Minutes for November 19, 1963

To: Members of the Board

From: Office of the Secretary

Attached is a copy of the minutes of the Board of Governors of the Federal Reserve System on the above date. 1/

It is not proposed to include a statement with respect to any of the entries in this set of minutes in the record of policy actions required to be maintained pursuant to section 10 of the Federal Reserve Act.

Should you have any question with regard to the minutes, it will be appreciated if you will advise the Secretary's Office. Otherwise, please initial below. If you were present at the meeting, your initials will indicate approval of the minutes. If you were not present, your initials will indicate only that you have seen the minutes.

Chm. Martin WM

Gov. Mills

Gov. Robertson R.

Gov. Balderston CCB

Gov. Shepardson CCS

Gov. Mitchell JM

1/ Meeting with the Federal Advisory Council.

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., on Tuesday, November 19, 1963, at 10:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Balderston, Vice Chairman
Mr. Mills
Mr. Robertson
Mr. Shepardson
Mr. Mitchell

Mr. Sherman, Secretary
Mr. Kenyon, Assistant Secretary
Mr. Hackley, General Counsel

Messrs. Martin, Murphy, Petersen, Stoner, Hobbs, Zwiener, Maestre, Moorhead, Breidenthal, Aston, and McAllister, Members of the Federal Advisory Council from the First, Second, Third, Fourth, Fifth, Seventh, Eighth, Ninth, Tenth, Eleventh, and Twelfth Federal Reserve Districts, respectively
Mr. Wallace Davis, President, The Hibernia National Bank, New Orleans, Louisiana

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

Before this meeting there had been distributed a memorandum concerning the topics that had been suggested for discussion. The topics, the statement of the Council with respect to each, and a summary of the discussion at this meeting follow:

1. Domestic economic conditions and prospects.

   A. What are the views of Council members about the business outlook on the assumption that the proposed tax cut will be passed? On the assumption that it will not? To what extent does it appear to members that anticipations of a tax cut are already reflected in current levels of consumer and business spending, and in reports of spending plans?

   B. Does an accumulative rise in prices appear to be developing, or are price increases expected to remain selective, with decreases continuing generally to offset increases in the over-all averages?

   C. What are the views of the Council members regarding the quality of consumer and business credit? Are repayments on mortgage and consumer instalment credit at unduly burdensome levels?

A. The members of the Council believe that the outlook for business for the months ahead is favorable, even without a tax cut. Underlying this opinion, however, is the widely held view that Federal taxes on corporate profits and personal income will be reduced some time next year. Tax reduction would have some stimulating effect on the economy. If the Congress should not pass the tax bill, it probably would have some unfavorable psychological consequences both on business expectations and consumer attitudes.

The Council believes that the anticipation of a tax cut has contributed to the prevailing confidence in the business outlook. This in turn has been reflected in current levels of consumer and business spending and in reports of spending plans.

B. The members of the Council do not believe that an over-all accumulative rise in prices is developing. A reduction in taxes next year, coming at a time when economic activity is already at a high level, might create some inflationary pressures which would be reflected in the price indices.

C. There has been some deterioration in the quality of consumer and business credit but the quality of the over-all loan portfolio is generally satisfactory. Repayments of mortgage and consumer instalment credit represent an unusually high level of disposable income. Although the rate on delinquencies to date does not indicate that repayments have reached burdensome levels, there is a risk in a continuation of the present trend.

President Murphy said the Council members agreed that the prospect of tax reduction had had stimulating effects. They also agreed that business was good and felt it probably would continue to be good well into next year, if not all year. The Council did feel, however, that if a tax cut was not forthcoming next year, that would have some impact on business, although it was not necessary to assume the worst until it was known what would happen. In his personal opinion, there would be a tax cut, but the way it had been delayed had been a little disappointing to the business community. Nevertheless, business sentiment was good from coast to coast. Conversations with businessmen in different areas and segments of industry had a very good flavor. Sales, spending, and incomes were all running at high levels, the automobile industry was doing well, and it was generally predicted that next year would be a good year. Many months had passed since the trough of the last recession. Even so, the Council felt that the expansion could be stretched out for a considerable period, particularly if there was some reform and reduction in the tax structure.

Mr. Martin commented that initially the tax cut seemed to have been justified on the basis that 1963 would otherwise produce a recession. However, that prediction had proved to have no substance, and this was causing a little thought in the First District. In any event, the psychology of the businessman and the banker was good. The prospect of a tax cut seemed to have captured their imagination and produced a good state of mind. There seemed to be ready acceptance of the thought that a tax bill would be enacted. If it should not be, the current state of mind would undoubtedly suffer. Regardless, however, businessmen were going ahead with spending plans wherever there appeared to be opportunities for profit, and individuals were willing to borrow and spend based on the expectation of holding their jobs.

