MINUTES OF THE MEETING OF THE FEDERAL ADVISORY COUNCIL

May 16, 1960

The second statutory meeting of the Federal Advisory Council for 1960 was convened in Room 932 of the Mayflower Hotel, Washington, D. C., on May 16, 1960, at 9:30 A.M.

Present:

Ostrom Enders	District No. 1
John J. McCloy	District No. 2
Casimir A. Sienkiewicz	District No. 3
Reuben B. Hays	District No. 4
John S. Alfriend	District No. 5
General John C. Persons	District No. 6
Homer J. Livingston	District No. 7
Norfleet Turner	District No. 8
Gordon Murray	District No. 9
R. Otis McClintock	District No. 10
I. F. Betts	District No. 11
Charles F. Frankland	District No. 12
Herbert V. Prochnow	Secretary
William J. Korsvik	Assistant Secretary

On motion duly made and seconded, the mimeographed notes of the meeting held on February 15-16, 1960, copies of which had been sent to the members of the Council, were approved.

A complete list of the items on the agenda for the meeting, and the conclusions of the Council are to be found in the *Confidential Memorandum to the Board of Governors from the Federal Advisory Council,* which follows on pages 17 and 18.

The meeting adjourned at 12:35 P.M.

HERBERT V. PROCHNOW
Secretary

WILLIAM J. KORSVIK
Assistant Secretary

MINUTES OF THE MEETING OF THE FEDERAL ADVISORY COUNCIL

May 16, 1960

At 2:30 P.M., the Federal Advisory Council convened in the Board Room of the Federal Reserve Building, Washington, D. C.

Present: Mr. Homer J. Livingston, President; Messrs. Ostrom Enders, John J. McCloy, Casimir A. Sienkiewicz, Reuben B. Hays, John S. Alfriend; General John C. Persons; Messrs. Norfleet Turner, Gordon Murray, R. Otis McClintock, I. F. Betts, Charles F. Frankland, Herbert V. Prochnow, Secretary, and William J. Korsvik, Assistant Secretary.

Dr. Woodlief Thomas, Adviser to the Board, discussed the subject, "Scope of Monetary Policy and Availability of Credit". Copies of his remarks were distributed to each member of the Council.

HERBERT V. PROCHNOW
Secretary

WILLIAM J. KORSVIK
Assistant Secretary

MINUTES OF THE MEETING OF THE FEDERAL ADVISORY COUNCIL

May 16, 1960

At 8:00 P.M., the Federal Advisory Council reconvened in Room 932 of the Mayflower Hotel, Washington, D. C.

Present: Mr. Homer J. Livingston, President; Messrs. Ostrom Enders, John J. McCloy, Casimir A. Sienkiewicz, Reuben B. Hays, John S. Alfriend; General John C. Persons; Messrs. Norfleet Turner, Gordon Murray, R. Otis McClintock, I. F. Betts, Charles F. Frankland, Herbert V. Prochnow, Secretary, and William J. Korsvik, Assistant Secretary.

The Council reviewed its conclusions regarding the items on the agenda, and sent to the office of the Secretary of the Board of Governors the *Confidential Memorandum* which follows on pages 17 and 18, listing the agenda items with the conclusions reached by the Council. The Memorandum was delivered to the Federal Reserve Building at 10:30 P.M. on May 16, 1960.

The meeting adjourned at 9:15 P.M.

HERBERT V. PROCHNOW
Secretary

WILLIAM J. KORSVIK
Assistant Secretary

MEMORANDUM TO THE BOARD OF GOVERNORS FROM THE FEDERAL ADVISORY COUNCIL RELATIVE TO THE AGENDA FOR THE JOINT MEETING ON MAY 17, 1960

1. What are the views of the Council regarding the current business situation and prospects of business activity during the remainder of the current calendar year? The Council's judgment as to the current expectations of the business community and the general public and the impact of those expectations on capital expenditures, business inventories, and consumer expenditures would be appreciated.

The members of the Council report that business is at a relatively high level. While there was some hesitation in the economy in the latter part of the first quarter, employment, retail sales and business activity in general improved in April. However, the output of steel, the production of durable goods and construction, including housing, are not enjoying the high level of activity that characterizes the economy generally.

The Council believes that the expectations of the business community and the general public indicate that capital expenditures and consumer purchases will be at a high level for the remainder of the year. Despite the favorable outlook, the rate of business buying for inventories will probably lessen, as total inventories are at record levels, reflecting the rapid buildup in the first quarter. While the ratio of inventories to sales is below historical averages, there are some indications that it is less favorable than it was earlier this year.

Although business may not be as buoyant as the optimistic forecasts early this year, the Council believes that business will continue good during the remainder of the current calendar year.

2. How does the current demand for credit compare with demands at this season of other recent years? What is the prospective demand for bank loans and other credit during the remainder of this year? Will the anticipated substantial increase in plant and equipment expenditures be financed by internal funds, term loans, or resort to capital markets?

Most members of the Council report that the current demand for credit exceeds that at this season in other recent years.

The Council believes that the demand for bank loans and other credit will be strong during the remainder of the year. The anticipated substantial increase in plant and equipment expenditures will be financed largely by internal funds with some resort to the capital markets. In those instances where internal funds prove to be inadequate, principally in medium and smaller businesses, term loan financing by banks may be required.

