Minutes for May 18, 1965.

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. Robertson R

Gov. Balderston CCB

Gov. Shepardson

Gov. Mitchell

Gov. Daane

Gov. Maisel

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., at 10:30 a.m. on Tuesday, May 18, 1965.

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

Mr. Sherman, Secretary
Mr. Kenyon, Assistant Secretary

Messrs. Martin, Moore, Day, Stoner, Watlington, Fleming, Smith, Hickok, Moorhead, Knight, 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 Council
Mr. Korsvik, Assistant Secretary of the Council

There had been distributed a memorandum listing the topics to be discussed at this meeting, together with the statement of the Council on each. The topics, the Council's statement on each topic, and a summary of the discussion at this meeting follow.

1. Economic conditions and prospects.

A. How does the Council appraise the general outlook for the U.S. economy during the remainder of the current year?

The Council believes the general outlook for the U.S. economy during the remainder of the current year is favorable. While some adjustments in steel and auto production and in the rate of inventory accumulation are probable, these are not likely to have a significant effect on business activity before the end of the year.

President Moorhead said it was difficult for the Council to find any soft spots. There seemed to be such general agreement with this view that unless the Board members would like to discuss the topic it might be in order to proceed to the other topics on the agenda.

B. What are the implications of the extension of the steel labor contract for inventory accumulation, industrial activity, prices, and wage settlements in other industries?

The full implications of the extension of the steel labor contract cannot be forecast. However, a number of members of the Council believe that some further inventory accumulation is likely by those firms which were unable to accumulate the stocks they desired prior to May 1. Furthermore, as it is unlikely that steel users will begin to pare down their previously accumulated stocks until the threat of a strike is eliminated, a continuation of a high level of steel production and industrial activity in general is anticipated. This chain of events enhances the prospects of some further strengthening of industrial prices. The Council is uncertain as to the implications of the extension on wage settlements in other industries. To the extent, however, that the decline in steel production, and possibly industrial activity in general, is pushed into the future, wage settlements probably will be more generous than they might otherwise have been.

Mr. Smith said this was obviously an important question, yet hard to answer. Many businesses had as much inventory as they wanted, but a number were still accumulating stocks in order to be on the safe side. It was hard to tell how much accumulation was still going on. As to the terms of the ultimate wage settlement, no one of course could tell. However, the fact that the settlement date had been postponed seemed to indicate that the heating of the economy would go on and there would be more pressure on prices. Activity in steel in the Seventh District was tremendous, with one steel company reportedly operating at something like 140 per cent of capacity. There did not seem to be as much apprehension about a strike as might have been anticipated. High production rates were putting pressure on costs, but the companies were making good money.

C. Are businesses becoming uncomfortable with present inventory levels relative to sales?

There is no evidence to date that businesses are becoming uncomfortable with present inventory levels relative to sales. Although inventory accumulation has been substantial in recent months, the continued increase in sales has held down inventory-sales ratios.

President Moorhead said that while statistics indicated very substantial inventory accumulation, the Council felt that no one was particularly worried. Inventory-sales ratios were not out of line. However, a slight turndown in sales could bring about concern.

Mr. Cook commented that in the Twelfth District there was heavy inventory accumulation in certain industries. Farm equipment inventories were quite heavy, and it seemed that auto inventories would have to be worked down rather soon because of the approaching model changeover. Generally, however, excessive inventories were not apparent. There seemed to be a good bit of imported steel in the steel inventory accumulation, and the financing was reflected in bank loans. Thus, when a steel wage settlement occurred, there would have to be not only a using up of steel manufactured in this country but imported steel as well.

1629

2. Banking developments.

A. After expanding vigorously in the first quarter, business loans appear to have moved erratically in April. Does the Council feel that the peak may have been reached for this year, or are demands likely to persist or even intensify? To what extent do recent credit demands represent temporary borrowing for inventory needs, as contrasted with longer-run needs to finance plant and equipment expenditures?

In view of the probability that business activity will continue to rise, although less rapidly, the members of the Council believe that the peak in business loans for the year has not yet been reached. With expanding business activity, inventories and receivables are likely to continue to rise, requiring further increases in bank credit.

Although the evidence is not conclusive, most members of the Council believe that recent credit demands have been broadly based. This has included borrowing to carry accounts receivable, term loan financing of plant and equipment, an expansion of consumer credit, and borrowing for inventory needs.

