FR 609

Minutes for November 15, 1966

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. Shepardson	CNS
Gov. Mitchell	GM
Gov. Daane	JD
Gov. Maisel	SJM
Gov. Brimmer	AFB

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, November 15, 1966.

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

Mr. Sherman, Secretary
Mr. Kenyon, Assistant Secretary

Messrs. Simmen, Moore, Day, Stoner, Watlington, Fleming, Bodman, Brinkley, Moorhead, Knight, Stewart, 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

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 follow 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 the general economic outlook for the remainder of 1966 and the year 1967?

The members of the Council anticipate that general business activity will continue to rise during the remainder of 1966 and into the new year. However, there is evidence that the rate of growth in retail sales has slowed. This development, together with a possible topping out in capital investment in 1967, suggests a more moderate advance in the private sector. On the other hand, military operations in Vietnam point to a rise in defense expenditures. Nondefense Federal spending may also increase. Moreover, expenditures by State and local governments seem certain to rise as they have annually in the postwar period.

Because of the uncertainty of developments in Vietnam, the outlook for the latter part of 1967 is particularly obscure.

President Moorhead observed that the question always seemed to come back to the problem of prospective expenditures for Vietnam, for which no one appeared to have an answer. However, while there was evidence of some slowing down in the rate of growth of the private sector of the economy, it seemed to be the general feeling that Vietnam expenditures would take up the slack.

In further comments, President Moorhead referred to the current estimates of business capital expenditures in 1967, which suggested a 3 to 5 per cent increase as contrasted with the 17 per cent growth rate this year. The estimated growth rate in 1967 would mean a high level of activity but a considerable slowing down in the rate of expansion. As to GNP, concerning which various projections for 1967 were now being made, it was his feeling that a 4 per cent rate of growth would be sustainable and that such a forecast might be quite realistic. The Council was aware of the wide range of the estimates currently being made, but the members had found in their contacts no indication that business sentiment was converging on any particular estimate.

B. Do Council members have the impression, from information received by bank loan officers, that any significant number of firms have been cutting back on actual or planned capital expenditures and inventories because of stringent bank lending terms or tight credit conditions in general? Because of the temporary suspension of the investment tax credit and accelerated depreciation allowances?

The members of the Council believe stringent lending terms or tight credit conditions in general have had some restraining impact on planned capital expenditures. Actual outlays on previously planned projects have not been significantly altered. However, there are reports of business firms which are reducing their 1967 capital budgets. The temporary suspension of the investment tax credit and accelerated depreciation allowances may be contributing factors, but these have not so far been as significant as the Council believes they will be.

President Moorhead said the Council members felt that many projects, particularly of smaller firms, had been postponed because of tight credit conditions. No member could recall having heard that any specific project was being deferred because of the suspension of the investment tax credit. However, there tended to be a delayed reaction to any measure of that character, and in time it might become an important factor.

Mr. Day expressed the view that the suspension of the investment tax credit would have a dampening effect on the purchase of railroad equipment, but not for some period of time, and Mr. Fleming observed that orders placed today for such equipment would not result in deliveries until 1968, which emphasized the likelihood of a delayed impact.

President Moorhead reiterated that a vast number of projects had been postponed by small firms, such as automobile dealers, that wanted to expand but were unable to obtain financing.

C. In the judgment of Council members, have the reductions in housing starts in their respective regions resulted primarily from the reduced flows of funds into mortgage markets through nonbank depositary institutions and life insurance companies, or has there also been some significant weakening in the demand for housing for other reasons?

The decline in housing starts resulted in part from a reduced flow of funds into mortgage markets. However rising building costs, the scarcity of construction funds from commercial banks, a lessening of demand for housing, and overbuilding in some regions, particularly the West, have all been significant factors in the reduction in housing starts.

President Moorhead said it was the Council's view that perhaps there had been too much of a tendency to blame the slowdown in housing starts exclusively on the fact that savings and loan associations, insurance companies, and other long-term lenders had been short of funds. He then turned to Mr. Cook, who commented that a slowdown definitely had been foreshadowed on the West Coast because of overbuilding, as discussed at earlier meetings of the Board and the Council. In other words, there would have been a slowdown even if no money shortage had occurred. Total construction seemed to be going along at a good rate, even though housing starts were down more sharply than in other parts of the country.

Mr. Cook also commented that the construction business was a leading offender in pushing wages up; wage increases in that industry had led to competitive increases in the oil industry and elsewhere. Despite the slowdown in housing, there did not seem to be a great deal of unemployment in the construction industry. The unemployment impact was being felt in the lumber and building material industries and among real estate sales people. The requirements of Vietnam had pulled money, equipment, and labor into the heavy construction area and had pushed the cost of heavy construction up rapidly, as indicated by the fact that the Bay Area rapid transit program could not be completed within the limits of the funds originally allocated. The housing situation was quite adequate at present, and some further delay in increasing the pace of housing starts could be tolerated. Although banks would be glad to buy some FHA loans, they were unavailable, with builders inactive because they were not sure they could sell. The six-point discount was also a handicap, but aside from that construction costs had risen. They were up 10 per cent in the past year, against a normal increase of 5 per cent, and many components were up 20 per cent, with further increases indicated the first of next year.

