Minutes for February 18, 1964

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

Gov. Mitchell

Gov. Daane

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 offices of the Board of Governors in Washington, D. C., on Tuesday, February 18, 1964, at 10:30 a.m.

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

Mr. Sherman, Secretary
Mr. Kenyon, Assistant Secretary

Messrs. Martin, Moore, Day, Stoner, Watlington, McRae, Smith, Hickok, Moorhead, Breidenthal, Aston, and Cook, Members of the Federal Advisory Council from the First, Second, Third, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth, Eleventh, and Twelfth Federal Reserve Districts, respectively

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

The Board had been advised of the election by the Council of the following persons to serve in the capacities indicated for the year 1964:

John A. Moorhead, President
James W. Aston, Vice President
John A. Moorhead, James W. Aston, Lawrence H. Martin, J. Finley McRae, and M. L. Breidenthal, Members of the Executive Committee
Herbert V. Prochnow, Secretary
William J. Korsvik, Assistant Secretary

Before this meeting the Council had submitted a memorandum setting forth its views on the subjects suggested for discussion. The topics, the Council's views, and a summary of the discussion of each topic follow.

1. Domestic economic conditions and prospects.

A. What are the views of the Council as to the economic outlook for the remainder of this year? To what extent are these views influenced by the tax legislation now under consideration in Congress?

B. What effect does the Council expect the forces of supply and demand in the markets for funds to have on interest rates during the rest of 1964?

A. The members of the Council believe that the level of economic activity will continue to rise during the remainder of this year. This view of the economic outlook reflects the expectation of a reduction in Federal taxes on personal income and corporate profits. Consumer spending, which has been strong, is likely to be further stimulated as a result of the reduction in taxes. The resulting demand and its impact on production and the percentage of capacity being utilized should give a further impetus to capital spending, as well as to inventory accumulation and investment.

Several members of the Council expressed concern about the added stimulus of a tax cut during a period of good business. Inflationary forces could develop which would intensify wage demands, accelerate inventory accumulation, and increase the upward pressure on prices.

B. While most members of the Council expect that the demand for funds will rise during the rest of 1964, the flow of corporate cash, as well as personal savings, will also expand. In these circumstances, the Council anticipates that interest rates will be fairly stable in the months immediately ahead. However, changes in interest rates in foreign money markets might force our rate structure higher. With the advent of Fall and the customary seasonal rises in credit demands, and with the stimulus to economic activity provided by a possible tax cut, upward pressure on interest rates may develop.

Chairman Martin commented that it would be helpful to have any views Council members might care to express on the likely impact of the prospective tax cut on employment and unemployment. He noted that there were two schools of thought: (1) assuming the tax cut would be stimulative, that it would nevertheless have little effect on the unemployment problem as it currently existed; (2) that the possibilities of inventory build-up and plant investment were being underestimated, and therefore that there might be a substantial decline in the rate of unemployment in the second half of the year.

Mr. Martin stated that in the First District there was little reason to change the views expressed three or six months ago concerning the generally favorable economic outlook. However, persons in the District were putting emphasis on certain caveats. First, there was the possibility of over-stimulation of consumer demand, with the consequence that industries might take advantage of this and raise prices. Second, while the relationship between inventories and sales had been good in recent months, the vagaries of demand forces might change this relationship. Third, with a prosperous year in 1963, probably to be followed by another such year in 1964, it seemed unrealistic to think that the labor unions would not take advantage of the situation to make strong wage demands. If those demands were granted, upward pressure on prices might be expected; if they were not granted, there might be some disruption of business.

Mr. Martin also said that the kinds of industries prominent in the First District--electronics, for example--were suffering from the change in defense production philosophy. The trend of manufacturing employment in the First District was not as good as nationally, particularly in Massachusetts, and the trend could be expected to continue. Also, the impact of automation was beginning to be felt in the white collar area. These factors would tend to offset any stimulative effects on employment resulting from a tax cut.

President Moorhead noted that the Council had seen charts presented by the Board's staff yesterday that were on the discouraging side with respect to the employment outlook. In a business expansion, he observed, there usually comes a point at which employment begins to rise rapidly. With the stimulative effects of a tax cut superimposed on the present rate of expansion, employment could rise markedly. In each succeeding period of post-war expansion, however, the rate of unemployment had failed to reach as low a level as in the preceding expansion.

Mr. Day noted a development of concern in the Philadelphia area; namely, that the cut in defense spending had changed the mix in electronics work from emphasis on hardware to emphasis on research and prototypes. At various plants, there had been heavy lay-offs of workers as a result. Mr. Day also expressed some concern, from the longer run standpoint, that the impact of a reduction in tax withholding rates might be concentrated primarily in the year 1964.

