some offsetting influence might be exercised by Treasury debt management operations. The Treasury is expected to increase the supply of bills at least by early October to cover its seasonal cash needs, and the timing and dimensions of such bill sales might be partly adapted to counter any undesired strength in bill markets.

The bill rate impact of System buying might also be moderated somewhat by supplying part of the indicated reserve needs through purchases of coupon issues and through repurchase agreements with dealers. Dealer financing needs may be sizable as a result of Treasury financing this fall and on such occasions there should be considerable opportunity for making repurchase agreements. In particular, if a "rights" issue is included in the November refunding, sizable repurchase agreements against rights and other issues might be feasible around late October and early November, the period when projections indicate the largest increase in reserve needs.

One other means of accommodating short-term fluctuations in reserve needs with minimum bill purchases would be the occasional lowering of the Treasury balance at Federal Reserve Banks, thereby injecting reserves and lightening pressures on the large money market banks.

Projected Reserve Needs--August 1965 through January 1966

| Period | Changes in reserves as projected in reserve memorandum 1/ | Allowance for continued growth in private deposits 2/ | Cumulative change (from week of July 29-Aug. 4) |
|---|---|---|---|
| | | (millions of dollars change in reserve week averages) | |
| Aug. 5-Sept. 8 | 540 | 106 | 646 |
| Sept. 9-22 | - 895 | 42 | - 207 |
| Sept. 23-Oct. 13 | 1,080 | 63 | 936 |
| Oct. 14-27 | - 770 | 42 | 208 |
| Oct. 28-Nov. 10 | 1,360 | 42 | 1,610 |
| Nov. 11-24 | - 570 | 42 | 1,082 |
| Nov. 25-Dec. 8 | 565 | 42 | 1,689 |
| Dec. 9-Jan. 26 | - 970 | 148 | 867 |

1/ Projections in the reserve memorandum reflect principally estimated seasonal changes in factors affecting reserves and in deposits absorbing reserves. In addition, those projections allow for growth in currency outside banks at a 3 per cent annual rate, gold outflow after August at the rate of about $50 million per month, and estimated reserve absorption by U.S. Government demand deposits reflecting anticipated receipts, expenditures, and cash financing operations. Projections above also reflect effects of System operations through August 4, including scheduled maturities of repurchase agreements against U.S. Government securities in current weeks.

2/ Annual rates of expansion assumed at the same rates as in the year 1964--about 13 per cent for time deposits and 3 per cent for demand deposits. Such expansion would absorb about $525 million of reserves, or about $21 million per week.

(5) 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 the coming weeks?

In recent weeks net borrowed reserves and member bank borrowings have averaged about $160 million and $525 million, respectively, although with considerable week-to-week fluctuation. The 3-month Treasury bill rate, affected by swings in investor demand and dealer psychology, has moved back and forth in a 3.80 to 3.88 per cent range. Federal funds have traded mainly at 4-1/8 per cent, although occasional trading below that level was induced by the relatively comfortable reserve position of major New York banks, which experienced some seasonal decline in their loans in July along with an expansion in their CD deposits.

If net borrowed reserves continue at their recent levels and market concern with the international situation does not mount, bill rates appear likely to remain within their recent range, with the 3-month bill probably fluctuating between 3.80-3.90 per cent. Seasonal influences will be tending to firm bill rates in the weeks ahead, and such a tendency could be accentuated by international uncertainties. The market is in a good technical condition, however, with dealer bill inventories reduced. This should help to restrain an increase in rates, especially if the basic reserve positions of major New York banks do not tighten further. On the basis of current projections, the System will not be an important factor in the bill market for several weeks ahead; reserve needs will require only minor operations on both sides of the market.

Long-term interest rates, which have fluctuated in a fairly narrow range in recent weeks, are not likely to show significant change in the weeks ahead, barring a sudden shift in expectations related to developments in Vietnam or the United Kingdom. Some further up-drift in U.S. Government yields and some down-drift in corporate yields could occur as a result of investor arbitrage. Also, dealer positions in intermediate- and long-term Government bonds remain large, at just over $1/2 billion. Recent Treasury investment account purchases, however, have reduced some of the overhang in the market and dealer acquisitions of 1969 bonds in the current refinancing were small. The corporate and municipal calendars in August will be seasonally light--although there are indications of a pick-up in volume in September--and further distribution of recent underwritings should proceed with little impact on yields.

Given the economic prospects and credit trends outlined in the staff comments on questions 1 and 3, expansion in bank credit and money is likely to be vigorous over the next few months, although loan growth may moderate somewhat after a resolution of the steel labor situation. Banks probably will continue to encourage growth in their time deposits, both to meet current needs and in anticipation of seasonal loan demands later. The projected decline in Treasury deposits at commercial banks in the weeks ahead should contribute to continued growth in private demand deposits. On balance, an annual growth rate in private demand deposits of between 4 and 5 per cent may be a reasonable expectation for the months immediately ahead. This growth rate would be considerably smaller than the June-July average, but substantially above the 2.7 per cent average rate for the first 7 months of the year.

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

Business activity continues to expand, and further growth is in prospect. Developments in Vietnam have had, and will continue to have, an important stimulative effect on the domestic economy; they have virtually removed any prospect of an economic let-down in the second half of 1965. It is apparent that there will be increased spending in connection with Vietnam, although the amount of the spending and its timing are uncertain. It is quite clear, however, that the changed situation is already having an effect on the thinking of businessmen and of the public in general.

Except for automobiles, inventory increases at the wholesale and retail levels remain moderate. The recent build-up in inventories has taken place largely at the manufacturers' level. The speed and size of inventory liquidation following a wage settlement in the steel industry will, of course, have an important effect on the total business expansion. The Vietnam build-up will probably moderate the liquidation, making it easier for the economy to absorb it.

Trends in prices, both wholesale and retail, are disturbing. The first half of 1965 witnessed a substantial increase in employment. While there are still a number of areas of substantial unemployment those areas are declining, and in many there are special situations which would be affected in only a very limited way by an increase in over-all demand. A number of wage increases under collective bargaining in the first half of 1965 apparently have exceeded by significant amounts the guidelines of the Council of Economic Advisers. Labor costs per unit of output in manufacturing apparently are now rising after declining gradually over a period of several years. Although in the past an increase in unit costs has usually occurred on the upswing of the business cycle, fortunately it did not occur on the upswing beginning in 1961. But this development now seems to be with us. In the meantime, profits continue to rise. We have not seen many instances where the fruits of greater productivity are being passed on to consumers in the form of lower prices.