Mr. Knight said his area had experienced overbuilding a number of years ago, resulting in a slowdown in the housing industry that was continuing. However, total construction figures were up. One savings and loan association had attempted to go into consumer credit until the State caused it to desist on legal grounds; apparently the association attempted to do that because it was not able to use some of its funds.

President Moorhead then commented that in the East it appeared that housing demand was still good and that the tightness of credit was a more important factor.

Mr. Day indicated that that was true in his area, although the scarcity of labor was a contributing factor. The scarcity of construction financing was evidenced by the large volume of loan requests that had been turned down and specifically by the difficulty in obtaining adequate financing for a large project designed to rebuild a slum area in Philadelphia.

Mr. Stoner cited not only the scarcity of funds but the fact that insurance companies were dragging their feet on take-outs, which made banks hesitant to undertake financing.

2. Banking developments.

A. How strong does the Council expect business loan demand to be over the remainder of 1966? Does the recent slackening in growth of business loans at banks primarily reflect bank lending policies, or is there also evidence of some moderation of demands? If the latter, is the moderation due mainly to a less expansive outlook for sales, or to earlier anticipatory borrowing?

The Council expects business loan demand to continue strong over the remainder of 1966. The slackening in the growth of business loans that has appeared in recent weeks largely reflected bank lending policies rather than any important moderation of demands. The widely publicized tight money situation appears to have discouraged some would-be borrowers from submitting loan requests.

President Moorhead said it was the Council's opinion that the tightness of credit had been so widely publicized that many would-be borrowers were getting a rather good idea as to which loan requests probably would be turned down summarily. It was believed that a strong demand still existed and that there would be a flood of requests for credit the moment the gates were opened.

Mr. Moore said that the Council's statement fitted the situation in New York. Loan figures had leveled off somewhat in the past few weeks, but the banks had a lot of commitments outstanding that no doubt would be drawn upon at some point. It was hard to tell at this moment whether the current lull reflected short-run peculiarities of the calendar in relation to corporate programs or whether there had been a shift in basic sentiment. There had been a rash of corporate take-downs a couple of months ago, and the companies therefore might not have so much need for funds temporarily. A few cases might be found where borrowers had taken money down because they were afraid they might not be able to get it later, but such circumstances appeared to be quite rare. At the time of the previous Board-Council meeting, a number of companies that theretofore had been satisfied with informal agreements to take care of their needs were shifting to formal contracts. The next step would have been to take that money down, but only in a few cases did the companies seem to have reached that point of nervousness.

President Moorhead observed that almost everyone who came into the banks at the present time seemed to expect more business and desired to increase his lines of credit. The banks were holding loans down, but that did not mean that the demand was not there.

B. What does the Council foresee as to the ability and willingness of banks in coming months to attract time deposits through large and small denomination CD's? Do banks expect their main competition for time-deposit funds to come from other depositary institutions or from market instruments?

The members of the Council anticipate continued difficulty in the coming months in holding present balances and in attracting new time deposits through large and small denomination CD's. This will result from the inability of the commercial banks to compete effectively for funds not only with other depositary institutions, but also with other market instruments, particularly the obligations of the U.S. Government and its agencies.

President Moorhead commented that the most recent regulations had again put the commercial banks at a serious disadvantage. How the banks would fare depended on the market. A month ago the banks were completely out; the gap had narrowed a bit recently, but the banks did not know from week to week where the market could be. With the banks operating under a ceiling, it was difficult for them to predict deposit levels.

Asked which rate ceilings seemed most onerous on the whole banking system, looking ahead to 1967, President Moorhead said they were all onerous. If the 4 per cent savings deposit ceiling were raised, he would expect the banks in the larger centers to move their rates up quickly. That ceiling was completely out of line and unrealistic in today's market. If banks were to be allowed to stay in the savings business, they should be able to compete and not be held down to a point where they were completely out of the market. At present, savings deposits were declining steadily.

Mr. Day said that in his area the attrition in passbook savings was merely being offset by the sale of consumer-type CD's at 5 per cent. Mr. Prochnow reported that savings deposits in his area were going down almost every day. Efforts were being made to offset that decline by the sale of consumer-type CD's. Since the first of the year his bank had lost about $100 million in savings deposits and had gained $104 million in consumer-type CD's. In the past 30 days, however, a net loss was shown. Mr. Bodman reported a slight net gain.

