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, D. C., on Tuesday, May 25, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Bryan
Mr. Daane
Mr. Ellis
Mr. Galusha
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Shepardson

Messrs. Bopp,[1/] Hickman,[1/] Clay, and Irons, Alternate Members of the Federal Open Market Committee

Messrs. Wayne, Shuford, and Swan, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Brill, Holland, and Koch, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Molony, Assistant to the Board of Governors
Mr. Cardon, Legislative Counsel, Board of Governors
Messrs. Garfield, Partee, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Associate Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors

1/ Entered the meeting at point indicated in the minutes.

Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Mr. Patterson, First Vice President of the Federal Reserve Bank of Atlanta
Messrs. Eisenmenger, Sanford, Eastburn, Mann, Ratchford, Jones, Parsons, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, St. Louis, Minneapolis, Kansas City, and Dallas, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Messrs. Fousek and Sternlight, Assistant Vice Presidents of the Federal Reserve Bank of New York
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market operations and on Open Market Account and Treasury operations in foreign currencies for the period May 11 through 19, 1965, and a supplemental report for May 20 through 24, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Sanford said the gold stock would drop by another $60 million this week, the second such decline this month. The total decline since the beginning of the year thus amounted to $1,095 million and the gold stock now stood at $14,293 million. At the moment, it looked as though the pace of sales in the next couple of months would be below the very high levels of the recent past, mainly because the accumulation of dollars by France now seemed to have tapered off, at least temporarily. However, as was

evident from past experience, it was hazardous to assume that because French reserves, or those of any other country for that matter, ceased to grow for a month or so, that could be counted on as a continuing trend.

Turning to the London gold market, Mr. Sanford reported that the major development in the last two weeks had been the reappearance of Communist China as a substantial buyer. Apparently, their purchases were a reflection of the officially expressed distrust of sterling by China. Purchases during the latest period amounted to $18 million on top of the $50 million or so taken earlier this year. The Bank of England permitted the fixing price to rise somewhat, to $35.1168, from the relatively low level at the beginning of the period, $35.0916 on May 12. But to avoid sharp fluctuations in price, the Pool had to sell some gold; it sold $19 million, increasing the overall deficit from $174 million to $193 million. Apart from the Chinese demand, the gold market had been rather quiet. The price this morning receded further to $35.095.

The exchange markets had shown little movement of significance, Mr. Sanford commented. The Bank of England for the most part had been on the sidelines with the spot sterling rate drifting slightly lower. This morning sterling weakened a bit, to $2.7944, on reported selling from Paris, and Bank of England support had been necessary. The discount on three-month forward sterling continued to hold at about 1-3/4 per cent.

Mr. Sanford reported that the Canadian dollar fluctuated during the period without any lasting trend. However, it was possible that the concentration of new Canadian issues scheduled to come to the New York market in coming weeks could put pressure on the rate, especially since he understood that Chinese grain purchases from Canada were expected to reach $100 million. So far as the continental currencies were concerned, the dollar had managed to hold the gains it had made a couple of months ago. But it had not enlarged those gains except in the case of the German mark where a combination of factors--including the repatriation of foreign funds, general commercial demand for dollars, and possibly some speculation connected with expectations of an increase in the German bank rate--had pushed the mark to its lowest level since mid-1963 despite continued tight (and perhaps tightening) money market conditions. The Belgian franc remained at or close to the ceiling, and the Italians continued to take in dollars on a large scale, most of which they were swapping out to their commercial banks.

There had been a number of changes in the System swap network during the last two weeks, Mr. Sanford observed. Most notably, it had been possible to pay off another $45 million on the Swiss franc drawings--$20 million on the Swiss National Bank swap and $25 million on the swap with the Bank for International Settlements--bringing the amounts still outstanding to $60 million and $75 million, respectively. The purchase of Swiss francs to make those paydowns reflected for the most part a special one-time adjustment in the reserves of the Swiss National Bank rather than market developments. Nevertheless, it was

encouraging to have been able to liquidate $95 million of the swap indebtedness in Swiss francs since March 31. On the other side, the System increased its drawing on the Bank of Italy by $50 million to $250 million on May 18, to absorb part of that Bank's continuing dollar inflow. Also during the period the Bank of England paid down another $50 million on the swap drawing on the System with previously acquired dollar balances, thus reducing its outstanding drawings to $230 million.

As was indicated at the last meeting, Mr. Sanford continued, the System would make considerable progress in further reducing its swap indebtedness through transactions associated with the British drawing on the International Monetary Fund. Today $82 million of the swap with the Bank of Italy would be paid off with lire bought directly from the U.K. In addition, the System had bought an equivalent of $45 million of guilders from the Netherlands Bank and $40 million equivalent of Belgian francs from the National Bank of Belgium, both in connection with the U.K. Fund transaction. In the case of the Netherlands, the purchase would enable the System to liquidate completely its drawing under the swap arrangement, while in the case of the Belgium $40 million would be reconstituted of the fully-drawn portion of the swap, leaving a net indebtedness vis-a-vis the National Bank of Belgium of $60 million. Finally, the U.K., also for value today, was paying off its entire swap drawing with the System from the proceeds of its Fund drawings. As a result of all of those transactions, the System's gross and net indebtedness under the swap network would be reduced to $363 million.

One final point, Mr. Sanford said, was that he understood that the Japanese authorities had lost a fair amount of reserves this month in holding the yen just above its floor. If that trend continued, he thought the System should be prepared to see Japan make use of its facilities under the swap arrangement.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period May 11 through 24, 1965, were approved, ratified, and confirmed.

Mr. Sanford noted that the System's swap arrangement with the Netherlands Bank, in the amount of $100 million, would mature on June 15, 1965. He recommended renewal for a three-month period, the term of the present arrangement.

> Renewal of the $100 million swap arrangement with the Netherlands Bank for a further period of three months was approved unanimously.

Mr. Sanford then said that the System probably would have to renew all or some parts of certain drawings that matured during the next several weeks. These included (1) a Swiss franc drawing on the BIS maturing on June 8, which presently was in the amount of $75 million and which might be worked down a bit further but was not likely to be completely erased before maturity; (2) a drawing on the Bank of Italy of $18 million, which also matured on June 8; and (3) two drawings on the National Bank of Belgium maturing on June 22. One of the drawings on the Bank of Belgium, in the amount of $50 million, represented the part of the swap arrangement that was always fully drawn,

subject to renewals at six-month intervals. In the recent period that drawing had been completely utilized, but $40 million would be reconstituted today. The other drawing, of $25 million, was under the standby part of the arrangement and had a term of three months.

Chairman Martin asked why it was necessary to act today on renewal of drawings on National Bank of Belgium that matured on June 22, since the Committee would meet again on June 15. Mr. Sanford replied that the Account Management tried to work with a lead-time of at least ten days on operations of these types.

In answer to a question by Mr. Shepardson, Mr. Sanford said that renewal of the drawing on the Bank of Italy would be a first renewal, but those of the drawing on the BIS and of the $25 million drawing on the National Bank of Belgium would be second renewals.

Mr. Shepardson said he continued to have questions about the desirability of second renewals. As he recalled the discussions when swap arrangements were first begun, the intent was to use drawings to deal with flows that were considered temporary and likely to be reversed soon. The Committee was definitely committed to the view that drawings were not to be used to deal with nonreversible flows. If it proved necessary to renew drawings a second time, the circumstances requiring them were hardly temporary, and he questioned whether such actions were within the Committee's original intent.

Chairman Martin said that it might be desirable for the Account Management to prepare a memorandum for the Committee indicating the

number of times various drawings had been renewed. Mr. Sanford indicated that such a memorandum would be distributed by the time of the Committee's next meeting.

In response to Mr. Balderston's request for clarification of the nature of the swap arrangement with the National Bank of Belgium, Mr. Sanford observed that the agreement with that Bank differed from all others in the network, in that $50 million, the amount of the original arrangement, had been fully drawn on both sides on a six-month maturity basis since initiation of the arrangement. That was in accordance with the wishes of the Belgian authorities for reasons connected with their domestic money market. The $50 million drawn by the System was kept on deposit in Belgium until such times as it was needed, and much of the time it simply had remained on deposit. At the moment it was all utilized because of pressures against the dollar, but, as he had noted, $40 million would be reconstituted today. The $25 million drawing maturing on June 22, on the other hand, was under the part of the arrangement that, like others in the network, was on a standby basis except when drawings were found to be necessary.

Mr. Hayes suggested that it might be useful if the memorandum the Account Management was to prepare included information on the actual utilizations of funds under the fully-drawn part of the Belgian swap line, and the Chairman agreed.

Mr. Shepardson asked whether his understanding was correct that because part of the Belgian arrangement was always fully drawn

the System could be considered to have been in debt to the National Bank of Belgium for over a year. Mr. Sanford replied that that was not necessarily a valid conclusion. When the amount that was fully drawn was on deposit in Belgium, the System was earning interest on the deposit; at the same time, the National Bank of Belgium was earning interest on security holdings in this country. In his judgment the System should be considered indebted to the Bank only when it utilized the funds that were on deposit. It did so only part of the time, although recently it had been much of the time.

Mr. Shepardson remarked that he wanted to be recorded as objecting to the planned second renewals. As he understood the matter, they went beyond what the Committee originally had contemplated in connection with swap drawings.

Mr. Hayes commented that he thought the second renewals in question were definitely to the advantage of the United States. He did not think the Committee had a rigid policy against more than one renewal of swap drawings. Many drawings had been paid off without any renewals, and in his opinion the fact that from time to time some of them had been renewed one or more times was not contrary to the policy of limiting drawings to a short term, which he would define as one year or less.

Mr. Daane suggested that the contemplated memorandum give information not only on the number of renewals but also on their rationale, from the point of view of their advantages to the United States. Mr. Sanford replied that that would be done.

Renewal of the drawing on the Bank of Italy, as recommended by Mr. Sanford, was noted without objection.

Renewal of the drawings on the Bank for International Settlements and on the National Bank of Belgium, as recommended by Mr. Sanford, was noted, with Mr. Shepardson objecting.