3. Has there been a reduction in liquidity of banks so great as to hamper them in meeting the more essential needs for credit? Are there differences in this respect among groups of banks, such as money market banks, banks engaged principally in industrial and commercial lending, and banks in agricultural areas?

While there have been increases in certain types of longer-term credit, indicating some lessening in the liquidity of banks, the reduction has not been so great as to hamper the banks in meeting the more essential needs for credit. The Council uses the phrase, "essential needs for credit," in the sense of customary, short-term or seasonal credit requirements. In the opinion of the Council there are no significant differences in these developments among groups of banks. However, banks which are reluctant to liquidate portions of their bond portfolios at a loss may be hampered in meeting all of the essential needs for credit in their communities.

4. What have been recent developments in the volume of the various forms of savings? Is public interest in United States Government securities as widespread as it was last fall?

Total savings appear to be increasing with a larger share of the increase going to those institutions, such as the savings and loan associations which are paying higher rates. While the public interest in United States Government securities now is greater than it was a year ago, it is not as great as it was at the time of the issuance of the "magic 5's."

5. The Board would be glad to have the views of the Council regarding the appropriateness of monetary and credit policy in recent months.

The members of the Council believe the Board's monetary and credit policy in recent months has been appropriate and well executed. The degree of restraint appears to have been suitable under prevailing conditions.

MINUTES OF JOINT CONFERENCE OF THE FEDERAL ADVISORY COUNCIL AND THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

May 17, 1960

At 10:30 A.M., a joint conference of the Federal Advisory Council and the Board of Governors of the Federal Reserve System was held in the Board Room of the Federal Reserve Building, Washington, D. C.

Present: Members of the Board of Governors of the Federal Reserve System:

Chairman Wm. McC. Martin, Jr.; Vice Chairman C. Canby Balderston; Governors M. S. Szymczak, J. L. Robertson, Chas. N. Shepardson and G. H. King, Jr.; also Mr. Merritt Sherman, Secretary, and Mr. Kenneth A. Kenyon, Assistant Secretary of the Board of Governors.

Present: Members of the Federal Advisory Council:

Mr. Homer J. Livingston, President; Messrs. Ostrom Enders, John J. McCloy, Casimir A. Sienkiewicz, John S. Alfriend, Norfleet Turner, Gordon Murray, R. Otis McClintock, I. F. Betts, Charles F. Frankland, Herbert V. Prochnow, Secretary, and William J. Korsvik, Assistant Secretary.

Absent: Mr. Reuben B. Hays and General John C. Persons.

The President read the first item on the agenda and the conclusions of the Council as given in the *Confidential Memorandum to the Board of Governors from the Federal Advisory Council*, as printed on pages 17 and 18.

There followed an informal exchange of views on the business outlook, including some discussion of current international developments and the effect they might have on United States economy. In discussing the decline in the level of farm land prices, the view was expressed that the fear of inflation was tending to diminish. In response to an inquiry on foreign competition from Chairman Martin, President Livingston said that he was concerned that more and more people seemed to be thinking in terms of protection.

President Livingston read the second item on the agenda, and the conclusions reached by the Council, as expressed in the *Confidential Memorandum*. In response to a question by Governor Balderston, President Livingston said that term lending was on the increase but not to a significant extent.

The third and fourth items on the agenda and the conclusions of the Council were then read by President Livingston.

The President of the Council then read the fifth item on the Agenda and the conclusions of the Council as expressed in the *Confidential Memorandum* to the Board. An extended discussion followed.

In response to the question on monetary and credit policy in the months ahead, President Livingston noted that he felt the Council would favor making money somewhat easier rather than tighter. It was suggested by Mr. McCloy that the Board might wish to consider accomplishing this objective by acting on the reserve requirements of the central reserve city banks as outlined by the recent statute enacted by the Congress. President Livingston added that he shared Mr. McCloy's view but did not want to suggest action on reserve requirements of the central reserve city banks if that would be in conflict with the Board's general credit policy. Chairman Martin replied that the various questions involved in implementing reserve requirement legislation were under continuous study by the Board.

Various other matters were then discussed by the members of the Board and the Council. President Livingston noted that many members of the Council were concerned about the declining liquidity of the commercial banking system and its ability to provide the legitimate short-term credit requirements of the community. In response to a question by Governor Shepardson as to how banks would meet the problem if loan ratios were to go higher, President Livingston replied that most bankers recognized an obligation to care for the needs of short-term commercial borrowers. If necessary, he continued, the bank would turn down term loans and reduce consumer credit so as to be in a position to take care of the essential needs of short-term commercial borrowers.

Chairman Martin expressed agreement with an observation by President Livingston that inflation psychology seemed to have died down and recalled having publicly stated that in his opinion inflationary psychology had been partially liquidated.

There then followed a discussion of Regulation Q. President Livingston reported that he believed banks generally would be opposed to an increase in the 3 per cent ceiling. He also observed that there might be a question whether the law prohibiting the payments on demand deposits should not be changed. It might be argued, he continued, that the markets should determine the rates payable on deposits in a free enterprise system. While acknowledging this, Mr. Sienkiewicz observed that the soundness of the entire banking system was a prime consideration.