As for the international situation, our second-quarter balance of payments surplus rests largely on special and nonrecurrent factors. There is little evidence of a fundamental improvement in our basic balance of payments position. Indeed, so far this year our trade surplus has not been as good as it was in the corresponding period last year; and now it appears probable that for the year 1965 it will be less than it was in 1964. Tourist and transportation expenditures are likely to increase substantially. And we continue to lose gold.

The voluntary credit restraint program has had its greatest effect on the repatriation of short-term capital funds. It is doubtful that the movement of such funds from abroad will continue at the rate experienced in the first half of 1965. Indeed, the program and the weakness of sterling have tended to make international rate comparisons less significant. While movements of funds from the United States in order to take advantage of short-term rate differentials are not likely, there is still plenty of incentive for longer-term credits and investments abroad. Since most of the major banks are now below their 105 per cent credit ceiling under the voluntary program and the credit leeway of the whole banking system is fairly large, a moderate outflow of bank credit may be expected during the remainder of the year. It is hard to see any significant improvement in our balance of payments position in the second half of 1965 compared with the first half; indeed, some deterioration seems likely.

There have been increasing uncertainties in international financial sentiment, as evidenced by the highly delicate situation of sterling and the rise in the demand for gold, and the price of gold, in the London gold market. Further deterioration in sentiment could bring pressures on the dollar in international markets and on our highly sensitive domestic markets.

The demand at home for bank credit continues to be strong. The large New York City banks are projecting significantly greater than seasonal gains in business loans for the third quarter as a whole. Bank credit, and the money supply, have continued to rise in recent months, at about the same rate they have risen over the last several years. Bank credit and all types of credit taken together have risen more rapidly than has overall production. The ratio of total nonbank liquid assets to GNP has risen further; it is now near the highest level in a decade.

In considering the need for supplying reserves to the banking system this fall, it seems to me that the System should bear in mind the possibility of reducing member bank reserve requirements as well as using open market operations.

Later this week the new securities offered by the Treasury to refund maturing notes will be issued and delivered to the purchasers. Dealer participation in the refunding was quite moderate, and "even keel" considerations related to the Treasury's operation would not in normal circumstances be a matter of serious concern to us in our own policy deliberations. There was, however, considerable uncertainty in the Government bond market last week stemming from discussion about the future of sterling and the implications of the Vietnam situation.

As we approach policy, there are four basic factors to consider:

(1) Recent domestic developments show forces operating in the direction of an inflationary disequilibrium;

(2) Some deterioration appears in prospect for our balance of payments;

(3) The situation in international financial markets continues to be most delicate; and

(4) These factors and perhaps other factors have produced uncertainties in the U.S. Government securities market.

> In my opinion, this combination of circumstances counsels a cautious restriction in domestic credit availability.
>
> The weakness in sterling rules out, it seems to me, a dramatic move such as an increase in the discount rate at this time. Such a move on our part might be interpreted here and abroad as an indication of a withdrawal by the United States of its concern for the pound, and of a concentration on our own problems; resultant market reactions would, no doubt, place greater pressures on sterling. But a judgment that, on balance, a dramatic move at this time might do more harm than good need not result in no action at all. We still have the danger of excessive domestic liquidity and the distortions that excessive use of credit are likely to breed; and we still have the balance of payments problem.
>
> Therefore, it seems to me that we should move with caution toward somewhat firmer conditions in the money market. Somewhat higher net borrowed reserves and somewhat greater member bank borrowing from the Federal Reserve Banks would seem appropriate. The effect of the move might become apparent in the statistics published next week or the week thereafter. As for the form of the directive, I favor alternative B. 1/

Mr. Shuford commented that economic activity this summer had proceeded with all the strength that could have been anticipated and that was appropriate. Employment had been increasing rapidly. The rate of increase in personal income had accelerated in recent months. As further evidence of strong aggregate demand, wholesale industrial prices had increased more rapidly than in the last several years.

Recent and current monetary and fiscal developments had been quite stimulative, Mr. Shuford said. The money supply had increased rapidly since May and at a rate of about 3 per cent since the beginning

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1/ Three alternative drafts of the directive prepared by the staff are appended to these minutes as Attachment A.

of the year. The planned Federal budget recently had turned more expansionary. Beyond the current strength of the economy and recent monetary and fiscal developments, continued and additional fiscal expansion would be faced in coming months. The planned budget would continue stimulative during the second half of the year and, as already had been noted, there would be a further increase in military spending.

In view of the impact of the fiscal stimulation which had been anticipated earlier and that which would result from the new military situation, Mr. Shuford continued, excessive total demand could become more definitely the major stabilization problem. It might be that over the next few months a more restrictive combination of monetary and fiscal measures would be appropriate. It was not likely that fiscal policy--to any great extent--could be made more restrictive during the remainder of the year. Consequently, developments in stabilization policy during the next few months would have to be primarily on the monetary side.

If monetary restraint should be appropriate during the next few months, Mr. Shuford observed, it would not only help to prevent excessive total demand for goods and services and resultant price inflation but it should tend to bring U.S. interest rates into better alignment with those in some other major countries. That would aid in restoring reasonable balance to the international accounts, and it would be a contribution to the fundamental adjustment which, sooner or later, had to take the place of the present temporary voluntary restraints on the flow of capital. He hoped that at the same time certain foreign countries could be persuaded to adopt tighter fiscal and easier monetary policies, thereby pushing down their interest rate levels.

As far as the next few weeks were concerned, Mr. Shuford did not suggest that the Committee should take any overt action. For the immediate future he favored moderate rates of increase of reserves and money, lower than the average rates of the past twelve months. Reserves should not be supplied so rapidly as to support unduly large increases in bank credit. In view of the strength of business, the fiscal situation, and developing seasonal pressures, he thought such a policy stance would be consistent with some upward movement in interest rates. Somewhat higher interest rates would be appropriate if the domestic economy generated greater credit demands, from either the private or the Federal sector.

As at the previous meeting, Mr. Shuford said, his position on policy was close to one of "no change," and the first paragraph of alternative A of the draft directives was acceptable to him. However, he again would recommend a revision of the second paragraph, as he had last time, in order to emphasize the need for preventing any excessive increase in demand. Specifically, he would revise the language following the phrase "with a view to maintaining" to read, "at least as firm conditions in the money market as have prevailed in recent weeks, and to permit some tightening if demands for credit strengthen."