Mr. Day said the Council's statement reflected accurately the situation in his area. Yesterday, in meeting with the Council, a member of the Board's economic staff indicated that in his judgment the period of greatest loan demand might be behind. This was at variance with the thinking of the Council, but the point was an important one.

President Moorhead observed that if the Council was right in its thinking about the economic outlook for the balance of the year, this could scarcely help but bring about an increase in bank loans above the existing high level.

Mr. Martin suggested starting with the assumed inventory increase in April. If that rate of increase was extended on an annual basis, one would get a fantastic figure. The fact that bank loans moved erratically in April was not hard to understand because the total impact did not hit all at once. Bearing in mind that bank loans tend to follow the inventory curve rather closely, it was hard to imagine that there would not be a strong loan demand ahead as the inventory accumulation was worked off.

Asked about the financing of commercial construction as a factor in total bank lending, Mr. Martin said that in the First District construction credit demand was very strong and showed no sign of slackening. Further, this was not confined to the largest city in the area; it was typical of representative towns throughout the District.

Question was raised whether the Council felt that the projected increase in plant and equipment expenditures would have to be financed primarily through bank credit. President Moorhead replied that in the view of the Council banks were extending a disproportionate amount of the lending to finance plant and equipment. This might level off as corporations turned to long-term lenders, but to date the banks were financing more than their normal share.

Asked whether it appeared that the internal flow of corporate funds had been fairly well absorbed, President Moorhead said it was possible to get a somewhat distorted view of cash flows by looking at the very large corporations. In smaller businesses the flow did not take care of plant and equipment expenditures.

Mr. Martin commented that before the voluntary foreign credit restraint effort was instituted some First District companies had sent substantial amounts of money out of the country. This caused them to borrow over the March tax date. Looking from there to the contemplated plant financing requirements, it could be expected that there might be a further stimulus to borrowing. Whether this was general around the country, he did not know.

Mr. Moore reported that loan demand continued to be very brisk across the board in the New York area. Only two out of a dozen or so people he had talked with before this meeting felt that the demand might have peaked. A good deal of the plant and equipment expenditures seemed to be for additional capacity rather than modernization, thus showing a little different emphasis than in the recent past.

Asked whether companies appeared to have achieved about as much modernization as was feasible, Mr. Moore said it would be dangerous to generalize. In the steel industry, for example, there was a long way yet to go in modernization. He had simply meant to observe that in the past few years loans for plant financing were not so much for additional capacity as for streamlining present plant. Now financing to expand capacity was coming in more than formerly.

Mr. Day referred to the situation in the railroad industry, which was modernizing extensively while cutting back plant, while Mr. Smith commented on large plant expansion programs in the Chicago area.

President Moorhead observed almost every company up for renewal of its credit line wanted an increase simply on the basis that it expected to do more business. This was, in his experience, the principal contributing factor to heavier loan demand, with plant and equipment financing a secondary factor.

B. According to the March quarterly interest rate survey, bank lending rates were generally stable. However, another survey indicated considerable firming in lending policies and practices among larger banks, particularly with respect to interest rates and compensating balances. Would the Council care to comment on the reasons for this seeming inconsistency?

Most members of the Council report little evidence of any firming of lending policies with respect to interest rates, terms, and compensating balance requirements. There has been no firming of rates for prime customers, and an increasing number of them are finding it necessary to borrow. The few increases in rate that have occurred have been highly selective. In several districts members report some firming of lending policies and practices.

President Moorhead said it appeared that banks, being unable to move up the rate for prime customers, were attempting to edge up rates on other loans. The effect was so small that it did not show up in the average figures. Nevertheless, he thought there had been an effort to increase rates and to be more selective in the types of loans taken on.

Mr. Fleming commented that the prime rate had been maintained at 4-1/2 per cent while other short-term rates were moving up. Many customers with lines of credit that they had not previously used were now coming in for the full amount because they liked the 4-1/2 per cent rate. There had been no change whatever in the terms of financing for those customers, but for practically all other customers the banks were trying to put the credits on a more profitable basis.

Chairman Martin inquired whether there was discussion within the banking community of an increase in the prime rate, and Mr. Fleming replied that there was no discussion whatever. The banks felt they were stuck with a rate that was unrealistic and below the market. The average rate was weighted by the fact that prime rate borrowings were by the largest customers.