Reference was made to the consideration reportedly being given by the Treasury to offering a 5 per cent savings certificate, and Mr. Day said that it would be a potent instrument in competition with the consumer-type CD's even if the terms of the Treasury instrument were restrictive. Inquiry followed as to the terms on which such a savings certificate might be offered, and Governor Brimmer said that he understood the matter was still under discussion within the Treasury. It appeared, however, that there would be some tie-in with the purchase of Series E bonds, either on a payroll basis or otherwise. He had been told that various tie-in possibilities were under consideration, some of which might involve rather difficult administrative problems. In essence, however, the plan seemed to envisage a 5 per cent savings certificate with a maturity of either 18 months or two years, with some tie-in with the purchase of Series E bonds.

Mr. Day said the larger Philadelphia banks were continuing to press the sale of 5 per cent consumer-type CD's and had some $400-$500 million outstanding. The average sale probably was in the neighborhood of $2,500, but the CD's were available in denominations down to $25. This minimum amount was confirmed by other Council members.

Chairman Martin asked what savings deposit rate would enable the banks to be effective competitors at the present time, and Mr. Moore replied that the New York banks could live with a 1/2 per cent differential in favor of the mutual savings banks, which would mean a 4-1/2 per cent maximum for the commercial banks. Mr. Watlington agreed that the commercial banks could live with a 1/2 per cent differential, but no more than that.

Governor Brimmer referred to reports that the maximum rate for mutual savings banks might be reduced, and Mr. Moore said that much depended on the alternatives available to the depositor. Talking only in terms of passbook savings, he felt that the imposition of a lower maximum rate on the mutuals would be helpful to the New York commercial banks. However, other instruments were available as possible alternatives.

Mr. Cook observed that the question got back to where money was needed most. To the extent that costs of Government were met by borrowing rather than by taxation, the money must be obtained by the Government from some source. It was important, he thought, to decide whether the country's productive capacity was adequate to meet the needs of the economy. If there was a curtailment of funds available through the banks and other lenders to the extent that productive capacity could not be increased further, that question became critical. He noted that extended delays were involved in obtaining various kinds of equipment for plant projects, which seemed to suggest that the industrial capacity of the country was not as adequate as it should be. Everyone seemed to concur in the view that it would be desirable if the Government did not need so much money, but at some point a choice must be made between Government and private industry. It would seem less inflationary to improve industrial output, and in view of the manpower shortage that apparently could be done only through providing additional plant.

Chairman Martin observed that this got back to the problem discussed at the previous Board-Council meeting--how to supplement the savings of the community when they were not adequate to support effective performance of the economy.

Mr. Cook then turned to the question whether more people were hurt by high interest rates than were helped. The people who depended on earnings on their money were not the same people who were borrowing. The question was whether it was feasible to reduce consumption by more attractive interest rates. If a process of inflation was taking place, that made people want to buy and not save, even though they were offered a higher rate of return on their money. But it seemed inappropriate to reduce the attractiveness of saving, thinking in terms of developing more funds to meet the problems ahead.

Governor Brimmer recalled that at the previous joint meeting there was some speculation about what would happen if a ceiling in the neighborhood of 5 per cent was imposed on consumer-type CD's. Now a 5 per cent ceiling had been in existence for almost two months, and he inquired whether any unusual adjustments had been observed.

President Moorhead replied that the slight runoff in consumer-type CD's that banks in his area were experiencing had been reversed. However, he knew of no major shift of funds from savings and loan associations to banks or vice versa, despite the large amount of advertising that was being done.

Mr. Day said that banks in his area were spending a great deal of money on advertising and in merchandising different schemes. These included such features as daily compounding of interest and extension of maturities to the point that a maturity of 10 years was almost standard.

Mr. Knight observed that in his area savings and loans were issuing 5-1/4 per cent certificates, while others were advertising a 5 per cent passbook rate. A large savings and loan association recently advertised that its totals had increased a little over 10 per cent in October, which was better than the banks had been doing.

Mr. Cook inquired whether it was considered desirable for industrial requirements to be financed through the commercial paper market rather than through the banking system. That was occurring increasingly. The cost, with no compensating balance requirement involved, might compare favorably with bank financing, and the commercial paper would yield more to the investor than the return on CD's.

Mr. Cook added that sales of commercial paper were up very sharply this year, with the volume still increasing. The activity represented a by-passing of the banking system. Yet it was necessary to have bank lines of credit to back up the commercial paper dealers, and the banks were a little concerned about the whole development.

Comments by Board members included remarks by Governor Mitchell to the effect that the development was undesirable, of course, from the standpoint of those firms that were not in a position to get into the commercial paper market. In broader terms of social policy, further thought on the matter would seem to be required.