The meeting adjourned at 12:15 P.M.

HERBERT V. PROCHNOW
Secretary

WILLIAM J. KORSVIK
Assistant Secretary

NOTE: This transcript of the Secretary's notes is not to be regarded as complete or necessarily entirely accurate. The transcript is for the sole use of the members of the Federal Advisory Council. The concise official minutes for the entire year are printed and distributed later.

H.V.P.
W.J.K.

The Secretary's notes of the meeting of the Federal Advisory Council on May 16, 1960, at 9:30 A.M., in Room 932 of the Mayflower Hotel, Washington, D. C. All members of the Council were present.

The Council approved the Secretary's notes for the meeting of February 15-16, 1960.

Livingston noted that the Council's next regularly scheduled meeting on the third Monday and Tuesday in September will conflict with the annual meeting of the American Bankers Association. After some discussion, it was finally decided to suggest to the Board of Governors that the next meeting of the Council be scheduled for September 14-15, 1960.

ITEM I

WHAT ARE THE VIEWS OF THE COUNCIL REGARDING THE CURRENT BUSINESS SITUATION AND PROSPECTS OF BUSINESS ACTIVITY DURING THE REMAINDER OF THE CURRENT CALENDAR YEAR? THE COUNCIL'S JUDGMENT AS TO THE CURRENT EXPECTATIONS OF THE BUSINESS COMMUNITY AND THE GENERAL PUBLIC AND THE IMPACT OF THOSE EXPECTATIONS ON CAPITAL EXPENDITURES, BUSINESS INVENTORIES, AND CONSUMER EXPENDITURES WOULD BE APPRECIATED.

Livingston read Item I and asked the members of the Council to comment on this item as it pertained to their districts.

There was general agreement among the members of the Council that business is at a relatively high level. Many reported an improvement in April in employment and sales. The output of steel, production of durable goods, and construction, however, were not at as high a level as the economy in general. The Council observed that the expectations of the business community and the general public indicate that capital expenditures and consumer purchases will be at very satisfactory levels. The members of the Council tended to confirm the recent surveys of business capital investment plans and consumer buying intentions. It was agreed that inventories are high as the result of a rapid build-up in the first quarter and that as a consequence business buying for inventories probably will lessen in the period ahead. The Council concluded, however, that business will continue good during the remainder of the year.

ITEM II

HOW DOES THE CURRENT DEMAND FOR CREDIT COMPARE WITH DEMANDS AT THIS SEASON OF OTHER RECENT YEARS? WHAT IS THE PROSPECTIVE DEMAND FOR BANK LOANS AND OTHER CREDIT DURING THE REMAINDER OF THIS YEAR? WILL THE ANTICIPATED SUBSTANTIAL INCREASE IN PLANT AND EQUIPMENT EXPENDITURES BE FINANCED BY INTERNAL FUNDS, TERM LOANS, OR RESORT TO CAPITAL MARKETS?

Livingston read Item II. A brief discussion followed in which the members of the Council reported a strong current demand for credit that exceeded that prevailing at this season in recent years. It was agreed that the demand for bank loans and other credit will be strong during the remainder of the year. The Council anticipates that plant and equipment expenditures will be financed largely by internal funds with some resort to the capital markets. However, a number of members reported that the internal funds of medium and smaller businesses may prove inadequate and that some term-loan financing by banks may be required.

ITEM III

HAS THERE BEEN A REDUCTION IN LIQUIDITY OF BANKS SO GREAT AS TO HAMPER THEM IN MEETING THE MORE ESSENTIAL NEEDS FOR CREDIT? ARE THERE DIFFERENCES IN THIS RESPECT AMONG GROUPS OF BANKS, SUCH AS MONEY MARKET BANKS, BANKS ENGAGED PRINCIPALLY IN INDUSTRIAL AND COMMERCIAL LENDING, AND BANKS IN AGRICULTURAL AREAS?

Livingston read Item III and referred briefly to Governor Mills' recent speech on the increasing proportion of bank assets being invested in real estate, consumer and term loans. An extended discussion followed on the liquidity of banks. While it was agreed that some reduction in the liquidity of banks had occurred, the members of the Council did not believe it had hampered the banks in meeting the more essential needs for credit in their communities. The Council was of the opinion that there was no significant difference in these developments among groups of banks. It observed, however, that banks which are reluctant to liquidate portions of their bond portfolios because of the decline in bond prices may be hampered in supplying the credit demanded by borrowers in their communities.

A brief discussion followed on the reduction of reserve requirements of the central reserve city banks in accordance with the law enacted by the Congress at the last session. There also were comments on the possibility of lowering reserves on savings deposits.

Enders suggested that the members of the Council review these proposals, particularly those relating to changes in reserve requirements on time deposits, and that consideration be given to putting the matter on the agenda for the meeting in September. The members of the Council concurred with the suggestion.

ITEM IV

WHAT HAVE BEEN RECENT DEVELOPMENTS IN THE VOLUME OF THE VARIOUS FORMS OF SAVINGS? IS PUBLIC INTEREST IN UNITED STATES GOVERNMENT SECURITIES AS WIDESPREAD AS IT WAS LAST FALL?

