FR 609

Minutes for September 21, 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 SJM.

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, September 21, 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, Day, Stoner, Watlington, Fleming, Smith, Hickok, Moorhead, Knight, Aston, and Cook, Members of the Federal Advisory Council from the First, Third, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth, Eleventh, and Twelfth Federal Reserve Districts, respectively

Mr. James S. Rockefeller, Chairman, First National City Bank, New York, New York, representing the Second District in the absence of Mr. Moore

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

Before this meeting there had been distributed a memorandum listing the topics suggested for discussion and the comments of the Council with respect thereto. There follows a list of the topics, the Council's statement on each, and a summary of the discussion at this meeting.

1. Economic conditions and prospects

    A. How does the Council appraise prospects for the U.S. economy during the remainder of the current year? Have recent developments in steel had any significant effect on the Council's view as to the general outlook?

The Council believes that the level of business will rise further during the remainder of the current year. There is a widespread feeling of optimism among businessmen and investors. The rise in business, however, may be moderated slightly by the liquidation of steel inventories accumulated earlier in the year in anticipation of a strike in that industry.

Recent developments in steel have not had any significant effect on the Council's view as to the general outlook except that it has eliminated one uncertainty.

Mr. Smith said he fully endorsed the Council's statement. Business conditions were excellent in the Seventh District, with the unemployment rate down to 2.9 per cent in the Chicago area. There was a great deal of building and looking ahead. Obviously, there would be some adjustment as a result of the steel settlement, but not enough to offset the tremendous amount of momentum that had been engendered. It appeared that steel deliveries might be down about 25 per cent by the end of the year and the rate of production might be off from 100 per cent of capacity to about 83 in October through to the end of the year. However, there would be shorter hours to cushion the adjustment period. Although the steel settlement was somewhat moderate, the effects would go straight through industry generally and could give a further lift to prices. The situation in the auto industry was unusually strong, and production in the fourth quarter would offset any dampening consequences of the steel settlement.

Asked how the steel industry was measuring the amount of the steel settlement, Mr. Smith said that no one apparently could figure this out exactly. However, the package was judged to be around 3.4 per cent, or something in that area, rather than 3.7 or 3.8 per cent.

B. Are Council members aware of any substantial revisions in business inventory policies as a result of changing expectations--reflecting the Vietnam hostilities or other current developments? Have significant revisions been observed in capital expenditure or other business plans?

Except in certain retail lines, the members of the Council are not aware of any substantial revisions in business inventory policies as a result of changing expectations. However, the step-up in military operations in Vietnam and the expansion in defense spending, even though modest to date, have resulted in the general expectation that the uptrend in business would continue, presumably because Federal spending would rise further. As a consequence, the liquidation of steel inventories, for example, may be spread over a longer period. The members of the Council have observed significant upward revisions in capital expenditures and other business plans.

Mr. Fleming said that the seemingly inexorable rise in costs of all kinds was prompting businesses to spend freely for capital improvements wherever it was thought that costs could be reduced. An industrialist had commented to him recently that the objective of his company, world-wide, was to be able to manufacture at a lower cost than any competitor. The company was planning capital improvements to meet this objective, and perhaps to cut down on the use of labor. The same industrialist commented that in the past year or so the constantly increasing volume of production had made it possible to reduce unit costs. As operations approached capacity, however, the company would have to rely increasingly on reducing costs in ways other than through expanding volume.

Mr. Cook reported some changes in the Twelfth District because of the Vietnam situation; for example, shipping activity had stepped up a great deal. In agriculture it was being estimated that in two or three years some crops could be harvested almost completely by machines.

Mr. Rockefeller reported a number of companies coming in for financing to increase capacity under programs that had not been planned before the last two or three months. The range of companies was quite broad, spreading through a variety of industries.

Mr. Day referred to a recent Lionel D. Edie survey indicating that the preliminary 1966 plans called for a rise of 10 to 12 per cent in business capital expenditures over and beyond the substantially increased level of 1965.

In reply to a question, Mr. Cook said there had been a labor settlement in the construction industry on the West Coast just a few days ago that provided for a rather substantial increase in wages. On a delayed basis, such a settlement tended to affect other industries also--the oil companies and others had to grant comparable increases.

Mr. Watlington reported a contractor in his area as saying that if the right-to-work laws were abolished, contractors in the southeastern part of the country would automatically include a 15 per cent increase in all of their bids.

C. How strong does the Council judge pressures to be on businesses from the demand or cost sides to raise prices?

Steadily rising wage and material costs and a continued high demand are both exerting pressure on business management to raise prices.

President Moorhead said the Council members observed this pressure in almost every line, although there was some feeling that perhaps, because of competition and remaining unutilized capacity, prices of manufactured goods might go up more slowly than commodity and raw material prices.

D. How does the Council appraise the current status of the bond markets? What trends does it foresee over the rest of the year in interest rates on corporate, municipal, and Government securities, and in the differentials among these rates?

The recent behavior of the bond market is an indication of the continued strengthening of the interest rate structure. The extraordinarily strong demand for bank loans, together with the increased requirements for funds to finance the capital expansion program of business, has exerted an upward pressure on rates despite a continued expansion in the flow of personal savings and corporate cash.

As a consequence, the yields on corporate and Government securities are higher than at any time in the past four years and the spread between Government bonds and corporate obligations has widened. Yields on municipal obligations are approaching the peak levels of recent years. Despite the rise in yields that has taken place to date, the members of the Council anticipate some further upward pressure on the rate structure and the maintenance or widening of the present spread in yields. Because of the current high volume of bank loan demand, it is probable that the demand of banks for Government and municipal obligations will lessen.