Governor Maisel suggested that a basic question was whether the economy should not have some slow-moving factors in it so as to deter rapid interest rate escalation. In other words, the question was whether the whole economy was not better off if certain sectors moved more slowly and did not adjust on a day-to-day basis. The commercial paper market offered relief for short periods. As Mr. Cook had indicated, the answer was very complex, but some degree of stability in the whole system was desirable, as indicated by the discussion of consumer-type CD's. If the ceiling had been set at 5-1/2 per cent, that rate would have been almost universally offered by this time. The 5 per cent ceiling apparently had not produced undue distortions. It had been possible to adjust without great difficulty through competition at the 5 per cent level rather than at 5-1/2 per cent.

Mr. Cook commented that there was the question whether the banks could meet their obligations to the economy with a 5-1/2 per cent ceiling on negotiable CD's. Perhaps the banks could not do that unless the rate was more flexible in relation to market rates.

Governor Brimmer commented, with regard to the commercial paper question, that the more alternative sources of funds available, the more efficiently the financial system worked. If the commercial paper market did not exist, the burden on the banks would be even greater.

Mr. Stewart noted that practically all the negotiable CD's were now being written on a 30-day basis, which implied a potentially dangerous situation.

Governor Shepardson referred to Mr. Cook's comments about investments to increase productive capacity. In view of manpower shortages, it appeared that most of the increased productive capacity would have to come out of modernization. He asked whether the Council felt that loans were not available for such modernization, and Mr. Cook recalled that the banks had been admonished that business loans were rising at a faster rate than desirable. He added that commercial bank loans normally were not used for the construction of facilities, but they were used to buy machinery for plants. Thus, while facilities were generally financed in the public market, bank credit was a factor in stepping up industrial production. The question was whether the banks should not be allowed to compete for funds so that they would at least be able to take care of the working capital requirements of expanding industries.

Governor Mitchell commented that business expansion had been continuing at a higher rate for a longer time than in any other post-war period. However, he did not pretend to know the answer to Mr. Cook's question. For one thing, the computer had almost revolutionized the equipment side of plant expansion. It might be that the old standards were no longer pertinent.

Governor Maisel referred to certain statistical indications that the recent rate of capital expansion was not likely to be maintained indefinitely, and there ensued a general discussion of that question, including problems of analysis introduced by capital expansion overseas. Governor Maisel then referred to GNP statistics from which it appeared that the percentage going to business plant and equipment was about 10 per cent higher than it had ever been on any traditional basis. Perhaps there had been a fundamental shift in relationships, but he did not know that anyone had developed a sound analysis in support of such a change.

Mr. Day commented that it appeared to be the tenor of Board members' comments that the modernization of plant and equipment was going forward at a rate that was unsustainable, and Mr. Bodman observed that that view seemed to be indicated in the Reserve Banks' letter to member banks of September 1, 1966. Governor Mitchell expressed the view that this was the most likely sector to fall off in event of a recession. Perhaps this view was wrong, however, in light of the technical changes that had occurred in recent years and the revised tax rules.

3. Balance of payments.

   A. How strong and widespread are current foreign demands for term loans, short-term loans, and acceptance credits from U.S. banks? Have such demands shown recent signs of changing significantly?

> Current foreign demands for term loans, short-term loans, and acceptance credits from U.S. banks continue strong though demand may not be as intense as it was a year ago before the sharp increase in the interest rate structure in the U.S. With the exception of Japan, the members of the Council are not aware of any major change in these demands in recent months.

Mr. Moore said it was his feeling that the banks had not been pushed further because of the rather general understanding of the present situation. It was inconceivable to him that the demand for credit was not strong.

Governor Brimmer referred to discussion at the previous Board-Council meeting about the practice of some U.S. banks in borrowing deposits from their foreign branches to meet domestic credit demands. He inquired about recent developments in that regard now.

Mr. Prochnow replied that the cost of such funds was extremely high, ranging around 7 per cent. It was his impression that banks were using those funds with great reluctance. However, in light of the heavy demands for credit, they were concerned about having to rely on overnight funds continually and therefore were willing to pay the high rates for the foreign funds. The fact that the banks were bidding against each other in the market for such funds tended to hold firm a higher rate than otherwise might prevail, and the procedure might be criticized on that score.

Governor Brimmer commented that the inflow of funds had resulted in some temporary statistical improvement in the balance of payments.

However, there was the question what would happen in terms of the balance of payments in the event of a slackening of credit demand domestically.

Mr. Moore replied that if the outlook for deposits was more stable and business activity moderated, this would be one of the sources of funds that the banks would pass by first. It was certainly the most expensive. However, as long as uncertainty persisted regarding the demand for money and where the funds were coming from to meet that demand, the banks probably would continue to search actively for all sources of funds.

Mr. Prochnow commented, with regard to the effect on the balance of payments, that a great deal depended on what basis of calculation was used, that is, the liquidity basis or the official settlements basis. It was his feeling that by and large the use of the funds obtained through foreign branches did not affect the balance of payments adversely, although it was necessary to examine each transaction individually, but that it tended to exert upward pressure on the interest rate structure.