Livingston read Item IV. In the discussion which followed, the members of the Council reported that total savings appear to be increasing but that as in the past the larger share of the increase is going to the savings and loan associations which are paying higher rates. There was some discussion on the 3 per cent ceiling on interest which can be paid to savings depositors. Most of the members of the Council believe that public interest in United States government securities is greater now than it was a year ago but not as great as it was last fall at the time of the issuance of the "magic 5's."

ITEM V

THE BOARD WOULD BE GLAD TO HAVE THE VIEWS OF THE COUNCIL REGARDING THE APPROPRIATENESS OF MONETARY AND CREDIT POLICY IN RECENT MONTHS.

Livingston read Item V and observed that this item involved a review of the past rather than comments on the future. There was general agreement that the Federal Reserve Board had done a good job and that monetary credit policy had been appropriate and well executed.

The meeting adjourned at 12:35 P.M.

THE COUNCIL CONVENED IN THE BOARD ROOM OF THE FEDERAL RESERVE BUILDING, WASHINGTON, D. C., AT 2:30 P.M. ON MAY 16, 1960. ALL MEMBERS OF THE COUNCIL WERE PRESENT.

Dr. Woodlief Thomas, Adviser to the Board of Governors of the Federal Reserve System, discussed the subject, "Scope of Monetary Policy and Availability of Credit." A copy of Dr. Thomas' remarks is attached.

* * * * *

THE COUNCIL CONVENED AT 8:00 P.M. ON MAY 16, 1960, IN ROOM 932 OF THE MAYFLOWER HOTEL. ALL MEMBERS OF THE COUNCIL WERE PRESENT.

The Council prepared and approved the attached Confidential Memorandum to be sent to the Board of Governors relative to the Agenda for the joint meeting of the Council and the Board on May 17. The Memorandum was delivered to the Federal Reserve Building at 10:30 P.M. on May 16.

It was agreed that the President of the Council would make some comment at the joint meeting with the Board on the reduction of reserve requirements of the central reserve city banks. It was also agreed that the Council would inquire of the Board if it would be helpful if the Council took some action on the Patman Bill relating to membership in the Federal Reserve System.

Livingston invited members of the Council as an "intellectual exercise" to consider the idea of paying interest on demand deposits. He stated that a number of corporate treasurers had indicated to him that they would keep funds on deposit in their demand accounts rather than buy Treasury bills or commercial paper if they received 2 per cent on such demand deposits. A brief discussion followed in which a number of members of the Council indicated that the earnings of many banks would not permit the payment of interest on demand deposits.

The meeting adjourned at 9:15 P.M.

SCOPE OF MONETARY POLICY AND AVAILABILITY OF CREDIT*

Credit developments in the past year have furnished clearer -- though not necessarily new -- insights into the role and functioning of monetary policy. Newly developed statistical tools of analysis have contributed to this clarification. One of the common faults in appraising monetary policy is failure to recognize the limited area or scope of its operations, while at the same time belittling the broad area of its indirect consequences. Some of the recent events and some of the appraisals of monetary policy that have appeared in the past year illustrate this fault.

Scope of Monetary Policy Operations. - Monetary policy operations, it is always important to keep in mind, are directly concerned with the provision of money, defined narrowly to cover only cash balances that the public holds in currency or on demand deposit with banks. Monetary policy operations exert their influence by supplying reserves to the banking system to be used as a basis for expansion of their loans and investments and creation of money.

In deciding what course monetary policies should pursue, the basic question is how much money should the banking system be permitted to create at the time. What are the considerations involved in finding an answer to this question? Monetary policy operations should be viewed as a part of the saving-investment process that provides for balanced economic growth. Changes in the money supply are in effect the portion of savings that the public chooses to hold in the form of cash balances. The volume of bank credit extended necessarily corresponds to this amount (with due allowance for other elements in banks' balance sheets). This in effect is the quantitative limit on the scope of monetary policy operations. But determination of what is the appropriate quantity is not so simple.

In quantitative terms, changes in the money supply are but a fraction of aggregate current savings, and correspondingly changes in bank credit are ordinarily only a small part of total capital and credit made available in any period. On the average the total of commercial bank credit outstanding and annual changes in that total amount to less than one-fourth of the corresponding aggregates for all types of credit. If time and savings deposits at banks are excluded from bank credit, giving a figure corresponding to the money supply narrowly defined, the proportion is reduced to a smaller figure. The amount of Federal Reserve credit needed to meet the currency demand and supply the reserves held against the deposits created is in turn a small fraction of any addition to the money supply.

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*Remarks by Woodlief Thomas, Adviser to the Board of Governors of the Federal Reserve System, to the Federal Advisory Council, May 16, 1960.

These quantitative comparisons are significant because they indicate why monetary policy operations, or even commercial bank credit extension, should not be expected to provide directly any amount of credit that may be wanted to meet specific demands. The relationship between the amount of credit that may be desired at any time and the volume of cash balances that the public is willing to hold is not fixed or automatic. The bulk of credit needs must be met out of saving, not by the creation of additional money.