In reply to a question, President Moorhead said he had heard that there was more negotiating in an effort to move customers away from the prime rate. However, it was hard to move a customer off the prime rate. Pride and similar factors were involved. Most of the success in increasing rates had come not in this area but in moving borrowers from, say, 5-1/2 to 5-3/4 per cent.

Governor Robertson inquired whether the time was not coming when there would no longer be a prime rate. President Moorhead replied that he thought there would always be a prime rate whether it was called by that name or not. In other words, there would always be a best rate. Mr. Day agreed, saying there would always be a rate that the best borrowers would get whether or not it was called the prime rate. Mr. Fleming suggested that this might be referred to as the floor rate.

Mr. Cook observed that many term loan contracts contained provisions geared to the prime rate. He added that there had been times in the past when the prime rate was too high; for example, banks might have been getting 4-1/2 per cent while the market was perhaps 4 per cent. This was a reason so much business had been diverted to other lending institutions, but these credits had now been brought back into the banking stream.

Governor Robertson inquired why the prime rate had to be left in contracts, and Mr. Cook said that this presented a question of alternatives. The discount rate might be used, but sometimes this got away from the market, and he would not want to leave the matter open for negotiation. It was hard to find a substitute for the prime rate.

Governor Robertson nevertheless hazarded a guess that within a few years contracts would no longer make reference to the prime rate. In his opinion the prime rate concept had become obsolete, and he felt that some substitute would be found. This might mean the same thing as the prime rate, but it would not be so called.

Mr. Martin observed that years ago there was no prime rate. The press had fallen into use of the term. The banks had picked this up and were now stuck with it.

Mr. Fleming said too many customers considered the rate of interest at which they borrowed as an indication of their worth, whereas the important factor was the rate of profitability to the bank.

Mr. Aston reported that total loans were up in his area. It was difficult to move customers away from the prime rate, but there was more selectivity and a pushing of rates up here and there through negotiation.

Mr. Knight commented that his bank could not do a thing with the prime-rate customer, basically because it usually had to follow some participation, but for other customers the bank had been able to obtain a little better rate. Therefore, the average rate had gone up a bit. The bank was able to improve the rate when its position was strong; when the borrower was strong, the bank did not do so well.

Mr. Moore referred to 4-1/2 per cent as having been about in the middle of the rate structure. Prime customers had been sought out by insurance companies and other lending institutions. Also, lenders such as insurance companies had been coming down to loans of shorter maturities because they had so much money to work with. In addition, there was some possibility of financing in the public market, where rates had been around 4.40 or 4.50 per cent. Therefore, the 4-1/2 per cent prime rate had been pretty much in the middle. Any higher rate might drive certain borrowers away from the banks.

Mr. Aston observed that a number of individuals and smaller corporations also were quite interest-rate conscious. The most persuasive part of his bank's argument on rates was a showing that the cost of its inventory had gone up considerably. His bank had about 45 per cent of its total deposits in the time and savings account area, whereas ten years ago this was less than 10 per cent. When such a line of reasoning was presented, in many instances there was no resistance on the part of the borrower to a small rate increase.

Mr. Fleming reported substantially the same experience, but Mr. Smith said that in Chicago there had been no success in attempting to raise rates.

Mr. Hickok asked Governor Robertson whether the latter's reasoning on the prime rate derived from antitrust considerations or practical banking considerations. Governor Robertson replied that he had not been thinking of the antitrust aspect. It was merely his feeling that the banks tended to get in a box by using a prime rate that was not realistic. He thought the practice would give way to one of making loans at whatever rate was called for in given circumstances. In the absence of a prime-rate criterion, banks would be more free to adjust their rates as they wanted and as called for by the situation of the particular customer with whom they were dealing.

Mr. Watlington suggested that bankers were poor salesmen on interest rates and tended to wilt when anyone brought up the subject. If it were not for the prime rate, he did not know where the banks would be. In this sense he would hate to see the prime rate go, because the situation might develop into a debacle.

President Moorhead reported that an informal poll within the Council had suggested that the composite rate on loans was up very slightly; however, Mr. Fleming said his bank's composite rate was

1637

down because of the larger percentage of prime-rate customers that were borrowing.

