A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington on Tuesday, August 21, 1956, at 10:00 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Erickson
Mr. Johns
Mr. Mills
Mr. Powell
Mr. Robertson
Mr. Shepardson
Mr. Vardaman
Mr. Fulton, Alternate

Messrs. Bryan, Leedy, Treiber, and Williams, Alternate Members, Federal Open Market Committee

Messrs. Irons and Mangels, Presidents of the Federal Reserve Banks of Dallas and San Francisco, respectively

Mr. Harris, First Vice President, Federal Reserve Bank of Chicago

Mr. Riefler, Secretary
Mr. Thurston, Assistant Secretary
Mr. Solomon, Assistant General Counsel
Mr. Thomas, Economist
Messrs. Abbott, Parsons, Roelse, Willis, and Young, Associate Economists
Mr. Carpenter, Secretary, Board of Governors
Mr. Sherman, Assistant Secretary, Board of Governors
Mr. Miller, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mr. Gaines, Manager, Securities Department, Federal Reserve Bank of New York

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 7, 1956, were approved.

Before this meeting there had been distributed to the members of the Committee a report covering open market operations during the period August 7, 1956, through August 15, 1956, and at this meeting a supplementary report covering commitments executed August 16, 1956, through August 20, 1956, was distributed. Copies of both reports have been placed in the files of the Committee.

Mr. Treiber stated that Mr. Rouse had not come to this meeting because he felt it desirable to remain in New York in view of the disturbed situation in the Government securities market. He went on to say that net borrowed reserves had been larger than anticipated and that one of the reasons for this was a greater decline in the volume of float than had been expected. Government securities prices declined sharply during the last few days on the rumor that credit policy might become more restrictive, although the market steadied yesterday after purchases of $69.5 million of bills for the System account. Mr. Treiber suggested that these declines were related to recent increases that had taken place in yields on corporate, State, and municipal obligations. If no further System actions were taken, projections of the New York Bank indicated that average net borrowed reserves during the week ending August 22 would approximate $331 million. Mr. Treiber added that a report from the trading desk that morning indicated a great deal of uncertainty in the market, reflecting the discussion as to tight money and higher interest rates in the New York papers, and the reaction to the announcement that the First National Bank of Boston had increased its prime loan rate to 4 per cent.

Chairman Martin referred to Mr. Treiber's comment on float, noting that in accordance with the authorization at the preceding meeting a committee on float comprised of Messrs. Erickson, Johns, and Robertson, Chairman, had been appointed.

Mr. Robertson added that the committee would meet today with a subcommittee that had been appointed to assist in its study of float.

Mr. Mills referred to Mr. Treiber's comment on the assumption that the increase in yields for U. S. Government securities was a natural alignment with the increase in yields for corporation, State, and municipal securites and raised the question whether it was not more accurate to interpret the increase in yields on corporation, State, and municipal obligations as the result of a supply and demand situation in which market demands far exceeded the supply of investment funds. He cited the fact of a similar supply and demand situation at the time that yields on Treasury bills were forced down sharply and out of line with the general structure of interest rates, but in this instance with the demand for Treasury bills exceeding their available supply. Under these circumstances, Mr. Mills wondered if there were grounds for believing that present high yields on corporation, State, and municipal obligations are the result of a special supply and demand situation in the investment market and, therefore, it might not be correct to assume that the yields on U. S. Government securities should increase in direct relationship with rising yields on corporation, State, and municipal obligations. Mr. Mills stated that it was his belief that recent increases in yields on U. S. Government securities were a direct reflection of tight money market conditions.

Mr. Treiber responded that corporate, State, and municipal obligations were alternative investments for U. S. Government securities to an extent and that there was some shifting from one type of investment to another.

Mr. Hayes commented that it was difficult to separate the factors influencing these types of investments since they were closely related. He mentioned especially the tendency for higher rates on corporate bonds to lead to additional bank loans as an alternative source of financing, with the further result that banks were likely to liquidate Government securities to raise the required funds.

Mr. Mills suggested that the Committee should avoid a too facile conclusion in explaining the changes in the Government securities market.

> Upon motion duly made and seconded, and by unanimous vote, the open market transactions during the period August 7 through August 20, 1956, were approved, ratified, and confirmed.

At Chairman Martin's request, Mr. Young made a statement on the economic situation, supplementing the staff memorandum distributed under date of August 17, 1956. Mr. Young's statement was substantially as follows:

Since the last meeting of the Committee, domestic economic activity has featured three developments of special note:

(1) Price advances in the industrial commodity area, especially for metals and metal products, have been numerous and sizable.

(2) Industrial output has rebounded sharply from the July steel strike reaction.

(3) In the central money markets interest rates have risen appreciably.

The round of industrial price advances was tipped off by the general increase of about 7 per cent in steel prices. Prices of pig iron, coke, stampings and steel parts, and some machinery were promptly raised. About this time and also following wage settlements, prices of aluminum, magnesium and their products were advanced. Among materials, scrap copper recovered some, steel scrap attained a new high, rubber and tin rose a bit, and glass and brick were marked up further. At the consumer goods level, various metal product items, tires, and gasoline have risen.

While the general industrial price picture has had a noteworthy upward tilt, two significant areas, namely textiles and lumber, have been showing weakness.

Farm prices have changed little since May, with grain prices evidencing fair strength and livestock prices, especially for cattle, a definitely rising trend.