Mr. Watlington felt that a tax cut could have some effect on employment in the Fifth District because so many of the things manufactured in that District were consumer goods. If a tax cut stimulated the purchase of consumer goods, such as textiles and furniture, it could have an invigorating effect on employment in those industries. In commenting on the tobacco situation, he indicated that the longer run impact of the recent Government report on the harmful effects of the use of tobacco remained to be seen. The industry was not presently too dismayed, having in mind that following a similar report in England tobacco consumption increased after a relatively brief decline.

Mr. Smith said that, assuming the tax cut impact was stimulating, it seemed likely to help the unemployment situation in the Seventh District because of the variety of industries represented in the District. Business sentiment at the moment was bullish. Retail sales were up strongly in Detroit and Chicago, and the auto industry was strong, with production above the year-ago level in January and thus far in February. The machinery industry was hard to appraise as a unit but seemed to be doing well, with order backlogs up considerably. The construction industry appeared to be the most unfavorably situated. In Chicago, construction had been lagging behind the national average since 1959, particularly in the category of single-unit residences. Apartment building had picked up considerably, however. The stage of overbuilding had not been reached yet, although there were some signs of such a pattern developing. Construction of office buildings was active, with no signs of overbuilding as yet.

Mr. Moorhead commented that it seemed fair to say that there should be more jobs available with the stimulus of a tax cut. However, whether they would be available in sufficient quantity to outpace increases in the labor force was questionable, particularly in light of the inflow from the high schools into the labor force.

Mr. Day referred to a massive retraining program that had been planned in the Philadelphia area, it having been noted that there were various types of jobs available if people could be trained for them. Unfortunately, organized labor killed the appropriation from the Government that had been counted upon to support the program, which was now completely stalled.

Chairman Martin referred to unemployment as the major problem of the domestic economy at this time. The question remained as to how help could be given. There was debate as to whether the problem was primarily cyclical or structural, and as to the impact of a tax cut. There was further the question whether monetary policy could be used effectively in restraining price movements in present circumstances. The Council's statement implied a view that in the event of inflationary pressures a less easy monetary policy would be warranted. Generally speaking, bankers seemed to take the view that this would be effective, while nonbankers tended to be skeptical.

The Chairman inquired whether it was felt that the availability of money was about right at present, from the standpoint of the relationship of supply and demand. He also referred to the current discussion about the possibility of Federal Reserve monetary policy negating the stimulative effects of a tax cut. He happened to feel, he said, that any deficit resulting from the tax cut should be financed primarily through nonbank sources, but such a position was currently under attack.

President Moorhead commented that the leading question seemed to be how much further the economy could expand without any significant addition to the employed labor force. It appeared that there was still room for considerable expansion without putting any appreciable dent on unemployment.

Chairman Martin replied that he thought a case could be made that if a strong capital spending expansion should occur, there might be a considerable decline in unemployment.

Mr. Stoner said he did not think that the impact of a tax cut would increase employment too much in the Fourth District, where the steel and automobile industries were already operating at such high rates.

Mr. Aston reported that the Eleventh District had been gaining defense contracts, which would increase employment. Business in the District was strong, and he thought that a tax cut had been fairly well discounted so far as nondefense-type work was concerned. There was still an abundance of capital for construction needs. However, the District was still generating more job-seekers than jobs to be filled. The District had been enjoying less than average rates of unemployment, but it was difficult to see where too many new jobs would be created.

Mr. Aston said he detected some concern that there was an element of softness in the economy. There was some feeling that this was a time for caution. The buoyant sentiment resulting from recent economic conditions and tax-cut psychology might lead to an inflationary situation beginning in 1965 that could be harmful and dangerous.

Governor Balderston referred to an analysis made by the Atlanta Reserve Bank of changes in job opportunities in various lines of work. It was rather surprising to see which parts of the white collar area were providing jobs strongly and which were not. Retailing had declined comparatively as a provider of jobs, while State and local government jobs were up markedly. Financial institutions had been providing more jobs, and service occupations fewer. There had been a general feeling that the white collar area was the place where high school graduates should seek employment, but this appeared to depend on what part of this area one had in mind.

Turning to the second part of the topic, Mr. Moore commented that a lot of factors were contriving to exert upward pressure on interest rates. In New York City there was a deep awareness of the balance of payments problem, and strong competition for money from other international markets was seen continually. As to long-term rates, there would be a good deal more State and local spending. At the moment, loans were running off seasonally and demands were rather light. There is typically not so much talk of interest rate upswings at this time of year as later on in the year. Looking forward to the second half of this year, if there was the stimulus that apparently would come from the tax cut, activity should start to move ahead in some areas. In his opinion, there was likely to be significant credit expansion this year. One factor, of course, in the thinking about interest rates was what the nature of Federal Reserve policy might be. In general, it was his feeling that it would be hard to push interest rates down and that they were more likely to push upward. He was not advocating higher rates, but the pressure would be in that direction.

Chairman Martin inquired whether the Council members were willing to accept the optimistic forecasts currently being made about the balance of payments or whether they were skeptical.