Mr. Watlington referred to a recent informal survey within the Association of Reserve City Bankers which indicated that there had been some deterioration in the quality of credit. However, he understood practically all of the participants maintained this had not occurred in their own case.

Governor Balderston suggested that this implied a decline in the real price of money; banks were making loans at the prime rate that were less good than those made at the same rate a few years ago.

President Moorhead replied that more customers were now on the prime rate than a few years ago, to which Mr. Watlington added that more were on the prime rate than deserved it. Governor Balderston asked whether this did not mean the price had gone down for loans of the same quality, and there were several expressions of agreement.

C. The dollar volume of negotiable certificates of deposit outstanding at banks outside New York City has recently shown little net change. To what extent does this reflect inability to sell certificates under Regulation Q ceilings, and to what extent unwillingness to issue them?

The change in the dollar volume of negotiable certificates of deposit outstanding at banks outside New York City reflects largely the unwillingness on the part of many banks to issue them at the present market, in view of current lending rates to prime borrowers, rather than to the ceilings imposed by Regulation Q. An additional factor is probably at work, namely, the increased hesitancy on the part of many corporate treasurers to place deposits in smaller banks. Other limitations are the 4 per cent interest ceilings in a number of States and the regulation restricting the amount of S & L C/D holdings in a single bank.

Mr. Stoner commented that his bank had not issued any negotiable certificates of deposit because it did not feel that it could make money on them.

Mr. Martin noted a prevailing feeling among bankers that there was an "administered" 4-1/2 per cent rate, with a good deal of concern as to where this would lead. The banks were making money; 1964 was a good year. The question the investment man would raise related to the quality of the earnings, and this had a lot to do with tax-exempt municipal securities. It was not all the result of good management. The banks were unable to move rates in the commercial and industrial loan area, where the 4-1/2 per cent rate was involved, and further additions to certificates of deposit had become somewhat questionable because of the potential volatility of this money. In sum, the banks had been making money because of their holdings of tax-exempt securities, along with their loan and mortgage portfolios to a certain extent.

President Moorhead said there was no question but that with the certificate rate very close to the ceiling a lot of banks outside of the money centers had gone out of the market. In addition, the Comptroller of the Currency had said he was instructing his examiners to take a good look at banks with more than 10 per cent of their deposits represented by certificates, and this may have given some national banks pause. But the principal factor was that it was difficult, in fact impossible, to pay 4-3/8 per cent for money, loan the money at 4-1/2 per cent, and come out ahead.

Mr. Cook made the comment that as long as Regulation Q was in effect there would be at some point the question whether money obtained through the issuance of certificates of deposit would always be available. As the effective rates moved closer to the ceiling, there was a tendency for many banks to rely less on certificates, feeling that the New York and Chicago banks had an advantage in attracting these funds. Consequently, for banks outside those cities, the principal concern was with the supply situation.

Chairman Martin inquired about the selling by banks of so-called "savings bonds," and Mr. Watlington referred to a bank in Atlanta that he understood had been generating a substantial amount of money through the sale of such instruments. However, this had created an adverse reaction on the part of some other banks. Generally speaking, holders of the "savings bonds" were required to keep them for five years to obtain the full rate of interest.

Mr. Fleming said his bank had been selling such instruments with considerable success. However, a ruling by the Internal Revenue Service that tax on the income from the securities would have to be paid every year rather than at maturity had created a problem. In addition, in the State of Tennessee there was a prohibition against paying more than 4 per cent on savings deposits. This provision of law, which was also in effect in certain other States, had forced the banks in those States out of the market as far as negotiable certificates of deposit were concerned.

D. Does the recent trend in city bank mortgage acquisitions reflect more a reduced availability of mortgages or a changed attitude toward mortgage loans?

The members of the Council believe that the recent trend in city bank mortgage acquisitions reflects largely less willingness on the part of banks because mortgage rates and terms are not as attractive as previously.

President Moorhead commented that banks still liked mortgages, but not at current rates. Savings and loan associations, insurance companies, and others had large amounts of money to invest in mortgages, and rates had been driven down to the point that mortgages were no longer so attractive to banks.