Mr. Cook said the Council had discussed yesterday whether many banks had free Government bonds left in their portfolios. There were not many left in the Twelfth District, taking into account the practical need for some margin of collateral for public deposits. There had been a considerable movement into tax-free securities in an attempt to improve earnings. Thus, the availability of free Government bonds as collateral for borrowing, from the Federal Reserve or elsewhere, was becoming quite limited. In connection with Federal funds activities, his bank had had to look fairly closely at the situation of some correspondent banks. It had observed that free Government bonds were not too readily available and that in some situations the banks did not have any free bonds. It had been suggested to some of the banks that they might go out of the Federal funds market and try borrowing at the Reserve Bank for a while. He rather wondered, in looking at the Federal funds situation, whether this might not be pushing the Federal Reserve one step away from exerting pressure on some banks. In certain cases his bank was actually making unsecured loans to nonmember banks; in addition, it was lending on a secured basis under repurchase arrangements.

Asked for his view on the best way of correcting this situation, Mr. Cook said the Council had had some discussion about the availability of the discount window and whether or not the Federal Reserve was prepared to take care of liquidifying the banks that were quite a way from being liquid right now. With loan-deposit ratios high, a good deal of reliance on the certificate of deposit market, and the probability of increasing loan pressures, the question was to what extent banks were going to be able to look to the Federal Reserve for some cushion if the situation became more acute. This question was related to the matter of interest rates and how much of the demand for commercial bank loans could be pushed into other markets if interest rates were a little higher. There had been some movement to insurance companies for term loans, at rates somewhat higher than bank rates, but insurance companies had committed themselves quite freely for this year and were doing some warehousing. In short, the problem involved the pressures that might occur over the balance of this year in view of the present liquidity situation and with Government securities portfolios pretty well drawn down, along with the extent to which banks were willing to pay more than the discount rate to borrow funds because of a reluctance to turn to the discount window.

Mr. Martin emphasized the close relationship between rates in the corporate bond market and rates for bank credit, the latter having attracted to the banks credits that normally would be met elsewhere. Many larger corporations were borrowing on a temporary basis from banks to take advantage of the bargain rate situation.

Mr. Rockefeller said that in addition to the backwash from the bond market the banks were getting an unusual loan demand from corporations that felt rates were likely to be higher later on--certainly not lower--and were coming to the banks to get money while they still could.

Asked whether it appeared that the period of financing corporate expansion out of retained earnings and depreciation was about over, Mr. Rockefeller replied in the affirmative. He said corporations that had not been borrowing from his bank for ten years were now coming to the bank or going into the bond market. This situation was of concern to the banks from the standpoint of whether certificates of deposit outstanding would be renewed.

Mr. Cook was asked what he concluded the attitude of the Federal Reserve discount window should be, to which he replied that he had two principal observations. With the certificate of deposit rate at 4-1/2 per cent right now, it appeared that the ability of banks to draw more money from that source might be running out. If this was so, loans could not rise much without rationing of credit, and the banks could not pay more for funds and lend them at current rates. Thus, pressure would be on the banks to raise their rates whether the discount rate was increased or not. Second, the banks did not have too much experience with rediscounting and did not know the rules very well. Also, banks that used the discount window too much were admonished to discontinue their borrowing in accordance with the practice that had been traditional over the years. Therefore, the question was what the banks were to do now. Would the Federal Reserve prefer that they swap funds around outside the System, or would it prefer that they go to the discount window sooner so that the Reserve Banks might have a better look at the banks' liquidity problems? It had occurred to him, Mr. Cook said, that perhaps it was not to the best interest of the Federal Reserve to have so much activity going on in the Federal funds market because this might simply be delaying a showdown.

Mr. Cook was asked how, if the use of the Federal funds market reflected a long-standing banking practice, it would be proposed to change this practice. In reply, he said many bankers had the feeling that the Federal Reserve discount window should be as available to member banks as the window of the Home Loan Bank was to savings and loan associations. He added that the problem really reflected the interest rate bind in which the banks found themselves. The banks had probably kept their lending rates too low, and there was more demand coming in than they could handle. He rather thought the pace of business activity was so strong that the banking system might not be able to take care of its share of the job unless there was some adjustment in the tempo of the economy or some adjustment in the rate structure.

Governor Maisel suggested that a basic question was whether the banking system as a whole had shifted permanently to a structure of less liquidity, that is, whether in the future the banks were going to operate on a less liquid basis than in the past. Was this a temporary shift as a result of the interest rate structure or were the banks going to run their operations indefinitely with less liquidity?

Mr. Cook recalled that at the last meeting of the Board and the Council there had been some discussion of this matter and as to the liquidity ratios at which banks felt they had to stop. The situation now had reached the point, in some cases, that when a large prime-rate borrower came in, the bank had to test the certificate of deposit market to see whether it could find the money to lend. The economy was expanding at such a rate that it had run out of competent manpower and the banks had run out of resources available to finance the expansion. Perhaps the whole show was going too fast. If the economy was going ahead without the manpower or banking resources to support it, this could result in an unfortunate situation. Also, if much of a downward trend in the economy should develop, many bank loans would look quite sick, because most borrowers now had substantially higher break-even points. In essence, he wondered if the whole situation was not a little overheated and there was not need for a little slowing down.