Mr. Patterson said that at the risk of overworking an attractive definition introduced by Mr. Noyes at the previous meeting of the Committee on the "new semantics" that had developed along with the "new economics"--when he said that nowadays things were "unchanged" when they were increasing at the same rate as before, and things were going up only when the rate of increase exceeded the one previously established--he would carry Mr. Noyes' theme a little further and say there also was a "new semantics" with respect to declines. For example, there seemed to be three sorts of declines developing in the Sixth District, only one of which constituted a decline in the old sense. Some of the District statistics showed rates of gain lower than those previously established, and some were showing relative stability, both of which were declines according to Mr. Noyes. In addition, there were a few actual declines.

In the first category (rates of increase less than formerly), Mr. Patterson went on, one had to classify the behavior of the most recent statistics on employment, manufacturing payrolls, and personal income. The softness in manufacturing payrolls helped explain the slackening in the growth of personal income, although cash farm receipts, derived partly from rapidly rising farm prices, had helped to maintain income. For example, the first week's market for Georgia-Florida flue-cured tobacco, which opened July 28, yielded prices averaging $64.95 per 100 pounds, $17.75 above the same period last year. District livestock producers were, of course, sharing in the income gains from higher prices for cattle and hogs.

In the second category of declines--those sectors exhibiting relative stability--one had to classify the behavior of retail sales, Mr. Patterson said. If the ups and downs from month to month in 1965 were smoothed out, a chart would show an almost horizontal line. Construction outlays and construction employment also were moving horizontally on a high plateau.

Finally, Mr. Patterson said, the District had been experiencing a few old-fashioned actual declines. For example, construction contract awards had been in a downtrend since December 1964, with the decline concentrated in nonbuilding types such as missile and space projects, highways, and bridges. The downtrend in residential contract volume evidenced throughout 1964, however, had apparently been reversed, although the new uptrend was still in its infancy.

Turning to banking, Mr. Patterson remarked that the District definitely had been experiencing increases measured by any man's semantics, new or old. For example, loans at the end of July were up 15 per cent from a year ago; investments, 4 per cent; and deposits, 12 per cent. Placed in perspective, those increases were roughly twice as large as the increase in economic activity as measured by personal income. Moreover, there had been no letup in the rate of credit expansion over the first half of 1965, notwithstanding the firming of Federal Reserve policy this spring. Loan and deposit increases in the second quarter were equal to those in the first.

Viewed from several angles, Mr. Patterson continued, firming in Federal Reserve policy had not retarded credit expansion at District banks. Those banks, which had been in a net borrowed reserve position in June, moved into a free reserve position in July, a movement that was accompanied by a decline in borrowing; on the average, the banks had been net sellers of Federal funds; and the member banks had been able to increase their loans with only a slight loss in their holdings of Government securities and municipals. Judging from the response of 73 member and nonmember banks to the recently completed survey of lending practices, changes in bankers' attitudes to their loan requests seemed to be related more to the strength of the business loan demand than to Federal Reserve operations.

At the moment, Mr. Patterson was not prepared to say what all of those contrasting trends meant in terms of Federal Reserve policy. However, if he were voting and had to make a choice among the alternative draft directives it would be in favor of alternative A.

Mr. Bopp reported that economic activity in the Third District had continued to expand in recent weeks, but at a somewhat slower rate. Steel production in the Northeast Coast region decreased considerably more than nationally, and the rise in department store sales in the past four weeks was much less there than for the United States. Loans of reporting banks declined in July, reflecting substantial repayments by securities dealers and sales finance companies. Reserve positions of reserve city banks had tightened considerably, resulting in larger net purchases of Federal funds and additional borrowing from the Reserve Bank. Country bank borrowing from the Reserve Bank, however, had declined to a low level.

Discussions with bankers and businessmen revealed, Mr. Bopp said, that except for a helicopter manufacturer who planned to add over 1,000 employees to meet increased defense orders, most saw the proposed buildup of U.S. armed forces in South Vietnam as having little effect thus far. There had been no tendency to mark up prices, and a possible increase in inventories was mentioned only once. A textile producer with inventory somewhat low as compared to others in the industry reported that he was seriously considering building up his stocks somewhat in order to be in a better position to handle new orders that might come from the stepped-up defense program. Some expressed the view that steel and metal product inventories might not be reduced so much following a wage agreement in the steel industry as would have occurred otherwise.

Larger draft calls were unlikely to have much effect on unemployment in the Third District, Mr. Bopp thought. The average age of draftees currently was 21, and was expected to fall to about 20-1/2 in the next year. The unemployment rate in that age group was far below that for teenage males. Also, nearly one-half of the men examined by Selective Service were rejected, and the probability was rather high that those rejected were not qualified for the kinds of work for which job opportunities were good.

Those findings for the local area conformed with Mr. Bopp's expectations for the nation as a whole. The proposed step-up in defense expenditures apparently could be absorbed without any significant inflationary pressures. The increase estimated for the remainder of this year was small in relation to current GNP (only about 1/4 of 1 per cent), and the impact would be distributed among a number of industries. Moreover, it came at a time when the existing margin of unused resources, together with additions to capacity resulting from the high level of capital expenditures, appeared sufficient to meet prospective increases in aggregate demand.

Mr. Bopp could find no evidence thus far of a general upward pull or push on the wholesale price level. The rise in wholesale prices of the past few months reflected primarily supply situations in farm products, processed foods, and nonferrous metals, rather than total demand pressing against productive capacity. Reduced marketings of livestock as a result of low prices last year and short supplies of fruits and vegetables because of unfavorable weather were the principal reasons for the rise in the prices of farm products and processed foods. The rise in nonferrous metals reflected the usual price response of those products to wide cyclical swings in demand against a relatively inelastic supply. Generally stable labor costs per unit of output in manufacturing (the small fractional increases in the past three months were not sufficient to have much significance) and the rise in manufacturers' after-tax profits in the second quarter, and also in their profit margins, indicated no upward push on prices.

It appeared to Mr. Bopp that the absence of any significant inflationary pressures would continue. At the same time, liquidation of steel inventories might soon become a downward drag on the economy. Those considerations, plus the fact that the improved balance of payments position was continuing, led him to the conclusion that additional restraint was not called for. On the other hand, he would not relax the present degree of firmness in view of the stimulus that would be provided by larger defense expenditures and a more expansionary fiscal policy. He recommended, therefore, that current policy be continued for the next three weeks. An additional reason for that view was the current feeling of uncertainty in the Government securities market. Any change in policy would be likely to have a greatly magnified effect. He favored alternative A of the draft directives.

Mr. Hickman remarked that, while the economy continued to inch upward in July, the latest data on the leading indicators showed that a majority had either leveled off or declined slightly. Looking ahead, some uncertainties in the business outlook referred to at the previous meeting of the Committee had been alleviated by increased defense spending for Vietnam, but the steel settlement was still a major element to be resolved. It probably would be late September before it could be determined which way the economy would respond.

