William McChesney Martin, Jr., Papers

Box 21/Folder 5

Series V, Subseries A

FRB Official memos, 1965-1969

THE SECRETARY OF THE TREASURY
WASHINGTON

CONFIDENTIAL

January 21, 1965

MEMORANDUM TO Cabinet Committee on Balance of Payments:
Secretary of Defense
Secretary of Commerce
Under Secretary of State
Administrator of AID
Special Representative for Trade Negotiations
Director, Bureau of the Budget
Chairman, Council of Economic Advisers
Mr. Bundy, The White House

Attached is the revised main body of the report to the President. A shorter covering memorandum to the President will be prepared and distributed late today or early tomorrow before our 10:00 o'clock meeting.

Douglas Dillon

Douglas Dillon

Attachment

cc: Chairman Martin, Federal Reserve System

CONFIDENTIAL

REPORT TO THE PRESIDENT ON BALANCE OF PAYMENTS

Fourth Quarter Results. Preliminary data for the fourth quarter shows a sudden and substantial worsening of our payments position. As compared with a November projection of about $900 million, the actual fourth quarter deficit is now estimated to have been $1.5 billion. Most of the $600 million difference is apparently accounted for by larger than projected outflows of short-term funds and long-term bank loans and by a failure to receive the British debt repayment of $138 million.

Factors contributing to the fourth quarter deterioration may, in part, have been temporary, but

the sudden change for the worse, plus

the failure to achieve a more rapid reduction in our stubbornly large deficit that has persisted for seven years, plus

the resumption of large gold outflows have revived serious concern about the strength of the dollar.

Prompt action is needed to deal with the situation. This can best be announced by a special balance-of-payments message in early February. This message should contain a strong reaffirmation of your determination to defend the

dollar and a description of actions which you have ordered or are requesting from Congress to improve the situation.

Trend in the Deficit. Some improvement has been made in our balance of payments since 1960, our worst year.

-- Our commercial exports in 1964 were $4.7 billion above the 1960 level, thanks to an exceptionally large increase ($2.8 billion) last year, partly due to unusual agricultural exports to the Soviet zone.

-- Our imports were only $3.8 billion above the 1960 level, showing a percentage increase lower than the growth of our national income.

-- Private investment income was $1.9 billion higher in 1964 than in 1960, with an exceptionally large increase during 1964 ~~from 1963~~ due to several special transactions.

-- Government expenditures abroad last year had a $1 billion lower net balance of payments impact than in 1960. Included in the decline was about $675 ~~$600~~ million of net military expenditures.

-- The adverse balance on tourism on the other hand, was almost $400 million larger in 1964 than in 1960, although it showed no deterioration from the 1963 level.

-- Long-term bank ~~loans~~ credits to foreigners were some ~~$400~~ $850 million higher in 1964 than in 1960 and direct investment abroad was almost $500 million higher.

-- Short-term capital outflows were also higher than in 1960, but this outflow is highly variable, having been as low as $550 million in 1962.

-- Net purchases of foreign securities in 1964 were at about the 1960 level, but would have risen by a substantial amount in the absence of the Interest Equalization Tax. As it was, the tax discouraged all U.S. security flotations by the advanced countries at which it was directed.

These various changes were reflected in the regular transactions deficit which showed the following trend:

Years	$Billion
1960	3.9
1961	3.1
1962	3.6
1963	3.3
1964 (est.)	3.0

The $300 million reductions in each of the last two years are much too slow a rate of improvement to avoid a serious crisis of confidence in the dollar. A reduction

in the 1965 deficit to well below $2 billion, with clear prospects for further substantial improvements in 1966, must be our objective. This means we must achieve about $1 billion of savings from the deficit currently projected for 1965.

Outlook for 1965. Table 1 shows the composition of our estimated $3 billion deficit on regular transactions for 1964 -- final figures of this breakdown will not be available until early March -- and a projected range of $2.5 billion to $3.2 billion for 1965. The upper limit of the range would have been raised by several hundred million dollars by one agency representative and the lower limit would have been lowered by several hundred million dollars by another agency representative, but the majority favored the range shown. It is to be interpreted as follows:

(a) The upper limit of $3.2 billion is intended to suggest that under our present program the deficit could well be greater than the 1964 deficit, even in the absence of a crisis of confidence in the dollar.

(b) The lower limit of $2.5 billion is intended to suggest that the deficit, under the most favorable

Table 1
U. S. Balance of Payments 1964 and Projected Range for 1965
(Millions of dollars)

Recorded Receipts	1964 (est.)	1965 (proj.) Range
Exports (commercial)	21,985	22,885 - 22,685
Military sales	760	850
Income on investment		
Private	4,770	5,200
Government	443	560
Tourism (travel plus transport)	1,200	1,340
Misc. services (commercial)	3,295	3,485
Repayment on Gov't. loans	599	680
Foreign capital (other than liquid)		
Private	175	100
U.S. Gov't. liabilities	265	-55
Total	33,492	35,045 - 34,845
Recorded Payments		
Imports	18,570	20,250 - [illegible]
Military expend. (incl. uranium ore)	2,800	2,650
Tourism (travel plus transport)	2,850	3,150
Misc. services and remittances	4,855	5,110
Gov't. capital outflows and grants (dollar transfer portion)	700	660
Private capital: direct investment	2,150	2,150 - 2,200
new issues	1,030	1,000 - 1,100
outstanding securities	-220	-150
redemptions	-175	-175
long-term bank credits	1,000	900 - 1,100
other long term	350	50
(total long-term)	(4,135)	(3,775 - 4,025)
short-term bank credits	1,200	1,000
other short term	700	550 - 700
(total short-term)	(1,900)	(1,500) - 1,700)
Total	35,810	37,145 - 37,645
Unrecorded Items (debit)	682	400 - 400
Deficit on Regular Transactions	3,000	2,500 - 3,200

circumstances, will probably not show more than a moderate decline from the 1964 level.

(c) The mid-point of $2.85 billion is intended to indicate that the deficit will most probably show ~~little~~ only very modest change from the 1964 level in the absence of a crisis of confidence.

But the absence of any marked improvement from the 1964 position is very likely to create a crisis of confidence, particularly in connection with the resumption of large gold losses.

To avoid such a crisis, we must find and adopt measures which can reasonably be expected to improve our payments position by $1 billion in 1965 and by an additional amount in 1966. A table listing possible actions and savings from each in 1965 follows. The savings in Column (1) are not additive since in the case of capital, the taxation of one form of outflow will cause some diversion into other forms of outflow. An allowance is made for this in Column (2). The savings in Column (2) are not necessarily net since some of

the measures will have indirect offsetting effects on the balance of payments. Since such effects may be beneficial or adverse, they are assumed roughly to balance out.

Measures and Possible Savings
(Millions of dollars)

	(1) Savings (in the case of capital items, assumes all forms of outflow are taxed.)	(2) Adjusted Savings (in the case of capital items, allows for some leakage if all froms of outflow are not taxed.)
Agreed Measures:		
(a) Gore Amendment, imposed on present rate basis.	400	300
(b) Exert strong moral suasion to deter short-term lending and effect modest reduction in credit availability; also amend Fed. Res. Reg. A.	100	100
(c) Foreign Investment in the U. S.	20	20
(d) Tourist Import Limitations	50	50
(e) Direct Investment (moral suasion)	100	100
(f) Non-bank lending, long term (tax)	25	20
(g) Raise IET rates on capital outflows	150	60
		650
Other Measures:		
(h) Export Measures	-	-
(i) Military Expenditures (cut)	50	50
(j) Tourist tax	300	300
		1,000
(k) Direct Investment (tax on "take-overs")	150	
(l) Direct Investment (tax on all forms)	250	
(m) Bank and non-bank lending, short term (tax)	100	

The $1.0 billion of savings shown in Column (2) would meet our immediate target for 1965. Further substantial savings would occur in 1966 when the measures would have an impact throughout the year, thus gaining additional needed improvement. The moderate reduction in free reserve availabilities at the commercial banks would bring the posture of monetary policy back roughly to that prevailing last fall prior to the change in the British bank rate and the Federal Reserve's discount rate.

Additional savings for 1965 can be obtained, the amount depending on what measures, if any, are taken with regard to taxing direct investment and all forms of short-term capital outflow. Since we have already assumed that moral suasion would save $100 million of direct investment outflow; imposition of a tax on direct investment "take-overs" would add only moderate additional savings, particularly when allowance is made for some leakage if forms of direct investment other than "take-overs" and short-term lending abroad are not taxed. The same statement would also apply if the tax were to be applied to all direct investment, although in this case the savings would be somewhat more. If all short-term lending, except export financing, were also taxed, some additional savings would result.

The following sections discuss these measures in more detail.

I. Immediately Available Measures (Capital outflows):

-- Application by Executive Order on the date of your message to the Congress of the Gore Amendment to limit bank lending of one year or over to all advanced countries. Such loans (gross) ~~exceeded~~ were $1.~~0~~2 billion last year, with the bulk (about ~~$685~~ $720 million) going to Western Europe; about ~~$235~~ $249 million to Japan and relatively small amounts to Canada ($75 million) and other advanced countries. In the case of Japan, there may be some political reaction to this measure.

Also moral suasion on banks through the Federal Reserve, the Comptroller of the Currency, and the FDIC, to discourage short-term bank lending to foreigners. The Federal Reserve should be encouraged to amend Regulation A so that extension of re-discount facilities to a member bank can be based in part on whether that bank is ~~active or not in the~~ by expanding its foreign-lending ~~field.~~ activity.

(Possible 1965 savings: $400 million.)

-- Use of moral suasion to deter over at least the next two years direct investment in the developed countries abroad, an effort which most of those countries would welcome. This effort may be supplemented by a clear indication that U.S. would be receptive to discussions to consider measures that might be taken by foreign governments to this end. (This represents a change in our policy which heretofore has protested any foreign interference with U.S. direct investment.)

(Possible 1965 savings: $100 million)

II. Agreed Measures Requiring Legislation

A. Capital Outflows:

-- Request Congress to extend present Interest Equalization Tax law for two years.

-- Request Congress in extending the IET legislation to make it applicable, effective from the date of your message, to non-bank lending to foreigners (that is, by insurance companies, trust funds, etc.) of from one to three years' duration. The export exemption that applies to bank loans would also

apply to non-bank loans. The latter have been relatively small (about $100 million in 1964, excluding a special transaction). The argument for covering them under the tax is the potential substitution of non-bank lending for bank lending on a substantial scale when the Gore Amendment has been made applicable to the latter.

(Possible 1965 savings: $25 million.)

-- Should experience gained under Gore Amendment up to the time of Congressional action on extension of IET indicate that tax is not adequately deterring bank (~~and~~ or other) lending, request Congress, effective from date of such request, to amend the rate provisions so as to raise the rates of tax on the shorter maturities without increasing the 15% rate on the longest maturity (28.5 years or more).

(Possible 1965 savings: $150 million or more.)

B. Foreign Investment in U.S.:

-- Request legislation to improve the tax treatment of foreign investment in the United States, and otherwise encourage foreign long-term investment here.

(Possible 1965 savings: $20 million.)

C. Tourism:

-- Request Congress in extending tourist duty-free exemption for two years to reduce amount of exemption from $100 to $50 and confine it to items accompanying tourist; eliminate liquor from duty or other tax exemption; and eliminate duty exemption for gifts of $10 or less mailed from abroad. (Last action could be undertaken without new legislation.)

Possible savings: Approximately $50 million in 1965 if put into effect by May 1; $60 to $70 million in 1966. These combined savings from the actions have been estimated conservatively to allow the possibility that reduced expenditures for foreign goods may be offset to some extent by increased expenditures for services within the foreign country. Failure to act on either $100 or gift exemption would reduce savings from the other because of substitution effect.

Such action would leave U.S. policy still as liberal or more liberal than that of other advanced countries. Some increase in administrative cost necessary to make reductions effective but most, if not all, would be offset by additional revenue earned.

III. Not Fully Agreed and Requiring Legislation.

A. Exports. Long-range health of our payments balance depends in large measure on our success in this area. Further expansion is our most important need and relatively inexpensive measures can pay off in a substantial way. A 1 percent increase in our commercial exports over the 1965 forecast would reduce the deficit by about $225 million.

The export expansion program, with a fiscal 1965 budget of less than $10 million, clearly earns ~~several~~ many times this amount in additional foreign exchange. The Administration should press Congress to grant the full 1966 export expansion budget request of somewhat over $12 million.

The most basic action requirement in this area is for maximum emphasis on, and success in, the maintenance of continued cost and price stability in our domestic economy.

Our agricultural exports, for example, are facing increased restrictions in the Common Market area; and our non-agricultural sales will, among other things, be adversely affected by the import surcharge recently imposed by the U.K.

In any event, we must build for the future; to this end, the following actions are proposed:

-- Ease current Export-Import Bank procedures to assure fully competitive, risk-taking financing ~~for~~ of U.S. products and services; or, if this does not prove possible, support modified Magnuson bill establishing a $.5 billion special fund in the Eximbank to finance exports in cases not eligible for either AID or present Eximbank financing.

-- Support Federal Maritime Commission's efforts to investigate and eliminate apparent discrimination against U.S. exports in shipping rates.

~~-- Expand market development activities overseas.~~

It is impossible to project the long range results of these efforts for our balance of payments; but little can be expected during 1965 and only modest possible gains during 1966.

B. Military Expenditures Abroad.

-- Savings to be accomplished by cutting purchases of petroleum abroad, reducing the number of fighter squadrons abroad, thinning out of personnel in Japan and Korea, and other economies. Combat effectiveness will not be affected by these measures.

Defense notes that budget costs will be raised and State cites political problems that may arise.

Possible additional actions by Defense include cutting purchases of petroleum abroad by approximately 30 percent ($80 million) with a more than doubling of present budgetary costs, reducing the number of fighter squadrons in Europe, holding Army strength overseas generally below authorized levels, thinning out of personnel in certain selected countries, and other economies which also are likely to increase budgetary costs. State notes that, in the light of the existing situation in Asia and Europe, it is doubtful if certain of these actions can be carried out within the contemplated period, without seriously undercutting our political-military interests abroad.

C. Tourism:

-- Legislation establishing travel tax of $100 per person per trip to all foreign countries with an exemption, however, for trips that do not exceed 10 days in length and for students and teachers (including those covered by Government programs -- e.g., Fulbright scholars) departing the U.S. for at least a nine months' period of study abroad,

and for Government personnel on official business.

Probably save some $300 million in 1965 if put into effect by May 1 and ~~over~~ $400 million in full year of 1966. If Canada and Mexico were exempted, the savings would be reduced to less than $200 million in 1965 and ~~$275~~ about $250 million in 1966.

Arguments against:

Adverse effect on U.S. posture in regard to liberalizing international trade and payments. Many countries look on all current account transactions as basically same in nature and would argue that restriction on tourism contradicts U. S. stand on liberalizing international trade. Could compromise our position in current Kennedy Round negotiations under GATT.

The tax would be regressive. Lower income travelers, who spend relatively small amounts on their trips abroad, would not be able to afford the tax. The big spenders would and would spend as much abroad as before.

Less developed countries might make particularly strong protest since many of them trying to build up their tourism business.

There is also the question of merit of curtailing international travel and contacts with foreigners. Private travel may have important long run benefits to our international relations, and U.S. citizens may feel that freedom of movement is being challenged.

Some retaliation by foreign countries may ~~be expected.~~ offset. This ~~will~~ could both reduce net effect of tax by reducing our tourist receipts, and raise problems involving our political relations abroad. The increase in costs to American tourists could also be offset to some extent by air and shipping lines reducing fares.

Arguments for:

Deficit in tourism is one of largest deficit items in balance of payments and expected to total $1.8 billion in 1965 in absence of any action.

While receipts from foreign travel began to rise in past two years and net deficit in 1964 remained constant, expect travel deficit continue to widen, at least in 1965.

Tax would be directed at expenditure item which for most part in luxury category, and can be postponed with relatively little hardship.

Reduction in expenditures contemplated would still leave total payments for tourists for 1965 and 1966 at about the same level as in 1964, thus would not be significant reduction in earnings of those dependent on tourist industry such as U.S. airlines and shipping lines.

Ten-day exemption would permit tax free travel for great bulk of travel to Canada, Mexico, and Caribbean area. Very little impact ($50 million in 1965) on less developed countries excluding Mexico, which is in strong balance-of-payments position.

Tax on this item would broaden balance-of-payments program and tend to lessen opposition of financial community to tax on investments.

D. Capital Outflows:

Request Congress in extending the Interest Equalization Tax law to amend it, effective from the date of your message, in any or all of the following respects.

(All of these measures would apply only to transactions with advanced countries. Adoption of (1) or (2) below would be another way of capturing the $100 million savings estimated to result from "moral suasion" in connection with direct investment. Therefore, the figures at the end of (1) and (2) make an allowance for this and also for leakages in savings if other forms of capital outflow are not also taxed.)

-- (1) Make it applicable to any purchase of a 10 per cent or more interest in an existing foreign enterprise--i.e., a direct investment "take-over"--whether financed from new capital outflows or reinvested earnings abroad. At the present time, the IET does not apply to such acquisitions, if the U. S. buyer

has or obtains 10 per cent or more of the voting power of the foreign company. "Take-over" acquisitions are estimated at about $300 million in 1964: $250 million in Western Europe and $50 million in Canada. Action would achieve some balance of payments savings in a way that would be relatively welcome to advanced countries as compared with other recommended measures.

(Possible 1965 savings: $150 million minus the $100 million estimated savings from "moral suasion" and a small amount for leakages if (2) and (3) below are not adopted equals $50 million - .)

-- (2) Make it applicable to all direct investment. Such investment in advanced countries is estimated at $1-1/2 billion in 1964 of which about $500 million to $600 million was in petroleum. Of the $1.5 billion about $1.2 billion is direct investment other than take-overs. To prevent circumventing the tax by reduced remittance of earnings to the U. S., it would also be necessary to make the tax applicable on any earnings retained abroad in excess of a certain percentage.

Arguments for:

Large total of direct investment outflows other than "take-overs" suggests possibility of large balance-of-payments savings without having, for a few years, any substantial adverse effect on inflow of earnings from such investment. This is particularly true in case of Western Europe where net outflow reached almost $1-1/4 billion last year, as Table 2 shows. In 1963 roughly 2/5ths was in petroleum, 2/5ths in manufacturing and the remainder in miscellaneous other fields, including distribution subsidiaries. Net outflow to Canada last year was exceptionally low because of liquidations, but in previous years was $300-$400 million. Those to Japan and other advanced countries are relatively small; but the outflow to Australia has been rising recently. Also, if direct investment not covered by tax, it could to some extent become channel for avoidance of tax on long-term bank lending.

Arguments Against:

Application of the tax would raise extremely difficult question regarding exemption for exports associated with direct investments abroad. Effect of foreign manufacturing subsidiaries on U.S. exports

is highly uncertain. Exemption for all exports that could be associated with subsidiaries would greatly reduce deterrent effect of tax and consequent balance-of-payments savings; and possibly in entirely unjustified manner insofar as exports would have occurred even in absence of foreign subsidiaries. Failure to make an exemption for exports on the other hand would penalize direct investment operations which possibly would create additional U. S. exports.

(Possible 1965 savings: $250 million minus the $100 million estimated savings from "moral suasion" and a small amount for leakages if (3) below is not adopted equals $100 million + .)

-- (3) Make Interest Equalization Tax applicable to all acquisitions of claims of less than one-year maturity by banks, insurance companies, other financial institutions and, under certain circumstances, to manufacturing and trading concerns. There would continue to be an export exemption similar to that in present statute. The volume of short-term capital outflow to advanced countries has varied roughly between one-half and one billion dollars per year in recent years, with the bulk of the outflow in past years going to Japan. Recently, increasing amounts have been going to other advanced countries.

CONFIDENTIAL (FR)

A G E N D A

Board Meeting

Monday, July 12, 1965

9:30 a.m. Economic and financial review.

* * * * * * *

10:30 a.m.

1. Ratification of the actions taken by the available members of the Board on Friday, July 9, 1965.

2. The following items that have been circulated or distributed to the Board:

   a. Letter to Mechanics and Farmers' Bank of Albany, Albany, New York, approving the establishment of a branch on the south side of Wolf Road approximately 584 feet west of the intersection of Wolf Road and Sand Creek Road, Town of Colonie.

   b. Letter to the Federal Reserve Bank of San Francisco waiving the assessment of penalties incurred by Republic National Bank, San Diego, California, because of deficiencies in its required reserves.

   c. Application by Naumkeag Trust Company, Salem, Massachusetts, for permission to declare a cash dividend. (Memorandum from the Division of Examinations dated July 8, 1965, distributed)

3. Reconsideration of application by State-Planters Bank of Commerce and Trusts, Richmond, Virginia, to merge with The Tri-County Bank, Mechanicsville, Virginia. (Memorandum from the Division of Examinations dated June 7, 1965, distributed)

4. Application by The Bank of Virginia, Richmond, Virginia, to merge with Farmers Bank of Boydton, Boydton, Virginia. (Memorandum from the Division of Examinations dated June 22, 1965, distributed)

5. Application by Virginia Commonwealth Corporation, Richmond, Virginia, to acquire shares of First National Bank of Vienna, Vienna, Virginia. (Memorandum from the Division of Examinations dated May 28, 1965, distributed)

6. Memorandum from the Legal Division dated July 8, 1965, regarding time deposit by a market agency consisting of "float" portion of custodial funds. (Distributed)

7. Letter to the Comptroller of the Currency regarding a request for copies of reports of examination made by the Board of Edge Act or Agreement subsidiaries of National Banks. (Distributed)

8. Letter to the Comptroller of the Currency regarding borrowing by national banks from Federal Reserve Banks. (To be distributed)

9. Draft of Chairman Martin's statement to be made before the Antitrust Subcommittee of the Senate Committee on the Judiciary on July 15, 1965, on H. R. 5280, a bill to provide for exemptions from the antitrust laws to assist in safeguarding the balance of payments position of the United States. (To be distributed)

Interoffice memo
Federal Reserve

June 14, 1965

sent by Jim Sydd

MEMORANDUM TO: Mr. Paul Mazur

MARTIN'S SPEECH

I found the reason for the surprising difference in views expressed at Friday's lunch relating to Mr. Martin's speech. The difference was obviously caused by The NY Times.