Mr. Sanford then said he would like to make some observations on Mr. Coombs' memorandum of April 30, 1965, entitled "Action on International Liquidity," on which Messrs. Furth and Young had commented in their memorandum dated May 14, 1965. (Copies of these documents, which were distributed to the Committee on May 20, have been placed in the files of the Committee.)

It was Mr. Coombs' feeling, Mr. Sanford said, that time might be running out on some of the swap arrangements and that the Committee perhaps should look more to other means of repaying drawings than the ultimate one of gold. That thought was much in line with the view Mr. Shepardson had expressed today regarding continuing swap drawings for an extended period. It was Mr. Sanford's understanding that Mr. Coombs had in mind two exploratory approaches in the field of international liquidity. The first had to do with breaking the ice in the form of drawings on the IMF by the U.S. to settle swap drawings which proved irreversible within their normal span. Previous discussions with the Governors of the Bank of Italy and the National Bank of Belgium had indicated that they would favor U.S. drawings of their currencies from the IMF for this purpose, and that view was supported by conversations with other Governors. Hence, Mr. Coombs recommended that the U.S.

borrow lire and Belgian francs from the IMF to settle swap drawings that had not been settled within the usual terms. Such operations would obviate the necessity of ultimate settlement in gold; such settlement would be undesirable considering the large decline that already had occurred in the gold stock this year.

Secondly, Mr. Sanford continued, Mr. Coombs would like to explore with central banks the possibility of reaching advance understandings, however informal, in place of ad hoc ones on a last-minute basis, that in the event of speculative pressure on the currency of any member of the swap network, those central banks receiving inflows of funds would give sympathetic consideration to joining immediately with the Federal Reserve in short-term credit assistance to the central bank under attack. Thus, the System would have some partners to share part of the burden of new rescue operations, such as might be necessary later this year, for example, in the case of sterling and the Japanese yen. As Mr. Coombs had pointed out in his memorandum, there might be a basic reluctance on the part of most European central banks to commit themselves, however informally, to sizable credit facilities superimposed on the already sizable ones extended to the Federal Reserve. Accordingly, Mr. Coombs suggested the possibility of considering the Federal Reserve drawing rights of $2,650 million as a pool which could be partially and temporarily diverted to other central banks at a time of need. That would be a way of converting the bilateral swap lines between the Federal Reserve and foreign central banks into swap lines which could be made, to some extent,

multilaterally available and thus relieve the U.S. and the Federal Reserve of part of the financing burden that fell upon them because of the central role of the dollar in international finance.

He was sure, Mr. Sanford said, that Mr. Coombs would be glad to have the Committee's blessing on both of these points as soon as possible, so that he might engage in further exploratory conversations.

Chairman Martin observed that Mr. Coombs' proposals involved policy of the Treasury as well as the Federal Reserve. He thought the Committee might hold a preliminary discussion of them without contemplating any action today.

Mr. Ellis noted that Mr. Coombs proposed to make some of the System's $2,650 million of drawing rights under bilateral swap lines available multilaterally. He asked whether it might not be better to seek an enlargement of available drawing rights rather than simply to spread around the existing total.

Mr. Hayes remarked that while the System did have $2,650 million available under its swap lines, only part of that amount ordinarily would be usable in a particular case of need, depending on which currencies were experiencing drains. More generally, it seemed to him that Mr. Coombs' two ideas were simple and straightforward, and almost transparently likely to be helpful to the United States. Drawings by the U.S. on the IMF were, of course, the responsibility of the Treasury rather than of the System, but from the Committee's point of view Mr. Coombs' suggestion in this connection

seemed to fit exactly with the type of concern Mr. Shepardson had expressed. Other countries had drawn on the Fund relatively freely from time to time. The United States had used it only for technical purposes last year, but there had been much discussion of the possibility of its using the gold tranche more actively. Such a course obviously would be consistent with the idea of providing international liquidity when and where it was needed. It seemed to him that, although the matter was not a responsibility of the System's, it was logical for the Committee to give its blessing to a proposal that could only be helpful to the nation.

Mr. Coombs' second suggestion, Mr. Hayes continued, was simply to explore informally with a few central banks that were likely to be so minded the possibility of their agreeing to make short-term credit facilities available when needed. It had been possible to put together the $3 billion package of assistance to Britain quickly when their situation became critical last November, and matters worked out all right; but the operation was hectic, and he personally hoped it would not have to be repeated. If there were some possibilities of advance preparation for any necessary short-term assistance, it would be to everyone's advantage to explore them informally. It would be preferable if other countries were willing to make short-term credits available to one another without reference to their swap arrangements with the System. But it was Mr. Coombs' thought that if those countries were reluctant to do so in view of their commitments to the Federal Reserve, some of which were quite large, there was the possibility of

the System's temporarily relinquishing part of its drawing rights on them.

Mr. Hayes said he had found the Furth-Young memorandum to be interesting, and its points were well taken if one granted the assumptions made. But the assumptions were too broad; Mr. Coombs did not contemplate actions as sweeping as the Furth-Young memorandum implied. For example, it was said on page 1 that "It might be a difficult task to persuade the foreign banks to extend to all other participants the facilities they have thus far been willing to extend to the Federal Reserve." Certainly, he would agree with that statement. But there was no suggestion to make all of the System's swap lines multilateral; it was proposed only to talk further with a few central banks that were likely to be willing to do so. The next sentence read: "And to persuade the governments of the foreign countries involved to agree in advance to a quasi-automatic invocation of the General Arrangements to Borrow to permit IMF refunding of any intractable swap drawing would be even more difficult." But he did not think the System would have to so persuade the governments involved in order to get them to agree to make some short-term credit facilities available. Perhaps it was not wholly true that any short-term swap drawing could bring lasting relief to a currency under attack only if there was a refunding by the Fund in sight. After all, gold sales were one way of liquidating a drawing, and a good deal of relief could be brought to a situation by a short-term drawing by itself, as was seen last November. These were specific points that Mr. Hayes thought were of some bearing.

Mr. Hayes said he also agreed with the point in the memorandum that the proposed multilateral arrangements would not reduce the risk of gold outflows. But the purpose of seeking a few such arrangements was not to save gold; it was simply to obtain the psychological advantages of having more than one central bank render assistance to a country in need. Last November the United States might have supplied the full $3 billion of assistance to Britain, but such an action certainly would not have had the same advantages as did the multilateral assistance that was actually given.

Mr. Daane commented that he was sympathetic to Mr. Coombs' suggestion for U.S. drawings on the Fund, although as Mr. Hayes had noted the decision would be made by the Treasury. He felt that it would be unwise to invoke the General Arrangements to Borrow in connection with a U.S. Fund drawing but he thought it was appropriate to think in terms of a drawing for the described purpose without getting into the GAB. The United States deliberately had left itself some room for maneuver in the recent activation of the GAB in connection with the British Fund drawing by keeping down the size of the dollar component. Moreover, drawings by the U.S. would indicate that this country continued to view the gold tranche as a reserve asset. On the whole, he thought the idea was a good one.

Mr. Daane's feelings were mixed on Mr. Coombs' other proposal, for multilateral swap arrangements. As he sensed the climate there was not any real amenability to the idea at present, and he thought the question of timing had to be thought through carefully. If the

matter was widely pressed now, not only might it be rebuffed but other countries might conclude that the U.S. was taking the leadership in trying to assure that credit facilities would be constantly available to Britain, as well as to the U.S., regardless of the internal policies of those countries. Such possibilities did not necessarily argue against opening the subject in a private and informal way with one or two countries, but he would not like to see an all-out effort made at this juncture. In particular, one of the countries that might be most amenable to the suggestion at some future time might be turned against it if the issue was pressed now.

Mr. Wayne observed that although there was some reference to the Japanese yen in Mr. Coombs' memorandum he thought that what in fact was under discussion was the British pound, which might be under continual attack in coming months. On that basis he considered Mr. Daane's concerns to be well-founded.

Mr. Hayes agreed that the outlook for the pound was the foremost consideration underlying the suggestions for multilateral swaps, but said that he certainly would not exclude the possibility that the Japanese might be in difficulty in the near future.

Mr. Wayne replied that he recognized that possibility. However, the yen was not now under attack and the pound was; and the yen was not a reserve currency. He also questioned the desirability of the System's taking the initiative in this matter. It seemed to him that the Bank of England had an active role to play.

Mr. Hayes remarked that there obviously was room for judgment, but he was impressed by the fact that if the U.S. should be confronted by another sterling crisis it was likely to feel obligated to give aid. There was not only the swap arrangement on which the U.K. could draw; the British might also have to sell their dollar investments, which would involve a dollar drain. He would merely submit that it was not too early to think about how such a problem might be solved. He was not advocating a wholesale approach to foreign central banks; he agreed with Mr. Daane that it was desirable only to explore the attitudes of one or two central banks informally and cautiously. He also agreed with Mr. Daane with respect to the undesirability of activating the GAB in connection with any U.S. Fund drawing. Such drawings should be made on an ad hoc basis, involving whatever currencies the U.S. happened to need.

Mr. Wayne commented that he would feel more comfortable about the matter if the System had the benefit of the Treasury's views with respect to the IMF aspect of the proposals.

Chairman Martin said he thought it was important that all concerned be constantly alert to the international monetary problem, which might soon be coming to a head. As he had indicated, he did not think the Committee should take any action on Mr. Coombs' proposals today. The Treasury had been given a copy of Mr. Coombs' memorandum, and perhaps the Committee might have a discussion at its next meeting to determine whether it wanted to participate with the Treasury in

exploring the proposals further. There were no objections to the Chairman's suggestion.

In reply to Mr. Shepardson's question, Mr. Young said that the Treasury had not yet been given a copy of the Furth-Young memorandum. It was agreed that the memorandum should be transmitted to that Department.

Messrs. Bopp and Hickman entered the meeting at this point.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period May 11 through 24, 1965. A copy of this report has been placed in the files of the Committee.