Mr. Rockefeller said that his bank's situation--which was not greatly different from that of the other clearing house banks in New York City--showed that in dollar position the bank was loaned up to 80 per cent of deposits. This was not a tolerable situation; it must be temporary. The bank had started to allocate loans and to turn down some would-be borrowers. It was telling some borrowers that it would take a share of their requirements, but it was not making the situation easy for them. In other instances, the bank was deliberately pricing itself out of a piece of marginal business. Lending officers were working toward cutting back on loans; they were acting like the reverse of salesmen.

President Moorhead said a main worry was the reliance on certificates of deposit to meet loan demands. There was fear that this source of funds would dry up, and the banks could get in a serious bind if their outstanding certificates began to run off.

Mr. Rockefeller said that the banks were wondering to what extent they could go to the discount window. Many banks had been admonished by the Reserve Banks of their districts, which raised the question of how much the discount window was available to them.

Mr. Watlington commented that a traditional move in this kind of situation would be to raise the prime rate, but obviously this would not be a "popular" thing to do right now.

Mr. Fleming noted that there were $16 billion of certificates of deposit now outstanding, and that a large part of the expansion of bank loans had been dependent upon them. If $5 billion of certificates were lost, where could the banks expect to obtain the money to support their presently outstanding loans, to say nothing of the loan demand anticipated in the next few months?

Mr. Cook commented that the banks had been importuned not to raise their rates, but at the same time they were importuned to help the economy. The banks were now looking for guidance because part of the present problem was not of their own making.

Asked where the certificate of deposit money would go if the certificates ran off, Mr. Fleming said the funds would go principally into capital expenditures. They had come to a large extent out of corporate surplus funds, but the corporations had about reached the end of capital financing through retained earnings and depreciation.

Mr. Day said it had come as quite a surprise to many of the Council members when they saw statistics showing that banks were adding to their holding of municipals. This was not true in his area, where banks were considering selling municipals or letting them run off. Mr. Rockefeller said his bank, like those mentioned by Mr. Day, was thinking of selling some of its tax-exempt securities. It did not want to, but things were getting to that point.

President Moorhead commented that while the certificate of deposit money would not disappear, the certificates offered a channel that enabled funds to flow to the areas of demand. This was not true of demand deposits. A run-off of certificates might not change the total amount of money in the banking system, but there could be quite a dislocation.

Mr. Day pointed out that the differential in reserve requirements would sop up part of the loanable funds if money went out of certificates to demand deposits. Mr. Fleming observed that Federal funds often were not available on settlement dates when they were needed.

2. Banking developments.

A. What is the Council's appraisal of the factors underlying the more rapid increases in both savings deposits and time C.D.'s that have occurred since midyear?

The increase in savings deposits that has occurred since midyear varies from district to district, reflecting in part changes in interest paid on these balances. The more rapid increases in time C.D.'s are the result largely of the more aggressive bidding for C.D. funds by major commercial banks who have been offering higher rates to obtain funds to meet the borrowing demand.

Mr. Fleming commented that in Tennessee there was a ceiling of 4 per cent that could be paid on deposits, and certificate of deposit money therefore was not available to the banks in that State. Tennessee would lose about $100 million of funds that it had been counting on to finance the local economy. A similar situation prevailed in about ten other States.

B. Does the Council expect business demands for bank credit this fall to be substantially in excess of usual seasonal needs? Does it anticipate any firming of bank interest rates or other lending terms and conditions?

Most members of the Council anticipate business demands for bank credit this fall will be somewhat in excess of the usual seasonal needs. The strength and persistence of the loan demand of banks combined with the somewhat tighter reserve position is exerting upward pressure on interest rates and lending terms and conditions.

President Moorhead said that total figures did not show much change in lending rates. Rates to secondary borrowers had been moved up to some extent, but this was offset by the fact that so many prime-rate borrowers were using the banks more.

Mr. Hickok noted that his bank had made many attempts to increase rates and had been successful in a number of cases. However, more prime-rate customers had been coming in, so the overall figures did not reflect much change.

Mr. Stoner said his bank had been unable to raise rates, and this was not because the bank had not tried to raise them.

Mr. Day noted that a tally of composite loan rates showed that in spite of some intensive efforts, to the point of losing accounts, it had been very difficult to move up the average rate with the prime rate at its "indicated" level.

Mr. Aston, referring to the bargain rate on bank loans, said banks in his area were feeling increased pressure to take term loans on a competitive basis, as well as loans that in a sense amounted to purchasing an equity position. He cited a recent instance in which his bank, at the solicitation of a New York City bank, had taken a modest participation in a line of credit at a rate of interest insufficient to cover the cost of the money, this having been done in order that the bank might maintain its competitive position. He verified that the banks were experiencing a shift by borrowers from other sources of credit because of the cheaper rate. The banks now had the minimum liquidity ratios that he felt were desirable in a sound banking system, not only in the Eleventh District but all over the country.

Mr. Martin said that most of the banks in his area were running at record high ratios almost every day. However, the yields on this record loan volume had not moved up to any appreciable extent, and in some cases they had actually moved down a couple of basis points. In the face of a heavy demand, the price of bank credit had been stable, or was even moving down in some cases, in spite of efforts to bolster the rate structure wherever possible. The financial press had been recording the fact that bank profits were very good. This was true; they were highly satisfactory. They might be 10 to 15 per cent above last year. But the relationship between what the banks could do with their rate structures, because of the basic considerations involved, and the level of bank profits was not a good piece of sequential thinking.