Consumer prices, which rose about 2 per cent from early spring to June, are expected to show a further rise to mid-July, reflecting higher food costs and further rise in rents and prices of services.

With over-all activity in metal fabricating activity up in July, rather than down as a result of the steel shutdown, the rebound in steel activity has carried quickly to 95 per cent of capacity this week. While textile activity has been off further this month and auto assemblies have been off considerably for model changeover, other manufacturing areas have been operating at advanced levels. Thus, a better over-all performance for industrial production is likely this month than was expected two weeks ago.

Construction activity in July advanced further, with residential construction about unchanged and industrial construction and construction for military installations up. Construction costs continue to rise, but with some slackening in rise observable in residential building costs.

Some questions have arisen recently about the strength of the construction area because seasonally adjusted contract awards have been declining since January. This is an erratic series and a satisfactory seasonal adjustment is difficult to effect. Taking the performance of contract awards for the year to date, it is of interest that awards have run 8 per cent above a year earlier. While considerably below early-in-the-year figures, awards for the past two months have only been slightly below the all-time record for these months set last year.

Recent wage settlements as well as other labor market data confirm the continuation of strength for the labor market. While nonfarm employment was off in July, the decline represented mainly the direct effects of the steel strike. The average work week in manufacturing was unchanged at 40.1 hours, though it usually declines in July, and average hourly and weekly earnings experienced only a small decline as a result of the steel strike.

Farm production reports, reflecting improved agricultural conditions, now indicate a total output about the same as last year's, with livestock production up moderately and crop production off moderately. If the average of farm prices holds at current levels and with soil bank payments of a quarter of a billion dollars realized farm income should be maintained close to last year's total. Credit extensions to farmers have expanded further this year, but growth in nonreal-estate borrowing has been at a slower rate than last year.

Personal income is estimated to have shown a slight decline in July from the record June level, resulting mainly from the effects of the steel strike, but the rebound in industrial activity should put the August total ahead of June. In addition to the recovered flow of wage payments, income figures will commence to register recent wage settlements as well as upward cost-of-living adjustments.

Reflecting sustained strength in personal income and also favorable shopping weather, as well as widespread consumer optimism, retail sales for July were up 3 per cent over a year ago. Durable goods sales were off mainly because of reduced automobile sales. Sales at furniture, appliance, and department stores were in record volume, and sales gains at nondurable goods stores showed a very large increase from a year ago. Department store sales in August thus far have held at July levels. New car sales for early August have run about at the same rate as July, but used car sales have been up some. Stocks of new cars were up some, but for used cars down further. Outstanding instalment credit, seasonally adjusted, continues to show a small rise--about $125 a month. Diversified consumer durable goods paper and personal loans are now accounting for more of the rise than automobile paper.

> In major countries abroad, most recent information continues to show intensive utilization of productive resources and upward price and balance of payments pressures. Some European experts are commencing to feel that world-wide boom is losing momentum and tapering off, and are asking whether this development, if actually occurring, may not make more critical various persisting imbalances as well as uncovering new and unsuspected weaknesses. Foreign economic trends in these circumstances will warrant specially close attention by System observers.

Mr. Thomas reviewed important developments in the financial area since the preceding meeting, stating that the most striking of these was the sharp rise in interest rates of all kinds. Pressure on capital markets had continued and several offerings had been deferred or withdrawn. A moderate seasonal increase had taken place in bank loans. The first phase of the Treasury's cash financing had been completed with much of the offering having been placed in banks, at least temporarily. The reserve position of banks had tightened from the unduly easy situation that existed in June and July. Operations for the System account had been resumed within the past week, in line with the policy of meeting seasonal needs for reserve funds.

Treasury bill rates rose from around 2-1/4 per cent in July to above 2-3/4 per cent last week, Mr. Thomas said, and this week's bill auction averaged 2.82 per cent. Rates on three to five year Government issues currently had risen to nearly 3-1/2 per cent, a new high level since 1930. Yields on long-term securities also had risen and were now close to their 1953 peak. Mr. Thomas also noted that a Boston bank had increased its prime rate to 4 per cent. The rise in money rates appeared to be partly seasonal and was related to the Treasury's financing, Mr. Thomas said, and it also reflected a growing recognition of demand pressures, actual and prospective, in money markets; expectation of an increase in the discount rate; the cash offering by the Treasury; and the tighter reserve position.

Of the $3.2 billion total of Treasury tax anticipation certificates paid for on August 15, about $2 billion were subscribed for by banks, but many of these were sold immediately to nonbank customers. The Treasury balance was expected to be around $5.6 billion by August 22--an amount adequate to meet needs until late October, after which perhaps $2 billion of new financing would be needed to cover requirements during the remainder of this year.

Reporting member banks showed an increase of over 3/4 of a billion dollars in total loans and investments during the last five weeks, Mr. Thomas said, compared with an increase of $200 million in the corresponding period of 1955. Most of this increase was in holdings of U. S. securities reflecting the tax anticipation certificates acquired last week; loans increased less than last year. Demand deposits adjusted showed a bigger decrease during the past week than a year ago but this followed increases in immediately preceding weeks that were larger than a year ago. The reserve position of banks was tighter last week than had been contemplated, partly because float declined to a more nearly normal level after the abnormal increase during June and July. Mr. Thomas stated that in the absence of further System action, net borrowed reserves might rise to around $600 million in the week ending August 29 because of a further decline in float and because of a run off in repurchase agreements. Assuming normal seasonal changes and moderate growth in deposits, the September average would be above $600 million and the October average would be above $700 million.