In supplementation of the written report, Mr. Holmes commented as follows:

> System open market operations during the past two weeks were carried out in an atmosphere of continuing demand for Treasury bills and some other short-term securities, while a mood of caution pervaded the longer-term markets. On balance, System operations absorbed a modest amount of reserves over the period, with fairly steady absorption over the first portion of the interval being largely offset by reserve injections on the last three business days.
>
> The money market atmosphere remained about unchanged during the past two weeks, although Federal funds traded a little more often at 4 per cent than at 4-1/8 per cent, reversing the pattern of the previous several weeks. Borrowing, on the other hand, averaged a shade higher in the statement weeks ended May 12 and 19, and net borrowed reserves were a little larger. In both of those weeks a pattern developed in which Federal funds traded largely at 4-1/8 per cent before the week end, followed by substantial member bank borrowing over the week end, and then a shade more comfortable reserve situation after the week end with funds trading at 4 per cent and borrowing falling off. In the current

week the pattern has not been quite so marked, as borrowing rose more moderately over the week end--although we did return again to an effective funds rate of 4 per cent yesterday.

In carrying out System operations in the past two weeks, the Committee's authorization to make repurchase agreements against a wider range of collateral during Treasury financing periods continued to prove useful. In particular, it facilitated the meeting of a larger portion of the period's reserve needs through repurchase agreements than would have been possible otherwise--and thereby reduced the need for outright bill purchases. Even so, the scale of current and prospective reserve needs is such that yesterday it was deemed necessary to buy a fair amount of Treasury bills in a go-around of the market. Looking ahead, a very large reserve need still remains to be met in the balance of May and early June. Probably, this will call for a combination of techniques to provide reserves, including additional outright purchases of bills as well as new repurchase agreements and some buying of coupon-bearing issues.

Yesterday's purchases of bills by the System, coming on top of continuing demand from a variety of other sources, helped push rates slightly lower and the average auction rates, at about 3.89 and 3.94 per cent for the three- and six-month issues, respectively, in yesterday's auction were about a basis point lower than in most recent weeks. The June tax date should produce some let-up in corporate buying in the weeks just ahead but the reserve need may, as noted, make the System a large buyer in these weeks; on balance there seems little immediate prospect of any natural upward pressure on bill rates.

In contrast to the short-term market, the bond markets have been suffering from some indigestion in the past two weeks. Distribution by dealers of the Treasury's recent offering of nine-year 4-1/4 per cent bonds has been very slow. Apart from some takings at gradually lower prices by Treasury trust accounts, dealer sales of the 4-1/4s have been almost exactly offset by the need to absorb equally modest offerings made in the market by investors. High-grade corporate offerings have elicited an apathetic investor response and tax-exempt issues have had mixed success--with some attractively priced issues moving out and others proving quite

sticky. Increased demands on the capital markets seem to be largely responsible for this heavy atmosphere, although market discussion of official objectives has also played some part. Prices of Treasury issues have held up quite well during this period, as dealers have sought to protect the value of their large holdings. Price levels may be in for some testing in the period ahead, however, as further efforts are made to distribute holdings.

Following his statement Mr. Holmes responded to questions about the size of dealer inventories of longer-term Treasury securities and the nature of recent purchases of coupon issues by the Account Management and the Treasury.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period May 11 through 24, 1965, were approved, ratified, and confirmed.

Prior to this meeting the staff had prepared and distributed certain questions suggested for consideration by the Committee. These questions were as follows:

1. Business conditions.

What are the implications for price stability and for sustained advances in production and employment of (a) the inventory situation, (b) the capital goods situation, and (c) prospective fiscal developments?

2. Balance of payments.

Assuming voluntary restraint will hold down capital outflows this year, will other factors tend to bring a lasting improvement in our balance of payments?

3. Credit.

How is the pace of credit expansion likely to respond to prospective changes in the rate and composition of economic activity over the next few months? Are demands

on the banking system likely to become less intense than they were earlier in the year?

4. Money.

What do recent shifts in public holdings of money and time deposits suggest as to prospective changes in the demand for these financial assets?

5. Money market relationships.

How have relations among money market variables changed since last fall? Assuming a continuation of current monetary policy, what combination of money market conditions, interest rates, reserve availability, and reserve utilization by the banking system might prove mutually consistent during coming weeks?

Staff comments on these questions were included in the staff economic and financial review at the meeting, which was in the form of a visual-auditory presentation. Copies of the text of the presentation and of the accompanying charts have been placed in the files of the Committee.

The introductory portion of the review, presented by Mr. Noyes, was a follows:

As the United States moves into a fifth year of expansion, questions persist as to the danger of inflationary developments, and also as to the threat of slackening growth or even recession. These two very different possibilities have both been in the foreground during the two years since the spring of 1963, along with our serious balance of payments problem.

This morning, the staff review is addressed once again to the prospects for sustained domestic expansion and improvement in our international payments position.

It is only two weeks since the staff last reviewed the economic scene, but even in so brief a period additional evidence has become available to confirm trends then just emerging in the first of the April statistics. Growth in production has slowed, and the interim steel settlement has moderated inventory demands. Bank credit

and deposit expansion are less vigorous, as the initial impact of the Regulation Q change fades and as credit demands appear to be shifting from banks to the capital markets.

But some upcreep in prices has continued, with further increases in metals and meats. And rising defense needs and higher plant expansion targets are being translated into rising orders for durable goods, particularly machinery. The Congress seems disposed to go at least as far as, and perhaps further than, the Administration has recommended in excise tax cuts.

We will begin the staff review with a discussion by Mr. Reynolds of the influences at work on our balance of payments and the prospects in this area for the period ahead.

There followed sections on the balance of payments, presented by Mr. Reynolds; on inventories and business fixed investment, by Mr. Williams; on prices, production, and employment, by Mr. Garfield; and on financial developments, by Mr. Koch.

The concluding portion of the review, presented by Mr. Brill, was as follows:

The slight firming of monetary policy that took place first around early February and again in late March, has not been evenly transmitted to all money market variables. As can be seen on the chart, member bank borrowings have risen steadily in recent months, and net borrowed reserves have deepened by even more as banks have economized on excess reserves. The increased pressure on bank reserve positions has been reflected mostly in the interest rate on Federal funds, which has pierced and generally remained above its former discount rate ceiling, while the bill rate has remained generally stable to declining at a level somewhat below the discount rate.

The slight decline that has occurred in bill rates from their late February- early March peak has been accompanied by a slight decline and then stability in Government bond yields, and a fluctuating but on average higher Federal funds rate. The decline in bill rates can be explained by a number of factors, including a sharp reduction in bills available to the public, some repatriation of funds from abroad, and a large bill demand from corporations and State and local funds.

In the weeks ahead, maintenance of net borrowed reserves in the $100 to $150 million range, as indicated by the shaded area on the chart, would likely be accompanied by bill rates remaining in their recent range, although there might be temporary upward rate pressure just before the mid-June tax and dividend dates. It also appears that some upward adjustment in long-term rates could occur, as dealers distribute their relatively large takings of the reopened 9-year Treasury bonds, and with their large inventories of recent corporate and municipal underwritings. Corporate yields, not shown on the chart, have already risen since mid-March.

Such a complex of market rates and marginal reserve availability would appear consistent with some slowing in bank credit and deposit expansion from the first quarter pace. In this context, growth in both time deposits and the money supply would be expected to average close to 1964 rates. This would represent some acceleration from the March-April '65 rate for time deposits, and some deceleration for the money supply.

Pushing net borrowed reserves to around an average of $200 million--below the shaded area shown--would increase the likelihood of an upward adjustment in bill rates, although probably not much above 3.95 per cent, the top of the range shown. The large margin that has developed since March between the funds rate and the bill rate suggests that there is likely to be little further scope for the Federal funds market to cushion bank reserve pressures without reflection in the bill market. Such pressures might also redound upon the cost and availability of CD money to banks. In view of the technically exposed position of the capital markets at the moment, a further move in the direction of restraint would also be likely to have repercussions, at least temporarily, on markets for longer Government and other bonds.

To sum up the staff replies to the questions distributed prior to the meeting, recent developments in the balance of payments are encouraging, but there is no evidence of lasting improvement from factors other than the voluntary restraint program. The review of domestic developments suggests some moderation occurring and in prospect in the pace of economic and financial expansion, even taking into account the likelihood of fiscal stimulation around midyear. This moderation should temper pressures on commodity and financial markets and on the banking system. In our judgment, the present posture of policy is contributing to a healthy transition from the excessively rapid pace of the first quarter to a more sustainable rate currently.

Mr. Ellis asked if there was any direct evidence to indicate the rate and probable duration of reflows of funds from abroad and how long such reflows were likely to affect the U.S. bill rate, if they were the principal factor in its recently reduced level.

Mr. Reynolds replied that confidential Canadian data indicated that U.S. corporations had brought back about $400 million from Canada in March. The normal reflow in that month was about $200 million, so it was obvious that more than seasonal forces were at work. There also was some evidence to suggest that the noraml return flow to Canada in April did not occur this year; instead, some additional funds were brought back to the U.S. Liquid holdings of U.S. corporations in Canada might by now be back to the level of December 1963, the goal the Administration had sought. In the chart show the staff had hazarded the guess that there would not be much further reflow; that seemed unlikely unless the Administration's program was intensified.

Mr Brill added that the staff had concluded that the principal factor holding down bill rates recently was the reduced volume of bills available to the public at a time of strong demand for them, rather than the reflow of funds from abroad.

Chairman Martin then called for the go-around of comments and views on economic conditions and monetary policy, beginning with Mr. Hayes, who made the following statement:

For a long time members of this Committee have been expressing some unease about the rates of growth of bank credit and liquidity in our economy over a period of months and even years, and periodic efforts have been made, with only very limited success, to check these rapid growth rates. International considerations have always provided strong backing for these efforts, as they still do. But in the absence of clearly visible inflationary pressures in the domestic economy, many members have felt reluctance, in varying degrees, to press these restraining efforts with much vigor or continuity. Recently, however, it has become increasingly apparent that the mere threat of inflationary pressures has been reinforced by an actual upcreep in industrial wholesale prices at an accelerating rate. The evidence of a developing inflationary movement is by no means conclusive; the upcreep could be slowed down or reversed--although in the present setting of great business optimism this may be wishful thinking. The stakes are so high, and the consequences of a real upward price movement could be so disastrous, both at home and more especially in our efforts to defend the dollar, that we would be fully justified, in my judgment, in taking a definite though moderate further step at this time to slow the expansion of bank credit and thus to contribute, to the best of our ability, to preserving a sustainable domestic expansion and a sound currency.