Mr. Cook indicated that he was skeptical. A good deal of what had taken place to achieve the current improvement did not seem to him to have sufficient depth to correct major ills. Among other things, it was necessary to keep watching the European situation to see what might develop in that area. Apparently, the Western European countries were feeling considerable pressure on prices and costs. The Japanese situation was still rather tense, and the Japanese were seeking loans actively. Part of the improvement in the balance of payments was obviously attributable to the introduction of the interest equalization tax proposal, but this was an unnatural situation. It was not known whether a bill was going to be enacted or what might happen if such a bill should be enacted. The threat of legislation might be exerting a stronger influence than would the legislation itself. There seemed to be some feeling abroad that if the U.S. did strike a payments balance, that would contribute to a depression in certain other countries.

Chairman Martin inquired what if any effect the Council members felt that the increase in the Federal Reserve discount rate last summer had had on the balance of payments problem.

Mr. Cook said he thought it had exerted a generally favorable effect, but he could not say how this might be precisely evaluated. Mr. Moore agreed that it had had a good psychological effect. Mr. Day commented that the short-term interest rate differential had grown so small that there was not much incentive for short-term funds to flow out of this country.

Chairman Martin noted that there was a good deal of discussion currently as to whether the discount rate move had exerted anything more than a psychological effect. If it had been separated from the interest equalization tax proposal, there would have been a better basis of measurement. The two steps were taken together, however. There was some body of opinion that the discount rate move had no effect on the balance of payments, while an easier monetary policy might have had a more stimulating effect domestically.

President Moorhead commented that the discount rate increase apparently had had no adverse effect on domestic business, and Mr. Moore noted that in any event there had been a credit expansion of record proportions last year. President Moorhead agreed that the discount rate move had not curtailed the lending activity of banks. Mr. Moore said he felt reasonably sure that a lot of funds had been kept in New York by the very fact that a sign was given to short-term investors that the interest rate mechanism would be used. Previously, there had been much nervousness on the part of foreign short-term investors. This again was in the psychological area, but nevertheless the talk died down and the money stayed in this country.

2. Banking developments.

A. What is the Council's judgment regarding the demand for commercial and industrial loans over the next six months?

B. What is the Council's judgment with regard to the demand for mortgage loans over the same period?

C. Have Council members observed any recent change in the willingness of banks to continue to add to their portfolios of longer term tax-exempt securities?

D. Do Council members believe that the ability of many banks to issue negotiable time certificates of deposit is being restricted by the current interest rate ceilings under Regulation Q?

E. Have Council members observed any changes in the standards banks are employing in judging their own liquidity positions?

F. What is the attitude of Council members toward the proposal sometimes made that regulation of interest rates on time and savings deposits be put on a standby basis?

A. The Council believes that the demand for commercial and industrial loans over the next six months will rise moderately, reflecting the probable expansion in business activity.

B. The large volume of construction activity, as well as the level of contract awards, indicates that the demand for mortgage loans over the next six months will expand further.

C. The members of the Council believe that banks are less willing now to add to their portfolios of longer term, tax-exempt securities.

D. Most members of the Council do not believe that the interest rate ceilings under Regulation Q are limiting the ability of major banks to issue negotiable time certificates of deposit. However, certain banks are finding it necessary to shorten maturities and pay slightly higher rates in order to attract funds. The Council is concerned about the effect on the volume of negotiable time certificates of deposit if the interest rate structure should rise and the yields on Treasury bills should approach 4 per cent.

E. The statistics on the banking system indicate that many bankers are accepting lower liquidity standards than heretofore. The pressure of increasing costs, especially the sharp rise in the amount of interest paid, has led many bankers to hold a larger volume of less marketable, longer term assets in the portfolios of their banks.

F. The Council is unanimous in its opinion that bankers generally would not favor the proposal that the regulation of interest rates on time and savings deposits be put on a standby basis, but would prefer the present arrangement. If conditions in the money market should warrant an increase in the maximum permissible interest rate paid on time and savings deposits, the members of the Council believe that any increase should be well above the then current rate. This would tend to preclude the maximum rate becoming the prevailing rate paid.

On commercial and industrial loans, President Moorhead said the Council had not attempted to specify any particular expected rate of increase. A rate of 3 per cent had been mentioned in one instance, and a range of 2 to 5 per cent in another.

Mr. Hickok said that Eighth District banks were not looking forward to any particular increase in loan demand over the next six months. Demand appeared to have just about leveled off. Mr. Day reported a feeling in the Third District that there might be anything from a flat curve to around a 3 per cent increase for the year, which involved looking a little further ahead than the next six months. Mr. Watlington said that in the Fifth District it was thought that loan demand would be stronger, with an increase of from 2 to 5 per cent over the comparable period in 1963.

President Moorhead commented that Ninth District loans were off seasonally since the first of the year, but that the volume was ahead of a year ago at this time. It was expected that demand might increase a little more than normally in the second half of the year. Mr. McRae reported that in an informal survey 14 bankers in the Sixth District felt that loans would increase, while four expected no change and one thought that perhaps the volume would slip off a little. The majority opinion was, therefore, that there would be at least a moderate increase, and demands were now strong. Mr. Smith indicated that in the Seventh District no increase was expected for the first six months.