Mr. Thomas then referred to a development since the end of 1954 in credit extensions by banks, stating that there had been a steady increase in loans and a decrease in holdings of Government securities that had resulted in a rise in the ratio of loans to total loans and investments to the highest levels since the early 1930's. While this ratio was only the roughest sort of an index, the recent development raised the question whether the higher current ratio of loans to total loans and investments would cause banks to restrict lending regardless of the availability of reserves. Mr. Thomas also pointed out that the sales of Government securities by banks meant that other investors had purchased them when they had not been willing to buy corporate securities, and he suggested that this might indicate a need for a higher interest rate on the latter. Higher bill rates and a larger volume of bills might induce banks to acquire and hold more Treasury bills and to make fewer loans. Also, higher interest rates on bank loans might encourage borrowers to go to capital markets for long-term capital purposes even at higher rates. Mr. Thomas suggested that higher rates on private security issues might attract savers away from Government securities. In concluding his comments, Mr. Thomas referred to the continued heavy demand for capital funds which was putting pressure on banks. In his view, this indicated a need for continuation of the policy of restraint that the Committee has been following.

Mr. Johns referred to a discussion he had had with a businessman within the past few days and to some of the comments Mr. Young had made in his review of the economic situation. This businessman indicated a growing concern that the capital expenditure boom might be "tailing off", Mr. Johns said, and he inquired of Mr. Young regarding information bearing on this question.

Mr. Young responded that figures on plans for plant expansion for the United States would not be available until September. However, recent similar data for Canada which would be affected by much the same factors as data for the United States showed quite an increase in capital expenditure plans of businessmen, compared with figures of expectations compiled last spring.

Mr. Thomas commented that postponement of plans for plant expansion would be a desirable development, in view of the near-capacity level of activity that now exists.

Chairman Martin then called on Mr. Hayes who made a statement substantially as follows:

1. Most of the measures of production, consumption, and prices seem to confirm that the economy is still

definitely in an expanding phase. There are a few indications, however, that consumer demand may have lost some of its forward momentum. Sales of new homes in some areas have fallen off rather sharply in recent weeks, and a further decline in residential building appears likely. Also, the current boom has been in progress for about two years and, with the exception of the highway program and perhaps heavier defense expenditures, there are no major new forces of expansion in sight.

2. The tendency toward price increases is spreading both in raw materials and in finished goods. This trend results primarily from recent wage increases rather than capacity limitations or demand pressures. Eventual offsets to rising costs through increasing productivity are only a long range possibility and are no remedy for the inflationary threat in the near future.

3. Pressure of demand for long-term capital funds is more pronounced than pressure on physical resources. With business and personal savings insufficient to match this demand, the latter is tending to "slop-over" into demand for bank credit, and this is accentuated by the reluctance of borrowers to accept sharply higher long-term interest rates. The recent deferring of a number of long-term offerings points up this problem. We cannot look with equanimity on the use of a large volume of bank credit for capital purposes.

4. Bank credit is expected to increase substantially this autumn, though probably less than a year ago. A large amount of reserve funds will have to be supplied during the remainder of the year to meet normal seasonal requirements.

5. The money market has been and remains very tight. The generally restrictive policy that the System has been following for more than a year has already created a notable degree of credit restraint and has been successful in restricting the growth of the money supply during the past year. Banks are very short of liquid assets and are already "rationing" credit to a considerable extent. Fears have been expressed in some quarters that credit might become unobtainable by many prospective borrowers at any price.

6. Under these circumstances, while continuance of a general policy of restraint is justified, we are inclined to doubt whether the use of open market operations to effect appreciably greater restraint would be justified. Net borrowed reserves have recently been around $300 to $400 million and gross member bank borrowings around $900 million to $1 billion. There may be risks in forcing borrowings much above the $1 billion level. In other words, the System should probably be prepared to supply through open market operations most of the reserves needed for seasonal purposes in the next few months, in order to leave net borrowed reserves and gross borrowings somewhere near their recent levels. Our tentative projections

suggest that moderate purchases of Treasury bills might be required in the next few weeks.

7. It is problematical whether corporations and individuals remote from the money market are sufficiently aware of the desirability of resisting price increases, deferring borrowing programs, stretching out capital spending programs, and expanding corporate savings as much as possible. (Parenthetically, it may be noted that equity financing has tended to be neglected in favor of debt increases, despite the new highs in the stock market.)

8. An increase in the discount rate would appear called for at this time. The way has been paved by continued imposition of strong credit restraints through open market operations. A rate rise would very probably not result in a more serious credit stringency than is desired. It would serve as a clear signal to the general public that the System is concerned over the inflationary outlook and is trying to resist this trend. We would hope that any action on the rate by the Federal Reserve Bank of New York would be coordinated with similar moves by other Reserve Banks (other than those whose rates are already in excess of 2-3/4 per cent). For this reason our Directors decided to defer action at last Thursday's meeting--although majority sentiment seemed to favor an increase now or in the very near future--so that the subject could be discussed fully here today.

9. In regard to timing of any rate increases, the prospective Treasury cash financing in October and a large refunding in November seem to mark the next six weeks as the only favorable period during the remainder of 1956.