Mr. Cook noted that West Coast banks had traditionally held large volumes of mortgage loans in their portfolios, and there was a need to roll them over continually. The banks had experienced some difficulty in doing this for the supply of mortgages was not quite so great as elsewhere and the demands upon nonbank lenders were not so high. The standard rate for mortgage loans on single-family residences continued to be somewhat higher than in other parts of the country.

Mr. Watlington commented that some banks had gotten fairly well loaded with mortgages in the recent past and therefore were not eager to expand their holdings further.

E. To what extent has reduced bank liquidity associated with the substantial reduction in Government security portfolios become a factor that might inhibit accommodation of future loan demand?

The members of the Council believe that the reduced bank liquidity associated with the substantial reduction in Government security portfolios is becoming a more important factor inhibiting the accommodation of borrowers. However, this may be a somewhat less limiting factor than in the past, inasmuch as many commercial bankers feel they can continue to obtain funds to accommodate borrowing customers by use of the C/D and/or short-term notes. There is no evidence currently of any general increase in rates or of the rationing of credit.

President Moorhead said there was quite a difference in emphasis from one district to another. In the Ninth District the situation was tight, and lending by banks might be inhibited.

Mr. Day indicated that this was also true in the Third District, where the holdings of Government securities of some banks had been reduced close to the amounts needed to secure public deposits. The issuance of certificates of deposit had alleviated the situation somewhat, but many banks no longer had a great deal of leeway because of pledge requirements.

President Moorhead said there had been discussion by the Council as to whether some banks were relying too heavily on their municipal portfolios for liquidity. There was general agreement that if banks had to sell municipals in volume it would probably be necessary to take heavy discounts.

Mr. Moore referred to the substantial switch from Governments into tax-exempt securities and mentioned that it was necessary to look at the whole investment portfolio mix, including maturities, when thinking of liquidity. He saw no signs yet in the New York area that lack of bank liquidity had been an inhibiting factor in meeting credit demands.

Asked about the use of tax-exempt securities as collateral for public deposits, Mr. Watlington said this could be done to a substantial extent in North Carolina. His bank was doing a great deal of it despite the administrative inconvenience involved. President Moorhead said he understood that municipals could be used to secure tax and loan accounts in all States. Mr. Day observed that municipals were generally held in rather small lots, which contributed to administrative inconvenience, and Mr. Fleming said one deterring factor was the cutting of coupons. Many banks were switching into registered bonds.

Governor Balderston observed that since 1962 commercial banks had taken about 80 per cent of the net addition to municipal issues outstanding. He asked whether the Council foresaw a significant problem, deserving of study by the Board, relating to the possibility of commercial banks having to sell municipals in quantity at some stage.

Mr. Moore replied that if banks were unable to attract additional certificates of deposit, loan demand continued strong, there was no change in Regulation Q, and banks started to think about liquidating their tax-exempt portfolios, a problem could arise rather quickly. The banks would be able to move their municipals at a price, but they might take substantial losses, particularly if they were selling during a period of credit restraint.

Mr. Fleming referred to a Supreme Court decision announced yesterday that would appear to have the effect of making tax-exempt securities less attractive to insurance companies. He added that if a situation should arise where banks were forced into substantial selling of municipals, this would raise the question what accommodation they would be given at the Federal Reserve discount window.

Mr. Cook referred to the increased supply of municipals and asked where it could reasonably be expected that this supply would be lodged if insurance companies were deterred from buying on account of the Supreme Court decision.

Mr. Martin commented on the fact that for years banks had operated on a version of liquidity that was dependent on a secondary reserve formula. If holdings of Governments were way down, the tendency must be to accept some part of the municipal portfolios within the definition of secondary reserves. There were differences of opinion on the extent to which this might be true.

President Moorhead said it was the Council's general feeling that while accommodation of loan demand had not thus far been seriously inhibited, if there should be another increase in loan demand comparable to that in the first quarter, the banks could have a serious liquidity problem with their Government holdings at a minimum.

Governor Balderston referred to the comments of Mr. Cook about Regulation Q imposing a restraint on banks in their search for funds. He inquired whether this line of argument would not, however, lead to the proposition that if Regulation Q were removed, banks still could not pay more for funds as long as the composite rate on loans was fixed by virtue of competition from other financial intermediaries.