Governor Brimmer then commented further on the favorable short-run statistical impact on the balance of payments and the possibility of an outflow of the funds on short notice under certain conditions. He noted, in addition, that the availability of these funds tended to undercut to some extent the policy of domestic monetary restraint.

On the latter point, Governor Mitchell commented that while some reshuffling among banks might be involved, adjustments could be made in monetary policy to maintain the overall degree of restraint that was desired.

B. Have Council members observed any significant changes in recent months in foreign attitudes towards maintaining deposits in banks in the United States and/or in the foreign branches of U.S. banks?

The members of the Council have not observed any significant changes in recent months in foreign attitudes toward maintaining deposits in banks in the United States and/or any foreign branches of U.S. banks. The relatively high rates which U.S. banks are presently willing to pay for such funds probably have helped maintain the volume of these balances.

President Moorhead said the Council felt that there had been some change in foreign attitudes, as brought out at previous meetings, but that this had not as yet translated itself into actual withdrawal of balances. The problem appeared to be related to the feeling of foreign bankers about the seeming inability of the U.S. to put its house in order. The recently enacted tax legislation would not become effective for several years, and he did not think that its passage had had any significant anticipatory effect.

C. Does corporate liquidity, or lack of liquidity, seem to be a factor now influencing corporate decisions to finance direct investments abroad by borrowing abroad?

The relative lack of corporate liquidity is perhaps having some influence on decisions to finance direct foreign investments by borrowing abroad.

President Moorhead said the Council's feeling was that U.S. corporations would be likely to borrow abroad whenever they could, particularly those corporations that were unable to finance themselves to the desired extent in this country.

Mr. Day noted that the amount of borrowing was relatively small in comparison to the total of direct investments abroad, and Governor Brimmer pointed out that one part of the Commerce Department's voluntary restraint program attempted to encourage companies to borrow overseas. He indicated that the Commerce Department program probably would continue in 1967 along generally the same lines as at present and that companies again would be encouraged to obtain financing abroad.

Mr. Moore said he thought efforts by U.S. corporations to borrow abroad did not reflect purely a liquidity problem. As indicated, such a practice was in accord with the Commerce Department program. However, not a great dollar volume was actually involved. Also, there was increasing possibility of resentment building up in European countries regarding the use of their funds by U.S. corporations. He did not know to what extent room might be left to continue such borrowing.

Mr. Cook commented that the practice seemed to be related to the increase in Euro-dollars resulting from the continuing deficit in the U.S. balance of payments. Those deficits measured the maximum amount of money that could probably be obtained, and U.S. corporations could not expect to get all of it.

Mr. Moore added the observation that the size of the corporation had a lot to do with this. When a very large corporation borrowed abroad, that was not really because of its inability to get funds anywhere else. However, medium- and smaller-size firms that might want to do some financing abroad probably would have little chance. The procedures were more complicated than in the case of obtaining credit domestically.

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

The members of the Council favor a continuation of a restrictive monetary and credit policy as they believe that inflationary pressures are likely to increase in the months ahead because of higher wages and a probable large budget deficit. Moreover, because of these pressures, the Council is hopeful that more restrictive fiscal measures also will be employed, including a reduction in nondefense spending, and, if necessary, a temporary, across-the-board increase in Federal taxes.

In the Council's memorandum to the Board in September, it expressed apprehension "about the impact on the credit and financial markets and the resulting distortions in the economy if monetary policy alone is to continue to be relied on to restrain demand." This undue reliance on monetary policy has already resulted in (1) a substantial decline in negotiable certificates of deposit outstanding, accompanied by an undesirable shortening of maturities, (2) the administration of the discount window by a kind of selective credit control, and (3) the inability of the commercial banks to compete effectively in the money markets. These developments have not lessened the apprehension of the Council as expressed in the September memorandum.

Chairman Martin expressed interest in knowing what the members of the Council would do at this juncture if they were sitting as members of the Board. For example, would they raise the discount rate, raise the ceiling rate on savings deposits, raise the maximum rate on consumer-type CD's, raise the maximum rate on negotiable CD's? The Board would also be interested in knowing how the Council members felt about the prospect for maintenance of the commercial bank prime rate under present monetary conditions. These were problems with which the Board was contending, and it was necessary to deal with the situation as it stood, not as it might have existed under different circumstances.

Mr. Day said the Council members had obtained the impression from their meeting with the Board's staff yesterday that monetary policy perhaps had accomplished about what was desired and that the peak period of attrition in CD's might now be behind. He added that banks in his area were looking ahead with some apprehension to what might happen around the middle of December and the end of the year. Periods of particular tightness had occurred this year at about 90-day intervals around tax and dividend dates. If such a situation recurred in mid-December, the Federal Reserve presumably would have to tide the banks over that hump as it did when conditions almost approached panic proportions in August. If a substantial additional amount of CD's was lost by year end, the banks would be in a most difficult position.