10. As for the amount by which the rate should be raised, we recognize that a case might be made for an increase of 1/2 per cent, one argument being that the market has already discounted a rise of 1/4 per cent by the ten Banks whose rate is now 2-3/4 per cent. However, we are afraid that a rise of 1/2 per cent might constitute too severe a "shock" to the market and might touch off a disorderly erosion of bond prices that would necessitate System intervention. Also there is at least a possibility that present boom tendencies may be more temporary than current business reports might suggest. Moreover, it might be a mistake to take rather drastic action when monetary measures at best are probably of only limited effectiveness against a cost inflation such as we now face. Also, a sudden large change in interest rates might create undue difficulties for the Treasury. The substantial adjustment now going on in market rates on long and intermediate maturities and also in the Treasury bill rate is accomplishing much that might be accomplished by a very sharp increase in the discount rate. This reduces the need for more dramatic rate action.

> We therefore feel that an increase of 1/4 per cent to 3 per cent is indicated, as it should provide the needed signal to the business community, should probably cause relatively little disturbance to the market, and should help to establish a new rate plateau on which dealers and underwriters could base their rate quotations and break the present log-jam in the capital markets.

In response to a question from Mr. Vardaman, Mr. Hayes said that it was difficult to name any figure of net borrowed reserves that should be used as a guide to open market operations although he had used the figures of $300-$400 million as a rough indication of his thinking. However, operations should be governed more by the feel of the market than by any figures.

Mr. Erickson said that the economic state of New England did not differ from the general description given in the economic review presented at this meeting. Sales, production, and employment are up. In June, loans of reporting member banks went up moderately, but during the past two weeks they had increased very markedly. Mr. Erickson recalled that at the preceding meeting of the Committee he reported a smaller use of the discount window in the First District. That had not been the case during the last two weeks, he said, when borrowings had increased to an average around $50 million. In speaking of screening loans, he told of a comment by one of the Boston bankers who had turned down an attractive 5 per cent large term loan application.

Mr. Erickson's view was that the discount rate should be increased, and he stated that he planned to recommend such an increase at the meeting of the Boston Bank's directors to be held on September 10 although he would attempt to have a special meeting called to consider the question if action was taken by other Reserve Banks prior to that time. He hesitated to suggest any figure of net borrowed reserves to be used as a guide to open market operations, stating that these should be judged by the feel of the market. He hoped, however, that negative free reserves in the $300-$400 million range would do the job.

Mr. Irons said that conditions in the Dallas District did not differ greatly from the reports he had given in other recent weeks. There had been further improvement in the petroleum industry, in retail trade, and in nonagricultural employment. While there had been some decline in residential building and drought continued to worsen the outlook somewhat in nonirrigated areas, on the whole the same high level of activity that had been maintained for many weeks continued in the Eleventh District, with such changes as were occurring being largely seasonal in nature. In the credit area, reporting member bank loans increased last week after several weeks of rather little change. Mr. Irons judged that there was less pressure than was true somewhat earlier and he noted that member bank borrowings at the Federal Reserve Bank were running in the $18-$25 million area in contrast with $40-$50 million a couple of months ago. As he had indicated at earlier meetings, relatively few banks were borrowing and only four or five of these were country banks.

Mr. Irons said that he felt we had reached the point where the discount rate should be increased to 3 per cent but he would dislike going to a higher level at this time. He did not think action should be delayed much longer and he planned to recommend an increase at the next meeting of the directors of the Dallas Bank. This was scheduled for September 13, but if another Reserve Bank acted before then, Mr. Irons stated that he would attempt to have a special meeting of the Dallas directors arranged to consider the question of the discount rate as soon as possible. He concurred in the view that this was a period in which open market operations should complement the discount action. He would not use any figure of net borrowed reserves, feeling that operations should be left to the management of the account, which should take actions with respect to the availability of reserves on the basis of needs, in accordance with the current general policy of the Committee.

Mr. Mangels said that the Twelfth District had given little evidence of change in economic activity since the preceding meeting. Demand for bank credit continues strong and banks still give assurance that they are screening loans carefully, although they state that no legitimate demands for credit are being turned down. Bank loans in the Twelfth District increased during July and early August at a lesser rate than Mr. Thomas had reported for the national total, Mr. Mangels said, or than the increase in June of this year or July a year ago. The moderate net increase reflected additional loans to mining and manufacturing firms as well as some increase in construction loans, while consumer loans declined.

Mr. Mangels suggested that the policy agreed upon by the Committee two weeks ago was about what should be continued for the present, with negative free reserves somewhere in the $300-$400 million range, depending upon the feel of the market. As to the discount rate, contrary to his report of two weeks ago, the directors of the San Francisco Bank at their most recent meeting unanimously acted to maintain the existing 3 per cent rate. Another meeting of the executive committee which would be attended by almost all directors of the San Francisco Bank would be held tomorrow, and Mr. Mangels said that he presumed the existing rate would be maintained at that time.

Mr. Powell said that the pattern of business conditions in the Ninth District was becoming fixed for the rest of this year. While the wheat crop is running about a quarter below that of last year, other crops are turning out to be large and livestock prices have risen since last winter, with the result that the farm sections of the district will have at least an average income this year. In the city area, retail trade is just about holding even with a year ago, which is quite a reduction from the experience of the last several months when the Ninth District was showing some of the largest gains in retail trade. Banks are considerably more comfortable than they were, with some reduction in loans and sales of sizable amounts of Government securities. They are not borrowing heavily at this time.