Mr. Petersen noted that the tax cut originally had been proposed as an anti-recession measure. Properly implemented it would have been an effective anti-recession tool, and this seemed to give some strength to the recommendation for limited stand-by authority in the Executive Branch for tax reduction. Inherent in this was the theory that tax policy has something to do with economic growth, that the incentive for profit may be a greater stimulant to economic growth than Government spending.

Mr. Stoner reported that economic conditions were good in the Fourth District, and he agreed with what had been said thus far about the tax cut. In his opinion there had been some deterioration in the quality of consumer and real estate lending, with emphasis on the latter. If there was trouble ahead, real estate credit was the thing that seemed likely to start it off. It was being overextended to a point that he thought was dangerous.

Mr. Davis wondered if there was not general agreement that now, as perhaps never before, there was concern--even on the part of the man on the street--about some of the possible consequences of a tax cut. Even those who did not understand much about Government finance seemed to fear the consequences of heavy budget deficits. They were wondering why some of the unusual spending of Government could not be curtailed along with a tax cut. The statements by some members of Congress that they would support a tax cut only if there was a reduction in Federal expenditures were finding growing support throughout the country.

Mr. Zwiener found no evidence that spending plans were being made on the basis of a tax cut. However, the business community would be somewhat shocked if it were announced tomorrow that there would be no such cut. There would be a considerable psychological effect. Expectation of a tax cut had created a business climate that he felt had been an important factor in 1963.

Mr. Breidenthal reported having attended last week a joint meeting of the head office and branch directors of the Kansas City Reserve Bank at which industry leaders who were present said that their companies had not changed their plans in any way in anticipation of a tax cut. They did not think such plans would be changed regardless of whether or not a tax cut was enacted. Mr. Breidenthal also commented on the weakness in cattle prices and the reasons to which that weakness was attributed.

Mr. Aston commented that perhaps unprecedented confidence in the economy was being witnessed at the present time. In his part of the country, he found no really enthusiastic sentiment about a tax cut. Several months ago it had looked as though this might be necessary to prevent a recession, but subsequent events had demonstrated that this was not the case, for economic conditions had been the strongest in the post-war period. It was the general feeling that whether there was a tax cut or not, this would not affect the progress of business or individual spending. The underlying factor was confidence. It was stronger than for a long time.

Mr. McAllister doubted very much whether any significant amount of business planning was being done in anticipation of a tax cut, or was contingent upon it. Businesses planning to build plants probably were going to go ahead regardless. The business community and the stock market had already discounted a tax cut, however. Therefore, if it did not occur, there undoubtedly would be a set-back that might trigger a turn-around in the economy. As to long-range implications, the banking system was now reasonably well loaned up, which raised the problem of financing deficits. There was talk of making up the effects of a tax cut in 1966, for example, but looking a year or two ahead he thought there could be some grave problems that would have to be resolved.

President Murphy referred to some of the business and financial charts contained in a booklet that had been distributed among the members of the Council and discussed the implications of the statistics reflected therein. (A copy of the chart book has been placed in the Board's files.)

Governor Mills turned to the question of the quality of credit and stated that if the quality of credit deteriorated, there were two parties involved, the lender and the borrower. If there was a deterioration in some areas of credit, in a sense this was being done with the knowledge and agreement of the lending banks. He asked if there was evidence of any movement within the commercial banking system to require that higher credit standards be applied by loan officers.

President Murphy replied that the Council would not want to overemphasize any indication of a deterioration in credit quality. One way of putting the matter would be to say that more aggressive banking was becoming evident. In the past, bankers around the nation had not been sufficiently aggressive in serving their communities, but they were gradually overcoming that deficiency. Competition was one of the important factors involved. Any deterioration of credit quality stemmed from the profit squeeze on the banks, who were now paying more for their raw material. Demand deposits had remained pretty much on level; the increase in deposits in the past few years had been almost entirely in the time and savings category. For these funds the banks were paying a price that was inching upward. These funds were important to the banks, and in putting them to work some banks had been aggressive in their investment policies, reaching out timewise for a better yield or sacrificing quality on tax-exempt bonds to get higher earnings. They were making loans that might not have been made five years ago in order to obtain income. However, looking at examination reports, little step-up in troublesome loans had been seen. Banks had more people working on their loans of a category that could be called unusual, but in many cases these were as good as the best loan on the books; therefore, he would not want to overemphasize the deterioration factor. It had not reached the point where it was at all troublesome. There had been some stretching out in term loans, but was that a deterioration? It affected liquidity but did not necessarily involve a deterioration of credit quality. In the real estate area, he did think that the banks had been more generous, perhaps, but most of the loans he saw were good loans, made against long-term take-outs. He did not think there had been any real letting down of standards, although there were no doubt some instances. If the economy moved into recession, there would undoubtedly be some trouble spots.