This does not mean, however, that monetary policies do not influence the broader aspects of economic activity. The influence can be tremendous, though not controllable through monetary policy measures. The multiple expansion of bank credit created on the basis of a given amount of reserves exerts a correspondingly greater direct impact on the economy than does the particular operation of the central bank in supplying the reserves. This expansion ratio at present is about six to one for demand deposits at member banks.

Use of the deposits by their holders provides a further multiple expansion, and this rate of use has varied widely during the past forty years, with significant variations in the course of a business cycle. The transactions velocity rate is somewhat more than 25 to one -- it was larger in the 1920's and half as much at the end of World War II. The income velocity rate (computed from GNP) has varied between 4 to one and 2 to one. It is now about 3 1/2 to one.

To what extent the total volume of monetary transactions is affected by monetary policies and to what extent determined by other factors may vary considerably from time to time. If the public should want to hold more cash than is provided, spending will be curtailed as attempt is made to build up cash balances. Under such circumstances policies may well be directed toward encouraging monetary expansion, if economic resources are not being fully utilized. If, however, more money is provided than the public wants to hold in cash balances, spending is stimulated; the total volume of spending might increase even more rapidly than the supply of money. At times of strong credit demands accompanied by restraint on monetary expansion, the bidding up of interest rates might induce the more active use of existing cash. Under these conditions the creation of additional money ought to be restricted. Conversely, slack credit demands that result in falling interest rates may encourage the holding of large idle balances. At such times an increase in the volume of money, relative to the volume of transactions, might appropriately be provided or encouraged.

In the final analysis, the willingness and ability of the public to spend are influenced by many other factors than the supply of money outstanding, narrowly defined to include only cash balances, or than changes in that supply. As previously pointed out, the velocity of money has varied considerably over time. One important influence is the public's holdings of liquid assets other than cash and the ability to convert such assets into cash. Monetary policy formulation must take into consideration any actual or potential changes in the public's holdings of liquid assets, including money substitutes, as well as money proper, and also changes in the rate of use of money. Policies adopted should be directed toward adjusting the supply of money accordingly.

Monetary policies through their ordinary procedures can exercise but little direct control over the types of loans and investments that banks acquire. Nor can they control the extent or type of uses that the public makes of the money that is being created -- not to mention usage of the large stock of money already in existence. Since the magnitudes of these uses are so much greater than the actual quantitites of monetary policy operations, it should be evident that monetary policy should not be expected to control or determine all aspects of economic activity.

For the same reason monetary policies should not be expected to determine the structure of interest rates, although they do have some limited effect on the level. In the long run, both the level and structure of interest are determined by the relationship between credit demands and the volume of saving available for lending. These amounts in turn are influenced by interest rates, and monetary policy must be careful to avoid endeavoring to maintain an inappropriate level of rates.

Credit Expansion without Monetary Expansion. - This rather simplified description of the scope and impact of monetary policy operations is well illustrated by events of 1959 and early 1960. The facts are cogently revealed in the complex interrelationships of the Federal Reserve flow-of-funds tabulations, which are now published quarterly in the Federal Reserve Bulletin. An extensive analysis of factors affecting saving and interest rates and the role of monetary policy, based in part on flow-of-funds data, is given in the 1959 Annual Report of the Board of Governors of the Federal Reserve System.

In brief, the striking feature of the past year is that the increase in the total volume of all types of credit outstanding was larger in 1959 than in any previous peacetime year, while bank-created money showed practically no growth. The total credit growth was $60 billion, against $45 billion in 1958 and also in 1955 -- previous record years. This credit growth included record-breaking increases in mortgage loans, other consumer credit, and U.S. Government borrowing (excluding war years), with business borrowing relatively moderate.

Total loans and investments of commercial banks and the Federal Reserve Banks (excluding interbank transactions) increased by less than $4.5 billion. Most of this expansion was counterbalanced by increases in time deposits, U.S. Government deposits, and bank capital, rather than by an increase in the public's holdings of demand deposits and currency, which amounted to little over $1 billion.

The next striking and somewhat paradoxical development is that commercial bank loans increased in 1959 more than in any previous year. In addition to the moderate growth in time deposits and in bank capital, the principal source of funds to meet these loan demands was the sale by banks of U.S. Government securities to nonbank holders. In other words, banks supplied record amounts of credit to businesses and consumers to finance expanding economic activity, but the funds to meet these credit demands were largely obtained from the savings of the public -- past and current -- and only to a negligible extent through creation of new money by the banking system.

In addition to absorbing about $8 billion of Government securities from banks, nonbank investors also took on some $10 billion of additional securities issued by the Government and by Government agencies. Furthermore, they supplied some of the funds for a record expansion in mortgage credit and other consumer credit and they increased their holdings of corporate and State and local government securities by moderate, though not record-breaking amounts.

Some of these funds represented genuine long-term savings of individuals invested directly or through savings institutions. A significant development in 1959 was the large increase in direct investment and the decrease in amounts channeled through financial institutions. A substantial portion of the funds reflected an increase in holdings of liquid assets and a shift in the form of such holdings from cash balances or other claims on financial institutions to direct investment in liquid, interest-bearing assets. The outstanding example of this type of development was the accumulation of short-term Government securities by nonfinancial corporations. Another of lesser magnitude was the shift of foreign banking funds -- and probably some domestic balances -- from time deposits at banks to Treasury securities. Another example is the popularity of the 5 per cent Treasury notes (the magic fives) and to some extent of Treasury bills among relatively small investors in the latter part of the year and in early 1960. Holdings of marketable Government securities by individuals showed a remarkable increase -- estimated by the S.E.C. at $10 billion.