Asked whether it appeared that the banks could obtain a substantial amount of bona fide savings by paying higher rates of interest or that they would only attract funds from other institutions, Mr. Day said that unless the ability to pay a higher rate created a whole new distortion in the interest rate spectrum, theoretically the banks would have access to substantial additional funds by paying, say, 6-1/2 per cent and thereby attracting new money through the CD market.

Governor Robertson suggested that it could almost be assumed from what had happened in the past that there was not much likelihood that the Federal Reserve would permit a severe crisis to develop. He then asked Mr. Day what the latter would recommend, over and above what was presently being done, in terms of the use of policy instruments, and Mr. Day responded that selective controls were throwing the whole interest rate structure out of balance. He felt that perhaps the first thing that should be done was to raise the maximum rate on savings deposits. Also, the discount rate was certainly far out of line with market rates. While he would not presume to speak for the other members of the Council, he felt that at the first opportunity the discount rate should be adjusted so that it was no longer a bait for member banks to come to the discount window.

Asked whether an increase in the discount rate would ease any problem confronting the banking industry, Mr. Day said that free access to the discount window at a rate above the bill rate would relieve one of the difficulties that member banks were going through now in borrowing. When asked whether he would be willing to see the price paid in terms of the relaxation of monetary restraint that would thereby be involved, Mr. Day said that that involved a question of judgment. If the discount rate could be raised without too much risk of provoking a whole new series of adjustments in the present interest rate structure, he was inclined to believe that a desirable result might be accomplished.

When Chairman Martin inquired whether that was the unanimous view of the Council, Mr. Moore commented that it might be well to move on the discount rate at a time when such a move would not have any significant effect. If the discount rate were gotten back into the proper area of relationship, it could be used effectively as an instrument of monetary policy when needed. If an increase in the discount rate were explained publicly on the basis of recognition that the rate had been way out of line with market rates, he did not see how such an action would have great significance, and he doubted whether there would be any drastic effects in the market place. Some day the Board would want to have the discount rate in its proper relationship again and possibly this was a good time to make the move. His offhand reaction was that a discount rate increase would not affect the prime rate; the availability of money was much more important at the present time than the rate.

Governor Mitchell suggested that some moderation of credit demands, if it occurred, and fiscal policy action, if taken, might make it possible to ease monetary restraint a little. He inquired whether a discount rate increase would seem appropriate in such circumstances.

Mr. Moore replied that there was a problem, of course, in isolating any one factor in simple discussion. If he were a Board member, he believed that he would probably want to move toward a little more monetary ease, after analyzing the situation to find the best way. From that point of view, this might not be the time to change the discount rate, but the policy moves might be only weeks or months apart. Despite what Governor Robertson had said earlier, the banks were concerned about running too close to the edge in circumstances such as Mr. Day had described. If certain events should occur, the support of the Federal Reserve at such a time would have to be more drastic than otherwise.

Mr. Fleming said that he would not raise the discount rate at this juncture because the action might be interpreted as an indication that the Federal Reserve saw reason for monetary policy to become even more restrictive. It was necessary to be cautious at this stage as far as public opinion was concerned. As he saw it, the main problem, as of now, was to enable banks to hold or increase their outstanding CD's by competing effectively with other market instruments. As to the maximum rate on savings deposits, he would be slow to make a change. The consumer-type CD's enabled banks to compete for that type of savings to a sufficient extent that they should not get hurt too badly.

Mr. Fleming added that the greater the reliance on monetary policy, the greater the distortions that would occur. Whatever move was made, it was likely to cause trouble in other fields. The need was for help through fiscal policy. In the meantime the Federal Reserve should not change too much from what it was doing right now except in terms of negotiable CD's, which were the real point of vulnerability.

Mr. Stewart agreed, except that he felt the ceiling rate on savings deposits should be raised. Savings depositors were being discriminated against, and they were steadily withdrawing their funds from the commercial banks.

Mr. Watlington agreed with Mr. Stewart that the banks should be allowed to compete effectively for savings deposits. Depositors were bound to become aware at some point that they were not receiving a competitive rate at 4 per cent, and when this realization occurred withdrawals could be expected quite rapidly. The commercial banks could live with a 1/2 per cent differential, but not a greater differential, in favor of the mutual thrift institutions. All of the banks represented on the Council were experiencing attrition in passbook savings.

President Moorhead said that although the rate on passbook savings was admittedly out of line he would not raise any rates at this particular time. Instead, he would favor some slight easing of monetary policy to try to bring interest rates down. That should take care of the situation with respect to negotiable CD's. As he saw it, the main hope for assistance was the enactment of fiscal measures, and he felt the prospect for action in that area was somewhat improved. He would not be inclined to increase the discount rate because that might be a signal for even higher interest rates generally. The announcement of such action might be regarded by many people as an indication that the Federal Reserve felt that rates should be higher.