I was referring to the speech made by Mr. Martin; others were referring to the excerpts of that speech as published in the Times. Some others even may have been referring to the Times' news story of that speech. The differences in these three documents undoubtedly caused the confusion, for all views expressed at lunch now appear logical when related to the particular document used as a source.

The Times version, by deleting most of Martin's favorable references, by deleting large sections of his speech, and by stressing other remarks out of context, gave the impression that Martin was saying that the present situation contained the same likelihood of a crash that caused the depression of the 30's. Their news story compounded the felony, and the headline preconditioned the reader at the outset.

The Times' manner of cropping followed its usual method so reminiscent of other days. Moreover, it did not indicate where the speech was cropped, and ran the excerpts as if they were part of a continuous text.

Martin's speech itself is 8 single-spaced pages. The subject of the speech is monetary conditions and international-payments. The title itself indicates its nature: "Does Monetary History Repeat Itself?".

Martin begins his speech by stating that economic prospects are at their brightest. The Times deleted that.

Martin stated that our current prosperity is continuing "on its record-breaking path". The Times deleted that.

Martin says that at such a time of economic prosperity it is prudent

> "to scan the horizon of our national and international economy for danger signals so as to be ready for any storm...
>
> "Some eminent observers (my italics) have recently compared the present with the period preceding the breakdown of the interwar economy, and have warned us of the threats of another Great Depression."

The Times gives the impression that Martin was quoting himself.

He lists these warnings (there are 10 of them) which he admits have some "disquieting similarities between our present prosperity and the fabulous 20's".

He makes clear his own reaction to these danger signals when, after listing them, he says:

> "If some of these likenesses seem menacing, we may take comfort in important differences between the present and the interwar situation."

He then lists 12 points of the important differences in which we may take comfort.

He then goes to the main topic of his speech which is a discussion of the causes of the Great Depression. He says,

> "Economic and political scientists still argue about the factors that converted a stock-exchange crash into the worst depression in our history. But on one point they are agreed: the disastrous impact of the destruction of the international-payments system...in 1931."

His speech is devoted mainly to a discussion of this cause of the Great Depression and compares the situation 35 years ago with that of today. In this connection he says:

> "Can anybody in good faith find any similarity between our position of today and our position of 1933, or even the British position of 1931?"

The Times deleted this.

He ends his speech by recommending three steps "for solving present and future difficulties in international monetary relations and thus avoiding a repetition of the disasters of 1929-33". In his final paragraph he says:

> "It should not have taken the Great Depression to bring these simple truths home to us... By heeding them instead, we will have a good chance to avoid another such disaster."

* * * * * *

The foregoing is, I submit, a fair summary of his speech. Much of the misunderstanding was occasioned, I believe, by the Times' emphasis on his introductory remarks as if they were the essence of his speech. Moreover, the Times featured only that part of the introduction that made some comparisons between the present situation and the 20's. The Times featured the phrase, "disquieting similarities" and headlined it with, "Reserve Board Chief Compares Boom Today With That Of The 20's".

The Times did not stress Martin's own view that

> "We may take comfort in important differences between the present and the interwar situation."

The Times could have, with more justice, featured, "Martin takes comfort in important differences", and could have used a

headline, "Reserve Board Chief Contrasts Boom Today With That Of 20's".

In short, it would have been more objective had the Times referred to the 7 pages of his main topic, rather than to the 1 page of his introductory remarks.

* * * * * *

If one is interested in Martin's views, the best picture can be obtained from a reading of the speech itself; if one is interested in excerpts, the US News excerpts are far more representative of his speech than those of the Times.

I feel as Martin does when he said the other day that he finds himself in a position of having advocated safe driving and as a result is being accused of causing all the accidents.

I can add that I see no hope of changing public opinion, for it is much easier to fight City Hall than the NY Times.

P. E. Manheim

PEM:ksm

FR 468
(Rev. 3-63)

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MEMO Date 9/6/66 Time

To: Chairman Martin

From: Daniel H. Brill

Tel. No. Ext.

	Please call		For your approval
	Returned your call	X	For your information
	Will call again		Note and return
	Phone me re attached		For comments and suggestions
	See me re attached		Preparation of reply

MESSAGE:

This is the memorandum on the investment tax credit referred to at the Board's discussion this morning. As I understand it, no new data are available to permit updating the memo. But an analysis of the impact of this as opposed to other forms of corporate taxation is in preparation.

Attachment

April 4, 1966

TO:

SUBJECT: Investment Tax Credit.

FROM: Daniel H. Brill

Attached is a memorandum on the investment tax credit which describes the existing provision, summarizes available statistics on corporate use of the credit, and raises some points that would need to be considered if the credit were to be suspended. The memorandum was prepared by Peter M. Keir, Chief, and Eleanor J. Stockwell, Senior Economist of the Capital Markets Section.

DHB

The Investment Tax Credit

Considerable support has developed recently for moderating the continued rapid rise in plant and equipment expenditures by temporarily suspending the investment tax credit. The objective of the suspension proposal is to strike directly at the sector of private spending thought to be contributing most extensively to overheating of the economy. Since the credit was originally adopted in 1962 as a means of stimulating lagging business investment outlays, the logic of removing it in 1966, when investment spending appears to be over stimulated, is clear. However, because economists generally anticipate a down-turn in business capital spending at some point within the next 9 to 24 months, few are prepared to advocate more than a temporary tax credit suspension.

On the face of it, the idea of manipulating the tax credit goal as a means of furthering counter-cyclical fiscal objectives seems attractive. But to be effective the question of timing is obviously crucial. The need for restraint on business capital outlays is immediate. If the impact of a tax credit suspension were to take effect with any appreciable lag, there might be serious risk that the results of the action would become perverse, tending to depress investment spending at the point when it should again be stimulated.

Unfortunately, given the extended time lag between business investment decisions and start-up of new equipment, together with the increasing tendency for corporate executives to view their investment plans in fairly long-range perspective, avoidance of lagged effects from any suspension of the tax credit might be difficult. Because the tax credit was originally adopted as a permanent part of the tax structure and is rather complicated, it does not readily lend itself to precise off-again-on-again manipulation. Given investments become eligible for tax credit under the act only when the new equipment is actually put into operation. Hence months and sometimes years may elapse between the initial decision to spend and the actual taking of the tax credit. Handling of this lag problem under a suspension measure is difficult without sacrificing either effectiveness or equity.

The memorandum which follows describes the major provisions of the investment tax credit and the limited statistical evidence available showing how the credit has been used. With this technical review as background, it then examines various possible approaches to suspension of the tax credit raising the question whether any would appreciably influence capital spending in 1966. Finally, the memorandum explains briefly how a tax credit suspension might discriminate against small business and why its likely effects on tax revenues would be difficult to forecast.

Major Features of the Tax Credit

The investment tax credit may be described in general terms as permitting a credit against Federal income taxes, equal to 7 per cent of qualifying investment.

Qualifying investment is defined in a special way. It excludes, among other things, all buildings and their structural components, as well as most short-lived equipment.[1/] Also, the equipment which does qualify becomes eligible for the credit, not when ordered nor when reflected in capital expenditures, but when "placed in operation". Thus the amount of investment that becomes eligible for the credit in a given year reflects project completions, which for any one company may or may not bear any direct relation to orders or expenditures for capital goods that year.

There is a ceiling on the amount of otherwise available credits which may be taken in a single year.[2/] The portion that exceeds this ceiling may be carried back three years (but not prior to 1962) or carried forward five years, so long as the total amount of tax credit taken in the earlier or later year does not exceed the ceiling for that year. As will be shown later, the most recent data

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1/ Qualified investment comprises the following proportions of the cost of equipment, by useful life: 8 years or more, entire cost; 6-8 years, two thirds; 4-6 years, one third; less than 4 years, none.

2/ The amount that may be taken in a particular year is limited to the lesser of: the amount of tax liability for that year; or $25,000 plus 25 per cent of liability over $25,000.

available (covering the tax year 1963) indicate that most companies with qualifying investment that year earned tax credits which exceeded their 1963 ceiling.

Statistics on corporate use of the investment tax credit 1/

The only published statistics relating to the credit are those tabulated from income tax returns for 1962, the year in which the investment tax credit provision was enacted. Similar data for 1963 will be published shortly and the Internal Revenue Service has made the figures available to us for internal use. The table below shows these 1962 and 1963 data.

Table 1

Corporate Investment Tax Credit 1/

(Billions of dollars)

	1962	1963
Total cost of types of property eligible for investment tax credit	22.2	27.4
Portion of above qualified for credit	19.5	24.3
Tentative investment tax credit	1.1	1.4
Carry-forwards	2/	.3
Total credits available	1.1	1.7
Portion of above actually used	.8	1.1
Unused tax credit	.3	.6

1/ All corporations other than small corporations electing to be taxed through shareholders.

2/ Returns of corporations with fiscal years ending January-June 1963 are included in the 1962 aggregates. Some of these corporations could have had carry-forwards but the item was not tabulated separate from current credits.

Source: Internal Revenue Service.

As may be seen from this table, use of the investment tax credit increased substantially from 1962 to 1963. However, the 1962 figures, and hence the 1962-63 changes, are probably subject to a significant reporting bias and should be used with care.[1/] The 1963 figures may be assumed to be much less affected by this bias and thus represent the only firm data available outside of individual corporate reports.

The total cost of equipment reported as becoming eligible for the investment tax credit in the tax year 1963 was $27.4 billion. This is a substantial figure. Though, for the reason noted earlier, it cannot be matched against outlays in 1963 or in any single year, some perspective on its magnitude may be gained by noting that total corporate spending on both plant and equipment in the years 1961 through 1963 ranged between $32 billion and $37 billion, according to Flow of Funds estimates.

Investment "qualified" for credit totaled $24.3 billion in 1963 or about one-ninth less than the total cost of eligible property, reflecting exclusion of part of the cost of relatively short-lived equipment. Qualified investment was also one-ninth smaller than total cost in 1962, which suggests that the mix of equipment with different useful

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1/ Data covering the first year's operations of a new permissive tax provision are customarily influenced by the fact that it takes time for taxpayers to begin taking advantage of the new provision. The investment tax credit was probably no

exception, particularly since, though it was applicable to all of 1962 and had been expected since early in the year, it was not actually enacted until fall. (A corporation need be in no rush to calculate the tax benefits from a new provision, since it can file an amended return later; information in amended returns is not tabulated by Internal Revenue.)

The 1962-63 rise of $5 billion, or 23 per cent, in the total cost of property reported as becoming eligible for the credit far outstripped the $1.7 billion, 5 per cent, increase in total corporate outlays for plant and equipment. To some extent this reflects the lumpiness with which outlays over a period become eligible for the credit. But to an unknown, probably considerable, extent the marked 1962-63 increases in eligible investment and tax credits thereon reflect more complete reporting in the later year. The 20 per cent increase from 1962 to 1963 in the number of corporations reporting eligible investment and claiming tentative tax credits is consistent with this hypothesis.

lives did not change on balance from one year to the next. The tentative tax credit on this qualified investment totaled $1.4 billion in 1963, and in both years was a little over 5-1/2 per cent of qualified investment. (The reason it was not 7 per cent is primarily because the credit is only 3 per cent for utility property.)

Estimating investment eligible for tax credit in 1966

If some lagged relation between eligible investment and capital expenditures could be developed, it would not be difficult to derive up-to-date estimates for the first three lines of Table 1.[1/] Since depreciation, like the investment tax credit, is also based on property placed in operation, someone at the Treasury may already have worked out schedules for distributing the lag between spending and completions, at least for total depreciable fixed assets, and it might be feasible to adapt such schedules, perhaps with some heroic assumptions, to cover equipment only.

In a period when outlays are rising as sharply as they have been in recent years (Flow of Funds estimates place corporate plant and equipment expenditures at $42.2

1/ A rough guess--not to be taken as a serious estimate--for 1966 is that, in the absence of any change in the investment tax credit provision, total cost of eligible property might be $38 billion, with qualified investment at just under $34 billion and tentative tax credit at $1.9 billion. The figure for total cost is based on a set of quite arbitrary assumptions that happen to produce the right ffgure when used for 1963; equipment outlays equal to three-fourths of total plant and equipment spending; eligible investment comprising one-fifth of 1964 equipment outlays, two-fifths of 1965, and two-fifths of 1966 (the latter derived from the Board's recent projection). The other two items are derived by using the relationships for 1962 and 1963.

billion in 1964, $49.8 billion in 1965 and a projected $57.4 billion in 1966), some notion of the lag between outlays and completions is essential to any reliable estimate of the volume of property likely to become eligible for the credit in a given year. And such a reliable estimate would in turn seem essential to any serious consideration of suspending the credit.

Knowledge, or expert opinion, about the lags would be equally important in another way. Two of the troublesome areas with which a suspension measure would have to deal are what to do about investment already underway at the start of the year, and what to do about imminent projects scheduled for completion in 1967 or later. How much attention would need to be given to these spillovers, in drafting a suspension measure, would greatly depend on how large they are. Data collected in conjunction with the Commerce-SEC plant and equipment survey provide some evidence for manufacturers and public utilities, though the figures cover plant as well as equipment and do not indicate the time period required to complete the in-process investment.

Table 2

Plant and Equipment Expenditures:

Inventory of Uncompleted Projects

(Billions of dollars)

	1964	1965	1966
	Manufacturers		
Remaining cost of projects underway at start of year	9.0	12.6	16.9
Plus: estimated total cost of new projects started during year	22.2	26.7	
Less: remaining cost of projects uncompleted at end of year	12.6	16.9	
Equals: outlays during year	18.6	22.5	26.8 (antic.)
	Public Utilities		
Remaining cost of projects underway at start of year	5.4	5.6	8.0
Plus: estimated total cost of new projects started during year	6.4	9.3	
Less: remaining cost of projects uncompleted at end of year	5.6	8.0	
Equals: outlays during year	6.2	6.9	8.0 (antic.)

Source: Commerce-SEC.

If the general impression given by the figures in Table 2 is correct, then spillovers from one year to one or more later years have been large indeed, and they have grown much faster than total outlays. The kind of breakdown one would like to have, and which estimates of average completion times would permit, is not the one shown in the table but one which would separate total spending each year into: funds spent to complete old projects; funds spent on new projects completed during the year; and funds spent on new projects still uncompleted at year-end. The figures shown in the table strongly suggest that such a breakdown would show the first and third categories each accounting for a significant share of annual outlays. In other words, it seems reasonable to assume that the spillovers are large enough to worry about.

Alternative approaches to tax credit suspension

The feature of the existing tax credit provision which creates difficulties in timing the impact of a suspension is the fact that investments become eligible for the credit when they are placed in operation. For this reason, if the suspension were accomplished simply by denying the credit to all investments which would normally have qualified for it in 1966, most such investments would already be well underway and many would be so near completion that planned spending would be little affected. This approach to suspension would be more likely to have a significant impact on current investment spending if projects placed in operation beyond 1966 were also covered by the suspension measure. Even so,

because time lags between investment plans and project completions are varied, the effects of such a measure on spending would be difficult to predict and might very well occur mostly after 1966.

To provide a more direct restraint on current business capital outlays, the suspension measure might be drafted to apply to the outlays themselves, rather than to completions. This could be accomplished if the investment spending undertaken during 1966 (or some more precisely designated period) were declared ineligible for the tax credit; that is, at future dates when "qualified" investment projects were placed in operation, any part of the project paid for within the 1966 suspension period would have to be deducted from the total eligible for the tax credit.

The effectiveness of even this more direct application of the tax credit suspension might still be blunted, since much of the spending undertaken in 1966 would represent an extension of projects already underway, on which spending commitments had already been made. Postponement or cancellation of such outlays might, therefore, be more costly than the added burden of the tax credit suspension itself.

To make the impact of the tax credit suspension more timely, the measure might be drafted to apply directly to new orders of capital goods in the designated suspension period, rather than to either equipment outlays or completions. Under this approach the cost of any new equipment <u>ordered</u> in 1966 (or whatever suspension

period were designated) would be ineligible for inclusion in the cost of subsequently completed projects, otherwise eligible for the tax credit. At the new order stage of the investment process businessmen would clearly have more flexibility to cancel or postpone planned outlays. Hence their response to this form of the suspension measure might be more immediate. Moreover, the general criticism that suspension would add unexpectedly (and inequitably) to the cost of investment projects originally undertaken on the assumption that they would be eligible for the tax credit, would be less serious than in the cases where the suspension applied to outlays and completions.

At the same time, changing the existing definitions of qualified investment, for the duration of the suspension period, might mean exchanging one set of practical problems for another. New orders, or even outlays, have some advantages over completions as a base for suspending the credit, but use of either of them would both delay the drafting and passage of a suspension measure and complicate business record-keeping.

Projection of impact on spending

Any estimate of the extent to which 1966 business capital outlays would be reduced by a suspension of the investment tax credit would be highly tenuous (whatever the approach followed). Implicit in the recommendation that the tax credit should be suspended

is the presumption that it has provided an important stimulus to investment outlays since its adoption in 1962. Certainly the record shows an impressive build-up in investment outlays since that date, but it is difiicult to weigh the relative importance of the tax credit within the total complex of factors stimulating growth of investment spending over this period. Economic activity, corporate cash flow, and corporate profits (before-tax) have all been high over the period, and other changes in Federal tax measures have also provided added incentives to capital expension.

Without any clear measure of the investment stimulus provided by the tax credit and with very little systematic knowledge of the way in which corporate decision-makers view the credit, it is difficult to say how much its withdrawal would in fact affect capital outlays. Add to this the many uncertainties about the timing of whatever spending effects might be induced, and it becomes clear why those most familiar with the technical provisions of the tax credit statute seem to prefer other more traditional ways of raising taxes at the present juncture.

The tax credit and small business

In addition to questions about the aggregate impact and timing of a tax credit suspension on capital outlays, the available evidence suggests that suspension might hit the outlays of small business harder than those of large enterprises--creating a sensitive political issue which could easily delay passage of any suggested

suspension measure. The investment tax credit has been used extensively by small corporations and, with their limited access to long-term funds, their investment is probably much more dependent on availability of the credit than is the case for large corporations.

The only investment credit data available by size of corporation are for the item on total investment cost. As might be expected, such data show that all but a small fraction of total cost represented investment by large corporations. However, information on the number of corporations reporting such investment and the number actually receiving tax credits indicates that, at least in 1962 and 1963, the provision was used extensively by small corporations.

Of the 1.2 million corporations that filed Federal income tax returns in 1963, only about 75 thousand had total assets of $1 million or more. But 403 thousand corporations claimed tentative tax credits on investment which became eligible that year. Again, 720 thousand corporations filing tax returns in 1963 reported having net income. Of those, only about 60 thousand had total assets of $1 million or more. But the number that were able to take tax credits that year totaled 295 thousand.

Other evidence that hundreds of thousands of small corporations must have received benefits from the investment tax credit provision lies in the average size of eligible investment and of tax credits. Such averages may be calculated, on an all-industry basis, for

all but one of the items in Table 1, and for one item--credits actually used--averages may be calculated by industry. The figures are shown in the table below. Note that the average amounts are expressed in dollars.

Small as the average amounts are, they are still greatly influenced by the figures for a few very large companies. If we exclude, from the number, all 691 corporations with assets of $250 million and over and, from the figures on total cost, the amounts shown for this size class, the average for the remaining companies is reduced from $68 thousand to $34 thousand. Perhaps any measure to suspend the tax credit ought to apply only to investment above a certain minimum.

Table 3

Average Size of Investment Tax Credit Items, 1963

All industries	Number cos. (thous.)	Average amount (dollars)
Total cost of types of property eligible for investment tax credit	403	67,903
Portion of above qualified for credit	403	60,301
Tentative investment tax credit	403	3,503
Carry-forwards	75	4,111
Credits actually used	295	3,750
Unused tax credit	322	1,943
Credits used, by industry		
Agriculture	5	946
Mining	3	8,613
Construction	23	1,066
Manufacturing	69	8,320
Transp., comm., pub. util.	16	20,793
Trade	104	767
Finance	43	883
Service	33	925
Other than transp. etc.	279	2,776

Source--Internal Revenue Service.