Rise in Interest Rates. - Interest rates played a significant role in these developments. Although there was an increase in gross savings -- by businesses and individuals -- available for lending and investment, borrowing demands were even larger.

With a monetary policy that restrained the creation of additional bank credit, the pressure of the enormous credit demands upon the supply of savings available for lending caused interest rates to rise. There were also other factors responsible for rising interest rates. One was the prevalent expectation of continuing inflation with a diminution in the value of savings. A corollary of this attitude was the popularity of equities and other forms of income-producing property, such as farm lands. Federal Reserve policy became more restrictive in supplying reserves. Reserves were reduced by the gold outflow, which was only partly offset by Federal Reserve purchases of securities. Member banks had to increase their borrowings at the Reserve Banks in order to maintain their reserve positions. This exerted a restraining influence that induced banks to sell Government securities in order to meet loan demands.

It is reasonable to draw the conclusion that the higher interest rates that resulted had a number of effects:

(1) They no doubt stimulated some increase in the total volume of saving -- at least as compared with what might have happened under the circumstances if attempt had been made to keep interest rates down.

(2) They caused savings, including liquid balances, to be shifted from lodgment in institutions with limited or no interest return to direct investment in marketable securities.

(3) To an increasing extent, higher interest rates, together with increases in stock prices without commensurate increase in earnings and dividends, offset the advantage of equities as an inflation hedge and diminished their popularity, while increasing the popularity of fixed-interest securities.

Loan Expansion, Monetary Contraction, and Declining Interest Rates. - Events in the first four months of 1960 introduced a somewhat different turn of events that give a further insight into the role of interest rates. In the first quarter of this year, abstracting from the usual seasonal decline in bank credit and the money supply, bank loan demand continued heavy and banks continued to meet these demands by reducing their holdings of Government securities. The securities sold by banks were absorbed by nonbank investors. In this process the money supply actually decreased by somewhat more than the usual seasonal amount.

This decrease in the money supply was not forced by any tightening of monetary restraints. To some degree, the reduction in required reserves resulting from the decline was permitted to ease the situation. Member bank borrowings (and net borrowed reserves) tended to decline, but in the early weeks of the year they continued large enough to keep the banks under some restraint and to induce them to sell Government securities to meet loan demands. In March and April, Federal Reserve operations eased seasonal pressures and member bank borrowings declined considerably.

The striking new feature that appeared in 1960 was a marked decline in interest rates. Most rates -- both short and long -- declined to the lowest levels since the spring of 1959. To some extent this decline in rates may be attributable to seasonal influences, similar to those that have developed following sharp rises characteristic of quarterly tax and other settlement periods during the past year or more. To a significant degree, however, it seems to reflect a change in basic forces and in expectations. March was the first quarterly tax payment month since 1958 when interest rates did not rise.

Many factors accounted for this decline in interest rates, along with a strong loan demand and net liquidation of total bank credit. Certainly one of the most important was the substantial decline in over-all credit demands due to the termination of the large Government deficits that characterized 1958 and 1959. Another influence has been the lessened allure of common stocks and the shift from stocks to fixed interest securities. A most significant factor seems to be the desire of the public to hold liquid assets in other forms than cash -- a tendency initiated by the higher interest rates in 1959 but which developed so far as to bring down the level of rates in 1960. To what extent the decline in interest rates may represent an increase in the volume of saving relative to over-all credit demands will be revealed only as more information becomes available.

Accompanying the decline in the money supply in the early weeks of 1960 was a marked increase in the rate of turnover of money. In the early part of last year, an increase in turnover accompanied a slackening in the rate of growth in the money supply. After the middle of that year, when economic activity was limited by the steel strike, the volume of money declined slightly and the turnover rate showed little change. Despite some lull in economic activity due largely to weather conditions in February and March 1960, the rate of deposit turnover rose sharply in February and remained high in March and April -- about 7 per cent higher than last year. Money supply was less than 1 percent lower. On balance, it is evident that expansion in the total volume of monetary transactions and of economic activity generally was not prevented by the decline in the money supply that has occurred since last summer.

Conclusions as to Past Year. - Restraint on monetary expansion in the face of vigorous credit demands in 1959 caused rising interest rates, which in turn attracted into investment savings adequate to finance a substantial economic expansion and a large Government deficit with little monetary creation. In early 1960 the continued flow of saving into investment, together with termination of the Government deficit, resulted in both a contraction of total bank credit and a decline in interest rates, along with a continued high level of economic activity. These developments may be viewwd as an indication of the effectiveness of a restrictive monetary policy in permitting economic expansion without unsustainable credit developments. Freely functioning money and capital markets with flexiblt interest rates served to bring saving and investment into balance and to allocate financial resources among various claimants.