Mr. Powell stated that nationally he felt the situation was delicate and that we might be on the verge of a disorderly market, although it had not yet reached that stage. An increase in discount rates for other districts seemed to be in order, and there was no expectation of a move to reduce the rate in the Ninth District. Open market operations should be conducted rather aggressively, Mr. Powell said, noting that this was the beginning of the peak of demand in the agricultural areas and that an increase in reserves through the open market could result in little danger at the present time, especially since such reserves would be needed shortly in any event to meet the seasonal demands. His preference would be to purchase bills to meet this need and to attempt to offset nervousness and uncertainty in the money market.

Mr. Harris said that the tone of economic activity in the Seventh District was similar to that described for other areas. The steel strike repercussions were nowhere near as great as had been feared. Production of automobiles was not likely to exceed 6 million passenger cars and 1.1 million trucks this year, compared with a total of 9.2 million vehicles last year. New car stocks are expected to be down to 550 thousand by August 31, about 100 thousand less than a year earlier, and year-end inventories are expected to be about the same as the August 31 figure. The automobile industry as a whole is very happy with the rate of clean-up of 1956 models and has complete confidence in the outlook for the 1957 models.

The subject causing most comment in the Seventh District during the past few days, Mr. Harris said, has been the state of the bond market. Some bankers feel that the market is disorderly and have wondered why the System does not do something about it by way of putting in reserves. One of the directors of the Chicago Bank indicated he would be loath to vote for an increase in the discount rate unless positive action were taken by the System to put reserves into the market to relieve the situation. Another banker had indicated that he no longer subscribed to Treasury bond issues because the market price would be below his subscription price before the securities were delivered. Mr. Harris felt that the uncertainty indicated by these and other statements was important. At the same time, many have already discounted an increase in the discount rate and have projected conditions that might exist based on increases in that rate to 3 per cent, 3-1/4 per cent, or 3-1/2 per cent. It might be desirable to increase the discount rate to 3 per cent to indicate an awareness on the part of the System of the rising price level, Mr. Harris said, but before doing so he would like to see the System put some reserves into the market through purchases of bills. He would like to see net borrowed reserves in the $200 million area or less. In other words, the Committee should reassess its present policy with a view to adding reserves to the market.

Mr. Leedy said he had no material changes to report for economic activity in the Kansas City District since the meeting two weeks ago except that agricultural conditions had worsened in certain areas because of the drouth. On credit policy, Mr. Leedy felt that in the period immediately ahead the System should move promptly on the discount rate, especially in view of the fact that the prime rate and other money rates have already been moved up. The Open Market Committee might continue with the policy agreed upon at the meeting two weeks ago of applying pressure on bank reserves. Perhaps it should aim in the direction of reducing net borrowed reserves somewhat while adjustments to an increase in the discount rate were taking place.

Mr. Leedy went on to say that the question in his mind was whether the System would be in position to move further toward restriction a little later, and whether an additional increase in the discount rate beyond a rise of 1/4 per cent would be required this fall. If further increase were to be necessary, he felt the System would be in difficulty unless the first step were taken promptly. One reason for a move of 1/4 per cent at this time was to get the market settled a little by eliminating uncertainty over the discount rate. Mr. Leedy emphasized that in making this suggestion he was speaking in the light of national conditions inasmuch as conditions in the Kansas City District were not such as to require immediate action on the discount rate.

Mr. Vardaman said that he felt about the same as he did two weeks ago when he thought somewhere in the neighborhood of $200 million negative free reserves would be proper, with the understanding that the Committee might go as high as $400 million if that seemed necessary in the light of any special circumstances that might develop. He was not conscious of any circumstances that had developed that had warranted more than $200 million of negative free reserves. He agreed that no single figure could be used as a guide and that the management of the account had to "play by ear" but he would prefer now to have a policy that would call for negative free reserves somewhere in the $200-$250 million to zero area at this particular time as a means of reestablishing confidence. Mr. Vardaman added he was not particularly concerned with the apparently chaotic conditions in the Government securities market, believing that this situation would straighten itself out. As to the discount rate, he did not feel that bringing the 10 Banks now below the 3 per cent level up to that rate would have any effect in the market, and he thought Mr. Leedy might have a point in suggesting that the Committee should be poised to go above a 3 per cent rate a little later if that seemed necessary.

Mr. Mills said that as he looked at the problems of the Committee, the abrupt increase that occurred in the level of negative free reserves to around $400 million had superimposed heavy pressure on an already tight money market and has been responsible for the disturbing market situation. As an indication of tightness, he referred to the approximately $11 million of bankers' acceptances reported by the Federal Reserve Bank of New York to be overhanging the market. The fact that the commercial banks took up $2.2 billion of the Treasury's recent $3.2 billion offering of tax anticipation certificates was also held by Mr. Mills to be a significant indication of tightness in that corporations and other types of investors did not participate more broadly in the offering. Considering the illiquid positions of the commercial banks, the possibility could now be raised that unless supplied with some new reserves they would be compelled rapidly to sell off their holdings of the new tax anticipation certificates and, in so doing, contribute further to the difficult position of the U. S. Government securities market.

Mr. Mills stated that in his opinion the System was presently following a destructively restrictive credit policy which, unless changed, would in its logical conclusions lead to waves of unemployment with consequences both to the Federal Reserve System and the economy that would be too many to discuss at the present time. It was his belief that a retreat should be made, to the end of bringing the level of negative free reserves down toward a $200 million level, but on a gradual basis that would test the response of the market to such actions by the System and in that way guide the System to the point at which the market for U. S. Government securities would stabilize. It was Mr. Mills' opinion that such a point of stability would fall realistically in line with a 3 per cent discount rate, and it was his thought that

that discount rate at the Federal Reserve Banks was in order.