In assessing recent business developments, the major contributions provided by steel and autos should be noted, Mr. Hickman said. Steel production, which amounted to a seasonally adjusted annual rate of 149 million ingot tons in July, would hold near that rate in August, but would decline appreciably in September, irrespective of a steel settlement. Assuming a settlement, the extent of the decline would be determined by the amount of inventories to be liquidated and the level of consumption, two measures about which there was a great deal of talk but little real knowledge. Because of Vietnam, steel inventory liquidation would not be as great as previously expected, but the extent of the adjustment could not be estimated until more was known about price developments and the impact of defense spending.

The record of the automobile industry continued to confound the experts, Mr. Hickman commented. Auto production in July amounted to 9.7 million cars, seasonally adjusted annual rate, while estimates for August indicated adjusted output at a rate of nearly 9.5 million cars. Car sales declined moderately in July, but were a record for the month; inventories increased slightly but were now declining sharply.

Although some price indicators subsided in early July, the odds now seemed to Mr. Hickman to have shifted away from price stability in favor of moderate price inflation. Because of short supplies of pork, beef, and vegetables, the upward drift of the consumer price index had accelerated. Increases that were first reflected on the farm in February and March subsequently showed up in wholesale prices of processed foods and finally in consumer food prices. If typical lead-lag relationships held, a further rise could be expected at the consumer level before the modest decline that occurred in farm prices in July took hold.

Vietnam had already had an impact on industrial prices, Mr. Hickman noted, with nonferrous metals, textiles, and hides and leather firming somewhat since mid-July. Upward pressure in nonferrous metals in some cases reflected tight supply situations. While industrial prices would probably not move up as rapidly as they did at the outbreak of the Korean conflict, the general climate was now more conducive to price increases than at any time in the recent past.

At this juncture, past trends seemed to Mr. Hickman to be even less reliable guides than usual to future developments. The key question concerned the effects of the step-up in defense spending on economic activity. Whereas previously a rate of growth in GNP had been anticipated during the second half that would not close the gap in the economy's potential--implying an increase in the aggregate rate of unemployment--the expansion could not proceed at a faster rate. At this point, he felt intuitively that it would take a much sharper escalation than presently appeared to be in the cards to overheat the economy. But to formulate appropriate monetary policy the Committee clearly needed to know much more than it did now about defense spending and the steel situation. Unfortunately, that was something it might not know for several weeks, perhaps until late September.

In recent months, Mr. Hickman noted, he had felt that monetary policy was slightly firmer than it should have been on the basis of information then available. Now, however, with the advantage of hindsight, he thought that it had been about right after all, although perhaps for the wrong reasons. In any event, in view of the current Treasury financing, hesitancy in the capital markets, uncertainties in the domestic business outlook, and growing pressure on the pound sterling, no change in policy seemed to be desirable at this time. By "no change" he meant net borrowed reserves around $150 million and borrowings around $500 million, with a personal preference for a shading downward from those figures. He favored alternative A for the directive.

Mr. Maisel agreed with the staff that the step-up in Federal activities resulting from Vietnam was nearly sufficient to offset the curtailment in private expenditures that had been expected during the coming periods. As a result, if the programs went forward as now projected, the rate of growth in the economy should continue about as it had recently. That would mean that existing slack would remain at the present levels.

The relationships which had developed among international interest rates made it imperative, Mr. Maisel said, for the Committee to undertake the careful reconsideration of current interest rate policy that was considered necessary when the present directive was adopted on March 23. Current indications were that the major European countries had decided to put the bulk of their faith in monetary rather than fiscal policy. That raised serious questions as to wh ther or not the United States could afford to be one of the few countries with its capital market open freely to buffeting from decisions made abroad. The voluntary foreign credit restraint program was clearly an indication that such pressures were basically unacceptable. As a part of the general reconsideration of its present policy, the Committee needed to consider the short-run implications for the balance of payments of existing short- and long-term interest rates while attempting to determine what type of capital markets, under what conditions, could be viable after the voluntary restraint program had passed. The Committee particularly needed a review of what capital market movements were a threat. Was the Committee concerned with Canada, Britain, developing countries, or continental Europe? Did short-run movements have the same implications as long-run ones?

Mr. Maisel felt that, given the present uncertainties as a result of Vietnam plus the continued negotiations in the steel industry, the Committee ought not to alter policy, since any change could be misinterpreted. As a result, he would support the current directive--alternative A. At the same time he believed that the creeping growth in the amount of net borrowed reserves ought to be reversed. The average of free reserves expected at the conclusion of each week's operations had risen by $15 million in each month under the current directive. Because most of the biases currently appeared to be on the restrictive side, the amount of net borrowing had been even larger than projected at the end of operations.

Since the market would be buffeted by many conflicting forces during coming periods, it seemed advisable to Mr. Maisel to recognize the existence of the voluntary foreign credit restraint program and to allow the bill rate to fall if that occurred as the result of normal market action. He did not feel that artificial pegging of the bill rate above the rate that the market would determine with the present level of reserves and demand for money ought to be the critical criterion for operations.

Mr. Daane said he continued to believe that there were times when a decision to maintain the status quo with respect to policy was as significant as a decision to make a change. He felt strongly that the present was one of those times. The uncertainties existing in the markets for Government securities and foreign exchange, the absence of clear and compelling evidence calling for a change in policy noted by Mr. Brill, the considerable skepticism expressed by the staff regarding the permanence of the improvement in the balance of payments, the uncertainty as to the kind of settlement that would be made in the steel industry, and the fact that some period of digestion with respect to the current Treasury financing still lay ahead--all of those considerations quite clearly called for no change in policy.

As to the draft directives prepared by the staff, Mr. Daane continued, he felt that there was too much change in wording for the sake of change alone. Assuming the consensus today was for no change in policy, he would recommend only a few revisions from the directive adopted at the previous meeting. Specifically, in the first sentence he would substitute the words "early in the year" for "the first quarter." Between the second and third sentences he would insert the sentence, "International developments are creating uncertainties in securities and foreign exchange markets," and leave the rest of the first paragraph unchanged. In the second paragraph, he would replace the phrase, "and taking into account the forthcoming Treasury financing" with the phrase, "and taking into account the current Treasury financing and unsettlement in market conditions," and retain the remaining language.

When the Committee was not making a policy change, Mr. Daane said, revisions of the directive language should be limited to those necessary to recognize significant developments, and in his judgment the only recent developments of major significance were the uncertainties and unsettlements occasioned by events in Vietnam and Britain. To make other revisions might suggest to the reader of the published record that the Committee had modified policy when in fact it had not. One change of the several the staff proposed seemed to him to be particularly inappropriate--that of substituting the words, "to defend the international position of the dollar" for the words, "to reinforce the voluntary restraint program to strengthen the international position of the dollar."