C. What are the prospects for further bank issuance of capital notes and debentures during the remainder of this year and next year?

The very rapid expansion in bank assets that has occurred in recent years, and particularly this year, has tightened the reserve position of most banks. In addition, the capital ratio and the risk asset ratio of some banks have become less favorable. These developments, together with the fact that prevailing rates on C.D.'s are very close to the Regulation Q ceiling, are factors which are likely to result in the additional issuance of capital notes and debentures during the remainder of this year and in 1966.

President Moorhead said the Council understood that the Board, in asking this question, was interested primarily in long-term capital notes and debentures rather than short-term promissory notes. The rates on the former had moved up, he said, and banks were reluctant to sell at the higher rates, but in the absence of a further significant upward movement the Council would look for more capital note financing by the banks.

Mr. Day said some States, such as Pennsylvania, were just getting around to authorizing the issuance of such notes, which would be an additional reason to expect an increase.

Chairman Martin asked whether or not the Council considered it desirable for banks to sell unsecured capital notes, short-term as well as long-term, and President Moorhead replied that the Council had not considered this question per se. There seemed to be a general feeling, however, that this was a source of bank capital that could not be disregarded.

Mr. Rockefeller said his bank was glad that it had issued its capital notes. It had not used the short-term notes. It had nothing against their use but regarded them as an ace in the hole, for use if the discount window was not available and the bank could not sell certificates of deposit. As a national bank, his bank was limited in the amount of notes it could have outstanding, and it had used some of this limit in selling its long-term notes. However, some banks in New York City were now using the short-term notes, with maturities as short as four to seven days, which seemed close to paying interest on demand deposits. When the September 15 tax date was approaching, he recalled, his bank was confronted with some situations where corporations urged that the bank sell short-term notes and give them interest for a short number of days. If it became general practice to use the short-term notes, the banks would become even more illiquid and vulnerable, but many banks were taking the position that they had to use them.

Chairman Martin commented that the Board probably had authority to classify the short-term notes as deposits by regulation, and Mr. Rockefeller commented that if he were sitting in the Board's position he might be inclined to classify them as such. Asked about long-term capital notes, Chairman Martin said the Board probably had authority to classify them also as deposits. There was, of course, the question whether it would want to do this; he was talking strictly in terms of the Board's authority.

President Moorhead observed that the sale of capital notes and debentures gave a bank the opportunity for leverage, although it might be expensive as compared to the issuance of stock. Mr. Day commented that in some ways the issuance of short-term notes was not as attractive to corporate treasurers as the issuance of certificates of deposit, because the notes showed up on the corporate balance sheets as investments rather than deposits. Since the certificate market was strong, his bank had not had a great demand for short-term notes; the corporate treasurers preferred the certificates despite the matter of the number of days involved. Chairman Martin noted, however, that this did not meet the tax-date problem referred to by Mr. Rockefeller.

Mr. Knight said that quite a few firms in his area seemed content to buy commercial paper, even though it was short term; if the banks gave them short-term notes, the banks might get some of this money. Although the term might be short, the companies kept renewing it all the time. Of course, if they did not, there might be a problem, but in the meantime it would be rather helpful for the banks.

Governor Robertson inquired whether a difference was seen between certificates of deposit and short-term notes in terms of whether they were really deposits or not, adding that the proceeds of sale of the short-term notes apparently were used in the same manner as the proceeds of issuance of certificates. A basic question, he noted, was whether a situation was approaching where the prohibition on the payment of interest on demand deposits was going out the window.

Mr. Rockefeller commented that repurchase agreements had the same effect; they served the same money function.

Governor Robertson then said he gathered from Council members' comments that they thought the banks were in a tight situation. The current demand for loans was very strong, as he understood it, and these were loans that should be granted to keep the economy going forward. Consequently, the Federal Reserve should make money easier so the banks could meet these demands.

President Moorhead observed that despite the seeming inconsistency the Council, in its answer to the question on the agenda later regarding its views on monetary and credit policy under current circumstances, had reached quite the opposite conclusion.

Mr. Day commented that demand deposits had been moving up recently at a rate of only about .7 per cent a year, whereas gross national product was increasing at a rate between 4 and 5 per cent a year. Fundamentally the banking system had run out of raw materials and now had to go out and pay for them, using all possible inducements to tap the stream of savings.

Mr. Watlington agreed that the bargain rates of the banks were bringing in demands that might otherwise go elsewhere. If the rates were somewhat higher, some of these demands would go to other sources of credit where they might rest more naturally. As it stood, banks felt that they must extend these credits in order to maintain their competitive position.

Governor Robertson said he would not quarrel with the facts presented by the Council but that he had difficulty reconciling the conclusion with the facts.

Mr. Martin noted that it must be recognized that banking was, if anything, a very long-term business. The banks depended primarily on people who had been with them over a long term. Termination of such a relationship meant a real loss. The banks did not give in to demands for credit because of indifference or weakness, but instead because they valued the relationships that had been built up over many years. In considering loan requests they had to evaluate many things, including the possible permanent loss of part of their clientele.

Governor Maisel said that, as he understood it, a basic question really was whether the Council felt the banks were lending too much money. Should the supply of money be increased, or should the demand be dampened?

Mr. Martin commented that the supply of money had been raised constantly, and Mr. Day said that the "indicated" prime rate was really the major problem. Mr. Fleming noted that when consideration was given to putting more money into the banking system, thought must be given to matters of the national interest such as inflationary pressures and the balance of payments problem. Mr. Aston doubted whether one could assume that all of the loans being sought were necessary for the ongoing of the economy. He did not think that all of the demands were legitimate. Instead, he felt that some of them were building up excesses that would eventually create problems.