Business activity. Let me revert, now, to a brief summary of recent data that have led me to this conclusion. Contrary to the impression given by some of the April data--which of course involve a pause in the excessively rapid pace of advance of the first quarter--the outlook for the domestic business situation remains very good indeed. It has been strengthened in the past few weeks by the step-up in capital spending plans (backed by strong corporate profits) and, more recently, by the President's proposal of a second-stage excise tax cut to take effect at the beginning of 1966. More important for the shorter run is the inclusion of the automobile excise tax in the first part of the program, with the cut retroactive to May 15. This should make the July tax cuts more of an expansionary factor than had been expected before. Developments in the steel industry appear less likely than they did to be a seriously disruptive factor. Apart from a continuing buildup of steel inventories, which is likely to lead, incidentally, to only a rather modest downward drag on total industrial production later in the year, the overall inventory picture and inventory policies remain quite conservative.

On the price front, industrial wholesale prices moved up another notch in April, and no reversal is evident in May. The edging up in this area has been going on since 1963, but it now seems to be accelerating. Over the last three months the rise works out to an adjusted annual rate of 2 per cent, as against roughly 1.5 per cent over the last six months and 0.6 per cent in the full year 1964. Raw material prices also continue to move up, and announcements of price changes remain virtually all on the upside. Demand pull seems more to blame than cost-push factors--and this might well have a bearing on our policy consideration.

Balance of payments. The improved balance of payments figures for March and April are a reflection of the initial success of the President's program of voluntary restraint. At the end of March the banking system as a whole was under the 105 per cent ceiling by $60 million--but 80 banks were under the ceiling by $330 million, while about 50 others were over their targets by $270 million. Detailed payments figures for March indicated especially sharp curtailment of long-term bank lending in Europe. Despite these favorable developments, there is no basis for believing that a fundamental payments improvement is under way; and yet there is an urgent need for such improvement, since the effective life of the voluntary program is expected to be relatively short--perhaps not much over a year. Meanwhile gold losses continue to be heavy, with more in the offing.

Credit and money. The current bank credit picture is far from clear. While the rate of increase in April (seasonally adjusted) was back close to the 8 per cent figure characteristic of 1963-64, as compared with the much more rapid growth of the first quarter--there is reason to doubt whether this really points to much of a slowdown, in view of special factors affecting the April figures. If we combine March and April, we find an annual growth rate of 11.5 per cent, the same as that for January and February combined. While some fragmentary May data do suggest a slowing of the expansion, I am impressed by the continuing great strength of loan demand, as indicated by our latest loan projection survey in New York. This demand is abetted by the vigor of capital spending plans and the relatively low level of the prime rate--though there are continuing efforts to make the prime rate somewhat more inaccessible to longer-term borrowers and to borrowers of less than top credit standing.

Turning to measures of liquidity, we find an 8.3 per cent rise in money supply plus time deposits in the first four months of 1965, well above last year's gains. And total nonbank liquidity has risen appreciably faster in the last six months than gross national product. On the other hand, the banks' liquidity position has shrunk, especially in the matter of short-term Government security holdings.

Monetary policy. I think we should now feel free to modify policy, if this seems desirable, without the restraints of an "even keel," even though dealer holdings of the 4-1/4's are still relatively large. With rather sizable corporate security offerings in prospect, we must probably accept the likelihood that a tightening of policy might find some reflection in slightly firmer long-term rates.

As I said at the outset, I think the time has come to make another moderate, but clearly visible, change toward greater restraint on the growth of bank credit. The abundance of liquidity is pressing supplies of funds on lenders and this works counter to the success of the voluntary credit restraint program. It may also be encouraging a gradual deterioration in the quality of credit, on which we hear frequent comments from financial observers. While some stiffening of policy is needed as a signal at home and abroad of our determination to help solve the payments problem, the domestic business and price outlook now permits and may even require such a change.

I would like to see net borrowed reserves somewhere around the $200 million level. The bill rate should, I believe, be a secondary consideration. Because of low dealer bill inventories and relatively light bank participation in this market, the suggested increase in net borrowed reserves may have only minor impact on bill rates; and this in turn may minimize any expectations of a near-term change in the discount rate.

The directive should be modified to recognize the recently quickened pace of price advances, to eliminate the reference to Treasury financing, and to call for firmer conditions in the money market, if the Committee reaches the same conclusion as I have on the need for current action. I think the staff's Alternative B is entirely satisfactory.[1/]

1/ The two alternative drafts of the directive prepared by the staff are appended to these minutes as Attachment A.

Mr. Ellis reported that the general atmosphere of the First District's just-completed semiannual business outlook conference seemed to substantiate the complaint of one participant that "euphoria seems to have broken out all over." While the horizon nine months away still seemed to have the traditional grey clouds impeding clear analytical vision, the projections for the remainder of 1965 were notable primarily for their bland uniformity. The standard forecast of a GNP increase of $24 billion by year-end centered in a range of only plus or minus 1.7 per cent of present GNP with none of the participants predicting a decline.

New England business trends tended to substantiate the widespread euphoria, spiced by some gnawing doubts, Mr. Ellis continued. The Boston Reserve Bank had just completed its annual quota of four area conferences and from those exposures he would judge that the question most on the minds of the District's commercial bankers was how they could satisfy the loan demand they faced in view of their tightened liquidity positions. They recognized that the liquidity characteristics of both assets and liabilities had changed substantially as banks had expanded term loan and instalment lending, shifted from Governments to municipals, and expanded time deposits and negotiable CDs; nevertheless, they continued to have real concern about their tightened liquidity positions. Loan-deposit ratios of all weekly reporting banks in New England averaged 73 per cent as of May 12, a level 3.5 points above the national average and an all-time peak for First District banks. Boston banks, of course, were much higher,

with an average ratio of 77.3 per cent. In spite of their concern about liquidity positions, each banker reported that he was going to "serve his customers" and satisfy loan demand as it showed up. The same bankers that reported they were making loans they would not touch a few years ago were not going to lose customers by rejecting loans now.

Mr. Ellis said he thought the staff's chart presentation had been excellent, and that he would not repeat the discussion of the general outlook for business and for prices. To answer the question about the balance of payments directly, he would say he judged that factors other than the voluntary restraint program would tend to worsen the balance during the rest of this year. He noted the care with which the staff had phrased the statement that they could not foresee an increase in the current account surplus this year. He personally expected some worsening on current account. U.S. exports of agricultural commodities were likely to be reduced, particularly to the protection-minded Common Market countries, and exports also would be adversely affected by lowered capital outflows, whether for direct or indirect investment. Total imports would be lifted by imports of steel in anticipation of a steel strike and in event of a shutdown. It was his personal hunch that foreign automobile producers would again enlarge their share of U.S. unit sales as domestic producers again lengthened the new models and increased their horsepower. Tourism already stood ready to worsen the balance by $200-$300 million, and expanding Government commitments in Viet Nam, Santo

Domingo, and so on might be expected to swell outflows on Government account. Against those possibilities stood the hoped-for achievements of the temporary voluntary restraint program. Unfortunately, to the extent that such restraint was effective it increased the likelihood that it would become less voluntary and less temporary.

To conserve time, Mr. Ellis said, he would blend his comments on the last three agenda questions. He expected that a slowed rate of business expansion would lessen credit demands from the obviously excessive first-quarter levels. Whether bank credit expansion would subside to tolerable rates or become merely "less excessive" remained moot. In any event, the obvious present strength of credit demands and the apparent willingness of banks to satisfy growing demands testified that the System's gradual policy moves over the past year to lessened credit ease had not stymied economic expansion. He found it helpful to describe the Committee's actions as cautious probing that had resulted in a gradual transition to modest credit restraint in face of steadily expanding demands for credit accomodation. In that process the Committee had simultaneously sought whatever balance of payments advantage might result from a narrowed rate spread between bills and long-term bonds. He was persuaded that such a policy of cautious probing had been successful and should be continued.

The staff report,[1/] Mr. Ellis noted, described April as a month when "the increase in industrial production was small, retail

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1/ "Current Economic and Financial Conditions," prepared for the Committee by the Board's staff.

sales drifted down further, and the labor market barely held its own." Yet, the April increase in bank loans and investments exceeded the gain of April 1964 by four times, and the April expansion in total bank reserves exceeded the three-month average growth rate by 18 per cent, ensuring a 10 per cent average rate of growth in bank reserves for the past three months. The evidence suggested to him that the Committee's modest moves to lessen credit availability had been outmatched by enlarged lending and investment activities by the banks, with a resultant acceleration of credit expansion that had carried well into the month of April.

Two factors, both probably temporary, suggested to Mr. Ellis that caution should be exercised in further probing. The first was the enlarged holdings of bonds by Government security dealers. The second was the possibility that repatriation of funds from abroad might peter out and substantially alter the balance of forces that had maintained such strength in the bill market in face of lessened bank reserve availability.

While recognizing the need for alertness to those two factors, Mr. Ellis would continue to probe toward lessened reserve availability. In terms of market forces of recent weeks, he would identify policy targets of $200 million net borrowed reserves, plus or minus $50 million; borrowings averaging around $500 million; Federal funds normally trading at 4-1/8 per cent; and dealer lending rates at 4-3/8 to 4-1/2 per cent. Such gentle probing was not likely to stiffen short bill

rates in light of the magnitude of nonbank funds available to the market, but, hopefully, eventual redistribution of investment funds would allow a 10 or 15 basis point rise in short bill rates.

Mr. Ellis preferred alternative B of the staff drafts of the directive.