Mr. Mitchell said that at the previous meeting he had seen no reason for making a change in policy and he saw none today, although he now regarded the economic situation and outlook as stronger than previously. The major factor underlying that view was the recent rate of consumer spending, which was surprisingly high. A second important factor was the improvement in business psychology as a result of the escalation in the Vietnam situation, although that improvement might be based on an erroneous reading of the outlook--Federal expenditures in connection with Vietnam might not rise as much as many expected.

With the uncertainties prevailing in securities markets, Mr. Mitchell said, the Committee should do what it could to reinstill confidence in the viability of the present pattern of interest rates. The differentials existing among rates on tax-exempt and corporate and Government securities at present perhaps were unstable, and that might lead to a decline in prices of Government bonds. In any event, he would not want to see any further rise in the levels of long-term rates.

As to the balance of payments, it seemed to Mr. Mitchell that the results of the voluntary foreign credit restraint program were all that had been hoped for, if not more. The program was not intended to produce a permanent solution to the balance of payments problem, and no one should be surprised that it was not doing so. A permanent solution had to be sought through other policy measures. The last measure he would recommend for that purpose would be an increase in domestic long-term interest rates to levels equal to those in, say, Germany.

Mr. Mitchell favored alternative A for the directive with one change in wording that was consistent with the views Mr. Daane had expressed. In the second sentence of the first paragraph he would replace the words, "to help defend" (the international position of the dollar) with the words, "to help maintain." To his mind, "to help defend" was unduly dramatic language.

Mr. Shepardson said that in preparing for this meeting he had tried to reconcile his own feelings with the staff's assessment of the conflicting factors weighing in the present situation. There were many uncertainties in the picture, and while he suspected that some of the concerns that Mr. Treiber had expressed today were warranted, he found it hard to document that belief. The nature of the steel settlement would, in his judgment, have important implications for the economy. Because the negotiations were still in process, and despite the fact that he shared Mr. Treiber's concerns, he had come to the conclusion that it probably was best to make no change in policy at present. He would not like to see any shading of market conditions to the easier side under a generally unchanged posture, as had been suggested; he would hope that there would be no relaxation of pressure.

As to the wording of the directive, Mr. Shepardson thought there was merit in Mr. Daane's observations but he found alternative A as drafted by the staff acceptable, with Mr. Mitchell's suggested change in wording.

Mr. Robertson then made the following statement:

> There are a number of powerful forces influencing economic trends at the moment--some pushing up and others pulling down. On balance I think they call for us to hold a steady course for monetary policy over the next few weeks, not turning consciously toward either tightness or ease.
>
> I would not want to ease policy right now, for a considerable degree of new fiscal stimulus lies immediately ahead of us. Some of this will come from the enlarged Social Security payments, but the more important impetus is probably the Vietnam buildup, and we have no dependable idea of how big that might turn out to be. Even before the new Vietnam action entered the picture, moreover, the economy was performing a bit better than expected, and it was being supported by a vigorous rate of monetary expansion.
>
> One final factor also weighs against easing today, in my view: steel contract talks are coming up against their previously agreed-upon deadline at the end of this month, and (without trying to forecast the eventual settlement) I would not want to have eased policy at this meeting and then find a big steel wage advance and an associated round of price increases developing.
>
> But, on the other hand, I also see considerations that I think would make it unwise to tighten right now. I am sensitive to a few symptoms of "tired boom" that could be seen to be developing in the clearer atmosphere pre-Vietnam. Furthermore, we can expect that some short-run downward pressure from steel stock liquidation ought to occur whenever we get either a settlement or a strike.
>
> Perhaps our greatest risks of precipitating unhappy consequences, however, center in our financial markets. These markets--particularly the long Government bond market--are already nervous and weighted down by dealer inventories. I hate to think of how those markets might drop if the receipt of bad news from abroad (as some people apparently think may be forthcoming) caught them at a time when we had already pushed them off balance and strained their resiliency by an unexpected further tightening of monetary policy.

In the absence of domestic developments which would make a policy change imperative, I would prefer to move through the weeks ahead on a steady course, with the Manager maintaining money market conditions about the same as in recent weeks. If investors in their nervousness, should shift toward liquid assets and depress bill rates in the process, I think we ought to let a bill rate decline occur. On the other hand, should bank deposit expansion continue unseasonally strong and boost required reserves more than expected, I would not object to some resultant revisions to deeper net borrowed reserve figures. But aside from such nuances, I would hold policy unchanged until the next meeting, or until and unless the international financial storm breaks over Britain. If that should occur, its reverberations in securities and foreign exchange markets are impossible fully to foresee, and I would want both the Special Manager for Foreign Operations and the System Open Market Account Manager to have all the power and flexibility it is feasible to give them to deal with the consequences, although that can be provided in a special meeting, if necessary. To that end, I would vote for the proposed alternative A for the current directive.

Mr. Robertson added that like Mr. Shepardson he felt there was much to be said for Mr. Daane's position against changes in wording for the sake of change alone. Nevertheless, he found that he could accept the staff's draft language with the modification suggested by Mr. Mitchell.

Mr. Wayne reported that business conditions in the Fifth District continued to display basic strenght, much as in the nation as a whole. In the Richmond Bank's latest survey, however, the size of the minority anticipating a business downturn had increased. Among businessmen, 21 per cent now thought some decline was probable, compared with 7 per cent eight weeks ago. Among bankers, however, whose sentiments usually were more volatile there was not a single pessimist who foresaw a downturn in the near future. Except for textile producers, manufacturers in the survey indicated a lower average level of new and unfilled orders for the first time in eighteen months but continued to report rising shipments and small increases in wages and prices. Textile producers expected sizable Government orders soon as part of the defense buildup; that would come on top of an order backlog which already pre-empted almost a year's production in several major lines. In agriculture, tobacco acreage-poundage controls were expected to cut the District's output of flue-cured leaf by 17 per cent, but favorable prices would probably reduce the impact on income.

At the present stage, Mr. Wayne continued, the precise scope of the current defense buildup was not clear and any assessment of its implication for business performance in the second half was probably premature. For the very short run, its principal impact was likely to be on business expectations patterns. He would expect some adjustment in business inventory planning in a direction that would work to offset the anticipated liquidation of steel stockpiles, and perhaps also some scattered price pressures. Considering a somewhat longer time span, consumer spending for durables might be stimulated, especially in view of prospective increases in social security payments and in military and civil service pay scales. Whatever the magnitude of the added stimulus, it would be superimposed upon a basically strong economic situation. Plant and equipment expenditures continued high, automobile sales remained at record levels, the consumer surveys showed that the public was still in a spending mood, and the latest construction figures were encouraging.