Mr. Zwiener said that many chief executive officers of banks in the Seventh District had pointed out to him that their lending officers were spending more and more time on troublesome situations. Loan portfolios were not made up of loans to prime credit risks; that is, loans to large national companies, in the volume that used to be the case and there was a disproportionate amount of time being spent on special situations to keep them moving in the right direction. In several instances, he had heard expressions of concern. It seemed a little shocking that this was occurring at this stage of the economic cycle, but apparently quite a few loans in the District were taking quite a bit of time for handling. On the other side, many banks had set up stronger review committees within the credit department or other similar mechanisms to keep track of special situations.

Mr. McAllister reported that several spots in the Twelfth District were characterized by overbuilding. In San Diego, where defense industries had lost large contracts, there were a great many vacancies but this was gradually being taken care of. Sacramento was another area of overbuilding. When this happened, things slowed up for a while, but there was nothing special to report.

President Murphy commented that he had seldom seen banks more aggressive to make loans. This could develop into a situation that would be troublesome, but banks were serving their communities and making money available. He felt that the management of banks, generally speaking, knew a lot more about the loan portfolio than ever before. Management knew the loans that demanded attention and were likely to cause trouble. Through the use of various techniques, loans were being caught before they got beyond the point of being saved.

Governor Mitchell said it seemed to him, as the Council members discussed the present situation and prospects, that there had been much emphasis on a tax cut as being needed to continue business and consumer confidence. It was, however, becoming increasingly questionable whether there would be a tax cut even next year. Further, there seemed to be a large body of thinking in the Congress that if there was a tax cut, there should be a cut in Government expenditures. The question he wanted to raise was how the Council regarded the problem that the monetary authorities would face if there was not a tax cut. Personally, he rather subscribed to the view that there was an underlying feeling of confidence in the economy not directly related to the prospect of the tax cut. As he looked at the economy, he did not see any real weaknesses. It seemed a fair prospect that things would continue about as they were now going.

President Murphy replied that it was rather difficult to know what might happen psychologically in the business community if there was not a tax cut. The prospect of a tax cut had been a subject of discussion for a considerable period of time, and sentiment nevertheless remained good. If it were announced tomorrow that there was not going to be a tax cut, there would be something of a let-down feeling. Businessmen would be disappointed. However, another possibility was that the tax bill would simply eventually fall by the wayside. Thus, the period of expectation would be prolonged, and business might keep pushing ahead. If so, it might be possible to get over this period without any real let-down in business. If a negative answer developed over a period of many months, the shock might not be as great.

Mr. Zwiener noted that the need for a tax cut had been suggested on the basis of absorbing a growing labor force and countering unemployment. Business confidence seemed unbounded and provided some lift from the standpoint of employment, but the prospect of a change in the tax structure had had a considerable influence on people throughout this period. It might be somewhat disconcerting if there was a realization that a tax cut was not going to occur.

Mr. Petersen expressed the view that if a tax cut was not obtained, this probably would shorten the period of time for which the economy remained at a high level. On the other hand, the obtaining of a tax cut would have the expected consequence of lengthening the period of time.

2. Banking developments.

   A. What is the Council's judgment as to business needs for bank financing over the next several months?

   B. In the opinion of Council members, have commercial banks recently become somewhat more selective in granting business or consumer loans?

C. What are the members' views as to likely developments over coming months with respect to volume and rates on time certificates of deposit? What are their views as to the implications of the recent sharp growth in time certificates of deposit for bank liquidity needs?

A. Most members of the Council believe that commercial and industrial loans will continue to show a more than seasonal rise following the customary decline after the first of the year.

B. The members of the Council believe that commercial banks have become somewhat more selective in granting business and consumer loans in recent months as the reserve position of the banks has become less easy.

C. The Council believes that the growth of time certificates of deposit will continue and that the rates on these deposits in the coming months will tend to remain near present levels. Concern has been expressed that banks may be unable to offer the competitive rates necessary to retain these funds. The growth in the volume of interest-bearing time certificates of deposit and savings is resulting in the acquisition by banks of higher yielding, longer-term assets with a consequent decline in liquidity.

President Murphy noted that bank loans were now at a high level and that the Council expected them to go higher. Loan-deposit ratios were inching upward. Banks would have to learn to live with the higher ratios, and he felt they could live with them because of the management techniques that had been developed in recent years.