Used and unused tax credits

Whatever benefit to Federal tax revenues would result from suspending the tax credit would come as a by-product and would not be a major consideration in developing the suspension measure. Also, it is generally assumed that the investment credit influences business decisions not through increasing cash flow but through reducing the cost of equipment, and that its stimulating influence is reduced only a little if the existence of unused credits means that the cost saving on a new project would not be recovered for some time. Since the tax revenue effect is not entirely unimportant, however, and since some may assume that it can be readily calculated from alternative assumptions about the level of eligible investment, it may be worthwhile to summarize what is and what is not known about the extent to which credits actually used have fallen short of credits earned.

It seems likely that the carry-back and carry-forward provisions were intended to cover special situations and that the amounts involved were not expected to be large. However, more than one-fourth of the tentative credits shown in 1962 tax return tabulations exceeded the company's ceiling and had to be carried forward for use in later years. In 1963, corporations reported $1.4 billion of tentative credits and an additional $.3 billion carried forward from 1962. Of this $1.7 billion total claimed in 1963, $.6 billion could not be used that year. Data are not

available to show whether any significant portion of the unused credits shown in 1963 tax returns did not need to be carried forward to future years but could be taken by amending the 1962 return. Nor is there any way of judging, from the available data. whether unused credits may have become increasingly large, or whether they may in fact have declined, by the end of 1965.

The number of corporations that reported unused credits in their 1963 tax returns is surprisingly large. As was noted previously, 1.2 million corporations filed income tax returns that year; 403 thousand of them claimed tentative investment tax credits and 75 thousand reported carry-forwards from 1962 (the extent of double-counting is not known). Of these 403-475 thousand corporations, 322 thousand reported that the credits to which they were entitled exceeded their 1963 ceiling.

If a sizable proportion of corporations continued to pile up unused credits in 1964 and 1965, and if most such credits had to be carried forward (i.e., could not be carried back to earlier years), then a rather large proportion of the tax credits which would be usable in 1966 would represent carry-forwards, and suspension of the credit (or more accurately, suspension or restriction of eligibility for the credit) might add relatively little this year to Federal tax revenues. On the other hand, if most corporations with unused credits in 1964 or 1965 had leeway under their ceilings for earlier years, unused credits carried forward into 1966 could be quite moderate, and suspension of the tax credit could produce a significant volume of additional tax revenue.

9/27

Mr. Martin

Governor Robertson returned this--said "I think we should see him (O'Leary) when he comes."

mnm

Chairman Robertson

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 27, 1966

To Chairman Martin

Subject: Policy loans at life insurance companies

From Daniel H. Brill

CONFIDENTIAL (FR)

At your suggestion, I called Jim O'Leary of the Life Insurance Association yesterday afternoon to get whatever information he had about the impact of monetary restraint on life insurance companies. Jim's story was very interesting; it adds up to a situation of some gravity and concern. While at the moment it would not be appropriate to label the situation as panic or crisis, there are several companies in difficulty, and continued restraint, along with strong credit demands, will undoubtedly result in a spreading of difficulty throughout the industry.

In aggregate terms, Jim points out, policy loans have increased sharply relative to cash flows. Using the group of companies who report current and prospective cash flows to the Association (a sample that does not include the largest company but does cover about 66 per cent of the industry's assets), the figures show that in the fourth quarter of 1965 the net increase in policy loans was running at about 4½ per cent of the cash flow excluding receipts from sales of securities. By the second quarter of this year, the ratio had risen to 11 per cent and indications are that the ratio jumped sharply again in the third quarter. Final figures aren't in as yet.

There is a great variation in experience of individual companies. One medium-sized New England insurance company -- with assets of about $750 million -- has had an increase in policy loans amounting to over 100 per cent of its cash flow. There are about a dozen companies where the policy loan outflow amounts to from 20 to 70 per cent of cash flow. (We have been informed by the Chicago Fed of one large Midwestern insurance company whose policy loan outflow in August amounted to a third of its cash flow.) In addition to the policy loan drain, some companies have been hit by increases in the surrender of policies by withdrawal of policy proceeds left on deposit and by declines in the expected volume of mortgage prepayments resulting from housing turnover.

It is true that some insurance companies have been asking for trouble by aggressively selling, in recent years, a type of policy known as "minimum deposit insurance." These policies have high initial cash values. The policyholder is encouraged to borrow from banks in order to pay the premiums. Given the tax deduction permitted on the interest cost of the borrowing as against the interest accumulating on the surrender value of the policy, there is a tax incentive to this transaction which has been used as a lure in selling large unit policies to moderately wealthy individuals. As monetary policy has tightened this year, banks have not been

CONFIDENTIAL (FR)

willing to continue making these loans, forcing the policyholders back to the insurance companies in order to get the funds to pay the premiums. Also, in recent years, there has been an increase in "key-man policies," life insurance policies taken out by companies on key executives. As the cost of bank loans has risen, small and medium-sized companies have increasingly been borrowing from insurance companies on the cash values built up in these policies.

Life insurance companies have adjusted to the increased drains on their cash flows by selling securities, paring cash balances, using bank lines and trying to open new ones, cutting back on new loan commitments, and trying to take the latest options available for disbursements under earlier commitments. But given the increasing unavailability of bank lines and the pressure of customers for funds and the drop in security prices which has already created substantial capital losses, some companies are severely pinched and a few -- particularly newer ones -- are in a more serious bind.

Jim has already talked with Bill Treiber at the New York Fed about this problem and is aware of the Fed's interest in it and the fact that some plans have been adopted to take care of savings and loan associations and mutual savings banks suffering from exceptionally large withdrawals. He would like to discuss the situation with the Board, not with the intent of pleading for creation of any counterpart plan for life insurance companies, but to clarify the dimensions of the problem. By mid-October, he expects to have information on the third quarter cash flow experience of his sample of insurance companies and would like to bring this information down, along with any other specifics he can pick up in the interim. Would you be interested in having Jim in for lunch with some of the Board and the staff following this matter? The date of October 18 was mentioned as a possibility, but I am sure Jim would adjust his schedule to accommodate whatever date and time suited the Board.

CONFIDENTIAL (FR)

January 20, 1967.

TO: Chairman Martin

SUBJECT: Criticism of Manager Action by FOMC Members

FROM: Robert C. Holland

Action taken by the Manager on Tuesday gave rise to a good deal of criticism by Governor Maisel and to a lesser degree by Governors Robertson and Brimmer and President Hickman, all of whom attended all or part of Tuesday's and Wednesday's calls.

Without going into too many details, these Committee members thought the Manager's action of engaging in $270 million 2-day matched sales-purchase agreements represented too much fiddling with day-to-day reserve supplies just to avoid temporary money market ease and a positive free reserve figure. In addition, Governor Maisel thought the Manager exceeded his authority in using matched-sale-purchase agreements, which were authorized to keep markets taut during a tight money policy, to snup up excessive ease during an easing monetary policy.

Nobody else involved agrees with Governor Maisel's criticism; the rest all feel Alan had the practical authority to operate as he did. Whether the operational judgment to absorb reserves Tuesday was right is perhaps a moot question, although I personally agree with Alan's view that another boost to easier money expectations right now might have created enough trouble for the future, particularly the forthcoming Treasury financing, so that it was wise to soak up the reserve excess. But that action looks unneeded with hindsight, since a big and unexpected reserve demand from the West Coast Wednesday so tightened the market that the Trading Desk had to put reserves back in with repurchase agreements.

Alan says he'd do the same thing over again, if his knowledge was the same; but he's embarrassed by the way events turned around Wednesday. I have told him to regard it as one of those adverse turns of events that are bound to happen once in a while, that all he can do is use his best judgment each day, and that I was sure you'd feel the same way.

The objecting Committee members may be more or less mollified after our several discussions, but they might bring it up at the next FOMC meeting and so I wanted you to be forewarned. If you'd like any fuller information on this, just let me know.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

April 17, 1967.

Mr. Solomon --

Bob,

I have been asked to make some comments on the following two questions:

1. Has the Federal Reserve changed its views in recent years as to the relative importances of changes in the volume of bank credit and the money supply?

2. Has the growth of the Euro-dollar market appreciably weakened the control of the Federal Reserve System over the U. S. banking setup?

Any comments will be appreciated.

WMM
(Chairman)

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 19, 1967.

To Chairman Martin

Subject:

From Robert Solomon

Here are some comments on the two questions put to you. If you would like something more extensive, I'll be glad to prepare it.

1. The answer is "no" to the first question--namely has the Federal Reserve changed its views in recent years as to the relative importance of changes in the volume of bank credit and the money supply. This question may have been stimulated by the recent ABA Symposium and by Jim Tobin's article in the Sunday Washington Post on Milton Friedman's money supply approach.

The Federal Reserve Board and its staff have never been close adherents of the quantity theory as preached by the Chicago School. While we are conscious of the importance of changes in demand for money, the traditional approach to monetary analysis and policy here has been via the supply of bank credit and interest rates. There has been no significant shift toward or away from this approach in recent years.

2. Regarding the second question--has the growth of the Euro-dollar market appreciably weakened the control of the Federal Reserve System over the U.S. banking setup--it may be said that though the relationship of U.S. banks to that market is in process of evolution, Federal Reserve control has not been weakened.

Last year, under conditions of tight money, U.S. banks borrowed a substantial amount of Euro-dollars through their branches abroad. Although this had a significant effect on our balance of payments, the domestic monetary effect was very small and cannot in any sense be said to represent a weakening of monetary policy. Even at their maximum, liabilities to branches represented only 1-1/2 per cent of total deposits of U.S. banks.

Similarly, as monetary policy has eased since the autumn, there has been a return flow of some of these funds to Europe. But the extent to which this outflow offset monetary easing here has been minimal.

Another interpretation of the question is that the development of the Euro-dollar market imposes an additional balance of payments constraint on the freedom of the Fed to ease monetary conditions here, for fear of a sizable return flow of funds to the Euro-dollar market from U.S. banks through their branches. What is relevant here is that these flows of short-term funds do not represent a basic change in our U.S. balance of payments. Last year's inflow was not interpreted as a basic improvement and this year's outflow is not a basic deterioration.

It should be noted that the IET and the voluntary programs tend to limit other forms of flow between the U.S. and other money markets, including the Euro-dollar market.

RS

BOARD OF DIRECTORS' MEETING
FEDERAL RESERVE BANK OF ATLANTA
JUNE 8, 1951 - 10:30 a. m.

ORDER OF BUSINESS

CALL TO ORDER:

PRESENT:

ABSENT: Frank H. Neely, Chairman.

ALSO PRESENT:

GUESTS:

Honorable William McChesney Martin, Jr.,
Chairman of the Board of Governors of the
Federal Reserve System.

Mr. Paul M. Davis, Nashville, Tennessee
Member, Federal Advisory Council

Mr. Thad Holt, Birmingham, Alabama
President and Treasurer, Voice of Alabama
DIRECTOR - Birmingham Branch

Mr. Howard Phillips, Orlando, Florida
V-President and Manager, Dr. P. Phillips Company
DIRECTOR - Jacksonville Branch

Dr. C. E. Brehm, Knoxville, Tennessee
President, University of Tennessee
DIRECTOR - Nashville Branch

Mr. E. O. Batson, New Orleans, Louisiana
President, Batson-McGehee Company
DIRECTOR - New Orleans Branch

COMMUNICATIONS:

1) Letter of May 22, 1951, addressed to Chairman Neely by Mr. William McChesney Martin, Jr., Chairman of the Board of Governors.

2) Invitation to Directors to attend opening of Bank of York building.

1. READING OF MINUTES OF BOARD OF DIRECTORS FOR MAY 1951:

1. Comm Bks - not now sufficient funds
2. rates last year
2/12/00 90%
3.6.

2. READING OF MINUTES OF EXECUTIVE COMMITTEE FOR MONTH OF MAY 1951:

3. BRANCH BANK BUSINESS:

1) Reports by visiting Branch Directors.

4. REPORTS OF COMMITTEES:

1) Salary and Personnel Committee
Director McCrary, Member of Committee

2) Auditing Committee
Director Williams, Chairman

3) Real Estate and Building Committee
Director McCrary, Chairman

4) Agricultural Committee
Director Reinhold, Chairman

5. UNFINISHED BUSINESS:

1) Approval of appointment and salary of Melvin McIlwain

6. NEW BUSINESS:

1) Declaration of semi-annual dividend.

7. SCHEDULE OF RATES OF DISCOUNT:

8. OPERATIONS REPORT - First Vice President Clark:

9. REPORT OF THE PRESIDENT:

10. REPORT BY MEMBER OF FEDERAL ADVISORY COUNCIL:

11. DISCUSSION OF CURRENT BUSINESS DEVELOPMENTS
By Mr. L. B. Raisty, Assistant Vice President.

12. GOVERNOR WILLIAM McCHESNEY MARTIN, JR:

13. ADJOURNMENT:

September 1, 1967

1 Feeney
+ Others

THE ROLE OF A DIRECTOR OF A FEDERAL RESERVE BANK, BASED UPON DISCUSSIONS BY THE BOARD OF DIRECTORS OF THE FEDERAL RESERVE BANK OF MINNEAPOLIS, AT ALEXANDRIA, MINNESOTA, JUNE 2-3, 1967

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In early June, 1967, the Board of Directors of the Federal Reserve Bank of Minneapolis met in a special two-day meeting at Alexandria, Minnesota as the guests of the Vice Chairman of the Board, Robert Leach, to discuss the role of a director on a reserve bank board. The Federal Advisory Council member from the Ninth District, John Moorhead; Dan Brill, head of the research department of the Board of Governors, and a representative group of the official staff of the bank also participated.

This discussion was the direct outgrowth of a deepening concern by some of the Board members about the validity of the historic structure of the reserve banks, prompted in turn by their desire to find avenues of service to the Federal Reserve System consistent with the realities of its operations today.

Although this analysis of the role of the director is not cast in the form of a conventional report of the Alexandria discussion, it fairly reflects the nature of the inquiry and the conclusions.

It is obvious that the parameters of a director's role at a reserve bank must grow out of the nature of the reserve bank. The surface similarities to the structure of a conventional corporation conceal profound differences in objectives and mechanics from any other corporation with which the director might be familiar, differences which must be understood before grappling directly with the role of the director. Although a federal reserve bank is a corporation authorized by statute, the organic act frames its objectives in only general terms; nor is it much more helpful in specifying the mechanics of its operation. As is true of most of the federal legislation creating operating structures of our government, particularly those that have survived any period, the purist seeking for precisely measured operating authority must give up in despair.

But it must be acknowledged there is no alternative. Our Congress historically has implicitly recognized that public institutions must be given latitude to shape themselves to changing social demands. Only when basic shifts in direction or organization are required, such as the Banking Act of 1935, which formalized the evolution of the open market operations, does Congress act, trusting generally to administrators of the legislation to stay within its broad outlines.

Congress can change the Federal Reserve System any time it wishes, and for any reason. Nor is Congressional action subject to any judicial review where the monetary power is involved:

> "Two of the greatest powers possessed by the political branches, which seem to me the disaster potentials in our system, are utterly beyond judicial reach. These are the war power and the money, taxing, and spending power, which is the power of inflation. The improvident use of these powers can destroy the conditions for the existence of liberty, because either can set up great currents of strife within the population which might carry constitutional forms and limitations before them . . . .
>
> "No protection against these catastrophic courses can be expected from the judiciary. The people must guard against these dangers at the polls."[1]

which is ample reason for those in policy roles within the System -- and this includes directors of the reserve banks -- never to stop the process of self-inquiry if the viability of the System is to be maintained.

Formation of "not less than eight nor more than twelve" federal reserve banks was authorized by the Federal Reserve Act on December 23, 1913, with this general statement of objectives:

> "To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

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1 Robert H. Jackson, Monetary Decisions of the Supreme Court, p. 102.

(And if this statement appears to lack specificity, remember the primary Constitutional authority for federal banking and monetary legislation is contained in the eleven words of Clause 5, Section 8, of Article I, in which Congress is given the power "To Coin Money, regulate the Value thereof, and of foreign Coin.")

But why twelve reserve banks? Why not just one? At least part of the reasoning was the populist fear of excessive centralization -- a fear that was hardly new, having run as a bright red thread through our entire history from the Constitutional Convention to the Economic Development Agency debates.

> ". . . a system which will give us at least one reserve bank of our own, . . . divorced so far as government of the bank is concerned from Wall Street influence or domination."[2]

Of greater intellectual appeal, but hardly as much popular appeal, was the statement of Senator Swanson (51 Cong. Rec. 429 (1913)):

> "Besides, it has been wisely said that there is such a diversity in industrial, agricultural and commercial conditions of our Nation that a system of regional banks with one for each section or region could be more successfully and profitably conducted for the benefit of that section than one great central bank."

Perhaps the only major philosophic amendment of the original Act evolved from the emergence in the 1920's of the coordinated efforts of the reserve banks designed to affect the monetary climate of the United States through open market operations. This was a mechanism undreamed of in 1913, but one which fitted, albeit sometimes loosely, into the function of "an elastic currency". It was a pragmatic response to an economic need and was conducted for more than a decade on an informal, cooperative basis among the banks and the Board of Governors before Congress amended the law to formalize the FOMC and close the schisms which had opened among the banks and the Board. In the Banking Act of 1935 it was

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[2] Rep. Hayes, 50 Cong. Rec. 4656 (1913).

explicitly recognized that the exercise of the monetary policy function required the unified stance of a single central bank, however constituted the policy council might be. The extraordinary visibility of the monetary functions of the Federal Open Market Committee and the Board of Governors, which have increased in public awareness immeasurably in the last few years, unfortunately has tended to overshadow the functions still carried on in the banks.

It cannot successfully be argued that Congress intended in the Banking Act of 1935 to change "federal" to "national" in its modification of the Federal Reserve System, except as it was necessary "to concentrate the authority and responsibility for the formulation of national monetary policy in a body representing the general public interest"; for in the same House Report, they concluded the general statement with these words: "to modify the structure of the Federal Reserve System to the extent necessary for the accomplishment of these purposes, but without interfering with regional autonomy in matters of local concern."

Finally, about itself the System has had this to say in cataloging its overall objectives:[3]

> "An efficient monetary mechanism is indispensable to the steady development of the nation's resources and a rising standard of living. The function of the Federal Reserve System is to foster a flow of credit and money that will facilitate orderly economic growth, a stable dollar, and long-run balance in our international payments."

What are the generally acknowledged central banking functions performed by the reserve banks? These are:

I. Housekeeping functions for the U. S. economy.

Processing of checks for the banking system;

Issuing and maintaining an adequate supply of currency and coin in circulation;

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[3] The Federal Reserve System, Purposes and Functions, p. 1.

Serving as fiscal agent for the U. S. Treasury.

II. Specific services to member banks.

Safekeeping of securities;

Making of loans to qualified banker borrowers;

Examinations of the member banks.

III. Participation in monetary policy formulation.

Research facilities;

Representation by the bank president in Federal Open Market Committee deliberations.

Perhaps also generally acknowledged in principle as a responsibility of the Federal Reserve Banks are the information programs of the various reserve banks designed to do these things (and this is hardly an inclusive list):

(a) Inform the public through publications, news releases, and talks on current economic developments.

(b) Inform commercial banks about both industry-wide developments in bank practices and credit policies, and matters of particular significance to individual banks. The Functional Cost Analysis program is an example of the latter.

(c) Maintain a base of support for the Federal Reserve System and an understanding of current approaches to economic policy.

Of less general acceptance (and this may be a factor of the response of each bank to the problems of its district, as will be developed later) is the catalytic role certain of the banks play in economic growth of their districts.

Given this broad statement of bank functions, a word about the legal

framework of the reserve banks would be appropriate, for it is within this framework the directors must find their roles.

To start with, the reserve banks are creatures of the body politic, and in that sense are like any other corporation, for all corporations find their genesis in a statute. They are referred to variously as agencies of the federal government, semi-governmental institutions, semi-private corporations, or, as Randolph Burgess seemed to prefer, "instrumentalities of the government" -- in terms which conceal more than they reveal.

Sufficient perhaps for the purposes of this discussion are these indicia shared with other central banks of the world --

1) They do not operate for a profit, but operate in the public service. It is only a slight exaggeration to note that more attention is paid in the Act to the mechanism of director selection to assure broad public representation than to what they do once elected.

2) Regardless of occasional nominal private ownership, they all have a peculiar relationship to their governments. As a system, the Federal Reserve is independent <u>within</u> the government, rather than <u>of</u> the government; as individual components, the reserve banks are independent within the Federal Res system.

3) They have an equally curious relationship with comm ial bank . We are related in the sense they constitute our stockholders; but urgess points out, "For every single occasion when a central bank may h ed some government policy, there may be found in history a dozen occasio when a central bank has acted to restrain commercial banking activities

However viewed, the district banks are separate organi structures with a considerable degree of autonomy. Only through the Presid ts' Conference, and staff participation in System studies and committees do the banks have much of an interchange. Active supervision by the Board of Gover ors is still

limited to relatively few operating areas.