Mr. Wayne went on to say that the recent relative increase of long-term rates abroad partially offset the advantages of the interest equalization tax and might well introduce some stress on the voluntary foreign credit restraint program. For the immediate future, however, he was more concerned over the tendency in some quarters to view the modest second-quarter surplus in the balance of payments as evidence that the problem had been solved. The current unfavorable prospect for the merchandise account struck him as more deserving of attention than improvements that were attributable to a program that could be viewed only as temporary. In surveying the international scene, however, he was most concerned with the position of the United Kingdom. It appeared to him that the sterling problem had moved into a new and critical phase and, while no one could predict the next development, he believed the

System might well be confronted over the next few months with what could be the gravest international payments crisis since the 1930s.

Bank credit behavior in June and July generally followed the usual seasonal pattern, Mr. Wayne said. Loan demand remained strong, and in view of the low level of corporate liquidity, rising business capital outlays, and the likelihood of increased inventory accumulation in many lines, business loans might be expected to continue at a high and perhaps rising level for the next few months. Consumer spending plans also indicated an increase in the demand for consumer loans.

In view of the prospects for continued strong loan demand in the second half, Mr. Wayne remarked, the need for bank reserves was likely to increase, although perhaps not as rapidly as in the first half. Developing seasonal needs coupled with limited new bill offerings by the Treasury might make it difficult to supply necessary reserves through open market purchases without unduly depressing bill rates. That situation could change if rising defense expenditures became large enough to require substantial amounts of additional Treasury financing.

Regarding policy, the current level of reserve availability appeared to Mr. Wayne to be altogether consistent with the rate of credit and money expansion required by the domestic economy. Aside from the problem of meeting seasonal reserve needs, he saw nothing in the domestic picture that called for any change in reserve availability. In particular, he would be reluctant to move in the direction of greater ease in view of the possibility that price pressures might develop from the impending step-ups in defense expenditures, from the increases in Social Security benefits and military pay scales beginning in September, and from possible increases in Civil Service pay scales. He believed that any substantial liquidation of steel inventories that might develop in the near future would be offset in large measure by those added fiscal stimuli and would not require any compensation from monetary and credit policy. On the international side, the deterioration in the U.S. trade balance cautioned against any move in the direction of more ease. In relation to sterling the Committee should not compound the problems of the British by any greater firmness of policy, but the heavily exposed position of the dollar in relation to the pound required serious consideration of the strength of this country's own situation. In brief, it seemed to Mr. Wayne that the considerations pro and con were quite evenly balanced, and he favored a continuation of the present policy and alternative A of the draft directives.

Mr. Clay commented that the domestic economy had performed quite well in recent weeks. As anticipated, the rate of expansion had been lower than during the bulge of the early months of the year. However, the performance probably had been somewhat better than generally anticipated.

The recent military decisions concerning South Vietnam had injected a new factor into future economic developments, Mr. Clay said. The staff analysis under question 1 covered that situation very well. The immediate impact on the domestic economy was small, and the projected impact in the months ahead appeared to be readily absorbable. The fact was that the Committee did not really know what the military program would be in the months ahead, however, and accordingly the effect on the economy would have to be re-evaluated constantly.

Substantial progress had been made in the fuller utilization of resources, Mr. Clay continued. The resource base was still growing and there appeared to be room for continuing orderly expansion in economic activity. If the military impact proved to be more pronounced than anticipated, however, the resource utilization situation would need to be observed very closely as a factor conditioning the formulation of policy.

Loan expansion had moderated, Mr. Clay noted. Business loan expansion had moderated somewhat also, although business loan growth had continued large. While loan demand remained strong, the increased use of bank credit was taking place in an economic environment that remained orderly.

To Mr. Clay, analysis of the domestic economy seemed to indicate the appropriateness of a continuation of the monetary policy of recent weeks, and the international balance of payments situation appeared to permit the pursuit of that policy. The staff analysis under question 5 included the necessary information concerning the targets involved in the implementation of such a policy approach.

Mr. Clay would not change the discount rate. In his judgment, alternative A of the draft directives would serve satisfactorily as the economic policy directive.

Mr. Daane left the meeting following Mr. Clay's remarks.

Mr. Scanlon reported that economic activity in the Seventh District had remained at high levels during recent weeks. Reductions in the rate of inventory accumulation, particularly in steel, were still considered a potential source of disruption to the pace of activity but no other weaknesses were evident. Prospects for a continuation of the expansion at or near current rates were good.

A Chicago steel industry analyst reported that it was now apparent that the peak in the buildup of steel inventories had been reached in the early part of July, Mr. Scanlon said. Order backlogs in the industry were being "worked off" at a slow and orderly rate. Unemployment compensation claims continued to decline in all District states except Wisconsin.

Mr. Scanlon observed that net farm income in the Midwest was expected to continue above the year-earlier level during the remainder of 1965, with gains in livestock, crops, and Government payments. Hog and cattle prices were expected to remain above those of a year ago and larger crops of wheat and feed grains were in prospect.

A continued strong demand for agricultural loans was reported by the "agricultural" banks surveyed by the Chicago Reserve Bank in early July, Mr. Scanlon remarked. The demand for loans to finance feeder cattle was expected to be especially strong this fall because of the large corn crop in prospect, higher feeder cattle prices, and relatively favorable prices for slaughter cattle. Loan pay-offs at the agricultural banks had been favorable, reflecting the rise of farm income. Current developments in the Midwest seemed to indicate the continuation of a strong underlying business loan demand. Stepped-up issues of CDs by the major Chicago banks suggested that they expected substantial loan demand in coming months. Other types of loans also showed greater gains than a year ago. Real estate loans at District weekly reporting banks were 21 per cent above a year ago and loans to finance companies were up 25 per cent. The gain in consumer (other) loans had been somewhat less vigorous--17 per cent.

Although the major Chicago banks showed continued tightening in their basic reserve positions in July, Mr. Scanlon said, their position was still relatively comfortable. They had not increased borrowings at the discount window and had not liquidated Governments in significant amounts.

Speaking specifically to question 4, Mr. Scanlon shared Mr. Treiber's view that in providing the substantial amount of reserves that the System would be required to inject in the period between September 1 and the end of the year consideration might be given to meeting some or all of this need by a reduction in reserve requirements on time deposits.