Governor Balderston noted that it was said that the flow of corporate internal funds might be sufficient to take care of plant and equipment additions. He asked whether this was true of any increase in inventories that might be ahead.

President Moorhead replied that it was the Council's conclusion that the situation was very spotty. There were large cash flows in the large corporations, but in many smaller corporations any substantial inventory accumulation would require bank financing. Mr. Moore commented that there were a lot of "haves" and a lot of "have nots." The "haves" had a great number of dollars, but their suppliers might not have them.

As to mortgage loan prospects, President Moorhead said the Council had discussed the apartment and office building situation at considerable length. Charts seen by the Council yesterday indicated that apartment building was growing at a substantial annual rate, and it would seem doubtful whether this rate of increase could be sustained indefinitely. All of the Council members knew of instances where apartment builders were in trouble, but there was an incentive to keep going because of the abundance of mortgage funds available. Mortgage rates possibly could soften because there was more money pushing on the mortgage market than that market could absorb.

Mr. Aston recalled expressing the view as long ago as the September 1963 meeting of the Council and the Board that there was a situation of oversupply in the Eleventh District, particularly of high-rise apartments. There was still a tendency to build, if the money could be obtained, without regard to need. Some slowing down of activity was seen on the part of institutional investors and insurance companies, who were not rushing to make commitments in the same way as six months ago. The availability of funds, however, was still more than sufficient. Some shading of rates, and of terms and conditions, was seen in order to get this money working.

Mr. Smith reported a general feeling in the Seventh District that there would be no change in demand for a while. In checking with national building companies, however, he sensed a feeling that there was going to be certainly no less demand for mortgages because it was felt that nonfarm starts would continue at about the same level or possibly a little higher, with an increased demand for public buildings of all types. There could be less desire to take these mortgages. Savings and loan associations were not growing as fast as they had been earlier, banks with savings departments were having the same experience, and mortgage companies were quite well loaded up. Thus, there might be less interest in seeking mortgages. A steadying of rates could develop, or possibly some increase, depending on what happened to the economy generally.

Mr. Stoner repeated a comment he had made at the November 1963 meeting that if there was trouble ahead the mortgage and real estate market would be likely to trigger it, to which President Moorhead added that all of the Council members had the feeling that this was a potential danger spot.

On bank acquisition of longer term tax-exempt securities, Mr. Day said that throughout the Third District there was widespread anticipation of more attractive rates on tax-exempt securities, and thus a wait-and-see attitude. There was a fairly substantial latent demand for municipals that might become active, particularly if any feeling should develop that rates were going to stabilize. Third District banks were not bearish; they were more or less sitting on the sidelines.

Mr. Watlington observed that after the last Regulation Q revision there had been a marked upward surge in holdings of municipals. He thought that that was now pretty well taken care of, and he did not anticipate any significant further change.

Mr. Moore foresaw some increase in holdings of tax-exempt securities in the Second District. He went on to say that his bank had taken a survey of 111 banks over the country, asking them about their plans for purchases of tax-exempt securities in 1964. About half said they planned to purchase as many as in 1963, 31 intended to buy more, and the others intended to buy less. Comparing the results with a similar survey taken a year earlier, his bank came to the conclusion that commercial bank buying of tax-exempts would be less in 1964 than in 1963, unless there should be changes in yields.

Mr. Smith commented that the big change was in the last half of 1962 and in 1963, and he felt that the banks were now quite well set.

Mr. Hickok suggested that many banks had acquired the amount of municipals they thought justified for their particular situation, and they were not willing to go into municipals further. On the other hand, other banks had not thus far utilized the municipal market to the same extent.

Mr. Martin noted that in the closing days of 1963 and the opening days of 1964 there was clear evidence of liquidation on the part of the larger banks, in contrast to slight increases a year earlier. There appeared to have been some change in philosophy toward an attitude of standing still and reappraising the situation. This related to the question of time money and certificates of deposit. A careful reappraisal evidently was taking place as to how much further the certificate of deposit movement should go. There was evidence that banks that had not used municipals historically were now using them effectively, while some banks had gone overboard, so the outlook was fairly mixed.

Turning to negotiable certificates of deposit, President Moorhead said it was his feeling that some banks were being restricted because certificate of deposit rates were so close to the 4 per cent ceiling. Banks whose certificates might not sell quite as well as those of the major banks could have difficulty in attracting funds even though they were willing to pay the maximum rate for short-term certificates. However, most Council members felt that the smaller banks, meaning the $100 - $500 million banks outside New York, Chicago, and the West Coast, were not particularly interested.