The sense of confusion sometimes expressed by directors about the banks, the System, and their individual roles is understandable then, when these elements, usually imperfectly comprehended, are added up:

1) The fact the banks wear the habiliments of private corporations -- habiliments bearing reassuring familiar names, but draped about a public service structure the like of which occurs nowhere else in our society, with objectives stated in only the most general of terms. From a number of the banks' operations which are of the essence of their corporate "business" and therefore normally would be within the purview of a conventionally defined board of directors, our directors are expressly precluded. Two examples will suffice -- no director can be privy to the current policy determination of the Federal Open Market Committee, much less attend the meetings; nor is he permitted to review the examination reports of member banks.

2) The apparent anomaly of a government created structure, one which Congress created and has total power to amend or abolish, that on occasion has the temerity as a System and for its own good reasons, to lean not only against the economic wind, but against the political administration as well.

3) Twelve separate reserve banks with enough real autonomy vis-a-vis each other and the Board of Governors to sometimes foster the delusion of total autonomy.

The list could be continued. It is precisely these inconsistencies that constitute the inspired pattern of dialectics and balanced tensions that make the Federal Reserve System at once fragile and seemingly imperishable, stodgy and innovative, national and regional -- and too often frustrating to the director seeking to make a contribution.

What place is there for him? First of all, he must understand he is not serving on a conventional corporate board. Probably it would help him if he left with his hat and coat in the closet outside the board room all he may

have known about director relationships to management, owners, and the corporation. This is said, even though there are far more of the normal director duties than he may think, simply because he becomes bemused by those he doesn't have. These are the customary ones he does have:

(a) Selection of the president and first vice president. The other officers are approved by the board, but it is in the selection of the first vice president, and especially the president, the board can alter dramatically the philosophic direction of the bank. The autonomy of the reserve banks in most areas is real, as has been said before. Not only do they express the flavor of their districts, but to a very considerable degree, their president's personal interpretation of what a reserve bank ought to be about. A visit to three or four of the banks demonstrates this fact beyond question or cavil. There are significant differences among the reserve banks -- differences in program emphasis, differences caused in the main by adaptation of that bank's operations to its economic and geographic environment. And this is worth preserving. The independence of the System and its responsiveness to economic and social change can only be assured by maintaining bank management of the highest possible quality. If this responsibility is abrogated to the Board of Governors, and the president's function encapsulated in an operating manual, the viability of the Federal Reserve System will be determined externally by the legislative political process instead of internally by the dialectic processes of the System. Its ability to respond to changes in the monetary environment will be curtailed -- and its ability to contribute in advance of the fact to an optimum monetary environment eliminated.

(b) Advice and guidance to management on the internal conduct of the bank. Salary administration; public service programs; technology; building design, location and administration, are just a few of these. The outside director has proved his usefulness too many times to the U. S. corporation to need exalting here. Directors can be enormously valuable in these areas to Reserve banks especially, because of the limited access reserve bank management has to general business practices. While it is essential that federal reserve bank officers be precluded from any outside directorships, this stricture closes one of the most useful avenues available to members of the business community to keep informed of new management techniques. There aren't too many ways to combat the institutional insularity of a federal reserve bank. Certainly the board of directors is one of the best links with the corporate management world.

(c) Contribution to the public image. Directors of stature in their own fields and communities contribute to every corporation by their very presence. Witness the efforts by national and regional corporations to have broadly representative boards. If the assurance to the public that men of substance are involved in the corporate process is important to A T & T, it is doubly so for a federal reserve bank. Here by statute, the boards must be representative. Historically, the bank boards have been composed of significant men who are leaders in their geographic and economic areas.

But of much more importance are the aspects of their roles flowing from the nature of the System itself. Consider its regional components; the fact there are twelve banks instead of one central bank. What is deemed a weakness by proponents of centralization of government function within the

System, Congress, and academia, is really one of its greatest strengths. Even in this age of enlightenment, no political scientist has yet found a mechanism to centrally administer, control, and operate national programs efficiently and effectively from Washington if the programs (1) involve the economic processes of many enterprises, (2) require the exercise of discretionary judgment on the facts of individual cases, and (3) apply across the spectrum of our economy. Small matter that precise homogeneity of districts is not attainable; nor is the number of districts particularly significant. But imperative is recognition of the geographic and psychological advantages of administration units dispersed in patterns of operating convenience to the public, and Congress did recognize them in the Federal Reserve Act. Having done so, they assured a degree of independence by using separate corporate structures, and then made certain they would have the shortest possible channels into the regional economies by casting commercial banks of each district as the nominal stockholder group, and specifying in great detail the criteria and manner of election of directors within each district.

While initially it was intended that the directors be intimately involved in the formulation and administration of monetary policy through the discount operations, the shift away from this monetary tool to other instruments has reduced their role as activists unfortunately. But their importance as informed sources of business opinion has continued. A case might be made that in fact it has been strengthened. The flow of printed data about our economy, a necessity for the making of technical judgments, has increased to such proportions as to foster the delusion that it can serve as a total substitute for value judgments. Advice and counsel of informed directors about economic trends is a major contribution to the president who must attempt each month to assess the economies of his district and the nation in the FOMC discussions, but even more important is the assessment of the direction of monetary policy in terms of national goals --

full employment and price stability; economic growth; interest rate structures and our balance of payments - the weight to be given each of these alters the direction of monetary policy. The dialog out of which must come the evaluation of the weights to be assigned social goals at any particular stage in the political-economic cycle should involve the best minds our country has -- not only within the government establishment and academia, but the outside worlds of "commerce, agriculture, and -- other industrial pursuit(s)".

It may be the directors are oversold sometimes on their positions vis-a-vis the FOMC. If so, it is a delusion to be dispelled. The truth is the specific contribution of any one group, much less an individual bank president, governor, or ranking staff economist, can seldom be identified. It requires no excess of humility to make such a statement. Our economy is so huge, its responses so complex, the signals so confusing, and above all the areas of influence of System action so narrow and imperfectly understood, that it would be a brave man indeed who would prescribe precise cause and effect relationships Ultimately the nineteen men who participate as principals in the FOMC process make decisions as to directions of monetary policy. But behind those 19 is the most remarkable economic research facility in the world. It is a single-minded effort of many equals. It is not entirely inappropriate to point out in this context, only 5 of the 12 presidents can vote at any one time; yet the opinions of the other 7 are accorded equal time and weight.

But into the deliberative process of the Open Market must go the best information available. And certainly the considered judgment of the two hundred plus directors of the Federal Reserve Banks and their branches is an important source, if not potentially the best source of opinion evidence.

It is public service. The stakes of the game are the highest possible - no less than the economic health of the United States. Public service is an obligation that increases in direct proportion to the benefits bestowed

by society, whether in the form of property or position. Service on a Federal Reserve Bank board is especially appropriate for the directors meeting the criteria of the Act, for generally they represent the elements of our society with the most to lose by an abuse of the monetary power or a malfunction in the flow of money and credit. In a purely personal sense, it can be enormously stimulating, for it can provide a director with a window on the economic world.

The directors can and usually do serve as bridges between the banks and the public -- bridges across which information flows in both directions. For if the Federal Reserve is to continue in its presently flexible and independent form -- a form that materially strengthens its ability to serve as trustee for the nation's currency -- a broader base of public understanding and support must be developed. Directors, because of their exposure to the System through the reserve banks can play a vital role in bringing this about.

No board of directors can function in a vacuum. It is axiomatic that management and boards of directors shape each other. Whatever failures of interest or understanding may occur with individual directors usually come acout because there has been a failure to develop this interaction. Management in Federal Reserve Banks has a real obligation to communicate to directors the special relationship a director has to his bank. This means management must develop ways of tapping the information potential of the director. In short, directors must be put to work. Directors, because of their greater breadth of general business experience, can be enormously constructive to the management of reserve banks; and by their active role in the market places of the United States -- and sometimes the world -- directors can contribute a sense of the business realities to monetary policy creation. However, the Federal Reserve System is unique, and it does operate with esoteric tools and a technical lexicon of its own which must be learned if the director is to be successful in relating his knowledge and experience to the reserve bank board room discussions.

Bank management has a responsibility to make this learning process as easy as possible.

Innovation in the relationships of boards of directors, reserve bank management, and the Board of Governors has to be stimulated. In this process directors can be exceedingly useful, especially if they always remember a reserve bank is in many respects a cloistered institution. The directors are not without obligation to suggest new ways for the improvement of operating procedures of their reserve bank; even the System itself should not be considered off limits to their inquiry. Research projects designed to improve the flow of money and credit, programs to encourage economic growth -- literally dozens and dozens of these are going on and contributing to the air of creativity that makes the banks and the office of the Board of Governors exciting places to be employed, but little of this spills over to the directors. In one of the areas of principal structural support -- the boards of the separate banks -- not nearly enough has been done, and it is on these boards the viability of the System, as we have known it for this much of its history, must rest.

A meeting of the Board of Governors of the Federal Reserve System with the Federal Advisory Council was held in the Board Room of the Federal Reserve Building in Washington, D. C., at 10:30 a.m. on Tuesday, September 17, 1968.

PRESENT: Mr. Martin, Chairman
Mr. Robertson, Vice Chairman
Mr. Mitchell
Mr. Daane
Mr. Maisel
Mr. Brimmer
Mr. Sherrill

Mr. Holland, Secretary
Mr. Kenyon, Deputy Secretary
Mrs. Semia, Technical Assistant, Office of the Secretary

Messrs. Simmen, Still, Mayer, Wilkinson, Craft, Kennedy, Fox, Nason, Conn, Stewart, and Larkin, Members of the Federal Advisory Council from the First, Third, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth, Eleventh, and Twelfth Federal Reserve Districts, respectively

Mr. William H. Moore, Chairman, Bankers Trust Company, New York, New York

Mr. Prochnow, Secretary of the Council
Mr. Korsvik, Assistant Secretary of the Council

The Council member from the Second District, Mr. George S. Moore, was unable to be present at this meeting, and in his absence the District was represented by Mr. William H. Moore.

It was agreed, since Chairman Martin had to leave shortly to begin an out-of-town trip, to turn first to topic 2-F on the agenda, as follows:

> What are the Council's views regarding the appropriate role of one-bank holding companies in the U.S. banking structure? Does the Council have comments on a proper legislative framework for the operations of such companies?
>
> The members of the Council are in favor of expanding the financial fields in which commercial banks are allowed to operate. If such new areas are in the public interest, banks should be permitted to engage in them directly, or through subsidiaries, or through a holding company. The majority of the members of the Council do not believe that one-bank holding companies should be allowed to become conglomerates.

President Mayer remarked that an earlier draft of the Council's statement had indicated that the majority of the members did not believe that one-bank holding companies should be allowed to engage in nonfinancial activities. However, those words had been deleted because they were not easily susceptible of definition. The Council had also deleted a paragraph that attempted to identify elements that would be important in the framing of legislation. The Council had concluded that in order to reply adequately to that part of the question it would be necessary to review the law thoroughly. In the absence of such a review, for which there had not been sufficient opportunity, any suggestions offered might have been wide of the mark.

There was agreement by a majority of the Council, President Mayer continued, that one-bank holding companies should not be allowed to become conglomerates. However, at least one member present dissented from that view, as did the member from the Second District, who was not present. A number of the members had rather strong views on the matter, which the Board might be interested to hear.

Chairman Martin stated that the Board would like to hear both the strong and the more moderate views.

President Mayer then turned to Mr. Simmen, who remarked that he had a personal interest in the question because his bank, through a plan of reorganization and merger, was about to become wholly owned by a one-bank holding company. The bank had taken this step because, although the 64th or 65th largest bank in the U.S., it was confined to the limits of the small State of Rhode Island. Also, for the past year or so the bank had been in the courts because of litigation brought by a service bureau contending that the City of Providence and the bank had no right to enter into a contract whereby the bank would operate the city's computer. The bank had felt for some time that there was a need to compartmentalize in order to provide specialized services for which it was qualified, rather than just to compete with nearby smaller banks for deposits. To accomplish that

purpose through a registered bank holding company had seemed out of the question not only because of the competitive situation in the small State but also because the bank would then be restricted from going beyond State lines.

Mr. Simmen believed it would be well to proceed cautiously with respect to legislation, in the absence of apparent problems regarding the several hundred holding companies that already owned only one bank. If legislation were approached without careful study, restrictions might be imposed that would inhibit expansion of services through one-bank holding companies in much the same way banks were now hampered. In the case of his own bank, the published proxy statement to stockholders had specified that the purpose of the new arrangement was to engage in financially-related activities. The plan had been approved by 85 per cent of the stockholders, with objections from less than 1 per cent. Moreover, he understood that the Comptroller of the Currency would have examining power with respect to any activity of the holding company, and thus examiners could determine whether or not unsound paper was being thrust upon the bank or whether the holding company was engaging in any activity that would impinge on the record of the bank.

Chairman Martin inquired whether Mr. Simmen visualized that consideration might be given to engaging in a completely nonfinancial activity and whether he would regard that as proper.

Mr. Simmen replied that management had no such plans in mind. The organization would be capable in the leasing field and in rendering computer services to customers. As indicated in the proxy statement, however, the organization would plan to stay within the areas it knew best.

In response to a question by Governor Robertson, Mr. Simmen indicated that at the moment he would not be inclined to oppose a limitation that would confine one-bank holding companies to activities related to banking and financing.

President Mayer suggested that it would seem preferable if any such limitations could be specified by the banking agencies. If the Congress had to deal with the question, it would be subjected to many pressures, with unpredictable results.

Governor Robertson then read from a list of activities being conducted by the several hundred existing one-bank holding companies. In response to a question whether the businesses mentioned were conducted by holding companies the organization of which had been initiated by a bank, Governor Robertson indicated that the list encompassed all holding companies that owned one bank, regardless of the manner in which the holding company had come into being.

Mr. Still commented that his bank--of moderate size--was considering the formation of a one-bank holding company, one reason being that management viewed the bank as otherwise vulnerable to takeover by interests with which it might not care to be associated.

Governor Robertson recognized the point but observed that any limitations, statutory or administrative, presumably would have to apply across the board.

Mr. Kennedy noted that the majority of the Council had taken a position in favor of one-bank holding companies, operating in banking and related fields. The majority would not favor conglomerates, engaging in the diversity of operations Governor Robertson had cited. Mr. Kennedy felt strongly that banks--and their holding companies--should stay within the area of financing; troubles had occurred in the past when banks stepped out of that area. However, he would be loath to see the problem of definition submitted to the Congress because its ramifications were so great that inequities might result. That was why the Council had been probing into whether the Board had authority to issue regulations on the subject and whether specific legislation could be avoided. The situation was critical at this stage because many banks, observing the accelerating trend toward formation of one-bank holding companies, were apprehensive of being frozen out if they did not take such action now.

Mr. Conn remarked that although the intent of Congress had been well expressed in the 1956 Act with respect to registered bank holding companies, there appeared to be a complete hiatus in

the law with respect to one-bank holding companies. This permitted a development that the Congress apparently had never intended. It was unfortunate that, while the activities of multi-bank holding companies were limited by statute and by the Board, holding companies that owned only one bank could engage in the range of operations suggested by the list Governor Robertson had read. He had no objection to an extension of powers within the field of banking, but if banking institutions went beyond that field they ran the risk that some of their powers would be given also to other types of institutions, such as savings and loan associations. If banks were to engage in the steel business, for example, they would have little basis for urging that no one else should be permitted to engage in the banking business.

If banks spread their operations too far, Mr. Conn continued, sooner or later there were bound to be abuses. For example, if a steel company owned a bank through a holding company, it could select the management. If the steel company then wanted to place some of its paper in the bank, the management would scarcely be in a position to refuse. He did not believe the examination process would be an adequate safeguard; a bank could hardly be stronger than its owners, and a bank examiner did not have sufficient knowledge to appraise the

operations of a steel company or a dairy. Yet if the steel company or dairy went broke, the bank was bound to be affected. If abuses occurred and legislation was passed, all banks were likely to be hurt. Although bankers might have the respect of Congress as bankers, they would not have the same support upon moving out to nonbanking fields. Many Congressmen would certainly view any extension of banking powers as contrary to the public interest, and he feared that inroads might in fact be made on the latitude now available to the banks. If the Board had regulatory authority in this area, and he supposed such authority must exist somewhere, he believed it would be in the public interest, and in the interest of banking, to specify by regulation that the powers of one-bank holding companies could not exceed those exercised by registered bank holding companies.

Governor Brimmer said it was his understanding that the Board did not have such power; because of the loophole in the law, the organizers of a one-bank holding company need not apply to the Board for approval. For a number of years the Board had recommended to the Congress repeatedly that the definition of a bank holding company be extended to encompass companies that owned only one bank, and thus put them on the same footing as companies that were now required to register. He inquired whether the Council was suggesting that the Board drop that campaign.

President Mayer replied that the Council was merely expressing concern that if the subject was opened up in the Congress many interests would press to restrict banks unduly, perhaps to an even smaller area than their present scope of operations.

Governor Sherrill pointed out that if one-bank holding companies initiated by banks were limited to financially-related activities, nonbank corporations presumably would be precluded from owning banks. He inquired whether the Council's thinking implied acceptance of that principle.

President Mayer said the Council's thinking had been mainly in terms of what the banks were doing. The other angle had not been given full consideration. The Council members did not have sufficient knowledge on that score to have formed a judgment, although it was known that there were some hundreds of companies that owned a bank and that fact was intuitively a matter of some concern.

His personal view, President Mayer continued, was that the current trend for so many organizations of all types to buy up other unrelated enterprises was unwholesome. The main purpose of many such transactions seemed to be the aggrandizement of individuals or corporate interests, rather than promotion of the public welfare. He could not foresee the ultimate social effect of this trend, but he suspected it might not be good. It seemed

evident that no one would want to take over an insurance company, for example, unless he hoped to gain access to the company's reserves, and banks might also become targets. If such a motive became apparent, one could appreciate the difficulty of the problem that would confront the bank supervisors.

Mr. Wilkinson associated himself with President Mayer's views.

Mr. Conn, referring to Governor Sherrill's earlier inquiry, expressed the view that a distinct difference was involved. If an insurance company, for example, owned 50 per cent of a bank, the bank must continue to operate within the normal purview of banking. If the insurance company's financial condition deteriorated, only its stock ownership in the bank would be jeopardized. This was to be distinguished from a situation where a bank organized a holding company and through it entered into other businesses concerning which it had no real knowledge.

Mr. Kennedy said he regarded the whole question of bank ownership as a serious matter. Despite supervisory efforts, a bank could easily get loaded with poor paper. This was a problem that went beyond the question of banks being owned by holding companies. There was danger that any corporation owning a bank could load the bank with unsound paper.

Mr. Fox commented that it seemed to him the dangers would be just as real in the case of ownership of a bank by a wealthy individual or group of individuals. The law at least had some safeguards written into it that restricted the ability of a bank to finance an affiliated corporation. His reasons for dissenting from the majority position were similar to those Mr. Simmen had mentioned. Everyone's views were conditioned upon his own experience and particular problems. Banks in his area suffered under growth restrictions about as severe as those in any part of the country. Branching was narrowly limited, and the registered bank holding company route seemed to be precluded for practical purposes. Although his bank had no specific plans at the moment, the one-bank holding company route appeared to offer the only feasible way to participate in a general growth pattern. Fears had been expressed regarding the solvency of banks if the trend toward one-bank holding companies persisted, but in several existing situations of which he had knowledge the banks had made excellent progress. The problems of which he had heard stemmed in large measure not from irresponsible corporate ownership but from irresponsible individual or group ownership. If there were loopholes in the law, he believed it would be preferable to amend the law in terms of the type of credit a bank could extend to sister companies than to attack the whole holding company concept.

In answer to a question about banks going into unrelated businesses, Mr. Fox said he would not want to be restricted. The bulk of his bank's deposits came from large corporate customers whose confidence in the bank was vital, and the bank was not likely to jeopardize that confidence by involving itself in ventures that might endanger its solvency. He saw no reason in principle why a one-bank holding company should not be permitted to buy a hotel, for example.

In response to further questions, Mr. Fox said he did not see why a bank charter should be refused to a corporation and granted to a group of individuals who could not provide anywhere near the same degree of strength. If a community need existed, he would not refuse a charter simply because it was applied for by a corporation. As to the responsibility of a bank to allocate resources in the public interest, he believed the profit motive of a bank under corporate ownership would lead it to be just as responsive in that respect as one that was owned by individuals.

In summary, he saw no reason to change the rules relative to granting bank charters simply because the bank was to be owned by a corporation. This did not mean, of course, that anyone who could afford it should be granted a charter, but the rules followed to date need not be changed simply to exclude corporate ownership.

Governor Brimmer expressed an interest in hearing the Council's view, since the majority believed one-bank holding companies should be restricted to financial activities, on the appropriate range of such activities.

President Mayer replied that the Council's thinking had been basically in broad terms--that banks should stay in lines of business that had some relation to banking. No attempt had been made to name such lines of business, and in his own mind he could not at the moment develop a serviceable definition.