President Murphy referred to an exhaustive study in New York State of prospective developments in the next decade. It appeared that the State's banking system was going to be pressed to be able to keep up with demands placed upon it. This emphasized the importance of attracting the savings dollar. A large increase in savings was expected, with the figure close to doubling in a period of ten years. It was important that the commercial banks get their share. With the demand deposit picture what it was, the banks' ability to service their customers would be hampered considerably if they did not get their share. Banks in the State were convinced that they were going to have to run fast to service the demands placed upon them. This feeling, he thought, prevailed generally throughout the country.

As to whether banks were being more selective in extending credit, President Murphy said there were mixed feelings within the Council. The members liked to think that banks were trying to be a little more selective, certainly as far as term loan commitments were concerned. The Council members would not want to see them move up much above present levels. On that basis, it could be said that banks were being more selective. But banks were getting substantial demands for credit from abroad from good customers. The loans, in many cases, were guaranteed by the central bank or the leading commercial bank of the country concerned. Demands frequently were from companies maintaining important balances with American banks. The banks, he thought, were being quite careful to avoid undue risks in making foreign loans. Careful watching was required on the part of banks that engaged in international business.

President Murphy felt that developments in the area of negotiable certificates of deposit had been constructive. New York banks appeared to have about $3 billion of the certificates outstanding, the figure having doubled in the past twelve months. Throughout the country the best guess was between $9 and $10 billion. Bankers were becoming a little concerned about this amount of money being outstanding because of the interest rate ceiling. The market in New York was now close to the ceiling. Most of banks had tried to stretch out the certificates of deposit by maturities, but if interest rates stiffened very much and there began to be a period of attrition on the certificates of deposit, the banks would get a little nervous. If $3 billion of deposits were pulled out of New York banks, and $9 billion across the nation, coupled with an additional demand for credit and a general feeling of tightness, the banking picture would tighten up quite fast.

Asked what he would look upon as the principal competitor to certificates of deposit, President Murphy said the longer term Treasury bills. Most certificates of deposit were for 6, 9, or 12 month maturities, so he would say the bill market in that area and also commercial paper. Corporate treasurers today were doing a lot of things that were unheard of five years ago. They were looking for the least fraction of a percentage point of interest. Some money was going to Canada, for example, to get a higher rate. He had never seen the corporate officer so interested in getting the last nickel of income. This was the reason why demand deposits were where they were. It was one reason why the municipal bond market was a popular source of investment by banks, and why banks were seeking mortgages. He hoped the negotiable certificate of deposit was here to stay, but this was somewhat dependent on Regulation Q. Banks were getting a little nervous at the moment because the rates were just under the ceiling.

Governor Mills said he understood that the money invited by banks when they issued negotiable certificates of deposit did not necessarily find its way into the ordinary run of bank loans and investments. To the extent that this was the case, were the certificates doing any real good or simply bringing up bank totals out of competitive pride?

President Murphy said that this was the type of question raised yesterday by two or three of the Council members. He was sure that in some cases in certain areas the situation involved a little competitive struggle on the part of banks prior to statement dates. However, he viewed the negotiable certificate of deposit as essentially another service to the banking customer. The corporate treasurer had money that he did not need. If the bankers could sit down and take that money and use it profitably, this seemed to him perfectly all right. He did not believe in issuing certificates and then just breaking even or losing money on them. Nor he did believe in issuing certificates of 6 or 9 month maturity and buying municipal bonds or mortgages just as a normal development. However, there was a demand for this type of investment of money on the part of the banks' customers. The banks that could produce and do better than break even were serving their customers; the banks thereby became more important in the daily lives of their customers. In general, the banks had been sensible in issuing the certificates. They had issued them when they wanted the money, and the rates varied from day to day depending on how much the banks wanted the funds. The banks did not feel compelled for business relations purposes to pay unnecessarily high prices to get the certificates. Instead, it was something like putting together a loan for a customer of long standing. But when the banks did not want the money, they did not bid for it. He could agree that there may have been some instances where for competitive reasons and statement purposes banks had bid for certificates, and he did not subscribe to such a practice.

Mr. Moorhead felt that there had been some attempts to use the certificates to gain a competitive advantage. Bankers had been under no delusion, he added, that all of the certificates represented new money for the banking system. Many just involved a shift of the character of deposits and their locale. His bank was getting funds from national corporations that did not normally have deposits with it. The effect was to take deposits from the money centers. This was not new money in the banking system.