Mr. Cook commented that banks that had gone into municipals heavily would be faced at some stage with a decision, given the anticipated increase in loan demand, whether to sell tax-exempt securities--

probably at reduced prices--or borrow from the Federal Reserve or go into the certificate of deposit market. It might not be easy for them to adjust. Certificate of deposit money, he noted, was close to demand money. This raised the question of possibly trying to extend some of the maturities. A test of the stability of certificate of deposit money would be afforded by offering a somewhat higher rate for longer term certificates, thus determining whether people depositing this money really meant to leave it there or whether the money was as hot as some were inclined to think.

Mr. Moore commented that everyone was trying to gauge how hot the money in the certificate of deposit market actually was. He felt that New York banks were influenced in a peculiar way because they were trying to compete with both foreign and domestic money rates. Their certificates were somewhat easier to handle than those of lesser-known names, but otherwise he would agree with what Mr. Cook had said. There might be a problem soon if certificate rates moved up to the ceiling and the Treasury bill and commercial paper rates advanced. Certificates of deposit were going to look a little thin.

Mr. Watlington said that Fifth District banks were not in competition with the money center banks to any substantial degree because they were willing to let them have the certificate of deposit money. The 4 per cent ceiling was therefore not a matter of great concern to Fifth District banks, and he did not think they would like to see a change. The smaller banks had a tendency to make the maximum rate the minimum, and some might go to the new maximum almost automatically. This raised a question as to what the banks would do with the money in order to make a profit on it. Banks must make money or they would not be sound banks.

President Moorhead noted that some banks were finding it difficult already, and others would find it difficult soon.

Chairman Martin mentioned that a party had raised the question with him whether there was a possibility that negotiable certificates of deposit could be forged, and he presented this question to the Council.

It was indicated that the possibility had not been given too much thought. Mr. Watlington commented that when banks formerly invested in savings and loan shares, a number of instances developed where small banks held certificates that were forged. Mr. Smith commented that the possibility of forgery would apply to a lot of other things handled by banks as well as negotiable certificates of deposit.

Mr. Breidenthal expressed the view that a lot of questions tied into the answer that might be given on Regulation Q. Practices with respect to investments in tax-exempt securities and longer term business loans were linked directly to the question of what the banks did on their interest rate on negotiable certificates of deposit. When the certificates first came into prominence, there was talk of $4 billion of them, then $6 billion, then $8 billion, and now $10 billion. A lot of funds had been put into this category, and he thought the banking system was now vulnerable. If the rate should go up, this would have a definite further effect on the liquidity position of the banks. The legislation recommended by the Board to change the character of assets eligible for discounting at the Reserve Banks might be needed badly if the current movement should go much further because banks would be loaded with certain types of assets not presently eligible. Perhaps with a large amount of short-term foreign credits in this country, it was going to be necessary to have a more flexible rule to enable the banks that were in the field of handling those credits to be able to meet any rate problem, but this did not apply to the domestic situation. While mention had been made of standby controls over maximum interest rates, he did not know exactly what this implied. One of the largest banks in the country was advocating a 5 per cent ceiling, but if this ceiling was in effect throughout the country he did not believe the banks could invest their funds in such manner as to safeguard their assets in the way they should be safeguarded. He thought the banks had about reached the limit, unless all interest rates were going to be much higher than at present. One might say that if the ceiling was fixed at 5 per cent, or Regulation Q was placed on a standby basis, the problem could be left to the judgment of the banks themselves. It could be argued that the establishment of a higher maximum rate did not mean that banks generally had to go to the maximum. But he felt competition would take care of that. Corporate treasurers were shopping for as little as 1/8 of a per cent. In his opinion the banking system was vulnerable with $10 billion of negotiable certificates outstanding. He felt sure those funds would drain out of the banking system just as rapidly as the owners could find a more profitable use for them.

Mr. Watlington said he thought Mr. Breidenthal was correct. A large sophisticated bank possibly could do something useful with such funds. However, people would go to their local bank and insist on the same treatment. The unsophisticated smaller banks would accommodate them without studying the results; then they would wake up and find that they were running into a disastrous situation. This would undermine the soundness of many units in the banking structure.

On liquidity standards, President Moorhead said the Council members agreed that there had been a change in the make-up of bank assets. The volume of time money had inevitably led to lower liquidity standards.

Mr. Day said corporate treasurers had become so efficient in handling their money that they had gotten demand balances almost to an irreducible minimum. The base was a real one now, with few excess demand funds.

President Moorhead observed that in present circumstances demand deposits might really be more stable than time deposits.

Reverting to the question of negotiable certificates, Governor Robertson said that assuming the present interest rate ceiling was not at the moment a limiting factor on the very large banks, he wondered about the effect on the $200 - $500 million banks. Were they losing their time certificates? Was the money they had heretofore taken away from the major banks by offering higher rates now being pulled back?

President Moorhead said that, while he had no statistics, he supposed some of this was occurring. Mr. Watlington said it had already happened. Consequently, the smaller banks were doing without the money. To get it back they would have to pay more attractive rates, but he thought there was no great pressure to get it back. The smaller banks would rather let it go than to have to pay higher rates to get it back.