Mr. Martin commented that banks had drifted into the use of short-term funds without having the assurance of a confirmed line of credit. In his opinion this was probably the greatest technical weakness in the whole operation. He was not suggesting that the banks should have the benefit of a confirmed line of credit with the Federal Reserve; he was simply pointing out the technical weakness that was involved.

Governor Robertson asked whether, if action were taken to define funds obtained through the sale of short-term notes as deposits, it would be realistic to draw a line between subordinated and unsubordinated obligations.

Mr. Rockefeller replied that he did not think so. People did not look at that aspect. If the bank's name was on the note, they did not care.

Governor Robertson pointed out that the long-term capital notes were generally subordinated, whereas the short-term notes were not. Mr. Rockefeller repeated, however, that he did not think it would be feasible to draw a line on this basis. Mr. Day said that in Pennsylvania the notes were automatically subordinated by law.

Mr. Smith said he thought things in the economy were beginning to pyramid and that there should be some slowing down. Raising the price of money was historically one way that this had been accomplished. By doing so, rather than permitting too much money to be available, he thought the period of prosperity might be prolonged.

D. What are the Council's expectations with regard to near-term developments in the Federal funds market, with respect to both the extent of participation in this market by medium and smaller size banks and likely rate levels relative to the discount rate?

The Council believes that the rates in the Federal funds market are likely to stay above the current discount rate because of the reluctance of borrowing directly from the Federal Reserve. In these circumstances, an increasing number of medium and smaller size banks are likely to participate in the Federal funds market.

In explanation of the reluctance of banks to borrow from the Federal Reserve, President Moorhead cited the traditional reluctance against undue borrowing, the question of being able to furnish Government bonds as collateral, and uncertainty on the part of banks in knowing how to pledge their note portfolio. He also said that medium and smaller size banks had participated in the Federal funds market to date largely on the selling side, but that quite possibly they might become increasingly active on the buying side.

Governor Robertson noted that the total number of banks participating in the Federal funds market had increased. He asked if this was true on the buying side as well as the selling side.

President Moorhead said he thought most were on the selling side so far, but if there was reluctance on the part of the Federal Reserve to have banks become indebted at the discount window the number of buying banks might increase.

3. Balance of payments.

A. How does the Council appraise the results of the voluntary foreign credit restraint effort to date? In particular, does it appear that the priorities for export financing and for the less developed countries are being reasonably met?

The results of the voluntary foreign credit restraint effort seem to have been helpful to date, although the large domestic loan demand and the pressure on reserves also have been of assistance in redressing the deficit in the balance of payments. Priorities for export financing and for the less developed countries apparently are being reasonably well met.

Mr. Rockefeller said the banks felt that the screws were a little tighter on them than on industry, which seemed to be going ahead with plans for direct investments abroad.

With regard to direct corporate investments abroad, Chairman Martin inquired whether there was substance in the view that the lag factor might be greater than in the banking area. Direct investments had made a poor record in the first six months of this year, but he heard it said constantly that in the third or fourth quarter such investments would taper off because the investments so far this year reflected commitments made earlier.

Mr. Rockefeller said corporations with which his bank was familiar were still looking for ways to expand their overseas business, particularly in Europe. They wanted to get into the overseas business or to increase their share. They had their people abroad looking for opportunities constantly.

Mr. Cook confirmed that corporations appeared to be going ahead with their plans to spend more money in various parts of the world. Pressure for bank financing was likely to be an increasing problem by next year.

B. What changes does the Council anticipate in the volume of U.S. bank lending to foreigners over the rest of the year?

Since most banks are near the 105 per cent ceiling, the volume of U.S. bank lending to foreigners probably will not rise significantly over the rest of the year.

President Moorhead observed that the Council might not have completely accurate information and that the members would like to hear from Governor Robertson.

Governor Robertson commented that the response of the bankers of this country to the voluntary foreign credit restraint effort had been superb. In fact, the response had been good on the part of all financial institutions. As of the end of July the banking system had not only conformed to the program target but had done much better. The banks, as a whole, were under the target by $600 million, and few banks were over the target today. Many banks would, of course, move up somewhat during the remainder of the year as disbursements were made under outstanding letters of credit.

The question, Governor Robertson continued, was what should be done from here on out. As successful as the voluntary program had been, the problem of the balance of payments deficit still existed, and improvement should not be expected to come from the banking sector only. Undoubtedly, the progress made by financial institutions had been much greater than in any other sector of the economy. In order to achieve the kind of equilibrium that was sought a better record would have to be made by direct investments, which for the first half of this year approximated $2 billion as contrasted with $2.6 billion for the whole of 1964.

Governor Robertson said he felt that the voluntary program would have to be continued in 1966. If this was done, there were several questions with which it would be necessary to deal. He believed it would be necessary to continue to use the end-of-1964 base date and raise the target figure to the extent that seemed appropriate, for otherwise there would be unfairness in the application of the program. It would also be necessary to try to remove some inequities that existed in the present program, which had exerted a greater impact on some institutions than others. For example, those banks that had only recently set up foreign departments did not have much of a base with which to work. Perhaps they could in some measure be encouraged to stimulate exports if given a better base to work with in 1966.