Mr. Aston said he thought the development of the negotiable certificate of deposit had been essential to maintaining the ability of the banks to meet credit needs for the growth of the economy. His bank did not employ certificate money in municipal bonds but rather for interim construction loans or short-term loans. Without these certificates, something would have had to be cut back. It was of vital concern to the banks that they have the ability to stay in this market. In certain respects, corporate certificates of deposit were not unlike the savings of individuals. Corporations were going to place their funds in some kind of market investment, and the certificate of deposit was just another type of market investment. In the early days there was no hard core, but with experience in this area, a hard core was beginning to develop. Investment of these funds should be the decision of the management of a bank, as it gained experience. The statement of the Council was a little on the mild side insofar as it reflected his degree of concern. He thought it was essential to the commercial banks and to the Board of Governors to recognize that the banks must be in a position to maintain the certificate of deposit operation on a competitive basis. With \$9 or \$10 billion involved, it was essential to the soundness and continuity of bank operations.

Regarding the shifting of funds from the money centers, President Murphy said he thought this was good for the country. Prior to this development, the large national firms tended to keep their excess funds in the money centers where they could most easily employ them in commercial paper and Treasury bills. But under this system the corporate treasurer could call 20 different areas outside the money centers and place \$50 million. Places that would take the funds were the places that could use them. This afforded fluidity and flexibility. If there was a problem, it was that this development had reduced demand deposits somewhat.

Mr. Maestre agreed that without question the certificates of deposit had made inroads on demand deposits. He thought there was no question but that they were here to stay; a permanent institution so far as banking was concerned. The question was whether the Board was going to permit the banks to be competitive at all times. If it was, the banks could use the deposits.

Governor Balderston inquired whether the Council had discussed bank investment policies. He was thinking of the fact that last year the commercial banks bought 80 per cent of the net addition to municipal bonds. One or two of the Council members had mentioned that banks were putting time deposit funds into longer municipals. Was there a change going on that the Board ought to know about?

President Murphy replied that loan portfolios were now higher, loan-deposit ratios were higher, the banks had increased their negotiable certificates of deposit, and they had received little in the way of additional demand deposits. As to pushing out into municipal markets or even mortgages, he thought it was the consensus of the Council that a kind of plateau had been reached.

Governor Balderston inquired whether, with the supply of municipals increasing year by year, the Council anticipated weakness in the municipal market if bank demand had leveled off.

President Murphy said that as the banks grew in terms of deposits and capital base, they could absorb a greater volume of new municipals without increasing the percentage relationship to their total portfolios. The pattern was quite mixed; it was mixed in New York City, for example, where some banks were pushing out and some were doing little, not wanting to sacrifice liquidity for a slightly increased yield. The yield curve was quite flat today; for an additional 1/4 per cent a bank sometimes had to lengthen maturity considerably. He had no fear as to the demand for municipal bonds; the banking industry was going to grow substantially in the years ahead. The volume of liquid savings in banks, savings and loans, and other institutions was going to reach very substantial proportions. If banks obtained their fair share of the savings dollar, they could buy more municipal bonds without extending the proportion of such holdings particularly.

Mr. Hobbs said he thought there had been a lot of wishful thinking in connection with the issuance of negotiable certificates of deposit, not in principle but in terms of volume and rapid increase. It ran counter to the rules of sound banking to take money that was virtually demand money and put it into longer term assets, either loans or investments. Last year the amount of certificates outstanding at New York City banks increased from $1.5 billion to $3 billion. The increase in investments other than Governments was $1.3 billion. If these figures were not evidence of what the money was being used for, he missed his guess. Of course, if banks could police the situation in a way such as Mr. Aston described, that was excellent. If they could earmark the certificate money and put it into short-term construction loans, that was good. But he was not sure that banks, in their effort to grow vigorously and absent any increase in demand deposits, were not reaching a long way for certificates of deposit. While he might be wrong, he thought there had been a lot of wishful thinking among bankers as to the value of the certificates of deposit.

Mr. Martin said that the question went directly to the matter of trying to define what a bank's liquidity should be. This had been a lively question since World War II, and it remained unanswered. In any event, however, the banks were currently a great deal less liquid. To determine what degree of liquidity should be maintained with the certificate of deposit money was the crux of the question. The reserve city bankers had commenced a special study dealing with the composition of bank assets in an attempt to get at the question, which was still very much unanswered. Whether the hard core theory would stand up or not, he did not know. The banks were now almost at the rate ceiling; they had reached the crossroads again, and quickly.

President Murphy thought it possible to have considerable confidence in the availability of certificate money if the banks had flexibility to compete for it. A lot of demand money went into five-year loans, but well-managed banks had various methods of measuring their liquidity position in light of foreseeable demands. It was almost easier to predict the action of certificate money, he thought, than demand deposits. If the banks had flexibility, they could step out and bid for it, whereas sometimes demand deposits were not available. He felt rather comfortable about the development of the negotiable certificate of deposit. It was a good development for the banking structure, and he thought the money was being handled in a statesmanlike fashion.