President Moorhead replied that the existence of Regulation Q meant that the banks were dealing with a money market instrument with a definite ceiling, which tended to make everyone uneasy. There might be situations where, in order to retain good customers, banks would go out and pay for funds at a rate that precluded profitability. With Regulation Q in existence the banks were not sure whether they could always renew outstanding certificates.

Mr. Cook said that in the absence of Regulation Q the banks would not have to resort to their holdings of municipals for liquidity so quickly. The banks felt an obligation to take care of their customers even though this might involve the sale of investments or paying higher rates for money. This would eventually force lending rates up, but the pressure would be somewhat less on the municipals if Regulation Q was not in effect.

Mr. Day commented that the plethora of long-term funds also contributed to the problem. He agreed that the banks would have more flexibility if Regulation Q was not in effect.

3. How does the Council appraise the results of the voluntary foreign credit restraint effort to date? Does it appear that the priority credit needs--for financing exports and less-developed countries--are being reasonably met? Are there any substantial changes in the guidelines, either for banks or for nonbank financial institutions, that the Council would recommend? Is there any evidence that the program is having a seriously detrimental effect on the ability of U.S. banks to attract or retain foreign deposits, or to perform other banking services for foreign clients?

Are there any other views or suggestions the Council would like to offer regarding the future administration of the program?

The members of the Council believe that the voluntary credit restraint program has tended to reduce the outflow of funds. It is doubtful that the priority credit needs--for financing exports and less-developed countries--are being fully met because of prior commitments and the 105 per cent ceiling. Accordingly, it is suggested that consideration be given to the problem of the financing of exports.

As loans guaranteed by the Export-Import Bank or FCIA are exempt from the 105 per cent limitation, some loans which would have been made without such guarantees are being routed through these agencies with delays and higher costs to the purchasers of American goods.

In general, U.S. banks are retaining foreign deposits, although this may become more difficult as the program becomes increasingly effective.

The Council believes it is inappropriate to request the banks to administer the revision of Guideline 13, circulated on April 29. The Council would welcome the opportunity to discuss this matter with the Board.

The Council would be interested in any comments the Board would care to make as to the steps that are being undertaken to meet the balance of payments problem after the voluntary restraint program ends.

Mr. Moore said that he had been, and continued to be, completely in favor of the voluntary approach to foreign credit restraint. He did not know of anything else that would have done the job quickly enough to meet the emergency. As the program went on, however, and the original impetus passed, serious questions were arising for the future. It was hoped that the banks could play a significant role in export financing, which in turn would help the balance of payments. Apparently, however, the banks were going to be limited more than had been expected in this type of financing. The thought had been that there might be enough leeway under the 105 per cent target to finance export trade. But substantial quantities of prior commitments and other deals had been entered into that the banks were more or less honor bound to meet, with the result that there was now some question whether what had been hoped for on the financing of exports was necessarily going to be true. The situation would have to be watched carefully.

Mr. Moore went on to say that the banks were doing their level best to try to get down within the 105 per cent target and also observe the priorities outlined in the commercial bank guidelines. Basically the program made a lot of sense, but there was a question whether exactly the right formula had been achieved and whether exports were going to be taken care of fully. Exemptions no doubt were being sought continually, and obviously all of these exemptions could not be granted if the program was to be successful. Not unsurprisingly to him, the program had done well to date, but it seemed necessary to find a means of getting the program out of the way before too long, or of placing it on a somewhat different basis. It was all right in an emergency to take customers to foreign banks, perhaps, but some of this business had been built up over a long period. In many instances, even in the absence of a formal arrangement, these customers had had their needs taken care of over a period of years.

Mr. Moore said he was making no special plea. He simply felt that another solution must be found if the banks were going to continue to do business in anything like the accustomed manner. As to the revised guideline 13, it was very difficult for the banks to administer. It was his feeling that the uses made by domestic corporations of credit extended to them should be covered under the part of the voluntary program administered by the Commerce Department.

Mr. Cook referred to lines of credit extended in past years that had been used in some cases and not in others. When the current situation developed, he said, there was a rush to use these lines of credit. Some financing had been done for countries in the Pacific area to cover the movement of goods that never came to this country, for example the shipment of cotton and wool from Australia to Japan and the shipment of copra from the Philippines to Europe. The countries concerned had been counting on this type of financing for a long time. Bank of America was perhaps presented with the greatest dilemma because of its extensive operations of this kind, but other West Coast banks also were experiencing difficulty with the 105 per cent target because they were heavily committed. As an additional complicating factor, there were some situations involving participation by several banks. He did not feel it was the intent of the Government that banks fail to honor their commitments, nor did he think it was the intent of the Government to have underdeveloped countries deprived of needed funds. Some production loans to Latin American countries were rolled over every year, although a certain amount of money was used continually. Clarification of policy intent in connection with the financing of underdeveloped countries, including their exports to Europe, would be welcome.