Mr. Irons reported that preliminary figures and estimates for the Eleventh District indicated that the rate of expansion in economic activity had slackened off a bit during April, but currently there were some signs of a resumption of earlier trends. The changes in April had been small; in May industrial production continued a slight decline and crude oil production was down. On the other hand, construction contract awards were inching up in May, employment was strong, and unemployment was running somewhat below 4 per cent. Retail trade in April was above March, but was showing no change in May. Automobile sales continued strong. Bank debits were up appreciably.

Recent weather was among the more favorable developments, Mr. Irons said. Heavy rains in all parts of the District, including areas that previously suffered from drought, made the agricultural outlook much better than it was some months ago. There also had been some improvement in agricultural prices, including livestock prices.

At District banks, Mr. Irons continued, there had been decreases in loans, investments, and deposits, but of very small amounts. The demand for Federal funds had been large and while sales also had been substantial net purchases were sizable. Borrowings from the Reserve

Bank averaged about $33 million in the recent period, compared with $23 million during the preceding period. Reports of Directors of the Bank's branches in Houston, San Antonio, and El Paso--which, while perhaps making up an unscientific sample, were interesting nevertheless--were more optimistic than one might be on the basis of available statistics and indexes. Bankers stressed the strength of loan demand, although they recognized that it might be diminishing a little from the first quarter of the year. Banks were pressing for deposits, and they seemed reconciled to doing business on a higher-cost basis. The outlook for the District as a whole was rather optimistic. The undercurrents of concern by businessmen seemed to relate mainly to such matters as the balance of payments, the recent heavy gold losses, and Government fiscal policies.

On the national situation, Mr. Irons was in general agreement with the staff's chart presentation. Among the expansive factors were business capital spending, new orders for durable goods, and defense outlays. The high levels of consumer spending and construction activity were elements of support if not strongly expansive. The level of inventories did not seem to be excessive, particularly when viewed in relation to sales. He doubted that there would be appreciable accumulation of inventories--in any event, not as long as prices did not seem to be rising too much and goods remained available from suppliers. Nor did he expect the impact on prices of inventory accumulation to be very significant. In sum, he thought the national outlook was for sustained advances in production and

employment, although perhaps at a slower rate than had been expected earlier. It would be necessary to stay alert to the possibility of excesses in such areas as wage increases, consumer debt, inventories, and stock market speculation.

Mr. Irons expected credit demands to continue strong, especially in the commercial and industrial and the consumer loan categories. Strong loan demands would be facing a lessened margin of liquidity in the banking system, and banks would be actively seeking funds to meet the demands.

Mr. Irons reported that the balance of payments voluntary restraint program continued to have the support of bankers in the Eleventh District and evidently was working satisfactorily. He thought the duration of the program would be one factor in its effectiveness; the longer it continued the less effective it was likely to become. There seemed to be a feeling among bankers that the program was a one-year effort, especially if there was a substantial reduction in the flow of funds abroad in that period. He did not believe that if the voluntary restraint program was successful in holding down capital outflows this year other factors in the payments balance would necessarily be improved. In his judgment there was a need for other policies and approaches in addition to the voluntary restraint program, and among those he thought there was a place for a firmer monetary policy. It would be necessary to stay continually alert to international price relations, which would affect the trade balance. There also were questions of confidence in the

dollar and the effects that gold outflows might have on attitudes. The level of U.S. military expenditures abroad also had to be taken into consideration.

Turning to credit policy, Mr. Irons thought there would be a strong demand for funds during the period from Memorial Day through the Independence Day holiday, and it would be necessary to supply additional reserves temporarily. Given the domestic and international situations, he would favor undertaking a moderate firming action by letting the market tighten against the expected demand. During the past week the market had firmed a little, although he could not say that it had been particularly firm. He favored a slightly lower level of reserve availability, increased use of the discount window, a Federal funds rate at 4-1/8 per cent, and a bill rate reflecting those influences. He preferred net borrowed reserves in the $150-$200 million range and borrowings in the $450-$500 million range. Alternative B of the staff drafts of the directive was acceptable to him.

Mr. Swan reported that in the Pacific Coast States employment was virtually unchanged in April and the unemployment rate rose a little as the labor force increased. However, employment in the aerospace industries rose from March to April, the first monthly increase since late 1962. Aerospace employment had been rising in the past few months in the State of Washington, but not in California before April. Present indications were that the rise might well be temporary, with declines anticipated in June and July.

Lumber markets were somewhat weaker in April and early May, Mr. Swan said, and prices continued well below the levels of a year ago. On the other hand, activity was high in metals, both steel and nonferrous metals. The livestock situation was much the same as Mr. Irons had reported for the Eleventh District; range conditions were very good and livestock people were quite optimistic.

The gains in business loans at weekly reporting banks in the Twelfth District continued to lag behind the country as a whole, Mr. Swan noted, and in the first half of May they were less than in the same period a year ago. On the other hand, the increase in real estate loans at reporting banks in April, on which he had commented at the previous meeting, apparently continued in the first half of May. Banks continued to be under some reserve pressure. For the five weeks ending May 19, borrowings averaged over $60 million and were about four times as large as in the previous five weeks.

Mr. Swan thought the analysis of the national picture given in the chart presentation today was highly interesting, and he would not take issue with it particularly. He would simply say that in view of the indications of some moderation in the rate of expansion--in production, retail sales, and inventories, for example--it seemed to him that there was little basis in the domestic situation at this point for a further firming of policy. To be sure, the rapid increases in bank reserves and bank credit in March and April were matters of some concern, but he expected the gain in bank loans to

moderate somewhat in the period ahead in view of the indications for the economy. He had been especially interested to note the comments in the memorandum on member bank reserves to the effect that "weekly average data for the three weeks ending May 19 show a marked shift from the rapid expansion of member bank reserves and deposits that occurred earlier in the year;" and that "Total reserves seem likely to change little in May on a seasonally adjusted basis." Those comments might indicate that the Committee's earlier moves toward firming were having some impact at this point. The period in question was too short to provide a basis for firm conclusions, but the developments reported seemed to argue against further tightening now.

Mr. Swan agreed that there was a disappointing lack of indications of lasting improvement in the balance of payments apart from the effects of the voluntary restraint program. But that was hardly surprising; the Committee had been concerned about the payments problem for quite a long time. While international considerations might call for action by the Committee soon, he would prefer to await further developments in light of the general slowdown of the domestic economy. In particular, he would like to know more about the shape that fiscal policy was likely to take, in view of the proposals now under consideration. Consequently, he would suggest that for the present the Committee continue the policy it had been following. To him that could mean a continuation of the conditions prevailing in the last two weeks, with member bank borrowings around $500 million and net borrowed reserves around $150 million, even though those

figures perhaps were slightly above the intentions the Committee had indicated earlier. However, he would not like to see any significant change. He also was concerned about the testing underway at present that had been mentioned with respect to longer-term interest rates.

In sum, Mr. Swan said, he would accept alternative A for the directive with the understanding that the money market conditions to be sought in the next three weeks would be substantially those prevailing in the last two weeks.

Mr. Galusha said that the Ninth District economy appeared to be in good shape and seemed likely to continue to expand, over the near-term at least, at a respectable rate. Attitudes toward the agricultural outlook depended on the kind of agriculture. Livestock people were highly optimistic, but people in the grain producing States were not happy; crops were very late this year.

There would be a great deal of construction spending in the Ninth District over coming months, Mr. Galusha commented. Rebuilding of structures destroyed or damaged by recent floods and tornadoes, particularly in the Twin Cities area, might lead to the District's having a boomlet of its own for some time to come. Spending on plant and equipment probably would be somewhat above the levels indicated for the District by the recent McGraw-Hill survey.

As far as Ninth District bank loans were concerned, Mr. Galusha said he had to distinguish between city and country banks. Among the latter, loans grew much more than seasonally over the first half of

May, probably because of heavy livestock feed costs. Among the city banks, however, loans did not increase at all on a seasonally adjusted basis; indeed, since mid-April loan growth had been about what would have been expected from the seasonal pattern alone. It was perhaps worth noting that by usual standards District banks were feeling a pinch. He had no hard information on loan charges, but loan-deposit ratios, both of reporting and nonreporting banks, were at or very near post-1960 highs. And there had been much selling, particularly among country banks, of Government securities. In fact, total credit at all District banks increased a bit less than seasonally over the first half of May, and much less than over the first half of May 1964.

Mr. Galusha went on to say that recent behavior of Ninth District banks might be accounted for, in part anyway, by a sharp drop in time deposit growth. Time deposit holdings actually declined over the first half of May, whereas they usually increased in that period. In consequence, total deposits of District banks increased considerably less than seasonally between the beginning and middle of May.

As far as the national scene was concerned, Mr. Galusha was inclined to agree with Mr. Swan. The numbers, which of course lagged events, seemed to indicate there had been some slowing in the rate of economic advance. One aspect of the domestic situation that concerned him was the apparently large growth of business accounts receivable. Someone had to finance business when bank credit was tight, and it usually was the suppliers. He was not sure of the

significance of the development but, in effect, the credit that banks were extending to their good customers was being made available to others indirectly through financing of receivables.

Mr. Scanlon commented that developments of the past several weeks had fortified the belief of Seventh District bankers and businessmen that economic expansion would continue throughout 1965. Forecasts of activity for the year as a whole typically had become more optimistic. He did not find support among businessmen in the District for the currently widely publicized view that activity might be topping out.

Most local labor analysts in centers not heavily dependent on steel or autos looked for further increases in employment in the second half of 1965, Mr. Scanlon said. The number of reports of labor shortages was rising and such reports were no longer confined to skilled workers. Jobs requiring only "bodies and hands" were going unfilled in some areas, especially areas where auto employment was at high levels. That situation was reported most often for service industries but occurred also in some manufacturing firms.

Demand for steel had held up extremely well since the postponement of the strike threat, Mr. Scanlon reported. In the Chicago area the rate of ingot output declined 6 per cent from the week ending April 17 to the week ending May 15. Despite heavy order backlogs, steel producers had begun to shut down facilities in need of repair that they had been operating up to the strike deadline.