President Moorhead commented that something depended on how the money was invested. His bank, for example, would have been hard pressed to meet all the demands upon it except for the certificate of deposit money, and it had pulled this money away from the major centers. If it should go out rapidly, the situation would tighten quite quickly.

Governor Robertson noted that the Council expected commercial and industrial loans to rise moderately, and mortgage loans to expand further. Where were the banks going to get more funds?

Mr. McRae said that in the Sixth District there were many banks that did not care to compete for certificate of deposit money at rates available at New York and Chicago. However, several banks that he knew about were very aggressive in wanting time money at 3-1/2 per cent.

Mr. Cook said his bank had concluded at the end of the year that the rate differential was a sufficient deterrent to justify moving away from the certificate of deposit business. This meant that the bank would not be in the tax-exempt market in the near future. It felt that certificate of deposit money was too hot to lend on a long-term basis. It was thought that perhaps half of the certificate money could be put in portfolio, but the rest must be used in terms of matching maturities. Other banks of about the same size had also started to back away from the certificate business.

Mr. Watlington noted that his bank experiences a seasonal decline in deposits from this time of year until September. To offset that, the bank decided it wanted a fairly substantial amount of certificate money. It went into the market and got it, at only a slightly higher rate than the New York banks were paying. The bank was able to get the money from the same people who were giving it to the New York banks, one reason being that national companies feel some obligation toward the local banks in return for various favors that are done for them.

Mr. Moore suggested that the outstanding certificates, in the amount of over $10 billion, might represent a good deal of money that was back in the banking system after having been elsewhere. The banks were finding that many parties other than banks, including corporations, were in the business of financing many things. It was his feeling that the banks would have to bid for deposits and pay for them from here on in; that this would be the only way to finance a general expansion of loans.

Chairman Martin inquired whether any members of the Council were in favor of paying interest on demand deposits, and there was no indication to such effect.

Mr. Day commented that with demand deposits almost static and loan demands rising, banks were practically pushed into the area of time money to stay in business.

Governor Robertson inquired about the reported practice of paying a finder's fee for negotiable certificates.

Mr. Martin replied that he had heard the practice was developing and that he would like to know more about it. Mr. Moore said he also had heard of it, but he did not know of any larger banks that had resorted to the practice.

Governor Robertson inquired about the percentage of the $10 billion of negotiable certificates outstanding that might be regarded as quite stable, and one of the members of the Council expressed the view that 25 per cent might be a fairly good guess. Other estimates ranged higher or lower.

Governor Robertson commented that there were banks in the Tenth District that were now losing funds. Originally they took money from the major banks by paying a higher rate on certificates. Now the major banks had moved their rates up, so these Tenth District banks were losing funds.

Mr. Breidenthal replied that he did not believe there was a bank of significance in the leading cities of the District that was not going after certificates of deposit and paying 4 per cent. If the ceiling were raised to 5 per cent, he expected that some of them would attempt to retain those funds by meeting the competition.

Governor Mills asked whether it was not a rather generally accepted proposition that the funds attracted by issuing negotiable certificates could be employed at a profit only by going into mortgages.

President Moorhead commented, on this point, that he did not believe banks should go after time money merely to employ those funds in ways in which they would not ordinarily put their funds to use. A sounder approach was to try to attract the money to meet ordinary loan demand. Mr. Watlington inquired as to the purpose of putting the money on the books if there was not a worthwhile result from it. Mr. Day said that his bank was budgeting substantial expansion in the consumer credit area. There was a logical basis for paying 4 per cent for funds to be used in this manner.

Reverting to the question as to how much of the negotiable certificates actually represented savings, Mr. Moore said that he did not think his bank would consider a dollar of its certificates as such, and Mr. Smith agreed. Mr. Hickok commented that if the certificate business had become an accepted way of life--one that had to be maintained at any price--the banks had gotten themselves into a bad situation. Mr. Aston said he thought it was indeed a way of life, but obviously not at any price. The profitability was taken out of it if banks paid beyond a certain price. But they had to react defensively to keep their customers; if it were not for the availability of certificates of deposit, a bank might lose customers. The whole banking business of today was a single competitive unit. His bank was calling on customers over the country, and so were the New York banks. His bank must remain competitive, although not at any price. Mr. Breidenthal commented that the qualification was important. The cost of the time money had to be kept under control.

On the question of putting the regulation of interest rates on a standby basis, Mr. Day expressed the view that if any standby arrangement was put into effect, that should be done at a time when there was no substantial pressure on rates. Any significant upgrading of rates abroad might force similar action in this country, and he did not think the Federal Reserve could afford to keep the present ceiling in effect if negotiable certficates actually started to flow out of the banks rapidly, for there would be a terrible competitive scramble.

President Moorhead expressed apprehension that if the maximum rates were inched up, the new maximum would become the prevailing rate. On the other hand, bankers had not shown much ability thus far to run their own lives. If the ceiling rate was 6 per cent, somebody conceivably might offer 6 per cent on a certificate of deposit. That was the dilemma the Council found itself confronted with in endeavoring to answer this question.