There followed an exchange of comments regarding the question of the authority to determine what activities were appropriate within the structure of registered bank holding companies, and Governor Maisel recalled that a number of years ago, in the Transamerica case, the Board had adopted a very narrow view of incidental activities. He wondered whether the majority of the Council was still thinking in terms of such a limited concept. Mr. Nason observed that all of the Council held the general view that there should be some liberalization of the activities in which banks were permitted to engage, either individually or through holding company arrangements. Governor Maisel inquired whether the thinking of the majority would be broad enough to encompass, for example, insurance and instalment finance activities, and several responses were in the affirmative.

Governor Daane inquired whether the Council believed that conglomerate holding companies were unsound per se. The trend of the times was in that direction. The question, then, was whether the situation would be better or worse if banks were left out.

President Mayer said he would not be prepared to classify all conglomerates as bad. Some had experienced sound growth. He had an intuitive feeling that some that had grown very rapidly might not be sound, but only time would tell.

Mr. Moore noted that many people were forming conglomerates because they were hemmed in from further growth of earning power within their own industries, for a variety of reasons. Some of this pressure was now being felt by the banks, which were not growing as rapidly as the rest of the economy and were trying to find some way to stay in the parade. This was the crux of the problem. Although individual members of the Council might view the issue in the light of the particular problems of their own institutions, all were agreed that some liberalization was needed and that it was vital for some way to be found in which the banking industry could grow in its own or related areas to keep pace with the rest of the economy. Otherwise the banks would fall behind. Like railroading, banking would at some point no longer be considered a good business for capital or personnel.

Mr. Kennedy observed that the Council's statement should not be read as condemning conglomerates per se. The focus of that statement had been on banks going into unrelated lines of business through the formation of one-bank holding companies. He did not recall any consideration having been given to the

other side of the question. President Mayer agreed, noting that the Council was not fully prepared to respond to the question involved in ownership of banks by corporations engaged in other businesses.

At this point President Mayer remarked that the Council member from the Second District, Mr. George Moore, had submitted certain comments in writing. At the Board's request, President Mayer read Mr. Moore's comments, as follows:

> One-bank holding companies have been a part of the corporate financial industry for many years. They have served the public interest by usefully providing capital and management for commercial banks. We regard this as an appropriate role for the one-bank holding company, which should continue to contribute to the growth and diversification of financial services to the public. Banks owned by a one-bank holding company are now covered by the same supervisory laws as all other banks. Such supervisory regulation in our opinion is ample. The fact that a bank has a single corporate stockholder rather than a group of individual or institutional stockholders should not require the introduction of a new layer of supervision. Our opinion is that:
>
> 1. There are no visible abuses.
>
> 2. Regulatory agencies have already sufficient powers to prevent any abuses from developing and to nip them in the bud. The Comptroller of the Currency is outspoken in saying this.
>
> 3. The public wants and deserves and will support aggressive constructive competition in financial services on a broad front and the congeneric financial holding company is the best vehicle to do this. There are many reasons such as capital-debt ratios, which vary from business to business in the financial world, which support the theory that it is better to do some of these things, such as factoring and leasing,

> via the separate corporate route in a financial family affiliated with the bank instead of having it all in the bank itself, wholly apart from the questions which might be raised as to whether a bank may legally perform these functions.

Mr. Nason remarked that he and the president of his bank's parent holding company both felt strongly about two points. First, banks should not be owned by conglomerate interests, because the banks might then be less motivated to serve the public. Banks enjoyed certain unique privileges, but they also had certain obligations to the community, such as allocating funds, which might not be handled responsibly if ownership chose to use the bank's resources selfishly. Second, it would be grossly unfair to accord one-bank holding companies extensive privileges not accorded registered bank holding companies. He would be well satisfied, Mr. Nason added, if the definition of what was related to banking was not spelled out in the law but was left as a regulatory decision for the Board.

Governor Sherrill inquired whether, since the fundamental problem leading to the desire to get outside the confines of banking was growth of profits, the Council members believed that a restriction to financially-related activities, with a definition that was not too stringent, would provide sufficient room for growth for at least several years to come. Replies by several members of the Council were generally affirmative, though Mr. Fox responded in the negative.

Mr. Conn commented that the growth of banks had, generally speaking, been satisfactory. Net operating earnings had been increasing, and the industry was in a sound position. Banks enjoyed special privileges conferred upon them by legislation, and they operated on other people's money. Yet they were not satisfied and wanted to engage in other activities, while at the same time arguing that others should not be permitted to engage in banking.

Mr. Fox remarked that if there were a different kind of banking structure in his area he might feel less strongly about the need for new avenues of expansion. In his area there were many activities that required funds and the banks were limited in achieving deposit growth.

Governor Robertson said he could remember well the events of the 1920's and 1930's that had led to the passage of the Glass-Steagall Act. Because of the abuses that had occurred, the banking fraternity found itself without influence in the framing of corrective legislation. It seemed to him that many of the same mistakes were being repeated in the present period. He hoped that the Council would continue to study the question of the proper scope of bank activities and offer recommendations soon, because he thought that legislation would be forthcoming. If abuses occurred before solutions were found, the banking industry would not get the kind of legislation it preferred, but something much more restrictive.

The other topics were then taken up in the order presented on the agenda. (Chairman Martin had left the meeting during the course of the foregoing discussion.)

1. Economic conditions and prospects.

   A. How does the Council appraise the general economic outlook for the fall and winter, now that the tax increase has taken effect? Comments would be especially helpful on the probable extent and duration of the steel inventory adjustment, on indications from customer contacts of capital investment plans, and on indications of any cutbacks resulting from reductions in Federal Government purchases or new orders.

The Council anticipates that the rise in business activity in the fall and winter months will moderate now that the tax increase is in effect. The slowing of economic activity also will reflect the liquidation of steel inventories accumulated during the summer months in anticipation of a steel strike. The estimates of the build-up of steel inventories suggest that the adjustment will last at least through this calendar year.

Contacts with customers indicate that capital investment plans are proceeding on schedule, with some step-up in outlays as corporate managements strive to offset increasing labor costs. The larger investment outlays also cover a rise in the cost of plant and equipment. The members of the Council reported that they had little indication from their customer contacts of cutbacks in output resulting from reductions in Federal Government new orders or purchases.

Governor Brimmer inquired whether Council members had any feeling about the extent to which consumers might be attempting to maintain their expenditures by increasing their borrowing and by drawing down their savings. He was somewhat puzzled by the lack

of response to the surtax in the consumer sector. He would have thought that by now the figures would have begun to reflect some reduction in the rate of expansion of consumer expenditures.

Mr. Kennedy responded that the Council members were also concerned about the level of consumer spending and the delayed impact of the tax package. The most recent available information on retail sales reflected all-time highs. Comments by directors of his bank indicated some expectation that October or November might see a beginning of the dampening of consumer spending that had been anticipated in September.

Governor Daane inquired to what extent Council members believed that the strength of the consumer sector reflected widespread inflationary expectations.

Mr. Kennedy commented that it was hard to judge. Consumers felt that prices were going up rather than down, generally speaking, and they were aware that serious unemployment or a real economic downturn were probably not in the picture; the danger of fiscal overkill had been largely dismissed from people's minds. However, he doubted that consumer goods were being purchased to any large extent simply as a hedge against price rises. President Mayer suggested that the successful clean-up of the 1968 model automobiles may have reflected to some degree expectations of substantially higher prices for the 1969 models. Another comment

was to the effect that there had been so many wage and salary increases throughout the corporate and public sectors that many people were not feeling the pinch of the tax increase as much as they otherwise would have.

B. What is the outlook for the cost and availability of mortgage funds and for residential construction activity in the Council members' respective regions?

The supply of funds for residential construction activity and mortgages has improved, and the members of the Council expect that this trend will continue. This development, together with the generally lower structure of interest rates which has characterized the money market, has resulted in slightly lower mortgage rates. With an increase in the availability of mortgage funds, some further decline in rates may occur. In some States, the relaxation of usury laws has increased the supply of mortgage funds.

Governor Robertson inquired to what extent, if any, banks had been increasing their percentages of real estate loans in the past year or so, and Governor Maisel remarked on the recent increase of real estate loans in the New York area.

Mr. Moore commented that with the recent relaxation of legally permissible rates in the State, there had been some increase in mortgages on single-family dwellings. However, apartment projects appeared to be drying up somewhat because of the prohibitive cost of land. Governor Maisel asked if the volume of construction might represent in part the working out of a backlog, and Mr. Moore agreed that it might, because earlier a great deal of mortgage money had gone out of the State in search of better rates.

Governor Brimmer, reverting to Governor Robertson's question, observed that figures he had reviewed in the spring of this year indicated that real estate loans as a proportion of total assets of commercial banks had receded somewhat from the position reached in 1967, which reflected an increase over 1964-65. He inquired about the position of banks with which Council members were affiliated.

Mr. Moore said that real estate loans represented only a small percentage of total assets at his bank, as at most of the large New York City banks. He did not think his bank would be increasing that percentage substantially, in view of the bank's location and the nature of its business. For banks outside New York City, real estate loans were a major portfolio item, and he believed those banks would be adding to them.

President Mayer noted that his bank had continued making mortgage loans under all conditions. The bank operated a lot of branches, and the making of mortgages was an important item of business However, the bank's ratio of real estate loans to other loans was probably less than it had been four or five years ago because of the large increase in total loans.

In response to an inquiry by Governor Robertson regarding the ratio of mortgages held by banks to those held by nonbank institutions, response was made that a decline probably had occurred.

2. A. What is the Council's assessment of the probable strength of business loan demand in the fall? Have there been any indications of a further shifting of short-term financing into the commercial paper market, or of corporate intent to repay debt through the issuance of long-term securities?

The Council expects business loan demand in the fall to rise only seasonally. A number of the Council reported some shifting of short-term financing into the commercial paper market. There has been little evidence of debt repayment through the issuance of long-term securities. However, several members of the Council anticipate such a development if and when the long-term interest rates decline somewhat further.

Governor Brimmer observed that at one time some banks were expressing concern about the competitive aspects of the commercial paper market and were urging the Board to do something. He inquired how the Council members now viewed that market.

President Mayer replied that he looked upon it more kindly than he had some time ago, because he did not know what would have been done during the recent period of expansion if the commercial paper market had not been available to meet some of the financing demands.

Mr. Moore expressed the view that, academically speaking, the commercial paper market did present a serious competitive problem. A great deal of financing was being done through that market that banks otherwise would have done. It was a serious competitor when a bank was looking for loans, even though the market was supported and made possible by the banks. What, if anything, should be done about the problem, he could not say.

Mr. Mayer said he was not so sure that the commercial paper market was as fully dependent on the banks as might be thought. He suspected that buyers could be found for much of the commercial paper even if it was not backed by bank credit lines.

Mr. Kennedy agreed with President Mayer's view. Some commercial paper was being issued without any real backing. He believed there was some cause for concern on that account. But the problem came down essentially to the matter of rates and he had no suggestions as to what might be done.

Mr. Nason observed that the commercial paper market had been a valuable device during the credit crunch of 1966, and that it was a profitable device as far as his bank was concerned. It provided a way to accommodate next-to-prime customers with ease, while the bank could maintain contact by virtue of its supporting lines of credit. He did not foresee a period when his bank would have difficulty in finding profitable investments for its available funds.

Mr. Fox expressed agreement with Mr. Nason's comments.

B. What are the Council's views regarding the liquidity position of banks? Does it believe that banks would wish to increase holdings of short-term securities substantially if they could obtain funds from CD's or other deposit sources?

> The members of the Council believe that most bankers in the money centers would like to improve their liquidity positions. They would like to increase their holdings of short-term securities if they could profitably obtain funds of the proper maturities from CD's or other deposit sources.

President Mayer expressed the view that most of the banks would be hesitant about increasing their holdings of securities unless matched by CD's in approximately the same maturity range.

Governor Sherrill noted that there had been a slight rise recently in rates outside New York City for 30-59 day CD's and he inquired what factors might have been involved.

Mr. Moore replied that although money had been somewhat easier recently, there had not been any big break in rates. They had drifted down, and some were likely to back up occasionally, but the changes were likely to be temporary. The occurrence to which Governor Sherrill referred may have had some relationship to the approaching tax date.

Governor Mitchell inquired whether the Council was concerned about what might be interpreted as a speculative position in securities at this point. Some banks had taken large positions, apparently expecting interest rate changes that would provide capital gains.

Mr. Kennedy questioned the use of the word "speculative." As a dealer bank, his institution participated in markets. For a while, buyers were not to be found, and the dealers were caught.

A number of nondealer banks that had at one stage withdrawn from the municipals market had recently been buying heavily as a portfolio adjustment move.

Governor Mitchell agreed that perhaps speculation might be too strong a term. However, some institutions were in overextended positions and were heavily dependent on a turn in rates. It was natural for an institution to increase its position moderately in anticipation of a turnaround in rates, but some of the positions appeared immoderate.

C. Does the Council believe that banks will significantly increase their interest in mortgages and municipal bonds, now that interest rates have declined somewhat and there is less pressure on current positions?

If the pressure on the current positions of banks eases further, the Council believes that banks will increase their holdings of mortgages and municipal bonds.

Mr. Nason observed that the Board's question covered two different kinds of investments. Governor Sherrill inquired to which of the types banks were likely to give precedence, and several members named municipals.

D. What is the Council's view regarding current and prospective inflows of consumer-type time deposits? Has the recent tax increase had any noticeable effect on such flows?

It is difficult to determine at this early date whether the recent tax increase has had an effect on the consumer savings flow. Savings are increasing, but at a slower rate than a year ago. Most members of the Council

anticipate that the inflows of consumer-type deposits may moderate further in the months ahead. This will reflect the impact of the recent tax increase and the rise in social security tax payments that will take effect early in the year.

President Mayer remarked that this question was posed at a rather difficult time. Among other things, August always tended to be an erratic month, and it was not easy to draw conclusions from the data.

E. What are the views of Council members on the recent Board action allowing State member banks, under specified conditions, to own and operate certain kinds of subsidiary corporations and loan production offices?

In general, the members of the Council look with favor on the recent Board action allowing State member banks under specified conditions to own and operate certain kinds of subsidiary corporations and loan production offices. This reflects not only a more flexible approach to bank operations permitting an expansion of bank services, but more importantly, the action also tends to equate the competitive position of State member banks with national banks.

Governor Sherrill inquired whether any of the Council members had misgivings about the establishment of offices to produce loans across State lines.

After comments by several members reflecting uncertainty about the impact of the ruling on State laws, Mr. Larkin expressed the view that the banking community had not yet really appraised the effect of the ruling and therefore it was too early to say what the response would be. He doubted that there would be any misuse of the

decision for the time being. In fact, he was not sure what would be regarded as constituting an abuse. Possibly, to go to an extreme, the conduct of nationwide banking through loan production offices would be so regarded. However, it was impossible now to predict the ultimate effect, or to define "proper use," and developments would have to be awaited.

President Mayer remarked that a bank presumably would have little immediate interest in the ruling if its problem was to obtain deposits to make the loans already available to it within its own community, and Mr. Conn observed that if a large New York City bank, for example, established a loan production office in Oklahoma City it would have to generate a lot of loans to make up for the balances it would lose. Mr. Moore commented that, despite such risk, some banks might choose to establish such offices because they would rather have the loans than the deposits. Mr. Fox noted that many banks already had "walking loan production offices." The opportunity now permitted seemed to involve just a question of degree.

Mr. Conn said that within the framework of the interpretation he could not see that branch banking was involved. The establishment of loan production offices would not appear to be contrary to the laws of Oklahoma, except perhaps in the sense of foreign banks coming into the State and doing business. An arrangement whereby an office simply generated loans did not seem very different from what was already being done.

3. Balance of payments.

How does the Council appraise the outlook for the remainder of the year for (1) demands for Euro-dollar loans at foreign branches of U.S. banks, (2) Euro-dollars advanced by branches to home offices, and (3) direct borrowings from foreign banks by U.S. banks (i.e., not through foreign branches)?

The Council anticipates a continued strong demand for Euro-dollar loans at foreign branches of U.S. banks. There is some evidence, however, that this demand is not quite as intensive as it was earlier in the year. The somewhat lessened pressure on the reserve positions of U.S. banks suggests that the volume of Euro-dollars advanced by branches to home offices may decline. The same pattern is likely to characterize direct borrowing from foreign banks by U.S. banks.

Mr. Kennedy said that when the foreign credit restraint guidelines were stiffened at the first of the year there had been a great demand by many corporations to insure that their foreign credit needs would be met. Because of this demand most banks that operated in the foreign field built up Euro-dollar credits that had not been entirely used. Now that the credit lines were fairly well established for this year, his guess was that there would be some further use of them as corporations were required to answer to the Department of Commerce toward the end of the year.

Governor Robertson asked whether the Council had given any consideration to the problem involved in the move by a number of banks to establish "shell" facilities in the Bahamas. President Mayer replied that the Council had not discussed the question. It

was his personal feeling, however, that there was a degree of risk in such operations that some banks might not envisage, for example, if a period of stringency in the Euro-dollar market should occur.

Governor Maisel referred to the Council's statement and inquired whether there was not the possibility that Euro-dollar rates might decline faster than CD rates, thus maintaining the relative attractiveness of Euro-dollars.

Mr. Moore commented that although Euro-dollar rates had eased slightly they were still relatively high. Even though the demand for such funds might not be quite so intense, there was a great deal of activity in that market, with many people involved in borrowing various amounts.

Mr. Kennedy observed that the question involved not only the use of Euro-dollars but also the supply of them, which depended in part upon actions of foreign central banks and the Bank for International Settlements. Moreover, it must be remembered Euro-dollars were used extensively by parties in a variety of countries, not just the U.S. Some U.S. banks had been worried about the supply of Euro-dollars drying up and what they would do if it did, but so far they had been able to get by. In the case of his bank, the choice between Euro-dollars and CD's was primarily reliant on comparative rates at any given time.

4. Are there any particular suggestions that the members of the Council would wish to convey to the Board regarding its implementation of the Truth-in-Lending legislation?

One key feature of the Truth-in-Lending Act is that consumer financing and consumer instalment sales are to be treated basically alike. This was a feature that the banking industry fought hard to achieve. In the case of term loans, instalment loans, and revolving loans, creditors must disclose the annual charge on the same basis. For a time, it appeared that department stores might be permitted to mention only the monthly interest rate on revolving credits whereas banks would have to specify the simple annual rate.

The Council believes that in carrying out the proposed equal treatment of consumer financing and consumer sales industries, the detailed regulation to be promulgated by the Federal Reserve System should aim at as much uniformity as possible within any industry and between one industry and another. There are several leading examples of this:

1. With regard to instalment sales by stores of one kind or another, the time-price differential is clearly a finance charge, comparable to interest rates on instalment loans. Therefore, retail stores should not be given any competitive edge vis-a-vis banks and other lenders in the terms and conditions of contracts and advertising of time-price sales, as compared to the contract and conditions of advertising pertinent to instalment loans made by banks and other lenders.

2. With regard to the advertising of credit cards, the rules should be made precise to insure competitive equality as between banks and other issuers of credit cards. It is clear that, with the possible exception of credit unions, the interest rates and other terms offered to borrowers by commercial banks will be more favorable than those offered by others--e.g., department stores, oil companies, etc. The fact that bank

terms are more advantageous to the public should not be allowed to be diluted by permitting retail stores to advertise in a way that conceals this matter.

There are several other matters pertaining to bank credit cards that are worth noting:

1. Since the merchant discount feature does not tend to change prices to consumers, there should be no requirement that the merchant discount be included in the required computation of finance charges made to holders of bank credit cards.

2. Since late charges, where applicable, are intended to compensate banks for the special handling costs and other costs associated with late payments, there should be no requirement that late charges be included in the required computation of finance charges to holders of bank credit cards.

Finally, it should be noted that the Truth-in-Lending Act authorized the Federal Reserve Board to waive the Federal statute in the case of any State which enacts substantially similar legislation and enforces it effectively. During the long period in which the Truth-in-Lending Act was being considered in the Congress, the general position of the banking industry was that it would be preferable to have legislation in the field of the disclosure of finance charges enacted by the States, partly because the whole area of interest rates, usury laws and creditors' remedies were already under State regulation and could be adequately handled by the States, and partly because it was felt that if the Federal Government got into the field of disclosure of finance charges, it would soon go beyond that into the field of creditors' remedies--which in fact proved to be the case in the Truth-in-Lending Act. Given the foregoing background, therefore, we would favor action by the Federal Reserve that would facilitate the transfer of administration of truth-in-lending programs to the States under State legislation as quickly as possible, provided only that such State administration would not interfere with the need for uniform administrative interpretation and hence competitive equality as between banks, other lenders, and retail establishments in terms of required contracts, statements of finance charges, and advertising of credit terms.

President Mayer remarked that the Council's answer had drawn upon a memorandum prepared by the staff of the bank of one of the members. In general, banks had found that merchants' representatives were able to serve their own interests well, at the level of State legislatures, frequently to the disadvantage of the banks. The Council believed it would be unfortunate if the same thing were permitted to happen in the case of the Federal truth-in-lending regulations. The principle of like treatment in the Federal statute had been hard won, and the banking industry would hate to see it eroded.