Governor Robertson commented that as everyone realized there could be no effective program that did not pinch and create problems, so it was necessary to look at the over-all picture to see whether the effort was worthwile. As to the less-developed countries, it was desirable to encourage their development, including their export trade. However, it was interesting to note that of the increased supply of gold and dollars that found its way to Europe in 1964, only a minor fraction came directly from this country, the balance having gone through the less-developed countries.

On the question of adherence to priorities, while information was not yet available for April, data for the first quarter showed that notwithstanding all the commitments entered into in the first six weeks of this year, 80 per cent of the new term loans went to less-developed countries, in contrast to 37 per cent in 1964. These figures suggested that the banks were standing firm in adhering to the priority accorded by the guidelines.

Turning to export financing, Governor Robertson noted that the percentage done through bank credit appeared to be greater than in 1964. Comments were heard continually about exports being jeopardized by virtue of the 105 per cent target and prior commitments, but specific information was not available to such effect. The matter was being followed as closely as possible, and all leads were being explored that might indicate that the voluntary program was having an adverse effect on exports. The data did not reflect this as yet, and the March export figure was large due to the catching up of shipments after the end of the dock strike.

With regard to the voluntary program as a whole, Governor Robertson commented that had it not been for this effort the country would now be facing an involuntary program. Whether the effort would be effective depended not only on the banks but what the rest of the United States did. The revised guideline 13 was obviously distasteful to the banks. There was no intent of putting the banks in the role of policemen; instead, the intent was to reinforce the program for nonfinancial institutions. With this guideline in effect, some domestic borrowers proposing to use borrowed funds abroad no doubt would be more reluctant to go in and request bank credit.

As to the Export-Import Bank, Governor Robertson observed that there had been a great deal of criticism on the ground of unfair competition. It was appropriate, in his opinion, to exempt loans guaranteed by the Export-Import Bank from the original guidelines. But obviously this exemption was not intended as a loophole through which banks could reduce pressure upon themselves. There had been meetings with Export-Import Bank officials, and reports were being received regularly. To date, there apparently had been no substantial increase in the Bank's activities. It was understood that steps would be taken to see that they did not expand in any unreasonable way, and that their exemption from the guidelines was not permitted to be used as a loophole. If certain trends occurred, other steps would have to be taken, and it was understood that the Export-Import Bank would cooperate.

As to foreign deposits, Governor Robertson said it appeared that U.S. banks were thus far retaining such deposits, as the Council had stated. This might not be true later on, and the situation would have to be watched carefully.

Governor Robertson emphasized that the voluntary program was not designed as a permanent solution to the balance of payments problem. At some point its effectiveness would come to an end. The program must be phased out, but it could not be lifted in such manner as to open the dam and let the flood go out, for then the country would be in a worse position than before. It was a matter of buying time during which other means could be devised to bring about equilibrium in the balance of payments.

Governor Robertson concluded his comments by noting that the guideline on export financing could be changed, but not without creating difficulties for the banks. Having in mind the program's dollar goal, if the target was raised to, say, 125 per cent on exports and 110 per cent on credits to less-developed countries, then the target would have to be dropped to about 75 per cent on all nonexport credits. This would obviously present many problems. But if exports were not being financed adequately, steps would have to be taken to assure their financing.

Inquiry was made whether portfolio loans of the World Bank and the Inter-American Development Bank were exempted from the scope of the voluntary program, to which Governor Robertson replied that no exemptions had been made except in the case of the Export-Import Bank. In reply to another question, he said there were no guidelines in effect for any Governmental or international agency. There was merely an understanding that they would abide by the spirit of the voluntary effort. Insofar as could be observed from information being received, they were doing so. In reply to a further question, Governor Robertson said that all investments by Edge and agreement corporations were counted within the 105 per cent target. In instances where specific Board approval was given, this was done on the basis of allowing such corporations to use their discretion as long as they were within the 105 per cent target, and if they appeared to be observing the priorities set forth in the guidelines. With respect to a question regarding the likely effect on the balance of payments of increased military expenditures in certain foreign areas, Governor Robertson said that this made the voluntary restraint effort even more necessary than before.