Mr. Robertson said that perhaps he was more fearful of inflation than some others had indicated by their comments this morning. Policy has not been too restrictive, he felt, and the results that have flowed from carrying on that policy have been just about what should have been expected. Mr. Robertson said that he would not be concerned with the market, and he would align himself with the view expressed by Mr. Leedy that pressure should be kept on. He doubted the adequacy of a 3 per cent discount rate and, while it was probable the System would go to that figure rather than to a higher rate at this time, he thought we might be better off to go to a higher rate now. He agreed that the System should be poised for a higher rate later on.

Mr. Robertson referred to the continuous borrowing showing up at the Reserve Banks, stating that he felt the Committee and the System should study the desirability of a penalty rate to be applied to continuous borrowers. While banks might be screening loan applications, a very large volume of credit was still being created and this was inflationary. In reiterating the view that pressure should be kept on through the open market window, Mr. Robertson said he would not hesitate to offset some of the need for additional reserves by supplying them through the open market during the next two weeks so long as nothing was done to indicate a retreat from the level of restriction that had been attained.

Mr. Shepardson said he felt much as Mr. Robertson had indicated. There were definite indications of rising prices and there was no indication of assuaging that trend. The comment had been made that possibly credit restraint could not do much toward stopping inflation, but his view was that this was no reason for the Federal Reserve System to fail to use all the restraint that was proper in an effort to keep balance in the economy. An attrition of the dollar was most unfortunate and it was almost impossible to regain its purchasing power once inflationary influences had been felt. Mr. Shepardson's feeling was that the discount rate should be increased as soon as possible and he thought the System probably would need to go higher than the 3 per cent level before this year was over. The System should, of course, supply the reserves needed to meet fall seasonal demands but these should not be supplied freely or in a way that would appear to negate the aims of the System that would be suggested by an increase in the discount rate. In other words, the additional reserves that might be needed should be supplied sparingly.

Mr. Fulton said that one of the surprising things in the Cleveland District was the rapidity with which the steel industry had come back into production following the strike settlement. Mills report they are booked almost solid for the fourth quarter of this year and express reluctance to take on more orders for steel. Tool steel and structural shapes are in record backlog, Mr. Fulton said. Other industries are also reporting high levels of activity and hugh backlogs of orders. Unemployment is very moderate and the situation as a whole is one in which all employable persons are able to find jobs readily. Loan demands in the Cleveland District are continuing strong and bankers look for further moderate increases in applications for short-term credit this fall. They state that demand for term loans is far beyond what they can handle. Some bankers have indicated that interest rates for bond financing have risen to a level that has caused corporations to turn to bank credit instead of floating new issues for capital expenditures. Bankers state that they are being selective but that demand is very insistent and large in total. It would be inappropriate for the System to supply funds through the open market in such quantity as to permit price pressures to build up further, Mr. Fulton said. He believed that restraint should be maintained, there should be no relaxation, and discount rates should be brought up to the 3 per cent level.

Mr. Williams said that the directors of the Philadelphia Bank acted a few days ago to increase the discount rate by 1/4 of one per cent to the 3 per cent level, following a full staff presentation of banking and economic data which showed that pressure of demand for credit in the Third District was relatively stronger than in the United States as a whole. The directors also discussed the situation in the United States as a whole. Two of the directors from the utilities field, in voting for the increased discount rate, emphasized the view that the market needed some certainty and while they were not enthusiastic about higher rates, they felt such a move would be desirable. Bankers in the Philadelphia District are concerned that they will not be able to meet the legitimate needs of business for credit this fall. Mr. Williams said that he felt the System should move to a higher discount rate. The Manager of the System Account would have to handle the situation skillfully during the period of adjustment to that rate, but the general objective should be to maintain pressure on the market. The country was obviously in the throes of uncertainty but this was only in terms of the internal situation and there was more to be lost by postponing action on the discount rate than by moving in the direction of putting pressure against the inflationary influences.

Mr. Bryan reported little change in the Atlanta District since the meeting two weeks ago noting that consumer spending continued to increase and that loans at commercial banks had risen rather contra-seasonally. Several banks which had been out of debt at the Reserve Bank a few weeks ago have now come back in. On the national picture, Mr. Bryan said that the difficult problems before us included not only what policy the Committee should follow but also what techniques it should use. His view was that further restraint had to be applied. The pressures with us are inflationary. At the same time, he was not clear as to what the market was trying to tell us, and his concern was that the situation be handled without precipitating a disorderly market if that was possible. If a disorderly market were to develop, the Committee might be compelled to undertake some support operations to prevent a panic, and that might result in loss of control to effect policy for some period of time. Mr. Bryan felt that the System should flag down borrowing banks by telling them that borrowing is going to cost them more, that they would have to police their loans more rigidly, and that they would have to try to avoid making capital loans in so far as that was possible. After borrowing banks had been flagged down by an increase in the discount rate, the account would have to be extremely adept if it were to avoid creating a disorderly situation in the market. The past has demonstrated that a given level of free reserves means one thing at one time and another thing at another time, so that policy decisions aimed at a given level of free reserves often produce unpredictable money rate effects; and that fundamental difficulty is compounded because the factors affecting free reserves often exhibit erratic and unpredictable behavior from day to day, so that, regardless of our difficulty in appraising the monetary effect of an aimed-at level of free reserves, we are even unable in the short-run to effect the intended level of free reserves with any substantial degree of precision. Mr. Bryan hoped that the management of the account in trying to estimate its actions would not have in mind any level of free reserves but would have in mind the behavior of the market which should be related to the interest rate. If large adjustments are indicated by an increase in the discount rate, action should be taken to supply reserves freely to avoid precipitating a panicky decline in the Government securities market.