Looking to the next three weeks, with the steel settlement and other uncertainties hanging over the economy, Mr. Scanlon thought the Committee should maintain about the current policy posture. On that basis, he would prefer alternative A for the directive, as amended by Mr. Mitchell.

Mr. Galusha said that he would omit most of the remarks he had prepared on recent developments in the Ninth District to avoid reiterating statements already made in connection with other Districts. However, he would note one respect in which the District differed from some others--the major city banks had indicated in an informal survey that they did not expect a resumption of the heavy loan demand of a few weeks ago.

On the basis of information now available, Mr. Galusha was inclined toward no change in policy at the present time and, accordingly, toward alternative A for the directive. He had some reservations about that judgment because he was not wholly confident about the near-term business outlook. On the other hand, it was possible that days to come would reveal evidence that the expanded military effort in connection with Vietnam would have greater economic effect than it seemed reasonable to expect at the moment. Were he to favor additional monetary restraint at this time it would be because long-term interest rates had been rising in other major countries and because of the balance of payments implications inherent in that shift. He was not sure of the significance of those current variations, however, and so was inclined to wait a bit until the impact of the changing differentials became clearer. Also, the effects of the Vietnam buildup might likewise be clearer in a few weeks.

Mr. Galusha indicated that he agreed whole-heartedly with Mr. Daane's observation that a decision by the Committee to make no change in policy was a positive act. He thought, however, that Mr. Daane's further observation--that modifications in the language of the directive should be kept to a minimum when policy was unchanged--involved a non sequitur. The directive adopted at each meeting presumably should reveal the major factors on which the Committee based its decision at that meeting, and since those factors ordinarily would change over time it seemed appropriate to change the language of the directive even though policy was unchanged.

Mr. Swan said that there had been some small recovery in the aerospace and defense industry in the Twelfth District in recent months, before the current Vietnam developments. To a considerable extent the recovery was related to an increase in orders for commercial aircraft. In light of recent developments, it certainly seemed that there would be some further rise in activity in that industry. However, as far as the District was concerned, he would agree with the staff comments under the first question that in general there as yet had been little public concern over the possible impact of the defense buildup and no significant movement to date toward anticipatory buying.

The District's lumber industry had been in somewhat better position in recent weeks, Mr. Swan continued, as a result of the combination of some increase in orders, some rise in prices, and vacation shutdowns. However, the position of the industry had not improved significantly over that of a year ago.

The question of the adequacy of the domestic agricultural labor supply probably would be rising again soon, Mr. Swan said. The peak of the tomato harvest period lay ahead, and although acreage was down sharply from last year there was some question of whether the harvest could be handled without using Mexican labor.

Mr. Swan remarked that the advertising compaign of District savings and loan associations that he had mentioned at the previous meeting evidently was not proving to be very successful in attracting deposits. The associations were in a rather tight position as a consequence of that fact and of the current efforts of the Federal Home Loan Bank Board to dampen their borrowing. As a result, the supply of mortgage funds was likely to be less than had been anticipated and there might be some firming of mortgage terms, as had already been noted. The reserve positions of District banks continued to be under considerable pressure. The banks recently had stepped up their borrowing from the Reserve Bank and they continued to be net buyers of Federal funds on a substantial scale.

Mr. Swan agreed with those who felt that in light of the uncertainties existing at present the Committee should not make a policy change. He was encouraged by the fact that nonborrowed reserves had increased by only about 2 per cent in

July--much less than in June--without any additional upward pressure on member bank borrowings and net borrowed reserves.

Mr. Swan noted that intra-monthly fluctuations in reserves were relatively small in August and that the need for supplying a substantial volume of reserves for seasonal reasons would not arise until later in the year. In view of those facts he wondered whether it might not be appropriate to put a little more emphasis on the figures for nonborrowed reserves in interpreting a decision to make no change in policy, at the same time widening somewhat the target ranges for borrowings and net borrowed reserves in both directions. If a policy decision for "no change" was interpreted in terms of supplying about the same amount of nonborrowed reserves in August as in July, a change toward either stronger or weaker credit demands would be reflected in the figures for borrowings and net borrowed reserves. Admittedly, the Desk might have difficulty in carrying out such an instruction, but in view of the many uncertainties existing at present it would be helpful if the Committee could get some better sense of the nature of market responses during the next few weeks.

Mr. Swan found alternative A acceptable for the directive with Mr. Mitchell's proposed change. Perhaps the Committee would want to use the phrase "to help defend the international position of the dollar" at some future time, but he did not think it was appropriate now. It seemed to him, as it did to Mr. Galusha, that if the Committee decided to make no change in policy today it would be for a set of reasons somewhat different from those at the previous meeting. Accordingly, he did not object to the modifications of language proposed by the staff, although he agreed that changes should not be made in the directive for their own sake.

Mr. Irons reported that there had been little change during the past month in most areas of business in the Eleventh District. Activity was at a high level, and as far as he could tell there was no evidence of developing softness at this time. There was strength in all major categories of employment; unemployment had declined; department store sales were strong; and both production and construction were about unchanged at very high levels. District businessmen and bankers were quite pleased with economic conditions, although they were concerned about the various uncertainties that had been mentioned at the meeting today.

There had been a fractional decline in loans and investments at District banks in the past month, Mr. Irons observed. The banks were facing strong loan demands, however, and they were expecting demands to increase in the months ahead. Several of the District's larger banks were in a rather tight liquidity position and had been heavy buyers of Federal funds. Borrowings from the Reserve Bank had not been large--the average was running at about $35 million--and mainly involved some of the smaller banks. However, the Reserve Bank was administering the discount window fairly strictly under the terms of Regulation A, and if administration were relaxed borrowings undoubtedly would rise substantially. Some bankers had commented frankly that they would prefer to borrow from the Reserve Bank at a rate of 4 per cent rather than to buy Federal funds at a 4-1/8 per cent rate. That situation might raise a question regarding the administration of the discount window. He would not pursue the matter at the meeting, except to note that he was expecting banks as a group to increase their borrowings and that, with city banks active, the problem of continuity of borrowing inevitably would arise.

In Mr. Irons' judgment the national economic situation was strong. He was optimistic about the outlook, although he recognized that there would be problems in the months ahead of the kinds others had noted in connection with inventories, the balance of payments, and the position of sterling.

Mr. Irons said that his position on policy for the next three weeks was close to that of Mr. Shepardson. In view of all the uncertainties existing he would not want to make an overt change toward firmness, nor would he move toward greater ease. As between no change and a slight shading toward firmness, he had found the choice to be a close one at the previous meeting and he thought it was even closer today. On balance, however, he would suggest continuing the posture of the past month during the next three weeks, maintaining reserve availability and conditions in the money market about unchanged. He would not be overly concerned if the bill rate drifted off; the bill rate had lost much of its significance recently, with Federal funds often trading at rates above the discount rate and with the various methods banks had developed for obtaining funds.