Governor Robertson noted that there were indications of a downward drift in exports. The Federal Reserve had checked every case brought to its attention where it was alleged that exports had been adversely affected by the voluntary program, but he had yet to find a case where exports had been lost by virtue of a failure of financing attributable to the voluntary program. There was a possibility, of course, that some banks would have been more active in encouraging smaller manufacturers to get into the export business if the program had not been in effect. If so, perhaps something could be done in this area. It did not appear that less developed countries had been adversely affected by the voluntary program. There was every evidence that the banks had been following the priorities stated in the program guidelines as closely as anyone could possibly expect.

Mr. Rockfeller referred to an article in the press concerning sale by an American corporation of an issue in the Euro-dollar market to meet its foreign needs. He observed that if the company used the proceeds to buy machinery in the United States, for example, that would help U.S. exports. But if it used the proceeds for materials or labor in European countries, the money might find its way into the central banks of the countries concerned, which could then demand gold from the United States.

Governor Robertson replied that, while this was a possibility, there was far less potential for harmful consequences to the U.S. balance of payments if companies obtained funds in the Euro-dollar market than in the United States.

Governor Robertson then commented that it seemed to him the banks of this country probably had not engaged for many years in any operation that they could utilize to such great advantage as the voluntary program in building up the image of the banking industry. He suggested that the industry ought to take advantage of this effort to show what kind of a job the banks could do in the public interest. Perhaps, if the industry was not prepared to do this, the Federal Reserve should, for the operation certainly had redounded to the benefit of the American people.

Chairman Martin mentioned the service that had been performed by Governor Robertson in heading up the Federal Reserve's role in the voluntary program, a task that was not an easy one from the standpoint of the System.

Mr. Martin inquired whether Governor Robertson would like to be informed of specific instances where it appeared possible that the existence of the program may have had a detrimental effect, directly or indirectly, or the promotion of U.S. exports, and the latter replied that he would appreciate any available information of such kind along with any suggestions as to how the program might be revised in such a way as to avoid an adverse impact on exports. Mr. Rockefeller asked about the possibility of allowing the target to be exceeded for the financing of exports, and Governor Robertson replied that while thought had been given to this possibility, difficult administrative problems were involved. Mr. Rockefeller commented that he did not know how such an exemption could be effectively policed.

C. As the Council appraises the balance of payments outlook, what does it believe would be the best course of Government action in this area in 1966?

Although the voluntary program has been helpful in restraining the outflow of capital, the fundamental adjustments required to balance our international payments have not been made. The present program tends to restrict the movement of goods and capital, and as such may be harmful to the long-term development of the economy. If the program is continued, the ceiling should be raised.

As the Council has indicated in the past, a comprehensive plan is required which would include such factors as the following:

1) a further reduction in U.S. economic and military aid overseas;

2) a curtailment of defense expenditures in Europe;

3) an easing of barriers tending to discourage the repatriation of earnings overseas;

4) a narrowing of the differences between domestic and foreign interest rates;

5) a continuation and expansion of the program to encourage exports; and

6) a continuation of efforts to keep wages and other costs within productivity gains.

President Moorhead inquired whether it appeared that any progress was being made on the fundamental adjustments required to achieve payments equilibrium, and Governor Robertson said he thought progress was being made, although not fast enough. He believed some good side effects could come from the voluntary program. It could contribute to the development of capital markets abroad to take care of exports and also the financing of third-country trade. Then too, if more progress could be made in stimulating U.S.exports, thereby increasing this country's surplus on current account, that would be helpful. He thought the steps being taken in this regard were likely to be successful, and that people were thinking more of what they could do to stimulate export business. It would be necessary, in his opinion, to do more on the side of direct investments to equalize the impact of the voluntary program. While he felt that continuation of the voluntary program in 1966 would be necessary, he hoped it would not become part of a permanent way of life.

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

> The Council is concerned with the increasing evidence of the development of inflationary pressures, the continued strong demand for bank loans with the reliance on C.D.'s to meet this demand, and the underlying difficulties with the balance of payments. Consequently, we believe the Board should be prepared to move in the direction of further restraint, including a tightening of reserves and an increase in the discount rate.

Chairman Martin inquired how much further, in the Council's judgment, the Federal Reserve could tighten the availability of reserves without coming up against the problem of the discount rate. To what extent, he asked, would expectations "carry us over the dam at this juncture?"

President Moorhead said that he thought any tightening whatever would result in a serious liquidity squeeze, and for a while the discount window would have to be open. One action would tend to offset the other, he realized, but in any event there could be a serious liquidity squeeze this fall if the certificate of deposit market should evaporate.

Mr. Rockefeller advised that if any action were taken, it not be signaled first. Everyone would be looking for signals.

Chairman Martin inquired whether, if net borrowed reserves increased by $50 or $100 million, this would create a great deal of expectational psychology, and Mr. Rockefeller said that everyone would be talking. Mr. Aston recalled that several months ago the Chairman asked the Council a question about the discount rate, and the Council members stated that they would not favor changing the discount rate at that point. Now, however, he felt that the time had arrived for a change in the rate. Mr. Smith expressed agreement.

Chairman Martin asked whether any Council member disagreed, and there were no comments to such effect. Mr. Cook said, however, that he felt a good part of the existing problem was due to the fact that the banks had been importuned not to raise the prime rate. As things stood, the rich people of the country were being allowed to obtain money at a rate that was out of line with market realities. If the banks could have increased the prime rate at some point during the past 30 days, some of the reduction of liquidity that had occurred could have been forestalled. If there was no change from the present situation, the question was what would happen if the banks were unable to control the demand and became so highly illiquid that they had to come to the Federal Reserve. A possible alternative would be another ABA credit rationing program. If the banks could get out of the strait jacket on the prime rate, this would be a constructive step.