Governor Balderston commented that if a large proportion of the negotiable certificates outstanding should be lost, the impact on the municipal market no doubt would be severe. He suggested the possibility that the maximum rate on certificates now held by the banks might be raised to some higher level, for example, 4-1/4 per cent, with a 4 per cent maximum rate retained on any new funds obtained through the issuance of negotiable certificates.

Mr. Moore asked whether this implied that other interest rates would not move at the same time. He would hate to think that banks would not be able to bid for any new money as it came along.

Governor Mills suggested that if there was a run-off of negotiable certificates, the money might not leave the banking system in the absence of a general contraction of credit, and instead merely be reallocated among the banks. It might be that some who had taken on certificates would feel a pinch and have to resort to emergency credit to carry them through. But whoever cashed in the negotiable certificates would have funds that would come on the market for investment. One could not know where the pressure would be felt, but if it was on the mortgage field, for example, mortgage lenders presumably would be compelled to reduce the rates they were offering. The whole rate structure would then soften to a degree that at some point would affect the rates being paid on negotiable certificates. If it were possible to work through those difficulties, the situation might be solved whereas it would be aggravated if rates went on up on a competitive basis.

Referring to Governor Balderston's suggestion, President Moorhead brought out that at some point the outstanding negotiable certificates would mature. It might be that the holders would not want to renew them, and he did not see how the banking system could retain the present $10 billion. Mr. Day added that if the short-term rate in England, for example, was sufficiently attractive, money could leave the American banking system rather quickly.

Chairman Martin commented that this was a point of concern to the Board. The Board did not want to encourage the negotiable certificate market unduly, but the question was how to get out of the bind.

Governor Mills inquired whether domestic funds were not moving into Europe in substantial volume through the channel of credits extended by the same banks that were attempting to attract European time money through ability to pay a higher rate. The banks guilty of stimulating the outward movement were the same ones complaining about inability to hold funds in this country.

Mr. Day commented, on this point, that the corporate treasurer would take money wherever he got the best rate and the funds did not always cross.

Governor Robertson asked the Council to suppose that the banks had to put the rate up to keep funds from moving out of the country. According to the Council's statement, it was anticipated that the demand structure would pretty much tend toward stability. He suggested that the interest rate ceiling might be raised for a percentage of each bank's total savings deposits, or total deposits. On that portion of total deposits, a bank could pay whatever it wanted to pay. But the maximum rate on the remainder would be held down.

President Moorhead said he thought the suggestion had merit, not only from the monetary standpoint but from the standpoint of the banks.

Mr. Watlington felt that it would be relatively easy to understand and enforce. If the banks could have a certain percentage of total deposits in certificates, it was reasonable to believe that they could invest such funds profitably. However, if they got too much into negotiable certificates, that could affect their profitability.

Governor Balderston then stated that he thought Governor Robertson's suggestion for enabling banks to defend themselves, as opposed to seeking additional funds aggressively, was more feasible administratively than his own suggestion. It would permit some further expansion of the $10 billion outstanding. Those banks that were not up to a certain percentage of total deposits could bid for and take on more certificate money, whereas those already at that level would be estopped.

3. Foreign lending by U. S. banks.

A. What is the current situation with respect to foreign demand for loans from U. S. banks?

B. What does the Council anticipate with respect to such demands in coming months?

A. The Council reports a strong foreign demand for loans from U. S. banks.

B. The Council anticipates that the demand for such foreign loans will continue strong in the coming months. However, should the domestic demand for credit expand as the level of business activity rises, the resulting pressure on bank reserves may make banks in the United States less willing to expand their foreign loans.

Mr. Cook said that in the case of certain foreign countries the U.S. banks in the habit of lending to them had now lent about as much as they felt they should. The Japanese, however, were going through the country soliciting loans even from banks that were not customarily foreign lenders. At some point, such banks might say that the foreign loans did not suit their purposes, and other banks must stand by and protect the exposure of the American banks. This was a reason why a well-entrenched bank should hold back on more foreign loans; it should have a little reserve to pick up the slack that might develop later on.

Mr. Day said that the interest equalization tax proposal had had the effect of putting pressure on two-year, eleven-month bank credit to developed countries. The Japanese, in particular, were trying to finance longer term expansion through the banks to avoid the tax.

On the matter of rates moving up abroad and inducing an outflow of funds from this country, Governor Mills suggested that a firming of rates by foreign authorities presumably would reflect inflationary or distressed financial conditions in the particular countries. Would American businesses be so interested in a rate differential that they would take the risk that was indicated?

President Moorhead replied that he thought they could protect themselves against a cheapening of the foreign currency and therefore they might be interested. Mr. Day said that if they could hedge their money, they would be happy to put money in all European countries if they could obtain a rate differential.