Governor Mills noted that banks outside the money centers were now crowding the 4 per cent rate. With the demand for certificates of deposit promoted by corporate treasurers seeking the highest rate possible, the certificate rate might be forced above any normal rate that would be responsive to the supply and demand of investment and other funds in the market. In other words, was there not a process at work that could force the rate up without any relationship to the supply of funds except the wish of the corporate treasurer to improve his rate?

President Murphy replied that a high rate would not be likely to attract a lot of money unless the bank was a top-notch name and the instrument itself was completely negotiable. If a top-notch bank stepped out of line and increased its rate above the going rate, it would be filled up with funds in a matter of hours and would have to put the rate back down. He could not conceive of smaller banks throughout the country stepping out of line ratewise, because they would have insufficient uses for the money. He saw no real problem in that respect. Someone, of course, might try to build a bank on the basis of certificates of deposit, but he saw no more probability of improper actions in that area than in a lot of other areas.

Governor Robertson asked what happened if the rate went up among the big-name banks. Could the smaller banks still sell certificates of deposit in the open market? Presumably, they were going to have to sell them at a little higher rate.

Mr. Moorhead replied "maybe 1/8 or 1/16"; smaller banks would then be in trouble. President Murphy said this was causing some concern as the ceiling was being approached. Mr. Petersen said that "some concern" was a little weak. If banks were not permitted to follow money rates up, there would be a real problem.

Mr. Breidenthal commented that his bank was a smaller bank that endeavored to maintain its relative position in its area. At first it turned down all of the certificate of deposit business that was offered to it. Then it found that it was losing business, as illustrated by a corporation that had maintained an inactive account but closed it along with other such accounts elsewhere to put the money in certificates of deposit. His bank ended up by telling the corporation it would meet the competition. In his opinion the second sentence in the final paragraph of the Council's statement was almost an invitation to modify Regulation Q, and he was opposed to it. At the end of October, 28 reporting banks in the Kansas City District had time and savings deposits equal to 28 per cent of total deposits. His bank's cost of time money as a percentage of total deposits used to run 1/4 to 1/2 per cent. This year the cost to his bank would run from 1-1/4 per cent to 1-1/2 per cent of all deposits. This was getting to be a pretty high price, and there was the question of what to do with the money. This whole thing, from the banking standpoint, was building up because of savings and loan competition. Banks were frustrated to see money going into savings and loans. He felt that the savings and loans had about reached the peak of their ability to compete, however; they just could not make the necessary earnings.

Chairman Martin presented a hypothetical question: if the Board should authorize a 1 per cent increase under Regulation Q, what would that do to the prime rate?

Mr. Maestre said he did not think it would have any effect. Mr. Petersen commented that if the consequence of changing the regulation was that banks would break through the present ceiling and seek funds more aggressively, this would have a good effect on long-term rates. Banks would try more aggressively to make long-term loans. Mr. Zwiener felt that a change in Regulation Q would not trigger a change in the prime rate at this time. The prime rate was still pretty solid. President Murphy said that this was his feeling.

3. Absorption of exchange charges.

> What are the views of Council members on the position the Board has consistently followed that absorption of exchange charges by member banks involves an indirect payment of interest on demand deposits? In view of the widespread evasions of the Board's ruling by member banks, the difficulties of effective enforcement, and the inquities to member banks resulting from the fact that the Federal Deposit Insurance Corporation interprets exchange absorption differently, does the Council believe that Regulation Q should be amended to provide that exchange absorption will not be considered a payment of interest on demand deposits?

The Council believes that the regulation should be enforced. Although the regulation may be difficult to enforce effectively, the members of the Council continue to believe that no change should be made in the present regulation covering the absorption of exchange charges by member banks.

President Murphy said the Council felt that any admission of defeat in this area would be a move backward. At the end of 1962 there were 1,617 nonpar banks in the United States. The number had been declining, albeit slowly, and a year did not pass without the number being reduced further. To move backward and say that the absorption of exchange charges was not an indirect payment of interest on demand deposits would be an invitation for the number of nonpar banks to increase, and such a development would certainly be detrimental to the over-all banking system. The Council recognized the difficulties that were involved; the violations that were occurring. It was difficult when one supervisory agency of the Government looked one way and others looked the other way, but the Council felt unanimously that it would be a mistake to amend the Board's regulation.