Governor Robertson commented that the drafting of the basic truth-in-lending regulation was almost completed, and that it was hoped to publish the draft regulation for comment by the middle of October. He urged that the Council members give careful consideration to the draft regulation and let the Board have their suggestions, even before the next meeting of the Council if possible. The Truth-in-Lending Advisory Committee, on which the banking industry was represented, had met last week, and some revisions were to be made in the draft regulation as a result of that meeting. He did not believe there was any point that the Council had mentioned in its answer that had not been covered. However, on a matter as broad and complex as this, something may have been overlooked. It was expected that public comments would be allowed until the middle of November, after which they would be analyzed by staff and reviewed

by the Advisory Committee. Plans called for issuing the regulation about January 15, 1969, so as to provide a period of several months before its effective date, July 1, 1969.

The Council could be especially helpful, Governor Robertson continued, with respect to the educational program. It would be necessary to educate lenders and sellers as to what was expected of them, and the banks could play a real part. There would remain the problem of educating the users of credit, and at this point he could not say exactly how the program would be carried out. Another problem related to the need for uniform enforcement. Several agencies would be involved, with the Board's own enforcement chore applying only to State member banks.

Governor Robertson concluded by mentioning that the ultimate goal was to shift the administration of truth-in-lending from the Federal Government to the States. The Federal law provided that this shift could take place with respect to any State that adopted substantially similar requirements. However, there would also be the question whether the State's enforcement machinery was adequate.

5. What are the Council's view on monetary and credit policy under current circumstances?

The Council is aware of the difficulties of determining credit policy because of the delayed impact of the recently enacted fiscal legislation and the lags involved in monetary policy. However, because of the apparent continued strength in the economy, as evidenced by the behavior of most indicators, including retail sales, automobile deliveries, and new orders, as well as the persistence of the upward pressure on prices, many members of the Council believe the recent reduction in the discount rate may have been premature. It is highly important that

the beneficial effects of fiscal restraint not be lost and that the strength of inflationary pressures be lessened.

If and when additional reserves need to be supplied to the system, the Council believes that consideration should be given to a small reduction in reserve requirements rather than using open market operations.

In response to Governor Daane's request for elaboration of the last part of the Council's statement, President Mayer said the Council thought basically that reserve requirements should come down. Mr. Kennedy observed that it seemed only reasonable that changes in reserve requirements should not all be in one direction. If the requirements were increased at times when credit contraction was needed--as they had been--they should be lowered if and when the situation warranted.

Governor Robertson said he would assume none of the Council members believed that monetary policy should be easing at the present time, and responses indicated that the appropriate stance would be to mark time.

Governor Brimmer noted that when reserve requirements were changed it was generally expected that the new rates would remain in place for quite some time. He wondered whether the Council was suggesting that smaller and more frequent changes should be made.

Mr. Kennedy responded that no such suggestion was intended. Reserve requirements were a blunt policy instrument, and open market operations should be used to effect day-to-day adjustments. However, if a need appeared for expansion of the economy, the opportunity should be used to reduce the present requirements, which were too

high. That could be done when a reasonably large amount of reserves was to be added, and the change in reserve requirements could be partially offset by open market operations if necessary.

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Mr. Wilkinson then reverted to the question of the proper scope of bank activities and observed that strategically the banking system was facing a real problem. The rise in resources and interest rates had permitted the banks to hold their percentage earned on assets fairly well, but there was a grinding pressure on profit margins because labor costs and money costs were continually going up. Just as Dupont had lessened its dependence on rayon by going to nylon, the banking industry had to press outward toward new services to buttress the profits available from its traditional operations. It was this basic issue that the banking industry was trying to meet.

Governor Daane inquired whether Mr. Wilkinson believed that the cost of money to the banks would be structurally much higher, in response to which Mr. Wilkinson said his guess was that the ability of banks to reduce the cost of their raw material would become much less flexible. The cost of the bulk of their time money was not going to be as flexible as one might think, and the pressure on profit margins would increase.

Mr. Kennedy added that banks were trying to serve their customers better. A revolution was going on in the business world,

and customers were demanding a broader range of services. If banks could not meet the needs, their customers would go elsewhere. It would be better if solutions could be found for meeting these needs within the existing framework. While it was true that there was a profit motive in providing new services, many of the services banks were now in position to provide were needed for economic growth.

Mr. Wilkinson commented that the greater the degree to which banks could move along such lines, the less would be the pressure to go into other businesses.

Governor Sherrill said he took it that Mr. Wilkinson would like to encourage liberalization in interpreting what might be thought of as the field of financing. He had sympathy with that viewpoint. But if it was assumed that there should be a boundary, and the present one was not proper, the question was where the new boundary should be drawn.

Mr. Wilkinson expressed the view that experimentation would be necessary.

Governor Maisel referred to the restrictions imposed by State laws, and Mr. Wilkinson said his personal feeling was that the Board should exercise its best judgment within the confines of the Federal law. That would put pressure on the States to modify their laws.

Mr. Conn commented that there was a limit on how far the framework of Federal law could be stretched in interpreting the term "incidental powers" in section 5136 of the Revised Statutes. At some point it might be necessary to seek liberalizing legislation.

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It was understood that the next meeting of the Federal Advisory Council would be held November 18-19, 1968.

The meeting then adjourned.

Secretary

Banking Seminar
Friday, March 20, - 8 p.m.

Topic: The New Form of the Federal Reserve Board - Its Relation to Government Intervention in Banking.

1. Scope of Topic
   a) Teaching of past generation as regards the efficiency of administrative Boards or commissions
   b) Actual experience with Federal Reserve Board
   c) Recent remodelling of Board and relationship to Reserve System

2. Scope of Commission Movement
   a) Growth of complex economic questions as staple of national political discussion
   b) Desire of Congress to shift responsibility
   c) Hence, great growth of Boards, Commissions, Special Courts, and the like
   d) Unsuccess of these new bodies
      (1) Partly due to lack of experience in assignment of functions
      (2) Unsatisfactory choice of personnel

3. Ideas Surrounding Original Composition of Reserve Board
   a) Elimination of banking control from politics
   b) Separation of banking policy from banking operation
   c) Local development of banking policy
   d) Failure in attaining any of these three objects; - reasons

4. Gradual Evolution of Board During First Twenty Years
   a) Board during first three years, - a working administrative body
   b) During next three years, - an adjunct to Treasury in war finance
   c) From 1920-1929, - a subordinate regulatory body
   d) From 1929 to present time, - a useless political organization

5. Lines of Remodelling
   a) New administration accepts centralization idea throughout
   b) Desirous reducing scope and activity various Reserve banks, transferring functions to Board at Washington
   c) Feeling that membership of Board should be politically subordinate to President - parallel indications other boards
   d) Defeat of Banking Act of 1935 merely converted movement into administrative instead of legislative step
   d) Effort inconsistent with action of Congress, giving Board long term and separating political officials from membership

6. Future of Board
   a) Organization probably unable perform new functions which are being assigned
   b) Gradual breaking down, - probable result
   c) Change of administration might bring on clash with President
   d) Change in financial position of Treasury might again alter scope of Reserve banks
   e) Present form probably unstable, likely involve reorganization

7. Can We Have a Non-political Banking System?
   a) Evidently cannot entrust financial system to banks without supervision
   b) Such supervision growing more and more influenced by political and other extraneous factors
   c) Pressure from many sources for direct government financing
   d) Circumstances seem to point to definite acceptation of banking policy as regular phase of politics, provided for in political platform
   e) Outcome of this new point of view in banking organization

July 7, 1969.

Definitions of Selected Monetary Variables

Several symbols and terms representing monetary variables are commonly used in current literature regarding U.S. monetary policy. Outlined below are brief definitions of four such monetary indicators and the shorthand terms used to identify them.

M^1 - Money Supply. M^1 is the symbol used to represent the total money supply, narrowly defined--that is, the total of demand deposits and currency held by the public. More specifically, the demand deposit component consists of total demand deposits at all commercial banks less (1) U.S. Government demand deposits, (2) domestic net interbank deposits (that is, balances due to banks less balances due from banks), and (3) cash items in process of collection (mainly incoming checks that have been credited to customer accounts and are in process of being cleared). The currency component includes all currency in circulation outside the Treasury and Federal Reserve Banks except vault cash holdings of commercial banks.

M^2 - Money Supply plus Time Deposits. M^2 is defined as the total money supply (described above) plus total time and savings deposits at all domestic commercial banks.

Credit Proxy. The credit proxy is the total of all deposits of member banks of the Federal Reserve System subject to reserve requirements. Thus, it includes not only all privately-held demand deposits, as defined above for purposes of the money supply, but also net interbank deposits, U.S. Government demand deposits and total time and savings

deposits. Since there is a fairly close relationship over short periods between changes in bank deposits outstanding and bank holdings of earning assets, this measure has been used as a proxy indicator for short-run changes in bank credit as a guide to Federal Reserve policy.

Credit Proxy plus Euro-dollars. In recent years, gross liabilities of banks to their own foreign branches (usually referred to as Euro-dollars) have increased sharply. In order to reflect this source of credit in the proxy these member bank liabilities have been added to total member bank deposits to generate a series called "Credit Proxy plus Euro-dollars."

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DRAFT--7/16/68
Robert Solomon

SOUTH AFRICAN GOLD AND THE TWO-TIER SYSTEM

The Problem

The two-tier gold system, established at the Washington meeting of March 16-17, is threatened in two ways: (1) by South Africa's offer to sell gold to the International Monetary Fund and (2) by the desire of some European central banks to purchase gold from South Africa for addition to monetary gold stocks.

The U.S. response to this problem ought to preserve the essential character of the two-tier system as the U.S. views it, while avoiding either a breakdown of international monetary cooperation or a divisive battle in the IMF over its legal obligation to purchase gold from members.

The two-tier system may be said to have both a short-term and a long-term significance. For the short-run, it was intended to discourage upward pressures on the market price of gold, by saying to the market that central banks would not be contributing to the demand for gold. All the participants in the Washington meeting were in agreement that the smaller the margin by which the market price of gold exceeded the official price, the greater were the prospects for international monetary stability. If the market price of gold remained relatively low, it was less likely (1) that central banks

would convert foreign exchange into gold out of fear of a rise in the official price of gold and (2) that private parties would speculate on a change in relative exchange rates by moving their funds into what they regard as strong currencies.

The longer-term significance of the Washington Agreement--and on this there is less than full unanimity among the participants--is that the two-tier system represents an important step toward diminishing the role of gold in the international monetary system. In particular, if monetary authorities would act upon the statement that, in view of the prospective creation of the SDR facility, the amount of gold in monetary stocks is sufficient, gold would play no significant role in the future growth of monetary reserves. In effect, gold would have been demonetized at the margin. This interpretation of the two-tier system has not been accepted by some European central banks and it is not possible at present to persuade them to accept it. In fact a public airing of this interpretation by U.S. officials would probably lead some European central bank officials to disagree publicly. The best the United States can do in present circumstances is to avoid an open breakdown of the Washington Agreement while seeing to it that any new policy agreements are not inconsistent with our preferred interpretation of its longer-term significance.

Solution to Problem

It is believed, within the U.S. Government, that the best way to meet the present challenge to the two-tier system is to agree to provide through the IMF a floor price at $35 per ounce for newly-mined gold that South Africa (and other gold producers) need to sell to meet their balance of payments requirements. As another concession, South Africa would be permitted to count its gold holdings as of July 1, 1968 as monetary gold.

In exchange for these concessions, South Africa would be expected to sell newly-mined gold in the market, as its payments position requires, and to avoid special efforts to withhold such sales. South Africa would not offer monetary gold to central banks or the IMF unless it had disposed of all of its supplies of newly-mined gold. Finally, South Africa would withdraw its present offer to sell gold to the Fund.

Advantages of this Solution

1. This solution provides for an accommodation with South Africa and makes it possible to end the existing uncertainties in South Africa's dealings with the market, monetary authorities, and the IMF. The alternative proposal for ending these uncertainties--

agreement on central bank purchases of some amount of newly-mined gold even when the market price is above $35--would constitute an open break with the Washington Agreement and would make it much less likely that the longer-term significance of that Agreement would be realized.

2. The proposed solution assures the market of a resumption of South African sales and prevents South Africa from choosing between market sales and sales to monetary authorities or the Fund as a way of maximizing the market price.

3. Central bank purchases of newly-mined gold continue to be precluded. Additional gold can enter the monetary system only if and when the market price falls to $35 per ounce or below. An opening of the system to additional gold in these circumstances would clearly be consistent with the short-run significance of the Washington Agreement. Purchases by the Fund when the price is at $35 or below would not be in conflict with the objective of minimizing the margin between the official and market prices, since such purchases would occur only when this margin were zero (or negative). (It should be noted that while the proposal would provide a floor price for sales of gold by South Africa as its payments position requires, the proposal would not put an institutional floor under the market price and would not therefore assure speculators that there is no risk at all of the market price falling below $35.)

Additions to IMF gold holdings (and the possibility that the Fund would sell such gold to members) under this proposed solution would not be inconsistent with the desire to see a diminished emphasis on gold in the long run. Gold would enter the official reserve circuit only if and when the market is placing a valuation on gold equal to or less than the official price. In the longer run, present expectations are that the market price is likely to rise above $35, as private non-speculative demand grows relative to supply. Thus, little gold would be bought by the Fund over the years.

As time goes on, the market price will have less and less significance for the monetary system, assuming the U.S. balance of payments improves and the SDR facility is activated. But during the present transition period, it is vital to avoid any sort of shock that would give the market price an upward push.

WILLIAM W. SHERRILL,

Member of the Board,
Federal Deposit Insurance Corporation.

Mr. Sherrill (40) was born in Houston, Texas, and received a B.A. degree in business administration from the University of Houston in 1950 and an M.A. degree from the Harvard Graduate School of business administration in 1952. Following his graduation he first worked for the Southwestern Bell Telephone Company until 1954 and then for the City of Houston. From 1956 to 1958 he was a private financial analyst and then he rejoined the City Government. He was first Executive Assistant to the Mayor, then Chief Administrative Officer, and in 1962 was named City Treasurer. He resigned later that year to become associated with the Jamaica Corporation, whose officers organized the Homestead State Bank in Houston, and Mr. Sherrill became its President when the Bank opened for business in 1963. Mr. Sherrill enlisted in the Marine Corps at age 15 (correct) and served in the Southwest Pacific during World War II. He was named as the University of Houston's alumnus of the Year in 1955.

HUGH D. GALUSHA, Jr.

President,
Federal Reserve Bank of Minneapolis,
Minneapolis, Minnesota.

Hugh D. Galusha, Jr. (48) was born in Helena, Montana and attended Carroll College and the University of Montana and was graduated from the Wharton School of Business at the University of Pennsylvania. Prior to joining the Federal Reserve Bank in May 1965, he had been a senior member of Galusha, Higgins and Galusha, certified public accountants, and of Galusha and Meloy, lawyers. Mr. Galusha had served as a director of the Federal Reserve Bank of Minneapolis from January 1963 until he resigned to assume his present position. He had taken an active part in higher education in Montana, having served as Chairman of the Board of Advisers of the University of Montana, as a lecturer in the tax school, and as a member of the Endowment Fund, Board of Trustees. He also served as a director of a number of business corporations including the Mountain States Telephone and Telegraph Company, Eddy Bakeries, Inc. and also served on the Executive Committee of the Yellowstone Park Company.

ATHERTON BEAN

Chairman of the Board,
International Milling Company,
Minneapolis, Minnesota.

Atherton Bean (56) was born in New Prague, Minnesota and was graduated with honors from Carleton College in 1931 with a degree in chemistry. Following a year at Harvard Business School he was chosen as a Rhodes Scholar and holds a masters degree in economics from Oxford University in England. Since 1937 Mr. Bean has been associated with the International Milling Company becoming its Executive Vice President in 1944, its President in 1955, and he was named Chairman of the Board in 1965. During World War II he spent some time with the Office of Price Administration in Washington and was also connected with Army Intelligence.

Mr. Bean was appointed a director of the Federal Reserve Bank of Minneapolis in February 1960, named its Deputy Chairman in July 1960, and became Chairman of the Minneapolis Board in January 1961. He held this position until the end of 1965 when, under a System policy for rotating directorships, he became ineligible to serve longer. Mr. Bean is Chairman of the Board of Trustees of Carleton College and also a trustee of the Blake School in Hopkins, Minnesota.

CARL J. THOMSEN

Senior Vice President,
Texas Instruments, Inc.,
Dallas, Texas.

Carl J. Thomsen (50), Senior Vice President, Texas Instruments, Inc., Dallas, Texas. A native of Wisconsin, Mr. Thomsen received a B.S. in industrial engineering from Rensselaer Polytechnic Institute, and attended graduate school at Johns Hopkins University. Before joining Texas Instruments in 1946, he served as industrial engineer with Methods Engineering Council, Wilkensburg, Pennsylvania, and time-and-motion analyst at Westinghouse Electric Corporation, as well as part-time instructor in industrial engineering at Johns Hopkins. In 1951 he was made vice President of control and finance at Texas Instruments, director in 1952, treasurer in 1960, and has been senior vice president since 1961 in charge of organization and management systems development.

Mr. Thomsen is a member of the engineering development council, Rensselaer Polytechnic Institute; advisory council, College of Business Administration Foundation, University of Texas; board of overseers, Old Sturbridge (Mass.) Village Museum; American Management Association. Mr. Thomsen became a director of the Federal Reserve Bank of Dallas late in 1963, was named Deputy Chairman in 1964 and designated as Chairman of the Bank at the beginning of 1966.

November 14

Governor Balderston--

Mr. Martin has asked me to pass along the attached two letters. He would like all the Board Members to have the opportunity to see them--if they could be "hand-passed" and returned to Mr. Martin please.

Thank you.

mnm

~~Governor Szymczak~~
~~Governor Robertson~~
~~Governor Mills~~
~~Governor Shepardson~~
~~Governor King~~
Chairman Martin

With velocity up 8 per cent over a year ago (at 24.5 outside New York City) and money supply (seasonally adjusted) at all commercial banks up by $2-1/2 billion over January 28 of this year and $6 billion over the year ago figure, the time may have come to consider raising reserve requirements by 1/4 per cent. The effect would be to absorb about $240 million of reserves and to reduce the money supply by about $1.7 billion.

Con 1. The Treasury is in midst of consideration of its package by the Congress.

2. Federal Reserve is asking Congress to approve its reserve requirement bill, which has enlisted some support from group desiring easier money. (In my view, this point lacks relevancy.)

3. Treasury faces financing operation before end of June. (Announcement June 25)

Pro 1. Subsequent to the end of January the money supply increased at an undesirable and unexpected rate.

2. Bank loans, especially in country banks, are more heavy than at the corresponding time of the last recovery (51 per cent vs. 44 per cent).

3. Inventories are mounting rapidly and, even if the ratio to sales is lower, the eventual effect will be to increase loan demand.

4. Plant and equipment expansion will probably increase even faster than the surveys of expectations indicate. In view of the rising costs of borrowing in the capital markets, many corporations will pressure their banks for term loans. The banks should be discouraged from making term loans or commitments. A prime objective of the System now should be to prevent the misuse of short term money for long term purposes.

5. Consumer instalment credit is rising rapidly again. It is being used not only for constructive purposes but for purchase of pleasure boats,

financing of travel, etc., which people used to delay until they had accumulated the necessary savings. The current boom has some characteristics of a binge.

Chairman Martin

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date ~~January 9, 1969~~

To ~~Records Section~~

Subject: ~~Federal Reserve notes bearing Secretary Barr's signature~~

From ~~John R. Farrell~~

CONFIDENTIAL (FR)

This refers to and supplements the discussion at the Board meeting on January 8, 1969, the Treasury press release of January 8, and Mr. Ring's memorandum to the Records Section of January 9, all concerning a new issue (Series 1963B) of $1 Federal Reserve notes bearing Secretary Barr's signature.

On the afternoon of January 8, Chairman Martin informed me that he had just talked with Secretary Barr about this subject, as agreed at the Board meeting that morning, and that he thought it would be advisable for Mr. Hexter and me to arrange to see the Secretary the next morning for a further discussion of the Board's position in the matter.

Later that afternoon Fiscal Assistant Secretary of the Treasury Carlock called me and said that--

1. He understood that I had some objections to the plan to use Secretary Barr's name on Federal Reserve notes.

2. The Secretary had discussed this matter with him before the plan was put into effect, and that he had advised the Secretary that he saw no objection to it.

3. He had not considered it necessary to clear the plan with the Board in view of the fact that Section 16 of the Federal Reserve Act provides that Federal Reserve notes "shall be in the form and tenor as directed by the Secretary of the Treasury..."

I mentioned to Mr. Carlock that the proposal to requisition the first batch (640,000) of the new Chicago notes for use in the Treasury Cash Room, so that Secretary Barr could purchase 32 of the low-numbered notes for a personal exhibit, would require Board approval since Richmond notes were ordinarily used by the Cash Room.

Mr. Carlock said that he had not heard of this aspect of the plan, that he was not in favor of it, and that he would talk to Secretary Barr about it.

Mr. Carlock called me again early this morning and reported that Secretary Barr had said that, if there were reservations on anyone's part about his acquiring the low-numbered Chicago notes, he felt it would be better to forget this part of the plan. Mr. Carlock added that in the light of this development, he wondered if much would be gained from a further discussion of the matter by Mr. Hexter and me with the Secretary. I told Mr. Carlock that Mr. Hexter and I had previously discussed the purpose of our visit under such circumstances and that, while we were both inclined to share his doubts, I would want to clear the matter with Chairman Martin.