More recently there have been signs of another shift in the money market. Interest rates have turned up, and in some cases have regained about half of the decline of the first quarter. Stock prices also rose from the lows of early March but then declined again. These shifts in securities markets accompanied growing indications of a pick-up in economic activity. The rise in interest rates has occurred notwithstanding an easier reserve position at banks, with a decline in member bank borrowing to the lowest level in over a year.

Interest rates -- particularly on Treasury bills -- have tended to fluctuate widely at below previous highs. Some decline in interest rates from the high levels reached in late 1959 and early 1960 might have been expected in view of the decrease in Government borrowing -- in fact a net reduction in the public debt. Private credit demands have not increased sufficiently to offset that influence. Yet, with so much liquidity held in Treasury bills rather than in bank deposits and with bill rates below the discount rate, wide fluctuations in bill rates are to be expected in response to temporary variations in cash needs.

Bank credit developments show evidences of some shift in trend. Bank liquidation of Government securities seems to have lessened. Banks acquired substantial amounts of the new Treasury issues in April and have been slower in liquidating them than in some other recent financings. Loans on securities have also increased -- particularly to dealers in Government securities which built up their position. Bank loans to consumers and to finance companies also increased. Business loans, excluding those to finance companies, have shown only moderate changes in recent weeks.

The money supply decline seems to have halted. Some increase -- seasonally adjusted -- has occurred in the past two months. U.S. Government deposits have remained at a higher than expected level. Time deposits have shown some moderate expansion, with an increase in interbank time deposits.

Federal Reserve operations played an important role in facilitating the flotation of the Treasury issues and perhaps in bringing about a shift in bank credit. Substantial purchases of bills in the market and liberal repurchase accommodation to dealers have provided additions to the reserve supply. In contrast to recent trends, required reserves increased much more in April than had been projected on the basis of the estimated increase in Treasury deposits at banks and the usual trends in other deposits. In addition, Easter currency demands absorbed more reserves than had been expected, but much of this has returned. Member banks were able to meet the substantial increase in required reserves and at the same time reduced somewhat further their borrowings at the Reserve Banks.

With respect to current Federal Reserve operations, it can hardly be said that the System is following a particularly restrictive policy. Although the discount rate remains at 4 per cent, reserves have been made available and member bank borrowings have declined to a moderate level with a lessening in the number of borrowing banks. Rates on Treasury bills -- except for the new one-year issue -- have remained below the discount rate. Question may be raised as to how much credit restraint is likely to be needed in the near future.

Although economic activity is at a relatively high level and will probably continue its expanding trend, the expansion is likely to be moderate and the threat of a boom in this country does not seem to have much basis, although boom conditions exist in some other countries. There are many structural elements in the current economic situation of this country that may serve to prevent or limit any revival of speculative tendencies, without the need for credit restraint.

The elimination of the Federal Government deficit has removed one of the most important factors working toward inflationary tendencies, but there can be speculative or otherwise unsustainable developments without a deficit. Evidences of excess capacity and of some elements of slack in the economy, however, may help to dampen any such tendencies. Growth in the labor force has not kept pace with the population of working age, yet reported unemployment continues larger than at some previous times of high activity. The margin is not large, but there are growing signs of successful efforts to economize on the use of labor. The high level of wages and other labor costs encourages such attempts. This tendency is likely to continue.

There is also an increased margin of unused productive capacity in industrial plant and equipment. Capital expenditures are expected to increase moderately in the year ahead and will add to that capacity equipment that will help to lower costs and further reduce the need for labor.

Building activity generally has been reduced from the high levels reached in 1959, and there may be some doubt whether a building boom of great proportions could be regenerated even with an increase in the availability of financing and lower long-term interest rates.

The post-strike inventory expansion quickly revealed that stocks of goods were larger than necessary under the circumstances. Although the adjustment to a more normal rate of inventory accumulation may have ended or be approaching an end, only moderate stimulation should be expected from this source in the near future.

Requisites for further maximum and sustainable growth in the economy rest primarily in the selling and pricing policies of business. Demands for the increased supply of goods and services that industry is capable of producing will need to be stimulated by attractive pricing and by offering goods that the public wants. It is to be hoped that growing competition at home and abroad will foster the adoption of such practices. The necessary adjustments, however, will not be easy to make in view of past rising price trends. Failure to make them and any tendency toward price increases will be more of a damper on the economy than a basis for expansion.

In the meantime, until demands are stimulated, business profits are not likely to increase much. Continued increase in wages and other labor costs may offset the effects of increased productivity and exert a squeeze on profits. For this reason there should be little cause to fear the resumption of speculative tendencies in the stock market.

Interest rates in the past year reached a level that has encouraged saving and attracted savings into fixed-interest investment. The current rate of saving is probably adequate to meet the credit and investment demand that will develop this year. Not only does the current level of interest rates relative to returns on equities put a damper on stock prices, but it may also restrain spending for consumption and encourage certain types of investment. At present there seems to be no reason to force interest rates any higher.

Slackening in the rate of growth in the money supply was necessary during the past year in view of the rapid expansion of the preceding year and the large volume of liquidity being supplied by the issuance of short-term Government securities to finance the deficit. Although these liquid assets are still outstanding, their growth has ceased, and some expansion in money might safely be resumed.