It appeared, Mr. Scanlon continued, that the average level of wholesale prices, led by aluminum and copper products, had moved up slightly further in recent weeks. Surprisingly, there was less outspoken concern over inflationary pressures than several months ago when solid evidence of price increases was less evident. Farm incomes were rising in areas where cattle and hogs were important and the improved price situation for livestock was expected to continue at least through 1965. The Reserve Bank's recent survey of country bankers indicated that the long-continued rise of farm land prices might be accelerating somewhat.

Business loans at District banks had continued to expand in the past few weeks at the slower pace that had been observed in April, Mr. Scanlon remarked. Borrowing by manufacturers of metal products had continued to rise contraseasonally, and loans to most other businesses remained at relatively high levels. The acquisition of municipal securities had slowed markedly, although it had not been reversed. Holdings of Governments were up, on balance, although Chicago banks had sold some bills over the past month. Those developments, plus the reserve positions shown for the major District banks, seemed to reflect a fairly comfortable reserve situation. There had been relatively little borrowing at the discount window.

Mr. Scanlon's views on policy paralleled those of Mr. Irons. However, as he listened to the figures mentioned around the table he found it difficult to detect any perceptible change in suggested

objectives with the exception of net borrowed reserves of $200 million. And even with respect to that figure, net borrowed reserves had been at $171 million in the most recent statement week, and so he would regard a figure of $200 million as merely resolving doubts on the side of firmness. If it took a change in the directive to accomplish that, he would favor alternative B.

Mr. Clay reported that farm income prospects in the Tenth District had improved very materially in recent weeks. In part that situation stemmed from more satisfactory weather conditions that had brightened the outlook for both grain and grass. Substantial rains had alleviated the drought in the Plains area, except for a hard core drought area centered in east central Colorado. The record snow pack in the mountains also assured abundant supplies of irrigation water.

The other principal factor improving farm income prospects, Mr. Clay said, was the higher level of livestock prices. While meat animal prices were not likely to retain their recent spread of 10 to 20 per cent over year-earlier levels, they were expected to remain above year-ago levels throughout the year. Supplementing those factors was the expectation that Government payments to farmers would be higher than last year. Accordingly, agriculture should be an expansive force on the general level of economic activity in the region in the months ahead. Despite the improved prospects for agricultural output and income, the structural readjustment in agriculture continued to take its toll as many farmers were unable to continue operations on a profitable basis.

Through the middle of May, Mr. Clay continued, bank credit developments at District city banks had continued the more moderate pace of April in contrast to the faster rate of the first quarter. Business loan activity in the District, which accelerated in January and February, did not show unusual strength in March, April, and early May. Time deposit volume, which expanded early in the year, had shown only modest growth in recent months.

Turning to the national scene, Mr. Clay said it was apparent that the pace of domestic economic activity had moderated. While the readjustments in steel and autos were taking place in an environment of expansionary general demand, the forthcoming configuration of domestic developments was not entirely clear.

On the international side, Mr. Clay said, the developments under the Administration's program had produced favorable results, re-enforced by monetary policy, but the full implications of that effort were by no means apparent yet. It seemed appropriate to await additional developments in the international area and to observe domestic credit developments further as well.

Accordingly, it appeared logical to Mr. Clay to continue monetary policy essentially unchanged at this time. That position was not intended to minimize the importance of the international payments problem, a problem that the United States had to solve. In addition to the basic monetary policy issue, however, was the fact that the

present was a transitional period in domestic economic and credit developments, as well as in the Administration's balance of payments program.

Such an approach to policy, Mr. Clay observed, would call for a continuation of recent money market conditions and about the same degree of credit availability as indicated at the last meeting. Alternative A of the draft directives was satisfactory to him. No change should be made in the discount rate at this time, he said.

Mr. Wayne reported that the strong trend in Fifth District business activity apparently continued without significant change. Cigarette output had been at record levels since February, and most other manufacturing industries had maintained or increased already high levels of production.

Nationally, Mr. Wayne continued, the April slowdown in the rate of business expansion apparently extended into May, but after the very fast pace of the first quarter some easing was to be expected. Apparently there had been no decline in the rate of business investment, which should be a substantial element of strength in the economy for the near future. The slight easing in the rate of business growth had been accompanied by some price developments that might merit attention.

In the international area, it seemed to Mr. Wayne that about the only conclusion that could be drawn from recent developments was that both the U.S. and the British were holding their own with some

difficulty. While the voluntary restraint program appeared to be working quite well, it could not be assumed that any basic improvement had been achieved in the U.S. balance of payments. In that connection, it was important to keep in mind the possibility that additional defense requirements associated with recent international political developments might introduce more strain on the U.S. payments position in the near future.

In the policy area, Mr. Wayne noted that the money market showed little reaction to the net borrowed reserves of the past three months; key money market variables had been almost static for many weeks. The banking system also seemed to have developed a kind of immunity to borrowed reserves. In part, that was because banks had obtained loanable funds in ways that used up fewer reserves or none at all, as by the sale of notes, debentures, and CDs. Also, they had used existing reserves more intensively through increased trading in Federal funds. In those and perhaps other ways banks might have postponed the restrictive effects of a reduced level of available reserves. It might be that any given degree of restraint now required a lower level of available reserves than was true by previous standards. If wholesale prices continued their trend of the past six weeks, it would be necessary to give serious attention to actions that might curb them. For the present, however, Mr. Wayne did not favor a change in policy. Alternative A of the staff drafts of the directive was acceptable to him.

Mr. Robertson said he would like to compliment the staff on the chart presentation, which in his opinion had been excellent. He then made the following statement:

From the facts we have before us, it seems clearer now than it was two weeks ago that the economy is in the midst of a transition. A slackening of steel inventory building, a lower level of automobile sales, and the heaviest fiscal drag since the tax cut are all serving to slow down the rate of domestic business expansion. Some drop from the unsustainably high rates of increase of the first quarter is desirable, but during such transition phases business is typically extra-sensitive to dampening influences, and I would not want monetary policy to add to the pressures slowing down activity at this time.

I realize that some observers, looking at the fractional increases in price indexes recently, may come to the conclusion that a generalized price advance is being born that ought to be vigorously opposed by monetary tightening. But I am more impressed with the relatively small number and small size of the price increases that were generated by the peak of demand pressures on our resources in the first quarter. That we held the line so well under the circumstances I take to be an impressive tribute to the basic forces making for price stability during the current economic expansion. Now, with the pressure of demand on resources being relaxed a little, national market forces will be working against further price advances. I think we should watch carefully to see if such events give us a satisfactory overall price performance before jumping to the conclusion that they cannot and that monetary policy should be tightened further. My own guess is that market demands are not sufficient to support a generalized price advance of any size at this time, except and unless business and labor expectations of inflation are so whetted as to start something of an administered price-wage spiral. If that unlikely event should occur, then a significant and overt tightening action by the Federal Reserve would be called for as part of a vigorous program of counter-inflationary public action. But until it is a fact rather than a fear, we had better keep our powder dry.

I see nothing in either the international or financial fields to gainsay this kind of policy prescription. The kinds of capital outflows that are believed to be interest-sensitive are already well in

hand with the combination of policy measures now in force. At the same time, our basic international competitiveness continues to be strengthened with each passing month by our persistently superior price performance and the increasing attractiveness of domestic capital investment.

On the financial side, bank loan and deposit expansion seem to have slowed down markedly. As I read the figures, there has been a net contraction of the banking system and the money supply since late in April. In these changed circumstances, I think we should be very careful about prejudging what trend of expansion, if any, the banking system might settle down to under the conditions of reserve availability we are now maintaining. It could turn out to be much smaller than the experience earlier this year--perhaps even enough to call into question the appropriateness of current policy. But this is a judgment that we will be in a better position to make a few weeks from now. In the meantime, I would be content with continuing policy unchanged, with money market conditions being kept about as they have been in recent weeks, and net borrowed reserves ranging around $100-$150 million. (I would not want to see them higher than that very often--even by inadvertence--with the bond market in its current technically vulnerable position. In other words, I would advocate resolving doubts on the side of greater ease.) In terms of the directive itself, I would favor alternative A as drafted by the staff.

Mr. Shepardson said that without going into detail he would express his complete accord with the views of Messrs. Hayes and Ellis. Granting that there had been a little easing from the domestic economic pressures of earlier in the year, all indications--including business expectations, the outlook for Governmental fiscal policy, and the possibility of increased Federal expenditures associated with political problems abroad--seemed to point to further increases rather than decreases. In his judgment the present relaxation of the excessive pressures of a short time ago was a temporary development.

For that reason, Mr. Shepardson continued, he would favor moving to less ease. He thought a $200 million target for net

borrowed reserves was appropriate. He favored alternative B for the directive, but questioned the desirability of including the word "slightly" in the phrase "with a view to attaining slightly firmer conditions in the money market." The Committee had used the term "slightly firmer" on occasions in the past, and he thought that at times more emphasis had been placed on the word "slightly" than on the word "firmer."

Mr. Mitchell remarked that the chart show must have been a good one, since those favoring both alternatives for the directive had been able to draw on it to support their views. In keeping with that procedure he would say that on the basis of the presentation he favored alternative A for the directive.

Mr. Mitchell went on to say that he thought much of present business confidence was engendered by the performance of the economy in the first quarter. But some of the activity then--particularly the high level of automobile output--was borrowed from the past; and some--particularly steel production--was borrowed from the future. He was confident that the economy would continue to expand, but did not think that an advance anything like that of the first quarter could be looked for. In the presentation today the staff had said that the $14 billion rate of increase in aggregate expenditures of the first quarter might be followed by a second-quarter rise at an $8 billion rate. In his judgment, however, the rise in the second quarter could easily be at less than an $8 billion rate. He also

would note that the buildup of steel inventories was continuing, and while its rate was difficult to assess it had been consistently under-estimated in the past.

On the question of prices, Mr. Mitchell observed, significant recent increases had been concentrated mainly in the area of nonferrous metals, and were due in part to strikes and political troubles abroad. He failed to see any price developments of a type that the Committee might appropriately try to snub. In his judgment, the Committee had to be prepared to tolerate more significant price movements than those that occurred recently, unless it was willing to say that it did not favor increased economic growth or a reduction in the unemployment rate.