Mr. Johns said that in attempting to present the comments of a businessman earlier during this meeting, he did not intend to associate himself, at least without grave qualifications, with the position that had been indicated. He, along with members of his staff at the St. Louis Bank, had been greatly concerned recently about the techniques that should be followed at this time in conducting credit policy. Yesterday afternoon he had read an announcement in Business Week to the effect that credit policy decisions have been taken, not only as to content but as to timing. Mr. Johns said that on the side of timidity this announcement generated relief, but on the side of his responsibility as a member of the Open Market Committee he felt some resentment that he was not to participate in the decisions. He recognized how ingenious writers are but in this case he wondered whether there was a basis for the story that had appeared in Business Week. Mr. Johns said that he felt the members of the Open Market Committee were entitled to know what, if any, basis there was for the statement.

With respect to policy, Mr. Johns said that he was inclined to believe greater restraint was necessary. He also felt it could best be accomplished by increasing the cost of credit rather than by further restriction on credit availability. Restrictions on the availability of credit in the capital markets are already well known.

There is an imbalance between the supply of investment funds and demand for such funds, he said, and he was inclined to think that if anything could be done to redress that imbalance, action should be taken on the cost side calculated to dampen the increasing demand for credit, realizing that whatever the System did about the supply side would be a slow process.

Mr. Johns went on to say that he was concerned about the spillover of capital demands into the banking sector. Restraint needed to be applied on the cost side with the objective of inhibiting borrowers rather than of inhibiting lenders. He was inclined to think that a moderate rise in short-term interest rates would not restrict lenders very much.

Mr. Johns said that, as indicated by Mr. Hayes, a case could be made for increasing the discount rate by more than 1/4 per cent. However, he was timid about making a greater increase at one time and would go along with an increase of 1/4 per cent at first, although he would be ready to take the next step without delay. He would not increase the pressure on reserves and would not permit the net borrowed reserve figure to go higher. If anything, he would wish to see it decline from the $400 million level, feeling that the desired effects should be gotten by an increase in the cost of credit.

Mr. Johns said he was interested in Mr. Robertson's suggestion as to a penalty rate to be assessed against continuous borrowers. He would be reluctant at the present time, however, to apply such a rate in the Memphis area where banks would be borrowing continuously for legitimate reasons at this time of year.

In response to a question from Mr. Vardaman, Mr. Hayes stated that during a transitional stage in which the market might be adjusting to a higher discount rate, he would not contemplate using open market operations as a means of applying additional restraint. In fact, it might be desirable to supply additional reserves through the open market. He would not hesitate to provide reserves, based on the feel of the market from day to day, especially if in the transition to a 3 per cent rate it was found that near-disorderly conditions developed.

Chairman Martin said that his views had not shifted since the previous meeting of the Committee. What he had said at that time would still apply, except for the recent developments in the money market which he felt placed on the Committee some responsibility for endeavoring to keep conditions that are not disorderly. His personal view was that conditions have not been disorderly up to the present time, although he recognized that this was a matter of judgment.

Chairman Martin referred to the question whether the boom in capital goods was coming to an end and to the fundamental point mentioned at the preceding meeting having to do with misdirection of economic resources. He noted specifically a comment that Mr. Harris had made, which confirmed his fears regarding the attitude of persons in the automobile industry. At this time of year, business activity might be expected to be seasonally slow and a real push in production would not be anticipated until mid- or late-September. Without intending to be critical of automobile company managements, he was fearful that they were again misjudging the market. We are dealing with a very difficult virus, the Chairman said, and there are indications already of overcapacity in some segments of the economy that have been created over a long period of defense build-up. In the long run, this build-up of capacity in certain lines would have important effects, and one of the problems would be to minimize undesirable effects. The System wished to preserve employment and prevent or minimize unemployment that would come from an excess of capacity created indiscriminately under the impression that industry could pass increased costs on to the public in the form of higher prices. One of the reasons it has been impossible to keep discussions that have gone on in this room from the public is that the public is participating in these discussions because of what they see every day. This should be expected when the signs of inflation are as clear as they are now. Chairman Martin referred to letters he was receiving bearing out this fear on the part of the public, adding the comment that the disease of inflation was recognized by many persons and that they were frightened by it. This included labor leaders who fear unemployment in mid-1957 or 1958, if the present trend continues.

The System should be trying to do everything that it could to prevent unemployment from arising in a way in which it could not be handled, Chairman Martin said. He recalled the closing comment that

Mr. Young had made in his economic review at the meeting two weeks ago to the effect that the problem faced by the economy at this time is inflation fed by the competitive spending, investing, and borrowing propensities of a highly optimistic business and consumer public, and that the dangers lie partly in misdirected use of resources. The Chairman emphasized the need for the System to use monetary and credit policy to produce an efficient allocation of the country's resources, including savings, as far as that reasonably could be done by market processes. He said that he was completely familiar with the fact that credit policy was inhibiting the lender more than the borrower, but he did not know how to achieve the other objective.