I later called Mr. Carlock back and told him that the Chairman had agreed to our not going through with the proposed discussion with the Secretary as long as it was understood by all concerned that the Board had not approved the Treasury plan and that the Chairman of the Board was strongly opposed to the entire undertaking. In this latter regard, I said that it was my understanding that the Chairman's opposition was based on a belief that the circumstances underlying the use of Secretary Barr's signature on Federal Reserve notes were such as to raise a question in the public mind about the way our currency was being handled, and that the Treasury January 8 press release was not of much help in this respect. I said that the headline "LAME-DUCK TREASURY CHIEF TO GET HIS BARR ON MONEY" appearing over the boxed item on page 20 of today's Wall Street Journal was, I thought, typical of the reaction feared by Chairman Martin.

cc: Chairman Martin
Mr. Hexter

January 9, 1969

Records Section

Discussions relating to

P. D. Ring

"Series 1963B" $1 notes.

CONFIDENTIAL (FR)

Mr. James A. Conlon, Director, Bureau of Engraving and Printing called me on January 3, 1969, to inform us of the following changes that will take place over the next several weeks in the printing of Federal Reserve notes:

(1) Secretary of the Treasury Barr's signature will appear along with the Granahan signature on $1 notes that are printed between now and the time that signature plates are converted to the new incoming Secretary.

(2) The $1 notes with Mr. Barr's signature will be designated Series 1963B.

(3) There will be no interruption in the numbering sequence on $1 notes, but by chance Chicago $1 notes being printed this month will jump to the new suffix letter I; i.e., Chicago $1 notes with Mr. Barr's signature will begin with G 00000001 I.

(4) $1 notes of other Reserve Banks will be printed in the 1963B Series--New York, Cleveland, and San Francisco--with as much coverage on other Banks as possible.

(5) "Coin World," the weekly numismatic paper had obtained some of the information from a member of the staff of the Bureau of Engraving and Printing, and Mr. Conlon was requesting that the paper not break the news.

(6) The Bureau of Engraving and Printing is endeavoring to get out an early press release on the subject.

(7) Notes bearing Mr. Kennedy's signature will be designated "Series 1969" because of the addition of the newly designed Treasury seal. Mr. Conlon is hopeful, however, that a Treasurer will be appointed promptly in order to avoid a short run on the new

series such as might occur if the Granahan - Kennedy signatures were used for a month or so and then changed by a new Treasurer's signature. An effort would be made to advise Mr. Kennedy of the problem.

(8) It may take perhaps six weeks after the January 20 inauguration to complete the signature plates on Mr. Kennedy. The plates are to be engraved.

I thanked Mr. Conlon and said that I would inform Mr. Kiley and Mr. Farrell. This was late in the afternoon and I immediately discussed it with Mr. Farrell. He referred to the considerable difficulty that the System encountered with regard to the low numbers on the first $1 Federal Reserve notes that were introduced in late 1963, and suggested that the files be reviewed and a memorandum prepared for the Board's early consideration.1/

On Monday, January 6, Mr. Donald C. Tolson, Deputy Director of the Bureau of Engraving and Printing, called me to say that Mr. Conlon had probably not told me in the earlier conversation what they were going to do in the way of arranging a special set of the Chicago notes for Mr. Barr. He said that Mr. Barr will get the first 32-note sheet of the Chicago $1's, that the Cash Division of the Treasurer will order the first 32 packages (4,000 note packages) and remove the first note from each package, that a personal check for $32 will be given to the Office of the Treasurer in payment for the notes, and that the 32 notes will then be returned to the Bureau for assembly into a sheet.2/

Mr. Tolson said that this had been done a couple of times before for a new Secretary and that there was nothing unusual about this situation. In a later conversation during the day, I mentioned to Mr. Tolson the firm stand that the System had taken in 1963 when Mr. Dillon asked for a low number Chicago $1 note for presentation to Senator Douglas, but he said that that particular situation was entirely different from the present one and emphasized again that it had been done before.

I discussed this new development with Mr. Farrell and the following morning he mentioned it to Governor Robertson. Governor Robertson suggested that it be brought before the full Board for their decision.

1/ Preparation of the memorandum was discontinued subsequently in favor of an oral presentation.

2/ Mr. Tolson later called back to say that the 32 notes would come from the first 160 packages of the Chicago $1's.

A verbal presentation with respect to the subject was given to the Board on January 8. Following the meeting, I talked with Mr. Tolson at Mr. Farrell's suggestion to ask why the Bureau was limiting Mr. Barr's signature to $1's only and whether Mr. Barr's signature would be on all $1's that are being printed. Mr. Farrell also requested that I describe our experience when short runs are made on coin, e.g., the 1968 nickels, and to mention in particular that we expect to have public relations problems with the Series 1963B notes.

Mr. Tolson said that the Bureau planned to print as many $1 notes as they can with Mr. Barr's signature, hopefully as many as $100 million. They are not going to print his signature on the other denominations since it would just make them a rarity. He felt that we would have no problem with collectors because of the large amount ($100 million) the Bureau is producing. He also mentioned that Mr. Conlon and Mr. Comee, who is Deputy Assistant to the Secretary, had already worked together on a press release which described the forthcoming change and that the release would probably be made shortly.

I subsequently asked if the Bureau generally initiates arrangements for signature plates when a new Secretary of the Treasury is appointed. Mr. Tolson said that the Bureau takes the initiative since they are always anxious to convert the plates as soon as possible, but in the present circumstances there was an exchange from both sides. Further conversation caused Mr. Tolson to ask me if there was a preference that no change be made. I replied that Mr. Farrell would have been happy with no change, to which he responded humorously that the Secretary of the Treasury would have been unhappy.

PDR:mta

TREASURY DEPARTMENT

WASHINGTON, D.C.

January 8, 1969

FOR IMMEDIATE RELEASE

FEDERAL RESERVE NOTE SERIES
TO BE SIGNED BY SECRETARY BARR

The Treasury announced today that an issuance of $1 Federal Reserve Notes, Series 1963B, will bear the signature of Secretary Joseph W. Barr.

It pointed out that the issuance means that every Secretary of the Treasury since 1914, when the signature requirement was initiated, will have signed a currency series.

According to James A. Conlon, Director of the Bureau of Engraving and Printing, new techniques in use permit issuing the series without increased unit cost or interruption of normal currency production operations. He said that present technique requires engraving the new signature in only one 32-subject master plate. The previous method requiring 384 signature plates, Conlon explained, could not have been used in time to maintain the historical relationship of the Secretary to a currency issue.

Full conversion to the changed technique at this time will also expedite subsequent issue of a new series for Secretary-designate David M. Kennedy. Mr. Kennedy's series will be identified as Series 1969 since it will also include the first use of the new Treasury Seal on all Federal Reserve Notes.

The Bureau of Engraving and Printing estimates it will produce a minimum of 100 million of the new Barr notes which will continue in production until they are replaced by the Kennedy issue.

F-1461

F. R. 468
(Rev. 7-62)

MEMORANDUM

Date 9-16 Time

To: MNM

From: Kay

Tel. No. Ext.

	Please call		For your approval
	Returned your call		For your information
	Will call again		Note and return
	Phone me re attached		For comments and suggestions
	See me re attached		Preparation of reply

MESSAGE:

Copies of Attached sent to:

Aug. 19 - Each Board Member
Messrs. Cardon
Partee
Fisher
Freedman

Aug. 28 - L. Gramley

F. R. 468
(Rev. 7-62)

MEMORANDUM

Date Aug. 19 Time

To: Chairman Martin

From: S. J. Maisel

Tel. No. Ext.

	Please call		For your approval
	Returned your call	XXX	For your information
	Will call again		Note and return
	Phone me re attached		For comments and suggestions
	See me re attached		Preparation of reply

MESSAGE:

Thanks. Have you several extra copies I could use

WM

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

SHERMAN J. MAISEL
MEMBER OF THE BOARD

August 19, 1969.

Mr. Bruce K. MacLaury,
Deputy Under Secretary for
Monetary Affairs,
Department of the Treasury,
Washington, D. C. 20220.

Dear Bruce:

You asked me for some background information concerning the degree to which monetary policy was likely to be frustrated by the fact that it probably acts perversely by raising directly the consumer price index to the extent that it succeeds in holding down housing starts.

First, as to the factual situation:

(1) The number of dwellings started in the past three years probably was at least one million units below a desirable level. This is approximately the decrease in available vacancies in this period. The Census vacancy rate fell from over 3.7 per cent in 1966 to below 2.4 per cent for this year--the lowest rate since vacancies returned to normal after the post-war shortage.

(2) Shelter has a weight of 20.66 in the consumer price index (see the table). The four major items are rents, mortgage financing, the cost of purchasing a house, and taxes, insurance, and maintenance.

(3) From 1966 to May 1969, shelter costs rose by 16 per cent compared to about 10 per cent for all other items. This occurred even though as would be expected rents were rising rather slowly. While they are affected directly by vacancy rates, rents move slowly and with a decided lag. For example, from 1948 to 1954, after the period of lowest vacancies had passed, this lag caused rents to rise twice as fast as the rate of increase in the general price index.

BLS CONSUMER PRICE INDEX

	Dec. 1968 Weights	BLS Index 1959	1965	1966	May 1969
Shelter	20.66	101.4	110.6	114.1	132.4
Home Ownership	15.07	101.4	111.4	115.7	138.0
Mgt. financing	3.38	102.0	100.5	106.9	134.3
Home purchases	6.00	n.a.	n.a.	n.a.	n.a.
Other	5.69	n.a.	n.a.	n.a.	n.a.
Rent	5.19	101.6	108.9	110.4	118.1
Other than Shelter	79.34	101.5	109.6	112.9	125.4
Total	100.00	101.5	109.9	113.1	126.8

In trying to analyze the monetary impact, there are at least five channels through which the consumer price index is influenced as monetary policy becomes more restrictive and interest rates rise:

(1) The rise in mortgage interest rates directly increases the index. From 1965 to May 1969, this sector increased by 34 per cent or more than twice the rate of the general index.

(2) Financing costs of construction rise directly, increasing the home purchase index and indirectly increasing the tax, insurance, etc., index. Builders say rises in direct financing charges increased the cost of construction by 5 to 10 per cent in the last year.

(3) The supply of rental units is decreased, thereby increasing the rent index. This direct relationship shows both in theory and in the econometric models.

(4) Through credit rationing and lower income there is an indirect effect on the demand and supply price of newly constructed units; more labor is available, demand is less, but fluctuations lower efficiency and productivity. While there has been a good deal of controversy in the literature on this point, most would probably agree that the price effect of the opposing forces can be considered a stand-off.

(5) There is the indirect effect through credit rationing and incomes on the price of existing units. Here the effect is probably favorable. Prices will be lower to the extent that the demand for existing units falls faster than the supply of vacancies plus distress sales.

I think you can see that when you put the five effects together the direct impact of a curtailment of housing through higher mortgage rates is likely to be decidedly inflationary--defining "inflation" as an increase in the consumer price index. This direct effect would be expected to be partly offset by indirect effects through lower incomes and more resources in the remainder of the economy. It is likely, however, in a period such as the present that considering both the direct and indirect effects, a level of housing starts close to the level of actual demand is less inflationary than either a smaller or a larger output.

For 1969 and 1970, the demand for new units is estimated to be somewhere between 1.7 and 1.8 million at an annual rate. Unless starts rise to that level, the vacancy rate will continue to fall and the shelter component of the price index will probably continue to rise at a more inflationary rate than the index as a whole. The total impact, both direct and indirect, of monetary policy through this channel will be inflationary on the assumption, which I believe valid, that the released resources will not have as much favorable price effect elsewhere.

Given the very low level of vacancies, unless starts exceed basic demand by a considerable amount, the acceleration of rent increases and perhaps of the selling prices of houses also may be

exceedingly difficult to halt in the future. Thus, I judge that efforts to raise housing starts above current levels would be anti-inflationary.

Cordially,

Sherm

Sherman J. Maisel.

THE DEPARTMENT OF THE TREASURY

DATE 8/14/69

TO Mr. Maisel

Col. Wasson makes same point you mentioned re effect on CPI of cutback in house construction. Any documentation on this issue? Do you buy our reply? Any suggestions?

B.K.M.

Bruce K. MacLaury
Deputy Under Secretary
for Monetary Affairs

Room 3321 Ext. 5848

August 12, 1969

Dear Colonel Wasson:

Please excuse the delay in our response to your thoughtful letter of July 1 concerning the current high level of interest rates, particularly as it affects the housing industry.

You express the belief that credit restraint and high interest rates have been counterproductive in the housing area since they have directly and indirectly raised the cost of living in this sector. I readily agree that high interest rates have a "cost" effect, although a distinction needs to be drawn between real and nominal rates of interest. But an evaluation of credit restraint must consider effects other than the "cost" of credit and include an analysis of other sectors of the economy than housing. After all, the interest rate is unique in being the price of money itself, and therefore plays a pivotal role in the exercise of monetary policy. A restrictive monetary policy is mirrored in rising rates of interest and reduced availability of credit thereby exerting a dampening effect upon aggregate expenditures, particularly where expenditures are heavily financed through borrowing as in the case of housing. I would expect the beneficial "monetary policy" effect to far outweigh the "cost of living" effect at least on an economy-wide basis if not for every individual sector. One would hardly care to argue the reverse proposition which would logically require that during periods of inflation the cost of living should be lowered by making money more abundant!

I recognize that your remarks were directed specifically to the housing sector. One might concede the need at present for general monetary restraint and yet still feel that in

the absence of alleviating measures too heavy a burden would be borne by the housing industry. The Administration recognizes the force of this argument and has shaped its policies accordingly. Both the Federal Home Loan Bank Board and the Federal National Mortgage Association have acted energetically to help maintain the flow of credit into housing. In the first half of 1969, the overall increase in mortgage credit from all sources held at a seasonally adjusted annual rate near last year's peak levels. Housing starts and lending commitments have held up very well this year despite monetary restraint. Ceiling interest rates on consumer-type savings deposits have prevented the reappearance of the self-defeating form of competition among financial institutions that aggravated housing industry difficulties during the 1966 credit crunch.

You point to the possibility that when existing housing supply is inadequate, a tight money policy increases the pressure to drive up the purchase price or rents in an increasing spiral as the shortage becomes more severe. Presumably the indicated course of action would be to bring prices down by increasing supply -- by producing more houses. This is taking place. Private housing starts are still near the 1.5 million mark and during the first half of this year averaged 7 percent above the 1968 rate. But there is a question as to how rapidly we can continue to add to our stock of housing during a period of serious inflation and intense pressure on skilled labor resources in construction.

I think there is a useful distinction to be drawn here between short-run and long-run effects. Over a longer period of time, the expansion of production and supply is a potent anti-inflationary force and will be necessary in any event if we are to achieve our national housing goals. But, in the short run, a "crash" housing program would drive housing costs and prices up all the more rapidly, in addition to strengthening general inflationary pressures in the economy.

Housing is financed largely by credit and draws on the economy's total savings. In a situation like the present, if housing is to receive more credit, more savings must be forthcoming or other demands for credit must be moderated. The surcharge and fiscal restraint are of crucial importance in this connection. Total expenditures on the economy's output are restrained and with a Federal budget surplus the Government becomes a net supplier of funds to the credit markets.

The housing situation remains a difficult one. By no means all of the problems are simply attributable to high interest rates. In particular, the sharply rising trend in construction costs pre-dates the present period of monetary tightening and may remain a problem after general inflationary pressures have been reduced. Much needs to be done to develop a higher rate of productivity advance within the construction sector. But it is true that high interest rates are a dominant feature of the housing scene at the present time. The best -- indeed, in my opinion, the only effective -- way to achieve lower interest rates in housing and elsewhere is to check the current inflation. That is the domestic financial objective of highest immediate priority.

We share your concern over the sharply rising cost of new homes and the hardships it causes. Thank you for your letter.

Sincerely yours,

(Signed) B. K. MacLaury

B. K. MacLaury
Deputy Under Secretary
for Monetary Affairs

Lt. Colonel Glenn E. Wasson
6503 Jay Miller Drive
Falls Church, Virginia 22041

1 July 1969

Honorable David M. Kennedy
Secretary of Treasury
Washington, DC 20520

Honorable Mr Kennedy:

This letter is written in the hope that you will consider lowering the burdensome interest rate which is slowly strangling the housing industry, and pricing the average family home beyond the means of the average family.

The purpose of raising the interest rates, as frequently stated, is to operate as an anti-inflationary measure. How ironic that this policy has just the opposite effect, and has probably had more influence in raising the cost of living than any other item in the family budget. As you must surely realize, raising the interest rates to their present usurious rates raises the total cost of a home purchased under normal mortgage terms by many thousands of dollars. Additionally, the increased cost of the money to the builders is passed directly to the buyer for mortgage points, and indirectly as increases in basic home prices and rents.

The high cost of money to builders is ostensibly an anti-inflationary measure, designed to lessen the demand for labor and materials needed for new construction. However, at a time when existing housing is inadequate, a tight money policy increases the pressure to drive up the purchase price or rents in an increasing spiral as the shortage becomes more severe. Whatever deflationary advantage is to be gained by restricting the housing industry will be more than offset by the inflationary tendency inevitably resulting from an increasing population competing for a static supply of housing. There are many consumer goods and services a family can forego; shelter isn't one of them. Families will be forced to pay whatever the market place demands.

I think you will agree with me that the hope of the typical American family to own a home is a goal to be greatly encouraged. Home ownership contributes more to a feeling of community responsibility and social stability than any other purchase a family makes. Our tortured urban society needs these qualities as never before in our history.

Unfortunately, the single family home is becoming a luxury item. The cost of homes is rising faster than the average family income, and the sharpest increase to the price curve lies ahead. I am personally familiar with several hard working, thrifty families who have been saving for a down payment for years and had almost reached the point of being financially able to purchase the home of their dreams. The recent rise in interest rates has postponed their ability to buy a home for several years, perhaps indefinitely. I cannot believe that it is the intent of this administration to benefit the banks and money lenders at the expense of the average home buying American family.

Mr Secretary, I urge you to use the prerogatives of your high office to lower interest rates for the housing industry to reasonable rates, and to take steps to make funds available for housing construction. Failure to reverse the present disastrous course will surely increase the inflation it is designed to prevent, and injure the consumer it is proposed to protect.

I will be sending a similar letter to other agencies of the government concerned with housing and inflation.

Sincerely,

Glenn E. Wasson

Glenn E. Wasson
Lt Colonel, USAF

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

SHERMAN J. MAISEL
MEMBER OF THE BOARD

August 19, 1969.

Mr. Bruce K. MacLaury,
Deputy Under Secretary for
Monetary Affairs,
Department of the Treasury,
Washington, D. C. 20220.

Dear Bruce:

You asked me for some background information concerning the degree to which monetary policy was likely to be frustrated by the fact that it probably acts perversely by raising directly the consumer price index to the extent that it succeeds in holding down housing starts.

First, as to the factual situation:

(1) The number of dwellings started in the past three years probably was at least one million units below a desirable level. This is approximately the decrease in available vacancies in this period. The Census vacancy rate fell from over 3.7 per cent in 1966 to below 2.4 per cent for this year--the lowest rate since vacancies returned to normal after the post-war shortage.

(2) Shelter has a weight of 20.66 in the consumer price index (see the table). The four major items are rents, mortgage financing, the cost of purchasing a house, and taxes, insurance, and maintenance.

(3) From 1966 to May 1969, shelter costs rose by 16 per cent compared to about 10 per cent for all other items. This occurred even though as would be expected rents were rising rather slowly. While they are affected directly by vacancy rates, rents move slowly and with a decided lag. For example, from 1948 to 1954, after the period of lowest vacancies had passed, this lag caused rents to rise twice as fast as the rate of increase in the general price index.

BLS CONSUMER PRICE INDEX

	Dec. 1968 Weights	BLS Index 1959	1965	1966	May 1969
Shelter	20.66	101.4	110.6	114.1	132.4
Home Ownership	15.07	101.4	111.4	115.7	138.0
Mgt. financing	3.38	102.0	100.5	106.9	134.3
Home purchases	6.00	n.a.	n.a.	n.a.	n.a.
Other	5.69	n.a.	n.a.	n.a.	n.a.
Rent	5.19	101.6	108.9	110.4	118.1
Other than Shelter	79.34	101.5	109.6	112.9	125.4
Total	100.00	101.5	109.9	113.1	126.8

In trying to analyze the monetary impact, there are at least five channels through which the consumer price index is influenced as monetary policy becomes more restrictive and interest rates rise:

(1) The rise in mortgage interest rates directly increases the index. From 1965 to May 1969, this sector increased by 34 per cent or more than twice the rate of the general index.

(2) Financing costs of construction rise directly, increasing the home purchase index and indirectly increasing the tax, insurance, etc., index. Builders say rises in direct financing charges increased the cost of construction by 5 to 10 per cent in the last year.

(3) The supply of rental units is decreased, thereby increasing the rent index. This direct relationship shows both in theory and in the econometric models.