Governor Robertson made the additional comment that it was necessary to assure as far as possible that funds flowing out of this country did not get into channels that would result quickly in demands for their conversion into gold. This was difficult, but essential if selective controls were to be avoided.

A member of the Council said that questions were asked frequently about the public sector, and Governor Robertson replied that so far as he knew steps were being taken to control foreign aid and military programs to the fullest extent that this could be done within the framework of this country's international policy objectives.

Chairman Martin said he could state categorically that the President was acutely concerned about the balance of payments problem. There was, of course, an outstanding commitment to keep the dollar fully convertible into gold at $35 an ounce. Among the factors to be considered were military expenditures, tourist expenditures, foreign aid, and the progress of the voluntary restraint program itself; and any suggestions the Council might have would be welcome. It was the general hope that direct capital controls would not have to be imposed, but the seriousness of the balance of payments problem and its implications must be emphasized. Unfortunately, some press reports following the initiation of the voluntary restraint effort had carried the tone that the problem was well on the way to a quick solution. This, of course, was not the case.

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

> In general, the Council believes that monetary and credit policy has been appropriate under current circumstances, although there was some discussion about the continued rapid expansion of bank credit and the growth in required reserves.

President Moorhead indicated that elements of concern and apprehension had marked the discussion referred to in the Council's statement. The Council felt the latent inflationary pressures were such that the brake should be kept on, at least to the same degree as at present.

Mr. Moore commented that a lot would depend, in the next few months, on the terms of the eventual steel settlement. It appeared as though the settlement might pass by fairly quietly, which would be helpful, but again there was the possibility that it might not. In the latter event, prices were likely to move. They would not have to move, but the mood would be one of trying to increase them. Then there was another conceivable possibility. Profits were being maintained in numerous cases by virtue of a large volume of business. If volume turned down and profits were squeezed, there might be a tendency to increase prices even in the face of receding economic conditions. All in all, it was difficult to look ahead. He would not like to see money any easier than it was now; if anything, he felt that monetary policy could be a little more restrictive. A close watch should be kept on developments on a day-to-day basis.

Mr. Smith said he felt the same way. He would not like to see further large amounts of reserves pumped in to supply banks with loanable funds at the peak of prosperity. In his view the availability of reserves could well be restricted a little. He thought there was still a lot of money available to make loans.

Chairman Martin inquired whether the Council felt that the rise in bank credit had come about primarily from borrowings in anticipation of profits or whether it reflected more a speculative phenomenon.

The answer given was that it appeared to reflect borrowings in anticipation of profit-making.

Chairman Martin then noted that in recent conversations in New York City real estate men seemed to feel that the office building space situation had improved markedly. There was still a plethora of apartments, and this might take some time to work out, but the real estate people were encouraged about the office space situation. Mr. Moore said this was the information reaching his bank also, although it was hard to understand in view of the volume of construction.

Governor Balderston suggested that the real test for high-rise apartments and new office buildings might not come immediately. Space could be sold at the time the buildings were erected, and the competitive pressure might not actually show itself until the initial leases ran out.

Mr. Day inquired whether figures were available on the reflux of corporate funds since the initiation of the voluntary foreign credit restraint effort, and Governor Robertson indicated that such figures were not at hand.

Governor Shepardson inquired whether there was concern about the trend of farm land prices. At a meeting of agricultural lenders he had attended recently, there were reports from all States of price rises of 6 or 7 per cent or better, except in isolated areas. The figures presented also indicated that the majority of land sales were for expansion of crop operations.

Mr. Smith said there was concern in the Seventh District, where land prices had been rising sharply. There was the question whether enough money could be made off the land to warrant the prices paid; in other words, prices seemed out of line relative to prospective yields.

In further discussion of aspects of the farm land price situation, the sentiments expressed were for the most part similar in tone to the comments of Mr. Smith.

It was understood that the next meeting of the Federal Advisory Council would be scheduled for September 20-21, 1965.

The meeting then adjourned.

Merritt Sherman

Secretary