Chairman Martin asked the Council's judgment about the impact on business activity of a change in the discount rate at the present time, that is, how much, if anything, it would do to slow down business activity, and Mr. Fleming pointed out that U.S. corporations borrowing abroad had to pay high rates and were not complaining. The high rates were not curtailing overseas expansion by U.S. corporations. He did not think that a change in the discount rate would have any effect on domestic business activity.

President Moorhead said a change in the discount rate would have some psychological effect, but the availability of credit was a great deal more important than the rate.

Mr. Day commented that a change in the discount rate would reflect itself down through the whole rate structure and at the margin there was bound to be some ultimate effect.

President Moorhead said he did not feel as strongly as others that the current problem of the banks was going to be solved by a change in rates. People wanted money, if they had a need for it, no matter what they had to pay.

Governor Daane inquired how much tightening was envisaged by the Council's recommendation, and President Moorhead said he thought the Council had in mind only a slight firming in reserve availability, with perhaps a 1/2 per cent increase in the discount rate. Mr. Watlington said he hoped any increase would not be less than 1/2 per cent, and Mr. Rockefeller said anything more than 1/2 per cent would frighten people.

Governor Balderston inquired whether the manner in which the discount windows were being operated really explained the fact that Federal funds were trading at rates higher than the discount rate, that is, whether banks were willing to pay 4-1/4 per cent because they were frightened by the discount officers.

Mr. Rockefeller said this was true without question, and his comment was seconded by Mr. Watlington.

Mr. Rockefeller remarked that he did not think his bank had abused the discount privilege. It had not borrowed steadily, but it had borrowed for one or two days in a reserve period to meet legitimate corporate demands. It did not borrow to sell in the Federal funds market at a profit. However, the Reserve Bank had expressed the opinion that his bank was using the discount window too much and had suggested that the bank consider buying Federal funds, which it was now doing at rates above the discount rate.

President Moorhead said about the same thing had occurred in the case of his bank, which had been going to the discount window for one day or so in each reserve period for several consecutive periods.

The bank's attention was called to this circumstance, and it was indicated that the Reserve Bank would rather see the bank operate in the Federal funds market.

Mr. Watlington said this implied that a bank might as well be indebted for a whole reserve period. A one-day borrowing often would be a big help, but if this was done in consecutive periods the borrowing bank got a message from the Reserve Bank.

Governor Robertson inquired whether the Council members were suggesting a rise in the discount rate, an increase in availability of reserves, and easy access to the discount window all at the same time.

Mr. Fleming expressed the view that if the prime rate were increased this would shift some loan demands that were now coming to the banks, because of the prevailing bargain rate, back to the market place and perhaps make more bank credit available for the types of borrowing normally taken care of by the banks. The banks were being loaded down with demands from people who did not ordinarily use the banks to such an extent as at present. Mr. Fleming further stated that if the discount rate were raised he thought that would take care of a lot of the problem. It was worth a try, and he would not suggest that the availability of reserves be increased.

Governor Robertson asked about easier access to the discount window, and President Moorhead said he would ease for a time because a change in the discount rate would not solve the banks' liquidity problem over night.

Governor Daane asked how the Council reconciled the idea of lessened reserve availability with greater access to the discount window, which in itself increased reserves. In reply, President Moorhead said the only way to reconcile this was that the easing would be temporary, in order to see what happened with a higher rate structure.

Mr. Watlington suggested that if access to the discount window was eased a little this might encourage some banks to go to the Reserve Bank that were now going to correspondent banks. A member bank had told him that some days it lent more funds to correspondent banks than it borrowed from the Federal Reserve. The correspondent banks were coming to the bank in question rather than the Federal Reserve because it was easier.

Mr. Fleming inquired whether, if a bank came to the discount window for one day only, it could not be judged on that basis, but it was pointed out that a matter of averaging was involved and that a bank might borrow heavily for one day, with the same practical result as a lesser but more extended borrowing.

Mr. Day said that in the Third District the Reserve Bank's attitude was one of apparently being little concerned about member bank borrowing from sources other than the Reserve Bank. Even though a bank was continually indebted in the Federal funds market, this would not necessarily attract the attention of the Reserve Bank officers. But if a member bank borrowed continually from the Reserve Bank, this was noticed. Also, the mechanics of borrowing from the Reserve Bank were not entirely clear, because not many of the member banks in the area had Government bonds left to use as collateral.

Mr. Aston said his bank had had several discussions with the Reserve Bank and was concerned about the Reserve Bank's reaction, primarily because of what appeared to be an arbitrary rule that no borrowing should continue more than a certain period of time, without looking to see what use had been made of the funds. Mr. Rockefeller had pointed out earlier that his bank's borrowings were for the purpose of meeting legitimate corporate needs, and Mr. Aston said he had suggested to the Dallas Bank that it look into why money was being borrowed. In a number of cases, his bank had sold Federal funds at no profit to correspondent banks. It was not trying to make a profit on the Federal Reserve; this just happened to be the most practicable vehicle for borrowing available to the bank. The reason why a bank had done certain things was important, whereas the Federal Reserve rule appeared to make no distinction between borrowing purposes.

Chairman Martin said he had sympathy with the point that a structural problem was involved. It was difficult to know how to separate the cost and availability of money. This had to be done on a flow basis, and against whatever trend prevailed at a given time. If the trend was toward expansion, a move could be made in one direction; if the trend was toward contraction, a move could be made in another direction; but now the question was one of working at cross purposes.