Chairman Martin inquired whether, if rates went up 1 per cent in England, it was felt that American funds would be likely to go into England in volume.

Mr. Martin replied that this would suggest the necessity for a rise in the Federal Reserve discount rate. If European countries had substantial further increases in their rates, a chain of circumstances would be set up, thus placing before the Federal Reserve the question of an immediate increase in the U.S. discount rate. The whole situation, including the Regulation Q question, would be back where it was a number of months ago.

Mr. Cook suggested that there would be no objection on the part of banks if interest rates paid increased provided interest rates earned also increased, and Mr. Martin observed that it was a one-sided proposition. Even the consequences of an increase of 1/2 per cent in the short-term rate structure did not affect bank lending rates much at all.

Governor Robertson inquired whether anyone felt that the balance of payments situation was so serious that steps should be taken to restrict bank loans to meet foreign demands, and Mr. Cook observed that such loans did not upset the balance of payments as much as one might think. They might have that effect temporarily, but the situation would adjust itself. Governor Daane observed, however, that if there should be simply a substitution of bank loans for long-term credit from the U.S. capital market, obviously there would be no net gain through the imposition of the interest equalization tax.

Mr. Moore suggested that there might be a lot of two or three-year loans with a balloon at the end of the final year. Asked whether the two-year, eleven-month loans were taking that form, Mr. Moore said he had not seen too many yet, but he thought the tendency was strongly in that direction. He felt the banks had to be careful on that score. It was hard to pick out what was a loan and what was not.

Mr. Martin commented on the volume of credit extended to Germany prior to 1931 with inadequate knowledge of developments on the part of the lenders. The situation today seemed somewhat similar, with inadequate knowledge as to what was being done in terms of bank loans to foreigners. In situations like that of Japan, American banks were extending credit to a country when they had no idea of its total liabilities. There were pieces of information, but no valid understanding as to the course of events in Japan. Banks were seeking income, and on the theory that the Japanese economy was prosperous, they were going ahead and extending large loans. He wondered whether something could not be done to provide better information.

Governor Daane observed that there were two questions involved in Mr. Martin's comments. The first related to the possibility of developing more information on the total liabilities of particular foreign countries. The second related to obtaining data on the volume of credit extensions by U.S. banks. On the latter, the Treasury was developing a reporting program in response to a request from Congress in connection with consideration of the interest equalization tax proposal. He did not know the precise status of this program at the moment. In any event, however, these data would not provide an answer to the first question.

4. Monetary policy.

What are the Council's views regarding the effectiveness of recent monetary and credit policy?

The Council believes that recent monetary and credit policy has been effective. Domestic business activity continues to rise while our balance of payments situation has been maintained since mid-1963. However, should the anticipated tax cut strongly stimulate business activity and create inflationary pressures, a policy of credit restraint would be warranted.

There was no discussion of this topic, it being noted that several aspects of it had been covered in the discussion of the preceding topics.

Absorption of exchange. Chairman Martin and Governor Balderston referred to the position advanced vigorously to the Board over recent months by a State member banker that the Board's present position on absorption of exchange charges served to place State member banks at an inequitable competitive disadvantage, not only in relation to nonmember banks but also in relation to national banks because of the lack of enforcement on the part of the national bank examiners.

President Moorhead inquired whether there had been opportunity as yet to discuss the problem with the new Chairman of the Federal Deposit Insurance Corporation, and it was indicated that this would be done in due course.

Mr. Watlington said that from recent conversations it was his conclusion that despite the existing situation, including the lack of enforcement efforts applicable to national banks, a great majority of bankers in the Fifth District felt strongly that the Board should not change its present position, primarily for two reasons. First, member banks had an opportunity to say that they were not allowed to absorb exchange, and as a consequence many corporate treasurers understood the situation and continued to do business with those banks. Second, if smaller banks were allowed to absorb exchange, the additional expense would place a substantial hardship on them. It was interesting that some of the larger correspondent national banks were adhering to the rule on their own accord, although the Comptroller was not enforcing it. The general situation, he thought, was better than a year ago, with the number of nonpar banks generally being reduced. If the Board were to change its position, he felt that the situation would retrogress. Member banks had been working under this competitive hardship for many years. It would be a greater hardship to go back and start all over again, and the continuation of the Board's present position offered hope for the gradual elimination of nonpar banking. A legislative approach did not seem feasible.

Mr. Martin reported on current discussions within the ranks of the American Bankers Association and the Association of Reserve City Bankers. He reported that a group from the former Association was planning to call upon the Chairman of the Federal Deposit Insurance Corporation. It was understood also that the incoming President of the Association of Reserve City Bankers was going to try to get that Association to face up to the problem this spring.

Eligible paper. Chairman Martin commented that the Board would appreciate any support that the Council members might feel was warranted for the proposed legislation to broaden the base of Reserve Bank lending to member banks.

It was agreed that the next meeting of the Federal Advisory Council would be held on April 22-23, 1964.

The meeting then adjourned.

Secretary