One limitation on credit and monetary expansion, other than the availability of reserves, rests in the reduced liquidity positions of banks. Although no satisfactory standards are available to measure the possible impact of this factor, there has clearly been a significant change.

This enumeration of existing structural limitations on exuberance is not intended to convey the impression that adequate growth will not occur. Nor should it be interpreted as suggesting that monetary and fiscal policies should be redirected toward increasing buying power or stimulating credit expansion. It is designed merely to indicate that official restraints on the use of credit may be less necessary in the immediate future than they have been at other times of high activity in the postwar period. The situation may change quickly and may even now be in the process of changing. Presently available information and analysis, however, supports the view that the current somewhat more relaxed monetary policy is not inappropriate.

CONFIDENTIAL

MEMORANDUM TO THE BOARD OF GOVERNORS
FROM THE
FEDERAL ADVISORY COUNCIL
RELATIVE TO THE AGENDA FOR THE JOINT MEETING
ON MAY 17, 1960

1. What are the views of the Council regarding the current business situation and prospects of business activity during the remainder of the current calendar year? The Council's judgment as to the current expectations of the business community and the general public and the impact of those expectations on capital expenditures, business inventories, and consumer expenditures would be appreciated.

The members of the Council report that business is at a relatively high level. While there was some hesitation in the economy in the latter part of the first quarter, employment, retail sales and business activity in general improved in April. However, the output of steel, the production of durable goods and construction, including housing, are not enjoying the high level of activity that characterizes the economy generally.

The Council believes that the expectations of the business community and the general public indicate that capital expenditures and consumer purchases will be at a high level for the remainder of the year. Despite the favorable outlook, the rate of business buying for inventories will probably lessen, as total inventories are at record levels, reflecting the rapid buildup in the first quarter. While the ratio of inventories to sales is below historical averages, there are some indications that it is less favorable than it was earlier this year.

Although business may not be as buoyant as the optimistic forecasts early this year, the Council believes that business will continue good during the remainder of the current calendar year.

2. How does the current demand for credit compare with demands at this season of other recent years? What is the prospective demand for bank loans and other credit during the remainder of this year? Will the anticipated substantial increase in plant and equipment expenditures be financed by internal funds, term loans, or resort to capital markets?

Most members of the Council report that the current demand for credit exceeds that at this season in other recent years.

The Council believes that the demand for bank loans and other credit will be strong during the remainder of the year. The anticipated substantial increase in plant and equipment expenditures will be financed largely by internal funds with some resort to the capital markets. In those instances where internal funds prove to be inadequate, principally in medium and smaller businesses, term loan financing by banks may be required.

3. Has there been a reduction in liquidity of banks so great as to hamper them in meeting the more essential needs for credit? Are there differences in this respect among groups of banks, such as money market banks, banks engaged principally in industrial and commercial lending, and banks in agricultural areas?

While there have been increases in certain types of longer-term credit, indicating some lessening in the liquidity of banks, the reduction has not been so great as to hamper the banks in meeting the more essential needs for credit. The Council uses the phrase, "essential needs for credit," in the sense of customary, short-term or seasonal credit requirements. In the opinion of the Council there are no significant differences in these developments among groups of banks. However, banks which are reluctant to liquidate portions of their bond portfolios at a loss may be hampered in meeting all of the essential needs for credit in their communities.

4. What have been recent developments in the volume of the various forms of savings? Is public interest in United States Government securities as widespread as it was last fall?

Total savings appear to be increasing with a larger share of the increase going to those institutions, such as the savings and loan associations which are paying higher rates. While the public interest in United States Government securities now is greater than it was a year ago, it is not as great as it was at the time of the issuance of the "magic 5's."

5. The Board would be glad to have the views of the Council regarding the appropriateness of monetary and credit policy in recent months.

The members of the Council believe the Board's monetary and credit policy in recent months has been appropriate and well executed. The degree of restraint appears to have been suitable under prevailing conditions.

ON MAY 17, 1960, AT 10:30 A.M., THE FEDERAL ADVISORY COUNCIL HELD A JOINT MEETING WITH THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM IN THE FEDERAL RESERVE BUILDING, WASHINGTON, D. C. WITH THE EXCEPTION OF MR. HAYS AND GENERAL PERSONS, ALL MEMBERS OF THE COUNCIL WERE PRESENT. MR. HAYS AND GENERAL PERSONS WERE OBLIGED TO BE ABSENT BECAUSE OF PREVIOUS COMMITMENTS.

THE FOLLOWING MEMBERS OF THE BOARD OF GOVERNORS WERE PRESENT: CHAIRMAN MARTIN, VICE CHAIRMAN BALDERSTON, GOVERNORS SZYMCZAK, ROBERTSON, SHEPARDSON AND KING. MR. SHERMAN, SECRETARY, AND MR. KENYON, ASSISTANT SECRETARY OF THE BOARD OF GOVERNORS, ALSO WERE PRESENT.

The minutes of the joint meeting are being prepared in the office of the Secretary of the Board of Governors of the Federal Reserve System. Their content will be compared with the notes of the Secretary of the Council. Assuming they are in substantial agreement, they will be distributed to the members of the Council.

The meeting adjourned at 12:15 P.M.

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The next meeting of the Council will be held September 14-15, 1960.