Mr. Moorhead said that the Council's first reaction was one of surprise that the question had been raised again because it was thought that the matter had been laid to rest about a year and a half ago. The problem appeared to be of major proportions only in three Federal Reserve districts. To change the regulation at the present time would put an extremely heavy burden on city correspondent banks in those districts. He could not believe that the difficulty of enforcement was insuperable. It seemed to him that one way the regulation could be enforced would be to send a simple questionnaire to the executive head of each member bank asking two questions: (1) Do you absorb exchange? (2) Have you entered into any arrangement that has the effect of absorbing exchange? If the answer to either question is in the affirmative, please explain this violation of Federal Reserve regulation.

Mr. Moorhead did not believe that executive officers of member banks would respond to such a questionnaire falsely. He added that the members of the Council would do anything that might be asked to get at the larger question, which was whether nonpar banking should be permitted. They would try to be helpful whether a solution was sought by legislative means or by moral suasion. But to say that the absorption of exchange would not be considered a payment of interest on demand deposits seemed untenable.

Mr. Davis entered a strong plea that the Board not amend its regulation. In the first place, such action would penalize severely those banks--and there were many of them in nonpar areas--that were large clearing agents of checks and observed the letter and spirit of the regulation. More importantly, however, the amendment of Regulation Q would undoubtedly have the effect of holding an umbrella over nonpar banks. It was beyond his understanding why, at this stage of banking progress, there should be a situation where a check drawn on some point was not worth its face wherever it was negotiated. The charging of exchange was simply an easy way for some banks to make money. He had formerly lived in Kentucky for many years and there were a lot of nonpar banks in that State, but Kentucky eventually went into the category of States with no nonpar banks. The problem could not be solved overnight, but the intent of the Board's regulation must be preserved. The problem must be worked on, and in the end the objective must be accomplished. National corporations with a volume of checks in the major nonpar areas would keep fighting the problem and those in the middle of these areas also would keep fighting, but to amend the regulation to permit exchange absorption would penalize severely a limited number of banks. It would be of no help to anyone, and it would preserve a system that should be terminated. There was certainly a solution, although it was not simple. It was not even in the area of trying to get the Federal Deposit Insurance Corporation to change its position, although that would be desirable. However, some suggestions might come out of discussion of the problem that would be helpful. He understood the position the Federal Reserve was in, but he would not give up the battle.

President Murphy said the Council had tried to think of constructive ideas that might be offered. One possibility might be a renewed effort on the part of the Association of Reserve City Bankers, perhaps in cooperation with the American Bankers Association. Part of the trouble, he thought, was that many senior executive officers of banks were not thoroughly conversant with the problem, which was handled at the operating level and did not come to their attention. An educational endeavor on the part of the bankers associations, with the help of the Federal Reserve, might make some headway, but this headway would not be possible if the regulation were amended.

Mr. Zwiener said he was not in a position to commit the Association of Reserve City Bankers one way or another, but that the matter would have immediate attention.

Chairman Martin noted that the Board's purpose in bringing up the matter was highlighted by Mr. Moorhead's comment. There had been a disposition to think that this problem had been put to bed about a year and a half ago, but it continued to be a very serious problem from the standpoint of the Board. The Board was fully aware of the implications and complications of the problem. It was not just a matter of attempting to persuade the Federal Deposit Insurance Corporation to change its position, although that would be helpful. If this problem continued to exist, at some point some Federal Reserve Board would give up the battle. He wanted to impress on the Council that this was not a problem that had been disposed of. At times it raised its head in a way that was detrimental to the banking community. This was the real reason for putting the subject on the agenda. The problem was one that appeared to have been getting more serious rather than less serious. The Board seemed to be hearing of more violations, and the subject was constantly coming before the Board in one way or another. The undercurrent was discouraging.

Mr. Davis expressed agreement with the view that the problem was growing worse; however, he felt that it could be controlled. With the knowledge that was available to the Board, he wondered why banks were permitted to violate the Federal Reserve regulation. One possibility might be for the Federal Reserve to go direct to the member banks, both State and national. Mr. Moorhead's suggestion might be a good one; it would be interesting to see the results of such an inquiry.

Governor Mills suggested that Mr. Hackley brief the meeting on the question of defining the absorption of exchange as an indirect payment of interest on demand deposits, noting that this question touched upon the whole range of services that were rendered by banks without cost in return for the benefit of holding accounts.