Mr. Brinkley expressed the opinion that a change in the discount rate might be construed as an indication that the monetary authorities saw no possibility of a downward trend in interest rates developing, and were admitting that this was a high interest rate period and everything should be adjusted accordingly. He saw the matter of timing as a key factor in deciding whether the savings rate or the discount rate should be increased. If the banks raised their rates on deposits and the Government needed money to finance the war and its other programs, the Treasury would have to be competitive to obtain the necessary funds, so a vicious cycle of interest rate increases might occur.

Mr. Stoner indicated that he would be inclined to ease monetary policy slightly at this juncture but not make any change in the discount rate or Regulation Q ceilings. Assuming that the Federal Reserve would stand by to help in any emergency, he would be inclined to go along as at present, except perhaps for a little easing of monetary policy.

Mr. Fleming asked for the Board's opinion about prospective inflationary pressures, and Chairman Martin replied that that was the core of the problem. In its statement on this topic, the Council had expressed the view that inflationary pressures were likely to increase in the months ahead. However, he understood from today's discussion that some of the Council members would favor a somewhat less restrictive monetary policy.

President Moorhead commented that a matter of degree was involved. There was the problem that had been mentioned several times during the discussion of enabling banks to compete for deposits, and that problem could be eased by bringing the whole rate structure down, although possibly at the risk of adding to inflationary pressures. As he had said earlier, he felt that the main hope lay in fiscal policy.

Chairman Martin commented that if some moderation of credit demands actually was occurring, as seemed possible, he assumed the Council members who favored a slight easing of monetary policy would then favor doing nothing, in hope that the moderation of credit demands would result in some decline in rates. President Moorhead agreed.

Mr. Fleming then commented on the need for information on prospective Vietnam expenditures next year in order to reach judgments, for the budgetary strain resulting from such expenditures appeared to be the principal source of inflationary pressure. If the banks could be enabled to compete in the CD market, they could perhaps get by until more facts were available on defense expenditures for 1967, but a potentially dangerous situation was involved when over $16 billion of CD's were outstanding, largely of short maturity, and the maximum rate that could be offered by the banks was less than the rate available to investors on competing instruments.

Asked what the banks would do with more funds if they were able to obtain them, Mr. Fleming mentioned the need for improving liquidity. Mr. Day emphasized that bank indebtedness was a widespread problem of high priority. He added that he was now inclined to agree with the view of Mr. Fleming regarding the discount rate. If there was any change in the discount rate, however, he felt that the terms of the letter of September 1, 1966, from the Reserve Banks to the member banks should be changed so as to permit easier access to the discount window.

Mr. Moore said he was particularly concerned about the use of selective credit controls, which he felt would lead to ever increasing problems. If such controls were not eliminated, it would probably be necessary to add to them. He doubted the feasibility of trying to help the real estate market and the home builders by switching certain rates around in a manner contrary to what was indicated by the market. When other segments of the economy got into trouble, the question would then arise of providing special help to those areas.

As to passbook savings, Mr. Moore pointed out that if depositors got out of the habit of using commercial banks for that purpose, it would take a long while to bring them back again. On the discount rate, a number of considerations admittedly must be taken into account, but it was a fact that the present discount rate level represented one of the major existing distortions. Interest rates were high in all markets at the present time, and he could not see any point in keeping the discount rate at an unrealistically low level except for the inferences that were involved in the use of the discount rate as a signal. The time might be right, in his opinion, to eliminate this particular distortion because the discount rate change would have no particular significance. He could not see why the discount rate should not be in reasonable relationship to market rates, and he felt that consideration should be given to restoring such a relationship. In his view, interest rates generally were not going to move down very fast. With the economy so active, he could not foresee any significant diminution in the need for money, so it would probably be necessary to live with some of the present rates for a while.

Mr. Cook suggested that it be borne in mind that the discount rate should be restored to a more reasonable relationship to the market at a suitable time. As to the savings deposit rate, if current conditions continued that rate should be adjusted some time in 1967, for the banks were likely to lose a whole body of savers if the rate continued substantially out of line for a protracted period.

Mr. Knight expressed the view that the savings deposit rate should be raised and that the discount rate also should be increased. As to the timing of such moves, he realized that the Board was acutely aware of the various problems that might be involved. He noted, however, that if the discount rate was not raised under present circumstances there would nevertheless undoubtedly be pressure to reduce that rate should market rates ease, so the distortion might persist for a long while. If the discount rate meant anything at all, he believed that the distortion should be eliminated.