(4) Through credit rationing and lower income there is an indirect effect on the demand and supply price of newly constructed units; more labor is available, demand is less, but fluctuations lower efficiency and productivity. While there has been a good deal of controversy in the literature on this point, most would probably agree that the price effect of the opposing forces can be considered a stand-off.

(5) There is the indirect effect through credit rationing and incomes on the price of existing units. Here the effect is probably favorable. Prices will be lower to the extent that the demand for existing units falls faster than the supply of vacancies plus distress sales.

I think you can see that when you put the five effects together the direct impact of a curtailment of housing through higher mortgage rates is likely to be decidedly inflationary--defining "inflation" as an increase in the consumer price index. This direct effect would be expected to be partly offset by indirect effects through lower incomes and more resources in the remainder of the economy. It is likely, however, in a period such as the present that considering both the direct and indirect effects, a level of housing starts close to the level of actual demand is less inflationary than either a smaller or a larger output.

For 1969 and 1970, the demand for new units is estimated to be somewhere between 1.7 and 1.8 million at an annual rate. Unless starts rise to that level, the vacancy rate will continue to fall and the shelter component of the price index will probably continue to rise at a more inflationary rate than the index as a whole. The total impact, both direct and indirect, of monetary policy through this channel will be inflationary on the assumption, which I believe valid, that the released resources will not have as much favorable price effect elsewhere.

Given the very low level of vacancies, unless starts exceed basic demand by a considerable amount, the acceleration of rent increases and perhaps of the selling prices of houses also may be

exceedingly difficult to halt in the future. Thus, I judge that efforts to raise housing starts above current levels would be anti-inflationary.

Cordially,

Sherm

Sherman J. Maisel.

THE DEPARTMENT OF THE TREASURY

DATE 8/14/69

TO Mr. Maisel

Col. Wasson makes same point you mentioned re effect on CPI of cutback in house construction. Any documentation on this issue? Do you buy our reply? Any suggestions?

B.K.M.

Bruce K. MacLaury
Deputy Under Secretary
for Monetary Affairs

Room 3321 Ext. 5848

August 12, 1969

Dear Colonel Wasson:

Please excuse the delay in our response to your thoughtful letter of July 1 concerning the current high level of interest rates, particularly as it affects the housing industry.

You express the belief that credit restraint and high interest rates have been counterproductive in the housing area since they have directly and indirectly raised the cost of living in this sector. I readily agree that high interest rates have a "cost" effect, although a distinction needs to be drawn between real and nominal rates of interest. But an evaluation of credit restraint must consider effects other than the "cost" of credit and include an analysis of other sectors of the economy than housing. After all, the interest rate is unique in being the price of money itself, and therefore plays a pivotal role in the exercise of monetary policy. A restrictive monetary policy is mirrored in rising rates of interest and reduced availability of credit thereby exerting a dampening effect upon aggregate expenditures, particularly where expenditures are heavily financed through borrowing as in the case of housing. I would expect the beneficial "monetary policy" effect to far outweigh the "cost of living" effect at least on an economy-wide basis if not for every individual sector. One would hardly care to argue the reverse proposition which would logically require that during periods of inflation the cost of living should be lowered by making money more abundant!

I recognize that your remarks were directed specifically to the housing sector. One might concede the need at present for general monetary restraint and yet still feel that in

the absence of alleviating measures too heavy a burden would be borne by the housing industry. The Administration recognizes the force of this argument and has shaped its policies accordingly. Both the Federal Home Loan Bank Board and the Federal National Mortgage Association have acted energetically to help maintain the flow of credit into housing. In the first half of 1969, the overall increase in mortgage credit from all sources held at a seasonally adjusted annual rate near last year's peak levels. Housing starts and lending commitments have held up very well this year despite monetary restraint. Ceiling interest rates on consumer-type savings deposits have prevented the reappearance of the self-defeating form of competition among financial institutions that aggravated housing industry difficulties during the 1966 credit crunch.

k You point to the possibility that when existing housing supply is inadequate, a tight money policy increases the pressure to drive up the purchase price or rents in an increasing spiral as the shortage becomes more severe. Presumably the indicated course of action would be to bring prices down by increasing supply -- by producing more houses. This is taking place. Private housing starts are still near the 1.5 million mark and during the first half of this year averaged 7 percent above the 1968 rate. But there is a question as to how rapidly we can continue to add to our stock of housing during a period of serious inflation and intense pressure on skilled labor resources in construction.

I think there is a useful distinction to be drawn here between short-run and long-run effects. Over a longer period of time, the expansion of production and supply is a potent anti-inflationary force and will be necessary in any event if we are to achieve our national housing goals. But, in the short run, a "crash" housing program would drive housing costs and prices up all the more rapidly, in addition to strengthening general inflationary pressures in the economy.

Housing is financed largely by credit and draws on the economy's total savings. In a situation like the present, if housing is to receive more credit, more savings must be forthcoming or other demands for credit must be moderated. The surcharge and fiscal restraint are of crucial importance in this connection. Total expenditures on the economy's output are restrained and with a Federal budget surplus the Government becomes a net supplier of funds to the credit markets.

The housing situation remains a difficult one. By no means all of the problems are simply attributable to high interest rates. In particular, the sharply rising trend in construction costs pre-dates the present period of monetary tightening and may remain a problem after general inflationary pressures have been reduced. Much needs to be done to develop a higher rate of productivity advance within the construction sector. But it is true that high interest rates are a dominant feature of the housing scene at the present time. The best -- indeed, in my opinion, the only effective -- way to achieve lower interest rates in housing and elsewhere is to check the current inflation. That is the domestic financial objective of highest immediate priority.

We share your concern over the sharply rising cost of new homes and the hardships it causes. Thank you for your letter.

Sincerely yours,

(Signed) B. K. MacLaury

B. K. MacLaury
Deputy Under Secretary
for Monetary Affairs

Lt. Colonel Glenn E. Wasson
6503 Jay Miller Drive
Falls Church, Virginia 22041

1 July 1969

Honorable David M. Kennedy
Secretary of Treasury
Washington, DC 20520

Honorable Mr Kennedy:

This letter is written in the hope that you will consider lowering the burdensome interest rate which is slowly strangling the housing industry, and pricing the average family home beyond the means of the average family.

The purpose of raising the interest rates, as frequently stated, is to operate as an anti-inflationary measure. How ironic that this policy has just the opposite effect, and has probably had more influence in raising the cost of living than any other item in the family budget. As you must surely realize, raising the interest rates to their present usurious rates raises the total cost of a home purchased under normal mortgage terms by many thousands of dollars. Additionally, the increased cost of the money to the builders is passed directly to the buyer for mortgage points, and indirectly as increases in basic home prices and rents.

The high cost of money to builders is ostensibly an anti-inflationary measure, designed to lessen the demand for labor and materials needed for new construction. However, at a time when existing housing is inadequate, a tight money policy increases the pressure to drive up the purchase price or rents in an increasing spiral as the shortage becomes more severe. Whatever deflationary advantage is to be gained by restricting the housing industry will be more than offset by the inflationary tendency inevitably resulting from an increasing population competing for a static supply of housing. There are many consumer goods and services a family can forego; shelter isn't one of them. Families will be forced to pay whatever the market place demands.

I think you will agree with me that the hope of the typical American family to own a home is a goal to be greatly encouraged. Home ownership contributes more to a feeling of community responsibility and social stability than any other purchase a family makes. Our tortured urban society needs these qualities as never before in our history.

Unfortunately, the single family home is becoming a luxury item. The cost of homes is rising faster than the average family income, and the sharpest increase to the price curve lies ahead. I am personally familiar with several hard working, thrifty families who have been saving for a down payment for years and had almost reached the point of being financially able to purchase the home of their dreams. The recent rise in interest rates has postponed their ability to buy a home for several years, perhaps indefinitely. I cannot believe that it is the intent of this administration to benefit the banks and money lenders at the expense of the average home buying American family.

Mr Secretary, I urge you to use the prerogatives of your high office to lower interest rates for the housing industry to reasonable rates, and to take steps to make funds available for housing construction. Failure to reverse the present disastrous course will surely increase the inflation it is designed to prevent, and injure the consumer it is proposed to protect.

I will be sending a similar letter to other agencies of the government concerned with housing and inflation.

Sincerely,

Glenn E. Wasson

Glenn E. Wasson
Lt Colonel, USAF

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Cordially,

Sherm

Sherman J. Maisel.

March 28, 1969.

Considerations Bearing on

Federal Reserve Policy Actions

Developments are intensifying which argue for additional overt action by the Federal Reserve to reinforce the policy of monetary restraint. Such action would need to include a one-half per cent increase in the discount rate to 6 per cent, and could also include a moderate increase in reserve requirements to act directly on bank credit availability.

The economy continues to appear very strong, with prices still rising rapidly and inflationary expectations deeply imbedded. Public policy intentions to restrain inflation are still regarded with a great deal of skepticism, with little hard evidence of any real dampening effects on business activity from stabilization actions taken to date. Private spending intentions and credit demands remain excessive.

Some of the reasons that argued against further overt Federal Reserve action earlier this month are now fading. We are now past the March period of seasonal financial pressures, when there was risk that the attendant increases in interest rates would have been escalated by a Federal Reserve discount rate advance. The April 1 dividend crediting period for thrift institutions is effectively passed, reducing the exposure of these mortgage lenders to large-scale withdrawals that could precipitate sharp cutbacks in housing credit. Banking and monetary aggregates, after showing little change on average over the first quarter, show signs of some strengthening ahead.

The second quarter of the year which we are now entering is expected to be characterized by downward short-term rate pressures in the absence of further actions. Seasonal factors will be contributing to this trend, preeminently the very large scheduled pay-off of Treasury debt. This easing influence is already beginning to be felt in the financial markets, and it is bolstering doubts that monetary policy can or will be an effective restraint. Further downdrift in short-term rates as the quarter progresses could reinforce these doubts, permit stronger bank credit expansion through CD sales, and generate a more accommodative credit environment that would make inflationary pressures even harder to control.

The discount rate is now unusually far below other money market and short-term rates, so much so that it represents a subsidy of sorts to borrowing banks. With Federal funds rates running around 6-3/4 per cent, 3-month Euro-dollars costing more than 8 per cent, and the prime rate up to 7-1/2 per cent, even a discount rate increase to 6 per cent would narrow the spread only moderately; over a span of weeks, its main effect should be more to counter the tendency for

short-term market rates otherwise to decline rather than to generate much net new rate advance. The extent of member bank borrowing at the Federal Reserve Banks has increased, partly because of the relatively cheap rate presently attaching to such credit.

The great preponderance of Federal Reserve Bank directors are strongly in favor of an advance in the discount rate. They advocate such action not only for technical and administrative reasons but also as a reaffirmation of System determination to achieve effective monetary restraint. As men with wide-ranging business contacts, they are keenly aware of the powerful grip which inflation has on business thinking and the consequent need for reinforced public policy efforts to restore economic stability.

The nature of business and financial attitudes are such as to suggest consideration also of an accompanying increase in member bank reserve requirements. Announcing such action coincident with a discount rate increase could serve to drive home to lenders and borrowers alike that the System is not intending to fight inflation simply by raising interest rates but it is aiming at constraining the availability of credit. Within the banking system, a great many banks--particularly of medium and smaller size--are as yet relatively unrestrained by monetary actions taken to date. While restrictive influences will gradually percolate more broadly through the financial system, the attendant passage of time allows further inflationary inroads to proceed. An announced reserve requirement increase of moderate size could serve to accelerate the rethinking of financial policies at all the institutions affected. To smooth market adjustments to such an action, it might be announced to take effect in the latter part of April, when technical factors may be supplying reserves to the banks and interest rates should be under some downward pressure from Treasury debt retirement. The precise amount of market impact from bank actions to adjust their assets and liabilities accordingly could be controlled as needed by Federal Reserve open market operations.

A requirement increase could be structured in a number of different ways. Given the pervasive character of inflationary expectations, however, perhaps the simplest and most easily understood action would be a one-half percentage point increase in requirements against demand deposits at all classes of member banks. This would amount to about a $650 million increase in reserves required, a figure large enough to be significant but not so great as to cause undue adjustment difficulties either for individual banks or the money market. A table presenting the detailed statistics relevant to this proposal, and to three other possible reserve requirement changes, is attached for reference.

Attachment

EFFECTS OF INCREASES IN RESERVE REQUIREMENTS
Four Alternatives
(Based on deposit reports for week ending March 19, 1969)

1. Increase reserve requirements against net demand deposits.

a. 1/2 percentage point increase against all net demand deposits.

	All member	Reserve City	Country
Distribution of increase:			
millions of dollars	$650	$377	$273
per cent of total	100%	58%	42%
Revised reserve ratios:			
net demand up to $5 mil.		17%	12-1/2%
net demand over $5 mil.		17-1/2%	13%

b. 1/2 percentage point increase on net demand over $5 million.

	All member	Reserve City	Country
Distribution of increase:			
millions of dollars	$546	$373	$173
per cent of total	100%	68%	32%
Revised reserve ratios:			
net demand up to $5 mil. (unchanged)		16-1/2%	12%
net demand over $5 mil.		17-1/2%	13%

2. Increase reserve requirements against time deposits.

a. 1/2 percentage point increase against all time deposits. 1/

	All member	Reserve City	Country
Distribution of increase:			
millions of dollars	$426	$250	$176
per cent of total	100%	59%	41%
Revised reserve ratios:			
savings and other time up to $5 mil. (unchanged)		3%	3%
total time deposits		6-1/2%	6-1/2%

b. 1/2 percentage point increase on time deposits in excess of $5 million (savings and other time up to $5 million exempt) 1/

	All member	Reserve City	Country
Distribution of increase:			
millions of dollars	$342	$246	$ 96
per cent of total	100%	72%	28%
Revised reserve ratios:			
savings and other time up to $5 mil. (unchanged)		3%	3%
other time deposits over $5 mil.		6-1/2%	6-1/2%

1/ Any increase from present 6 per cent requirements against time deposits over $5 million would be under temporary authority due to expire (or be renewed) September 21, 1969.

23,000 GNP - MS

September 17, 1969

2,000,000

USES OF ECONOMETRIC MODELS FOR POLICYMAKING

Arthur M. Okun
Senior Fellow
Brookings Institution

A. - Aids to decision-making should reflect the characteristics of the decision process and the instruments. For the Federal Reserve, the key characteristics are:

1. - Continuity - at least every three weeks
2. - Independence (of course, within the Government)
3. - Committee aspect
4. - Absence of no-action alternative
5. - Instruments work over a span of time
6. - Impact on several targets -- distributive as well as aggregative.

B. - Case for an explicit flight plan, which entails a quantitative forecast. Warnings:

1. - Remember the risks and uncertainties; can't focus only on the average expected outcomes
2. - The questions are as important as the answers
3. - Fight temptation to claim there's nobody here but us computers.

C. - Econometric Models

1. - Model is a fully specified recipe for using a fixed group of ingredients. It is necessarily a sketch-- not a photograph of the world

2. - Nobody ever really means: "That's all the evidence I want and need"

3. - Equimarginal principle: The last equation in all sectors should contribute equally. But that depends on uses

4. - Why a general purpose model can't make sense. Models must be made to order

5. - The particular conflict between explanation and prediction in model-building. Economic barometers that help predict but don't explain--e.g., plant and equipment surveys

6. - Models can (must?) be used with judgment, and judgment forecasters use statistical methods

7. - For Fed's purposes, structural, explanatory uses should take priority over predictive use of model. Need guidance of formal model most for add-on effects of policy actions, defining and refining controversial views on monetary impact.

D. - FRB-MIT Model

1. - It does properly emphasize explanation over prediction

2. - It asks the right questions. Empty-boxes on capital markets are the only significant exception. Balance of payments, criteria for choice among instruments also must come from elsewhere.

3. - Some particular views of the mechanisms:

   a. - Short rates determine long rates

   b. - Cash flow is not potent force on investment

   c. - No inventory results

   d. - Rationing effects (as well as rate effects) on housing, but elsewhere yields alone matter

   e. - But can't interpret yields except in terms of flows

   f. - Price expectations get into equity yields-- <u>not</u> elsewhere.

4. - Empirical messages:

   a. - Money matters a lot

   b. - Fiscal policy matters a lot (Review 1964-65 simulation)

   c. - Demand for money influenced by interest rates - one of the best established propositions in macroeconomics

   d. - Housing most vulnerable

   e. - Net worth effect on consumption

   f. - More money means <u>lower</u> interest rates for long run as well as short run.

   g. - Effects of monetary policy start fairly promptly but build up over a long period of time.

5. - Some cross-checks

   a. - Would the GNP path generated by FRB-MIT correlate as strongly with money supply as St. Louis Bank findings?

b. - Is there room for a "leading" demand for money either for portfolio balance or finance purposes?

c. - Does the research process put a premium on finding the biggest possible effects?

October 18, 1973.

Dear Mr. Speaker:

During my nearly 19 years' service in the Federal Reserve System, a period that spanned the Presidencies of Messrs. Truman, Eisenhower, Kennedy, Johnson, and part of Mr. Nixon's first term, I repeatedly concurred in the view written into law by the Congress in the Roosevelt era, that exemption from General Accounting Office (GAO) audit was an important factor in the independence of the System within the Government. Now, as then, the Federal Reserve is audited by the most reputable independent, outside certified public accounting firms and the job they do is, in my judgment, second to none.

H.R. 10265, the current bill in the House to change this, is a serious threat to the safeguards Congress has established to assure the impartial, objective execution of the vital task it has assigned to the Federal Reserve System. I strongly oppose this bill and feel constrained to register my protest in the public interest.

Let us keep in mind that there is no question here of whether or not the Federal Reserve should be audited: it is and long has been audited, and audited thoroughly, as I have stated, so as to assure the Congress and the public of the accuracy and honesty of its accounts. For that very reason, I would be less concerned about an additional audit limited to administrative expenses, such as proposed by Mr. Ashley, although even such an audit would be needlessly duplicative of the very effective control already in place. However, even such an audit, which would seem innocuous in itself and vastly preferable to H.R. 10265, runs the risk that the auditing process may slip into the areas of policy and procedure with effects adverse to the formulation and execution of sound monetary policy.

Our currency is in enough trouble now and we should be very careful of what we do.

Sincerely yours,
(signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.

The Honorable Carl Albert,
Speaker of the House of Representatives,
Washington, D. C. 20515.

P.S. I am also sending this expression of my views to Congressmen Ford and Ashley.

FEDERAL OPEN MARKET COMMITTEE
POSSIBLE INSTITUTIONAL AND PROCEDURAL CHANGES

(1) The Federal Open Market Committee should meet monthly (or, if necessary, on more frequent call by the Chairman).

(2) Between meetings of the Federal Open Market Committee, an executive committee composed of the Chairman and Vice Chairman of the Open Market Committee and the Vice Chairman of the Board of Governors should maintain a daily contact with the operations of the Account as carried out by the Manager of the Open Market Account. Such an executive committee should have responsibility between meetings of the Federal Open Market Committee for interpreting and implementing the policies and directives of the full committee.

(3) Associate Economists of the Federal Open Market Committee should report bi-weekly their impressions of the evolving economic situation and the implications for credit policy to the Economist of the Federal Open Market Committee. Using these reports, together with any other information at its disposal, the Economist of the Committee should submit a report bi-weekly to the members of the Federal Open Market Committee.

(4) The relationship of principal and agent that now exists between the Federal Open Market Committee and the Federal Reserve Bank of New York should be discontinued.

(5) The Account and its staff should be located in the Federal Reserve Bank of New York.

(6) The Manager of the Account and his senior staff associates should be appointed by the Federal Open Market Committee and should be directly and solely responsible to the Committee, or its executive committee as defined in (2) above, in all matters relating to policy, interpretation of policy, or

implementation of policy or directives of the Federal Open Market Committee. ~~or any of its directives.~~

(7) The Manager of the Account shall have responsibility for the selection and appointment of the junior staff associates and clerical and administrative assistants.

(8) The Manager of the Account, his senior and junior staff associates and clerical and administrative assistants shall be regarded as employees of the Federal Reserve Bank of New York, except in ~~any~~ all respects directly or indirectly related to the Federal Open Market Account.

(9) All expenses of the Account, including salaries of the Manager, staff assistants, and clerical and administrative assistants; retirement costs; cost of materials and supplies; space rental; and other miscellaneous expenses should be reimbursed to the Federal Reserve Bank of New York by the twelve Federal Reserve banks, prorated on the usual basis of capital and surplus.

(10) Payment for purchases of Government securities transacted in connection with the Account's operation ~~shall~~ should be made as at present by the Federal Reserve Bank of New York, with appropriate charges and allocation to the respective Federal Reserve banks. Receipts for sale of Government securities in connection with the Account's operation ~~shall~~ should be similarly prorated and allocated.

(11) The Manager of the Account should make reports of such frequency and completeness as to keep the members of the Federal Open Market Committee fully informed as to the faithfulness with which its policies and directives are being carried out.

(12) It should be the responsibility of the Federal Open Market Committee to state its policies and its directives to the Manager of the Account with such preciseness as to leave no question as to their meaning or implication to the

Manager of the Account or the steps which he should take in order to effectuate such policies and directives.