Some of the comments that had been made on the balance of payments also left him rather unhappy, Mr. Mitchell continued. Last year the U.S. surplus on goods and services transactions was very large--$8.2 billion. This indicated that the country's trading position is strong, he said, and any attempt to dramatically increase exports and decrease imports to eliminate the overall deficit would have serious repercussion on the country's longer run trading relation-ships. It was, in his view, inappropriate therefore to use monetary policy at this time to restrict imports or expand exports. Nor was it wise to use monetary policy to curb the capital outflow by raising the level of U.S. interest rates.

Any move now toward firmer money market conditions would be likely to lead to a rise in long-term interest rates, Mr. Mitchell

said, particularly in view of the large holdings of longer-term issues by Government security dealers and the vulnerable position of the tax-exempt market. In his judgment a rise in long-term rates would hurt not help the economy. Accordingly, he felt the Committee should keep policy about where it was and leave the directive unchanged.

Mr. Daane remarked that after noting the differences in emphasis in the discussion to this point his feelings about appropriate policy were mixed. He thought the most important consideration at present was that the Committee should maintain a policy posture that would be conducive to confidence in the dollar. He agreed with Mr. Mitchell that monetary policy alone could not reform the balance of payments, which was affected among other ways by the Government's foreign aid program. But the Committee did have a concern with general attitudes toward the dollar. If he felt that a change in policy was necessary today to maintain confidence in the dollar he would favor such a change; but in his judgment no overt policy change was required.

Mr. Daane thought that members of the Committee, including himself, sometimes tended to take too seriously the implications for the economy of minor changes in net borrowed or free reserves. Despite the staff review he considered the economy to be exceedingly strong at present. Perhaps his views reflected the ebullience he had found on a visit to Detroit last week; but it was difficult for him to believe that a small increase in net borrowed reserves would have much impact on economic developments in general and on long-term interest rates in particular.

Mr. Daane agreed with Mr. Swan that alternative A was preferable for the directive. However, in his thinking he translated "no change" into the range of net borrowed reserves suggested by Mr. Irons--$150 to $200 million. If effect, the figure had been in that range recently; net borrowed reserves had averaged $155 million in the last three statement weeks, and a little higher in the last two weeks. As he had indicated, his feelings were mixed; from some standpoints he would rather see net borrowed reserves at the $200 million level. On balance, however, he would hold to alternative A. However, he would suggest two minor amendments to the staff draft. In the first sentence he would say "The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy, although at a somewhat slower pace. . ." rather than that these developments indicated "maintenance of a high level of economic activity. . ." as suggested by the staff. To him the staff's proposed language implied that activity was on a plateau, whereas GNP was expected to rise at an annual rate of $8 billion in the current quarter. Secondly, in the last paragraph he would call for maintaining about the same money market conditions as had prevailed "since the last meeting of the Committee," rather than "in recent weeks."

Mr. Hayes remarked that in view of the comments by Mr. Daane and others regarding recent levels of net borrowed reserves, it might be useful for the Manager to indicate what range of figures he had had in mind in operations since the previous meeting.

Mr. Holmes replied that, as he had understood it, the Committee's intent was that net borrowed reserves should average somewhat over $100 million. However, he also had understood that the Committee wanted operations to be related to other conditions in the money market; and in some respects the money market had had a somewhat easier tone recently despite the higher level of net borrowed reserves. He could not say that he had had a target range of $150-$200 million net borrowed reserves in mind.

Mr. Daane commented that net borrowed reserves nevertheless had come out in the $150-$200 million area, and he thought the Committee could contemplate a continuation of that range without adopting alternative B for the directive.

Mr. Hayes observed that in his opinion the most recent figure of $171 million was regarded as a slight aberration on the high side, at least by some Committee members.

Mr. Maisel said he felt the tone of the staff report was excellent. From it he drew the following conclusions. The past six months had been characterized by a sharp increase in savings by businesses and governments. It was fortunate that increased auto sales, as well as the run-up of steel inventories, were available to offset that higher level of savings. He noted that industrial prices had not had any statistically significant rise in nearly six years and that the main recent price rises had been primarily in international goods and raw materials. It now appeared that the two

major spending factors which sparked the first quarter expansion would be missing in the next half year. Since even with that extra spending the economy fell short of a completely desirable level of production and employment, it was extremely important that plant and equipment investments rise to make up the gap. As a consequence, he thought no action should be taken that would endanger that growth. He felt that such growth was probable. On the other hand, he did not believe that a period of slackening growth with a declining workweek was a period for putting further pressure on financial markets.

As a general rule, Mr. Maisel said, he would prefer that the Committee not vote a change in policy which would have very little actual effect. It was too likely to be misunderstood. He believed that alternative A was the proper directive. He would, however, go along with Mr. Daane's first proposed change but not his second one. Perhaps, however, a change also should be made at the end of the first paragraph to call attention to the fact that as a result of movements in the past month the money supply was no greater than it was six months ago. While moderate growth might be proper, it had not occurred.

Mr. Hickman observed that for the first time the figures were beginning to show the hesitation in the economy that had been expected to occur from declines in autos and steel. That was the case in industrial production, where the increase in April was smaller than in recent months, as well as in such series as overtime pay and the wage and salary component of personal income. A similar pattern would presumably be reflected in the second-quarter increment of GNP.

Prices had moved up on a selective basis, but, with the exception of agricultural products, most increases appeared to have been adjustments to shortages and bottlenecks that might already have passed.

In addition to declines in autos and steel, Mr. Hickman continued, cutbacks were beginning to appear in associated industries. For example, the workweek at rubber plants had been reduced from six to five days to correct for extremely large inventories of tires. Reflecting those developments, some analysts had lowered their sights from the very optimistic levels prevalent earlier.

Mr. Hickman reported that the Cleveland Reserve Bank's staff estimated that the combined changes in steel, autos, and related industries would have a net drag on the industrial production index from the second quarter to the second half of the year averaging about two index points. That was expected to be only partly offset by further gains in machinery and defense. It thus appeared that further net gains in the production index this year would be small at best.

Despite strength in capital spending and the expected fiscal stimulus, the "standard forecast" for GNP indicated rates of quarterly gain below those achieved in 1964, Mr. Hickman remarked. His staff was inclined to project somewhat lower rates than the standard forecast, but by almost any reckoning momentum seemed to be diminishing. Thus, the U.S. would be losing ground in the national effort to close the gap between actual and potential GNP. That implied a rising rate of unemployment.

Against that background, Mr. Hickman said, fiscal measures proposed by the Administration appeared to be inadequate. For example, the full employment surplus for the second half of 1965 had been revised upward to reflect an unexpectedly large rise in Federal income tax receipts. Looking further ahead, he was also disturbed by the alarmingly large fiscal drag estimated for the first half of 1966, even taking into account further reductions in excise taxes. Thus, it appeared that U.S. fiscal policy, as now planned, would be inadequately countercyclical this year, and would become procyclical next year. Whether the Committee liked it or not, monetary policy might be called upon to make a still further contribution to economic expansion, despite the country's balance of payments difficulties.

Viewed retrospectively, Mr. Hickman observed, the level of net borrowed reserves, which averaged $161 million over the past two weeks, and member bank borrowings, which averaged $500 million, might prove to have been too restrictive. With the uncertainties in the business outlook, he would prefer to see borrowings around $400 million and net borrowed reserves in a range of $50 to $100 million. That, he thought, could be accomplished within the scope of alternative A of the staff's draft directives. He would accept Mr. Daane's recommendation with respect to the first paragraph, but not his suggestion for the second paragraph.

In concluding, Mr. Hickman noted that covered yield differentials were still not favorable to the U.S. and there were reports of attempts to attract funds to Canada from the Fourth District on a rate basis. He thus would like to see the Treasury

either offer a strip of bills or increase the weekly bill offering, despite the Treasury's temporarily large cash balances.

Mr. Bopp remarked that now that the interim steel settlement had been reached, the economy appeared to be experiencing the slight hesitation so widely anticipated earlier in the year. A recent meeting of Philadelphia area business economists held at the Reserve Bank, while noting the slowdown, reached the conclusion that the economy was in for no general downturn. Those economists felt that steel inventories would hold at about present levels until the latter part of the third quarter, whereupon some accumulation would occur. They felt also that if a final settlement was reached in early September, steel production would decline 20 to 25 per cent. It was felt that upward momentum would still be maintained, however, paced by high rates of capital expenditure and a moderately expansive fiscal policy. The median forecast for gross national product in December 1965 was almost $670 billion (annual rate), up 5.5 per cent from the fourth quarter 1964. A tapering off of the rate of increase was forecast during the latter part of the year, with wholesale prices remaining relatively stable and unemployment creeping up to around the 5 per cent level.

As for the strength of business loan demand in coming months, discussions with District reserve city bankers provided mixed appraisals, Mr. Bopp commented. Two of the larger banks expected some noticeable increase in business loans in the latter half of the

year; the remaining banks saw only a slight rise. None of the banks could pinpoint any category of business loans as likely to show particular strength. Instead, they viewed prospective loan demand as coming "across the board." Over all, no significant strengthening in loan demand was anticipated.

Turning to policy, it appeared to Mr. Bopp that the present monetary posture was appropriate to the near-term outlook. The rapid increase in business loans experienced in the past few weeks would be disturbing if continued over a protracted period. But the rate of increase seemed to be moderating, and with the pace of business activity likely to be slower in coming months, demand for credit should be more moderate. Though prices had shown some increase, pressures were confined primarily to metals and food. He continued to be impressed by the facts that productive capacity was expanding and unit labor costs remained stable. Unemployment would probably rise over the summer months and, while much of present and prospective unemployment might be structural in nature, it was still necessary to maintain a high level of aggregate demand if new entrants into the labor force were to find employment and if measures to alleviate the structural problem were to achieve ultimate success. Given those factors and considering also the apparent success of the President's voluntary balance of payments program, Mr. Bopp would make no change at present in the general posture of monetary policy. Hence, he favored alternative A of the staff drafts of the directive.