Mr. Fleming said that banks could not pay 4.5 per cent for money and lend it out at 4.5 per cent, yet this was taking place all over the United States. Governor Robertson inquired, if this was so, how the profitability of the banks' operations could be explained. Mr. Fleming said he thought this was a temporary situation. The banks had been expanding the volume of their credits to the limit and therefore were showing better earnings this year than last. But costs also were increasing. In 1966 he felt the situation would be different: the loan expansion would have stopped and costs would still be building up. The banks would not be able to absorb excess costs by increasing volume.

Mr. Watlington said the investing public was reflecting this analysis in its attitude toward bank stocks, the prices of which were already down. Mr. Fleming then added to his previous comments by expressing the view that the banking system would show smaller net profits in 1966 than in 1965, a year during which the banks had had, among other things, the benefit of a tax reduction. Even so, he understood that West Coast banks probably would not show as good profits in 1965 as 1964, and in other sections, also, banks were finding their costs overtaking their earnings.

Mr. Smith suggested that this situation could have an effect on the quality of bank credits, for there might be a tendency on the part of banks to lend longer and invest in longer maturities in order to try to offset rising costs. This would not be a healthy trend.

Governor Daane asked whether, if the discount rate was changed, the prime rate would be too meaningful, and Mr. Watlington said the prime rate involved a matter of prestige. Some borrowers did not care how much they paid for money as long as they got the "best" rate. Mr. Fleming observed that large corporations were getting the benefit of the prime rate as contrasted with others. Mr. Rockefeller said his bank would like to get away from the use of the prime rate but that it was written into a lot of agreements. Mr. Watlington referred to the risk of losing good customers and said that a bank must balance many considerations in dealing with its clientele.

Governor Shepardson referred to the Council members' comments that an increase in the lending rate was not going to bother borrowers too much if they needed the money. On the other hand, he understood it to be the idea underlying the Council's statement on this topic that a rise in rates would dampen some of the current demand for loans.

In response, several Council members indicated that an increase in rates should tend to cut down some marginal credits.

Governor Shepardson then commented that the views about providing easier access to the discount window would only seem to be justified if one was speaking of an adjustment period. He presumed the Council was not talking about a relaxed role of the discount window over a longer period of time, and several Council members expressed agreement.

Governor Balderston inquired whether he understood correctly that most of the Council members thought the greatest impact of an increase in rates would be the one Mr. Fleming had mentioned, namely, a shifting of some of the demand currently being experienced by the banks to other sources such as the capital market, the commercial paper market, and insurance companies. The replies by Council members were in the affirmative.

With further reference to the discount window, Governor Shepardson inquired whether there was really a feeling that the Reserve Banks were not responsive to the needs of member banks related to the making of bona fide adjustments.

President Moorhead replied that the Reserve Banks were responsive but that, consistent with traditional policy, if a member bank was indebted for too long a period it was urged to make an adjustment by selling some of its assets.

Mr. Rockefeller said that the element of uncertainty was the prime factor; the banks did not know where they stood. They wanted to know that if they came in with a legitimate demand they would be taken care of. While they did not want to stay indebted at the discount window, they wanted to know that they could have access to the window to take care of legitimate swings.

Mr. Martin agreed, stating that although it was hard to express, the question on the part of the banks involved uncertainty as to whether they had any place to go in event of need.

Mr. Fleming also agreed, stating that the major problem was to remove the uncertainty and let the banks know the rules.

Mr. Aston likewise agreed, stating that the banks desired knowledge that legitimate swings would be provided for. The banks should not use the discount window simply as a means of creating funds. It was not intended that the Federal Reserve would be used for this purpose but as a safety valve to take care of a legitimate swing.

Governor Shepardson then stated that the question seemed to come down to a definition of legitimate need. In talking with Presidents of the Reserve Banks, he had understood that all of them endeavored to take care of emergency needs. But if a bank was operating continually in such manner that it expected discount window assistance periodically, this was another question.

Mr. Cook recalled that the last time the Council met with the Board there were appearances that the economic expansion had peaked out, but now the situation was seen to be changing. If the prime rate was not changed, he felt that there must be some easing of access to the discount window. But if relief was provided in other directions, the easier access to the window would need to be only temporary.

Governor Maisel said he gathered the bankers would feel safer if they knew they could obtain borrowed reserves when needed even if their total reserves were somewhat reduced.

President Moorhead replied that he thought this was true. The banks had an uneasy feeling about operating on certificate of deposit money, and they wanted some backstop.

Chairman Martin commented that a study of the discount mechanism was currently in progress within the Federal Reserve System. It was interesting to note, he observed, that the operation of the discount window continued to be a subject of discussion year in and year out. This involved matters of judgment, administration, and the psychology of the banking community. He would guess that all members of the Board believed that at the present time the discount window was being administered substantially in the way the Council members had said that it ought to be operated. Maybe this was not the case. There might be differences of judgment, but the basic intent was to operate the discount window approximately in the manner that the Council members had indicated. This was not the easiest thing to do, because alleged abuses appeared in various places from time to time, and discussion continued along the lines that had occurred today. This was the basic reason why the Federal Reserve had undertaken the current study of the discount mechanism, and the Council would be kept abreast of developments.

It was agreed that the next meeting of the Federal Advisory Council would be held on November 15-16, 1965.

The meeting then adjourned.

Secretary