Question was raised as to the Council's views about the possibility of reversing the recent increases in the reserve requirement against time deposits other than savings deposits, and Mr. Fleming observed that that would not have the effect of enabling the banks to obtain funds, but instead would only reduce the cost a little. When the banks needed money, they would pay whatever rate was required. To retain the volume of negotiable CD's outstanding, they must be able to pay a competitive rate, and at present 5-1/2 per cent was not competitive.

Mr. Watlington remarked that to banks such as his the CD rate was not as critical as the rate on passbook savings, for they did not depend on CD's to the same extent as the money market banks. At some point the customers who were accustomed to using passbook savings accounts were going to become disenchanted, and it would be necessary to adjust if banks were going to keep in the savings business in their traditional manner.

Chairman Martin observed that if representatives of the savings and loan associations and mutual savings banks were present at this meeting they would no doubt raise strong questions about the division of available savings among different classes of institutions, assuming that it was correct to say that total savings, short or long term, were inadequate to meet all of the demands. The problem of inflation was in a real sense a by-product of that situation. In a situation of less than full employment and substantial unutilized plant capacity, the central bank might be able to create additional money without any particular problem, but today the situation was quite different.

Mr. Watlington expressed the view that the savings and loan people would not be too unhappy with a 1/2 per cent differential, which he felt would involve a reasonably competitive relationship.

President Moorhead then commented that saving as a percentage of disposable income appeared to be consistently declining, and Chairman Martin noted that it was possible to get into many statistical arguments on that score. He was personally convinced that at certain periods there tended to be oversaving and underspending, while in other periods the reverse was true, but it was difficult to make proper measurements.

Governor Shepardson said he found it difficult to reconcile the Council's statement reflecting concern about inflation and the need for continuing a restrictive monetary policy with the suggestions made during today's discussion that implied in one way or another making more funds available to the banking system.

President Moorhead agreed that the Council's statement and the discussion were to a certain extent mutually inconsistent. He felt, however, that it was a matter of degree. The banks were concerned that monetary policy had been implemented in such a way that some day they would find themselves unable to get the funds necessary to do business. Monetary policy had accomplished a great deal, and perhaps it was time to let up just a trifle and hope to obtain assistance from other quarters. Whatever course was followed, there was admittedly some risk.

Mr. Fleming said that the Council of course supported the effort to control inflationary pressures. However, the use of monetary policy alone, in the face of budget deficits, was creating many imbalances that presented problems for the banking system. It was his feeling that fiscal policy must be brought to bear. The question was what to do in the interim.

Governor Shepardson stated that he agreed with the view that had been expressed that one distortion tended to lead to another. He would like to eliminate them. But a decision on fiscal action was still pending, and the question was whether the distortions were so great that the Federal Reserve should be making policy moves prior to receiving a better indication as to what fiscal actions might be taken.

Mr. Fleming reiterated his view that the negotiable CD's presented the most immediate problem, with the bulk of them on practically a 30-day basis. The banks could not hope to retain them unless they could pay a competitive rate. As to passbook savings, if the maximum rate was increased the savings and loans were going to have to keep a 1/2 per cent differential, and he feared that the whole structure would simply move up.

Mr. Day commented that since the last Board-Council meeting there had been an attrition of about 14 per cent in CD's. If that rate of attrition continued until the end of the year, the banks would lose approximately another \$2-1/4 billion.

Mr. Bodman suggested consideration of some arrangement that would encourage banks to lengthen CD maturities, since he agreed that the 30-day maturities presented a considerable potential danger. He had been thinking about the possibility that perhaps CD's with maturities of more than 60 days might be exempted from the 5-1/2 per cent interest rate limitation.

Governor Mitchell commented that aggregate time deposits dropped only about \$1/2 billion in October, while negotiable CD's declined about \$3 billion. This suggested that the large banks had experienced more difficulty than the smaller banks. On the other hand, some of the large banks had been doing quite well through the inflow of funds from their foreign branches.

Mr. Moore pointed out that the drop in CD's at New York banks was at the rate of 24 per cent, and Mr. Prochnow cited a rate of 30 per cent in Chicago.

Mr. Moore observed that perhaps, all things considered, it might be necessary to play for time for a little while longer, awaiting some announcement on taxes and Vietnam expenditures. At the moment, he said, he did not have any real idea how banks like his would make out in respect to their negotiable CD's. Some foreign time deposits had been switched into CD's and presumably they would be renewable, but the banks could not tell what the corporate treasurers would do. Some had kept funds in CD's thus far simply on the basis of bank-customer relationships, but it was not possible to tell how long that would continue.

It was agreed that the next meeting of the Federal Advisory Council would be held on February 20-21, 1967.

Chairman Martin expressed appreciation on behalf of the Board to Messrs. Moore, Day, Stoner, Watlington, and Cook for their contributions as members of the Federal Advisory Council, noting that their service would conclude at the end of this year.

The meeting then adjourned.

Secretary