Mr. Irons said he could accept alternative A for the directive. He was not particularly happy with the specific language of the draft, but he thought it would serve the purpose and did not propose to suggest revisions.

Mr. Latham reported that recent economic trends in the First District paralleled national trends fairly closely. Nonagricultural employment registered further gains during the month of June. Nonmanufacturing employment slightly exceeded the normal seasonal pattern, while manufacturing employment was about in line with seasonal expectations. Percentage-wise, the net rise from a year ago remained at 2.2 per cent compared with 3.8 per cent for the country as a whole. Average weekly hours of manufacturing production workers rose to 41.4 hours from 41.1 in May and 40.5 a year ago. There was a slight downward revision in the manufacturing production index for the District in June, bringing it to the lowest point since February, but the index still reflected a net rise of 7.7 per cent from a year ago.

Construction contracts continued their erratic monthly course in June, Mr. Latham observed. As a result a cumulative lag of 5 per cent in nonresidential contracts and a cumulative gain of 1 per cent in the residential area was recorded for the first six months of the year in comparison with last year.

Mixed trends were in evidence in consumer spending, Mr. Latham continued. Deposits at reporting savings banks showed a slightly less vigorous growth in June due to heavier withdrawals, which were 9.9 per cent larger than in June 1964 and compared with new deposit growth of 3.3 per cent. The 12 months' gain in the net balance was accordingly further narrowed, to 8.2 per cent.

First District bank experience had generally paralleled that in the nation, Mr. Latham said. Total loans, although down, were not down to the extent that might normally be expected following the substantial June rise. Real estate loans continued to expand. Government security holdings were further reduced and the upward trend of time deposits was still in evidence. The ratio of loans to deposits of District reporting banks was

75 per cent on July 28 compared with 70.1 per cent for the country. Average daily borrowings at the discount window during the four weeks ended August 4 were relatively light.

Bankers' expectations were that loan demand would continue its strength on a generally broad base, Mr. Latham observed. A steel strike, military needs, or an intensification of the sterling crisis were the imponderables. Eliminating extremes in those areas, it was anticipated that business would continue good and that loan demand would be on the high side of seasonal limits.

Mr. Balderston said he shared the fears that had been expressed by some members of the Committee, including Mr. Treiber. The present season often had been referred to as that of "summer doldrums' in past years, with that term used to explain, or perhaps to rationalize, unsatisfactory figures for the domestic economy. This year, however, there was strength in business at home but worries abroad. In view of the complexities of the present situation he would continue current policy at least until the next meeting. At that time the Committee might need to consider adopting a different policy.

Chairman Martin noted that at the previous meeting of the Committee he had observed that in his judgment the only important recent change had been in psychology. To a certain extent the same observation seemed warranted at today's meeting. There was one point, however, that he thought needed to be emphasized--as President Johnson had said recently, the country was at war in Vietnam. Many might view the hostilities there as a small war, or a brush fire, but he did not. In his judgment it was necessary for the Committee to bear in mind that, while there had been no declaration of war, a war-time psychology might be developing more rapidly than was generally realized.

The Chairman went on to say that most members seemed to agree today that no change should be made in policy. Those whose views differed favored so modest a change that it would be difficult, in his opinion, to spell it out in the directive. He proposed that the Committee vote on a directive consisting of the suggested alternative A, with the change Mr. Mitchell had suggested.

Mr. Treiber commented that Mr. Mitchell had proposed substituting the words "to maintain" the international position of the dollar for the staff's suggested words, "to help defend." In preference to either, he would like to see the words "to strengthen" used. He noted that the previous directive had included the phrase "to reinforce the voluntary restraint program to strengthen the international positions of the dollar," and he thought it would be undesirable to drop the word "strengthen."

Mr. Mitchell said that Mr. Treiber's suggestion was agreeable to him.

> 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 that the domestic economy has expanded further, but at a slower pace than early in the year, and that the improvement in our international payments that occurred in the second quarter has been maintained for the time being, although gold outflows have continued and international developments are creating uncertainties in securities and foreign exchange markets. In this situation, it remains the Federal Open Market Committee's current policy 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, System open market operations over the next three weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account the Treasury financing about to be completed and the unsettled conditions in securities and foreign exchange markets.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 31, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.

Ralph A. Young
Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

August 9, 1965

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on August 10, 1965

Note: Because of the divergent interpretations of recent economic and financial developments expressed at the July 13 meeting, three alternative drafts of the directive are given below.

## Alternative A (no change)

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, but at a slower pace than early in the year, and that the improvement in our international payments that occurred in the second quarter has been maintained for the time being, although gold outflows have continued and international developments are creating uncertanties in securities and foreign exchange markets. In this situation, it remains the Federal Open Market Committee's current policy to help defend 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, System open market operations over the next three weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account the Treasury financing about to be completed and the unsettled conditions in securities and foreign exchange markets.

## Alternative B (firming)

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, some prices have been under upward pressure, bank credit and money supply expansion has been vigorous over recent months, and prospects are that increased Federal expenditures as a result of hostilities in Vietnam will expand overall demand in the months ahead. Although U.S. capital outflow has been moderate, reflecting the large initial impact of the Administration's balance of payments program, the trade surplus has diminished, gold outflows have continued, and international developments are creating uncertainties in securities and foreign exchange markets. In this situation, it is the Federal Open Market Committee's current policy to help defend the international position of the dollar, and to avoid the emergence of inflationary pressures, by moderating growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next three weeks shall be conducted with a view to attaining somewhat firmer conditions in the money market, while taking into account the Treasury financing about to be completed and the unsettled conditions in securities and foreign exchange markets.

Alternative C (easing)

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, although at a slower pace than early in the year. Inventories have continued to accumulate, particularly of steel, and final demands appear to be rising more slowly than industrial productive capacity. Recent price movements have been mixed and noncumulative in nature. Some long-term interest rates are up moderately this year. The improved position of our international payments has been maintained, and gold takings by foreign central banks have been somewhat reduced, but international developments are causing uncertainties in securities and foreign exchange markets. In this situation, it is the Federal Open Market Committee's current policy to facilitate fuller utilization of resources while helping to defend the international position of the dollar and to avoid the emergence of inflationary pressures, by accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next three weeks shall be conducted with a view to attaining somewhat easier conditions in the money market, taking into account the Treasury financing about to be completed and the unsettled conditions in securities and foreign exchange markets.