The question of timing of a change in the discount rate was important, Chairman Martin said, and he referred to the action taken by the Philadelphia Reserve Bank to increase its rate to the 3 per cent level, stating that he assumed additional Banks would soon be taking similar action. He then asked for comments as to the timing of an announcement by the Board of an increase in the discount rate and whether it would be preferable for such announcement to be made this week or a little later.

On this question, Mr. Hayes expressed the view that under the conditions discussed at this meeting, the sooner the action was taken the better from the standpoint of clarifying to the business community the System's policy.

After discussion of this question, Chairman Martin referred to Mr. Johns' comment earlier during the meeting regarding the statement that appeared in the current issue of Business Week. The Chairman said that while he had not read this statement, he had been following the press very closely for the past week or ten days and that he had observed positive statements in several different publications that the System was going to increase the discount rate. He was particularly anxious to state for the record, he said, that he had talked with a reporter for Business Week recently but that he did not discuss the question of current action on the discount rate, although he did discuss the action that had been taken last April. If the reporter deduced from this discussion anything as to action that might be taken at the present time he did so entirely on his own, Chairman Martin said. However, the timing of such action was entirely in the hands of the System. It was necessary always to keep in mind that a large number of persons was present at these meetings when the subject of a change in the discount rate was under discussion. It was impossible to keep conjecture from occurring, the Chairman said, but each of us must be extremely careful to remember that he has a special responsibility, vis-a-vis the press.

Chairman Martin then turned to the wording of the Committee's directive to the Federal Reserve Bank of New York, inquiring whether any members of the Committee wished to suggest a modification of that wording at the present time. There were no suggestions for change. The Chairman noted that there was some difference in the views as to the volume of net borrowed reserves that should be maintained during the period between now and the next meeting of the Committee. He did not know how these different views could be resolved, but he was glad to note that more and more the members of the Committee were moving away from the use of a figure of net borrowed reserves as a guide. In attempting to sum up the majority view as to policy for the immediate future, the Chairman said that he gathered that none of the members of the Committee wished an appreciable relaxation of pressure in the market and that for the most part they did not wish to use open market operations to increase pressure on reserves during a period of discount rate adjustments.

At Mr. Vardaman's suggestion, Mr. Hayes reiterated his comments as to the policy that might be followed, stating that he would favor maintaining restraint somewhere near its present level, that he would not have in mind increasing the restraint, and that he would be ready to reduce pressure at least temporarily if the Account Management felt that the tone of the market seemed to require such action during the transitional period of an increase in the discount rate.

Mr. Shepardson stated that he would understand this to mean that while the level of net borrowed reserves might be reduced, this would be done as a means of maintaining about the same pressure that existed in the market and of avoiding a further build-up in pressure, and Mr. Hayes stated that this was correct. Mr. Hayes also stated in response to a comment from Mr. Robertson that he would not have in mind taking action to put reserves into the market during the next few days in a way that would indicate relaxation, subject to the reservation that if the market seemed to be getting out of hand it might be desirable to put in some reserves. However, on the basis of projections it looked as though net borrowed reserves this week would average around $250 million and it probably would not be necessary to take any further action until early next week.

Chairman Martin noted that Messrs. Erickson and Irons had emphasized the point that the Account Management should use the "feel" of the market in its operations in this particular period. He agreed that it was necessary to depend on the Account Management to do the best it could within the framework of the Committee's general policy. In the immediate future, this should be with the understanding that the Committee wished the Account Management to make every effort to avoid indicating an appreciable change in policy through open market operations, recognizing that it would be very difficult to carry out this program. None of the members of the Committee indicated disagreement with Chairman Martin's statement of policy or of procedures to be followed in carrying it out.

The Chairman then inquired of Mr. Treiber whether he would recommend any change in the amounts specified in the directive, and Mr. Treiber stated that he had no change to suggest.

> Thereupon, upon motion duly made and seconded, the Committee voted unanimously to direct the Federal Reserve Bank of New York until otherwise directed by the Committee:

(1) To make such purchases, sales, or exchanges (including replacement of maturing securities, and allowing maturities to run off without replacement) for the System open market account in the open market or, in the case of maturing securities, by direct exchange with the Treasury, as may be necessary in the light of current and prospective economic conditions and the general credit situation of the country, with a view (a) to relating the supply of funds in the market to the needs of commerce and business, (b) to restraining inflationary developments in the interest of sustainable economic growth, and (c) to the practical administration of the account; provided that the aggregate amount of securities held in the System account (including commitments for the purchase or sale of securities for the account) at the close of this date, other than special short-term certificates of indebtedness purchased from time to time for the temporary accommodation of the Treasury, shall not be increased or decreased by more than $1 billion;

(2) To purchase direct from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed in the aggregate $500 million;

(3) To sell direct to the Treasury from the System account for gold certificates such amounts of Treasury securities maturing within one year as may be necessary from time to time for the accommodation of the Treasury; provided that the total amount of such securities so sold shall not exceed in the aggregate $500 million face amount, and such sales shall be made as nearly as may be practicable at the prices currently quoted in the open market.

Chairman Martin noted that the agenda provided for a discussion at this meeting of the proposal of the New York Bank that the System account be authorized to engage in swaps of Treasury bills. He stated that he would prefer that discussion of this topic be postponed until the next meeting of the Committee, and there was no disagreement with this suggestion.

It was agreed that the next meeting of the Committee should be held on Tuesday, September 11, 1956.

Thereupon the meeting adjourned.

Winfield W. Riefler
Secretary