Mr. Bryan remarked that relatively few new statistics for the Sixth District had become available in the two weeks since the

Committee had last met. However, the new statistics that were available for the District seemed to confirm the indications of the national figures of a slowdown in the upward trend of the economy. As he saw it, the question was whether that represented merely a reduction in upward momentum that might make for more stable growth in the long run--in his judgment the economy had been growing at an unsustainable pace earlier--or whether it reflected a genuine downturn. Obviously, he was not enough of an economic forecaster to say with certainty at this point which was the case. As a result, he favored no change in policy. He would vote for alternative A for the directive, with Mr. Daane's suggested change in the first paragraph.

Mr. Bryan's only other comment was on the balance of payments. He was gratified by the contribution that the so-called voluntary restraint program was making, but doubted that the program would result in a lasting amendment of the situation. Unless some new approach was fashioned--such as in the area of Government foreign loans and grants--he thought achieving improvement was going to be slow and hard work.

Mr. Shuford said that economic and financial developments continued to demonstrate strength, even though there perhaps had been some slowing of the economic advance in recent weeks. Employment had increased rapidly in the past few months, and production had risen faster than the upward trend in capacity. While retail sales were off a bit recently they were at a high level and, after allowance

for special fluctuations, had been rising at an average 5 per cent annual rate.

Wholesale prices had been working up since late last summer, Mr. Shuford continued. They rose early last fall; in the fourth quarter they were nearly stable; and since December they had risen at a 3 per cent annual rate. On the average, since last June they had moved up at a 2 per cent annual rate. Both the extent of the rise compared with the virtual stability over the previous six years, and the acceleration of price increases in recent months compared with declines for corresponding periods of the three previous years, were reasons for some concern.

Business activity in the Eighth District had approximated that nationally, Mr. Shuford said. Production and spending had been expanding at slightly faster rates than nationally since last August. Employment, while strong, had been increasing a little less rapidly than in the nation.

Mr. Shuford noted that national financial markets continued to reflect the strength of the economy. As interest rates had remained about unchanged, bank credit--chiefly loans--had expanded at a marked rate. Time deposits had increased at a rapid rate, and a major share of the reserves supplied to the banking system had been used to support them and also to support an unusual jump in Government deposits. The growth in the money supply had probably slowed since November, but he was inclined to think not so much as current data indicated after adjustment by the new seasonal factors and for the unusual temporary transfer of funds from private to Government accounts.

As to policy, Mr. Shuford felt that some firming was in order. Without repeating the reasons that had been outlined today by Messrs. Hayes, Irons, Ellis, and others, he would simply say that he too would think in terms of net borrowed reserves fluctuating around $200 million, and the Federal funds rate above the discount rate most of the time. In addition, while he did not advocate attempting to raise short-term rates, he nevertheless would be pleased if higher bill rates resulted from the slightly firmer position he favored.

Mr. Shuford said that he would not change the discount rate at this time. As to the directive, alternative B seemed acceptable.

Mr. Balderston noted that much of the discussion at today's meeting had centered on the domestic economy; he thought the minutes would reveal that much more stress had been placed on domestic than on international considerations. He did not know whether a real slowdown was occurring in the rate of economic expansion that the country had been enjoying for four years or whether there was merely a little deflation in the bubble that might have grown on top of the boom. The money supply had been affected by the large increase in Treasury deposits. The relapse in the stock market was what one would expect and perhaps even hope for after the kind of ebullience that had been witnessed for a while.

In short, Mr. Balderston said, he was not willing to make a judgment right now as to whether the domestic advance had really slackened. He suspected, however, that unless the Committee took some further steps with respect to policy, it might find that the

psychology of businessmen had led them to decisions they would regret. He thought he had observed some unhealthy ebullience in the thinking of businessmen. In any case, whatever the domestic concerns, the international problem was very much with the Committee.

Mr. Balderston said he was reminded of the challenging statement that Mr. Mitchell had made at the Committee's April meeting. He (Mr. Balderston) had found many of Mr. Mitchell's individual observations intriguing, but disagreed completely with his conclusions. Mr. Mitchell had observed that overall restraint of credit growth was not a desirable or feasible way of dealing with the problem of capital outflows. He also had argued that any effort to reduce the flow in credit markets by more restrictive monetary policies was offset, in part, by a diversion of the flow of current income away from consumption and durable goods expenditures into credit markets. He had concluded that the restrictive impact of a tight money policy would slow up the rate of domestic expansion and not curtail substantially the flow of funds seeking investment outlets abroad. Mr. Mitchell also had observed, and Mr. Balderston agreed, that interest rate differentials were bound to persist for some time between the U.S. and other countries which were not as intensively capitalized. Mr. Mitchell had concluded further that in the longer run the U.S. must establish controls over capital outflows that did not have to be backed up or reinforced by tighter money. It was at that point, Mr. Balderston said, that his own thinking departed from Mr. Mitchell's. While the

latter would stress domestic goals, Mr. Balderston would give equal weight to international considerations.

In Mr. Balserston's opinion the Government had to act quickly to curtail its foreign spending, or all efforts to improve the payments balance would be fruitless; the private sectors of the economy could not be asked to carry all of the burden. But also, what progress was being made in the private sectors would be undermined, in his judgment, unless it was supported by some reduction in credit availability. That was the responsibility of the Committee.

It might be argued, Mr. Balderston continued, that the recent increase in bank credit had been more rapid than in other forms of credit, and therefore was not as serious as it might appear. However, banking institutions had the know-how and the incentive to push funds abroad. Accordingly, he thought that the rate of growth of bank credit was particularly in need of control.

Mr. Balderston concluded that the Committee should not concentrate on domestic goals to the exclusion of international objectives. Further restraint on credit availability was required, in his judgment, to achieve the nation's balance of payments goals. He favored alternative B of the draft directives for the reasons stated by Messrs. Hayes and Ellis.

Chairman Martin noted that some members of the Committee favored one alternative for the directive today and some favored the other. He could argue the case either way. There seemed to be only slight differences in the objectives sought by the two groups, and he

wondered if the distinction being made was not too fine to serve as a basis for a policy change. His own thinking probably tended in the direction of the group favoring firming, although no one could be sure about the appropriate timing. He was becoming increasingly worried about both the balance of payments and the possibility of domestic inflation. His views were not firm on either point but he certainly was not worried, for example, that a deflation would occur.

The Chairman said he was not sure that monetary policy would have any influence on price developments; sometimes he felt discouraged on that score. But he could not go along with Mr. Robertson's suggestion that the Committee should wait until there was clear evidence of a price bulge before acting, because then it would be too late. With respect to the balance of payments problem, it there was a clear hemorrhage in U.S. international payments it might be necessary to follow Britain in raising the discount rate to a high level. That might happen.

Those were matters that the Committee had to weigh in arriving at its policy decision, the Chairman remarked. On the directive, he thought the Committee was in a difficult situation when the two alternatives could be interpreted in the same way by different people. Speaking not from his own point of view but in light of the discussion today, a directive along the lines of alternative A might be adopted, with the understanding that the conditions to be kept unchanged were roughly those that were currently prevailing, whether they had been attained inadvertently or not. Net borrowed reserves currently were

in the neighborhood of $150 million, he noted. The Chairman said that he could not support alternative A if it was taken as an instruction to the Desk to get net borrowed reserves back to around $100 million; in advocating no change in policy he meant no change in either direction. On the whole, he thought present policy, which he would describe as "mildly restrictive," was appropriate.

Mr. Mitchell observed that the second paragraph of alternative A called for maintaining about the same conditions in the money market and not for maintaining net borrowed reserves at any particular level. On that basis the figures for net borrowed reserves could be expected to fluctuate He was unclear from the discussion whether it was now proposed to shift to a net borrowed reserve target or to continue the earlier practice.

Chairman Martin commented that he personally did not favor introducing numbers for net borrowed reserves into the directive. But in its discussions around the table the Committee had tended toward the use of such numbers in measuring the results achieved by the Desk.

The Chairman then noted that Mr. Daane had suggested changes in both paragraphs of alternative A, the first but not the second of which seemed acceptable to those commenting on them. He proposed that the Committee vote on alternative A with Mr. Daane's first proposed amendment. There followed some further discussion of the wording of the directive.

Thereupon, upon motion duly made and seconded, the Federal Reserve Bank of New York was authorized and directed until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The economic and financial developments reviewed at this meeting indicate a generally strong further expansion of the domestic economy, although at a somewhat slower pace, and some improvement in our international balance of payments, but with gold outflows continuing. In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

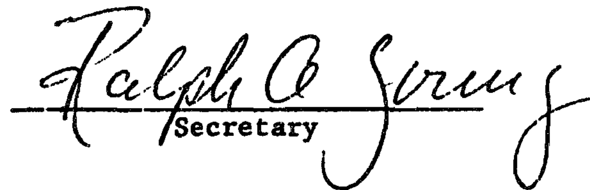
To implement this policy, System open market operations over the next three weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Votes for this action: Messrs. Martin, Bryan, Daane, Galusha, Maisel, Mitchell, Robertson, and Scanlon. Votes against this action: Messrs. Hayes, Balderston, Ellis, and Shepardson.

Mr. Hayes said he dissented from this action because he considered it desirable to move toward firmer money market conditions at present, even if the change was a slight one. Messrs. Balderston, Ellis, and Shepardson also dissented because they favored a move toward firmer money market conditions, for the reasons indicated by their statements earlier in the meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday, June 15, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

Attachment A

CONFIDENTIAL (FR)

May 24, 1965

Drafts of Current Economic Policy Directive
for Consideration by the Federal Open Market Committee
at its Meeting on May 25, 1965

Alternative A (no change in policy)

The economic and financial developments reviewed at this meeting indicate maintenance of a high level of economic activity and some improvement in our international balance of payments, but with gold outflows continuing. In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next three weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Alternative B (firming)

The economic and financial developments reviewed at this meeting indicate maintenance of a high level of economic activity with some upward pressures on prices, a large expansion of bank credit and reserves in recent months, and continuing gold outflows despite some improvement in our international balance of payments. In this situation, it is the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, by moderating growth in the reserve base and bank credit.

To implement this policy, System open market operations over the next three weeks shall be conducted with a view to attaining slightly firmer conditions in the money market.