Mr. Hackley pointed out that the Board had taken the position over a long period of years that exchange absorption should be considered a payment of interest on demand deposits. He thought this position was sound. However, persuasive arguments could be made to the contrary. The Board's position was complicated by its rulings on the absorption of some service charges, which rulings were based on the theory that there was not a payment to the customer but merely the omission of a charge. Arguments could be made to the effect that this was only a technical distinction; that in the case of absorption of service costs, there was just as much, perhaps greater and more widespread benefit to the customers of member banks than in the case of absorbing exchange charges. This was just to point out that the question was debatable so far as the lawyers were concerned; he was not suggesting that the Board's position in the past on exchange absorption had been fundamentally unsound.

Chairman Martin commented that the Board's concern was a longer range concern. The Board had an obligation to keep the matter in front of the banking community until there was some resolution of the various aspects of the problem. The problem could not continue to be dealt with on the present basis.

President Murphy said that the Council appreciated the difficulties with which the Federal Reserve was faced, particularly in light of the different viewpoints among the supervisory agencies. Responsible elements of the banking community acknowledged a deep-seated responsibility, and it might be that helpful efforts could be devised.

Question was raised whether the Federal Deposit Insurance Corporation might be more likely to change its position with the coming into office of a new Chairman, and Chairman Martin indicated that this angle of the matter would be explored as promptly as feasible. President Murphy suggested that it might be helpful if a committee of bankers were to talk with the new Corporation Chairman before he took a definite stand on the subject. Governor Balderston pointed out that even a change in the position of the Federal Deposit Insurance Corporation would, of course, not solve the problem. There was also the problem of inequity arising out of inconsistent enforcement as between State and national banks.

4. The U. S. balance of payments.

A. What are the views of Council members as to prospects for further improvement in our balance of payments position. To what extent, if any, do members believe that monetary policy has contributed to the recent improvement in our balance of payments?

B. In the opinions of Council members, has there been any recent change in the strength of demand for bank loans by foreign customers?

C. Do members observe any indications of significant improvement in the competitive position of the United States in world trade?

A. The members of the Council believe that monetary policy has contributed to the recent improvement and to the somewhat more favorable short-term outlook on the balance of payments.

B. The members of the Council have not detected any recent significant change in the strength of demand for bank loans by foreign customers.

C. Although underlying trends in wages, prices, and productivity here and abroad tend to be helpful to the United States, the members of the Council have not observed any real improvement in the competitive position of the United States in world trade.

President Murphy said the Council continued to feel that the balance of payments was one of this country's primary problems. It noted that the recent trend was favorable. Although there were mixed feelings as to whether or not the interest equalization tax made sense, the threat of its enactment was already proving effective, as indicated by the Council's chart on foreign security issues in the United States. In summary, the third quarter balance of payments figures were encouraging whereas the second quarter figures were discouraging. However, just as the second quarter figures should not have been interpreted as pointing permanently in one direction, neither could the third quarter figures be regarded as definite proof that the balance of payments problem was nearing a solution.

Referring to another of the Council's charts, President Murphy said the members felt that the efforts on the part of the Government and private industry to boost U. S. exports were quietly paying off. Total export figures were close to an all-time high, and the net export figures were moving in the right direction, not as high as early in the year but at a fairly good level. To summarize, the Council was pleased by current balance of payments trends but did not think that the war had yet been won.

Mr. Petersen did not look for any substantial increase in the U. S. balance on current account. In fact, there probably would be some deterioration. In his judgment, relief would not come from that source. He did not know how much the Treasury and Federal Reserve schemes had helped, but they were kind of one-effect operations. U. S. monetary policy and the increase in short-term rates seemed to have been effective, according to the third quarter figures. Some inflow of funds into the United States would be highly desirable, which suggested that a further rise in short-term rates might be indicated.

5. Monetary policy.

How do Council members evaluate recent monetary and credit policy?

The members of the Council believe that recent monetary and credit policy has been most appropriate. Domestic business activity has had sufficient strength to accommodate itself to the somewhat less easy credit position and the firming of rates. At the same time, monetary and credit policy has been helpful to our international payments position.

The Council believes the increase in the margin requirements on stock purchases was desirable and timely.

President Murphy said the Council felt that the moves made in the area of monetary and credit policy had strengthened the international position of the United States without harm to the domestic position.

In response to a question, members of the Council expressed the view that a continuation of current monetary and credit policy would be appropriate.

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Chairman Martin referred to the various problems that had been encountered during the year 1963 and expressed appreciation to the members of the Council for sharing their views with the Board. He noted that the service of several members of the Council would conclude at the end of this year and expressed the hope that they would continue to give the Federal Reserve the benefit of their advice.

President Murphy made appropriate responding remarks in which he stressed that the members of the Council had enjoyed meeting with the Board and exchanging ideas.

It was understood that the next meeting of the Federal Advisory Council would be held on February 17 and 18, 1964.

The meeting then adjourned.

Secretary