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, July 13, 1965, at 9:30 a.m.

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

Messrs. Bopp, Hickman, 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. Sherman, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Garvy, and Koch, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Molony, Assistant to the Board of Governors
Messrs. Partee and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Hersey, Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
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, Eastburn, Mann, Jones, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Cleveland, St. Louis, Kansas City, and Dallas, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Monhollon, Assistant Vice President, Federal Reserve Bank of Richmond
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York
Mr. MacLaury, Manager, Foreign Department, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 15, 1965, were approved.

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 June 15 through July 7, 1965, and a supplemental report for July 8 through July 12, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury said that the gold stock would again remain unchanged this week. It now looked as though the extra $100 million in gold transferred to the Stabilization Fund at the time of payment of the U.S. gold subscription to the International Monetary Fund at the end of June should meet requirements through the remainder of July. The only gold sales of any significant size in prospect at the moment were $34 million to France and $12.5 million to Austria.

During June, Mr. MacLaury observed, demand for gold in the London market was generally lower than it had been in earlier months this year, and the pool was able to make some progress toward recouping its previous deficit. By the end of June, sufficient gold had been accumulated for the Bank of England to make a distribution of $44 million, of which the U.S. received half. There was some further accumulation during the early part of July, but last Friday (July 9) demand again picked up temporarily, sending the price as high as $35.11-1/2 after the fixing. At the moment, the pool's position was about the same as at the end of June--a net deficit of approximately $150 million--and the price had now fallen back below $35.10-1/2.

Mr. MacLaury noted that supplies of gold coming onto the London market this year had been augmented to a considerable extent by South African sales of gold from their reserve holdings, apart from new production, reflecting that country's balance of payments deficit. Whereas sales from South African reserves added only about $60 million to market supplies in all of 1964, they had added some $200 million during the first half of this year alone. Thus, while Russian sales had continued to be conspicuously absent for over a year, the gold market had benefited from a source of supply that could not be counted on indefinitely.

In the exchange markets, Mr. MacLaury said, attention continued to focus on sterling, and on the figures that gave clues to its prospects. For example, it was the disappointing trade figures for the month of May, released at the beginning of the current reporting period, that touched off several days of selling pressure and cost the Bank of England more than $150 million in support operations. More recently, the spot rate had held pretty much on its own, and in fact had withstood some fairly heavy pressure from official operations by the Bank of England designed to roll over maturing forward contracts. Not all the maturing contracts were extended, and paying off a part of them put an additional burden on U.K. reserves. Given the keen market interest in U.K. statistics, it was decided to draw on the Federal Reserve swap to the extent of $360 million at the end of June to reduce the published reserve decline to $67 million. As it turned out, the market was not visibly affected one way or the other by the reserve announcement, despite the fact that the public statement said that use had been made of the swap arrangement. No figure, of course, was given.

Subsequently, Mr. MacLaury continued, the U.K. repaid $85 million of its drawing from unutilized proceeds of its previous IMF drawing, reducing the amount presently outstanding on the Federal Reserve swap to $275 million. The market was once again focusing on the trade figures which had been released today. They showed imports down noticeably from their swollen May level. But exports also were slightly lower, thus failing to show the hoped-for improvement. The market's preoccupation with those figures--not just for a single month, of course, but over a period of time--was quite understandable. The Chancellor of the Exchequer had himself indicated that developments in the next few months would be of crucial importance in determining whether further measures were required.

On the continent, Mr. MacLaury observed, currency rates fluctuated somewhat in response to changing money market conditions in Germany, Switzerland, and the Netherlands. On balance, however, the System had been able to make substantial further progress in reducing its commitments in guilders and Swiss francs, in the latter case partly through the use of marks. Specifically, the drawing on the Bank for International Settlements swap, which was $55 million at the beginning of the period, had been entirely liquidated. Roughly $15 million equivalent of the necessary Swiss francs were purchased from the Swiss National Bank when that Bank needed dollars. The remaining $40 million equivalent were obtained through the BIS by selling marks against Swiss francs on a covered basis, using marks acquired either in the market or from the Bundesbank, which had undertaken some support operations as the mark rate softened. In effect that meant that while the System still had $40 million equivalent of forward commitments in Swiss francs, it had improved its overall position in foreign currencies by the $40 million equivalent of marks acquired. Apart from that operation, the System also purchased $8 million equivalent of Swiss francs from the Swiss National Bank and paid off the last of its market forward commitments in Swiss francs. As the Committee would recall, those commitments were initially entered into last December to provide cover for Swiss commercial bank dollar investments that otherwise would have been sold to the central bank.

Similarly, Mr. MacLaury continued, during the period the System was able to buy some $52 million equivalent of guilders from the Netherlands Bank which had sold dollars in its market apparently mainly in connection with commercial demand. Those guilders were used by the System to pay off maturing forward contracts, reducing the amount outstanding in guilder market forwards to only $2.5 million, which matured later this month. It was expected that the System's remaining forward guilder commitments would be liquidated by the end of July. In addition, the System had been able to reduce its $10 million equivalent sterling-guilder swap by half during the period, also purchasing the required guilders from the Netherlands Bank. All in all, it was evident that considerable progress had been made in reducing System commitments in those particular currencies without recourse to funding or gold sales.

In the case of Italy, Mr. MacLaury said, the picture was quite different. The Italian authorities had been taking in dollars at a very rapid rate. Reserves had not risen more than they had mainly because of the very large swap transactions between the Exchange Office and the Italian commercial banks. In effect, some $900 million had been shifted back out of official reserves through such operations during the first half of this year. The present prospect, however, was that the Italian balance of payments would be in surplus by more than $1 billion this year. Unrelated to market developments, but of interest to the Committee, was the fact that the System had been able to pay down $5 million equivalent to the Bank of Italy during the period through acquisition of lire from Ceylon, which in turn had drawn them from the IMF. There was still a strong likelihood that the System's remaining drawings on the Bank of Italy, in the amount of $163 million, would be liquidated by the end of July as a result of a U.S. drawing of lire on the IMF and issuance of a lire-denominated bond by the Treasury. Likewise, it was hoped that most, if not all, of the U.S. debtor position under the Belgian swap arrangement--which during the period first rose by $20 million to $80 million and subsequently (on July 12) was reduced by $10 million--could be liquidated by similar means.

Finally, Mr. MacLaury noted that the Canadian dollar had had a softer tone in the spot market recently, dropping on Friday to $0.9219 and eliciting some support from the Bank of Canada. On the other hand, the premium on the three-month forward Canadian dollar at one point rose to well over 1/2 per cent, although it was now back down to levels around 1/4 per cent. The fluctuations in the forward rate appeared to be related to the bunchings of repatriations of U.S. funds from Canada, and did not seem to have generated any significant movement of funds in the reverse direction.

Mr. Daane asked about the implications of the transaction Mr. MacLaury had described, in which the System in effect had converted $40 million of its Swiss franc debt to the BIS into a third-currency swap of marks against Swiss francs.

Mr. MacLaury replied that there was a distinction--although one that should not be pushed too far--between a System debt incurred by drawing on a standby swap arrangement and a third-currency swap such as had been arranged with the BIS. In the former case, the System was simply in a short position on a foreign currency; in the latter case, its net position was not a short one. In the transaction in question an opportunity had arisen for the System to acquire marks, and it had appeared desirable to use those marks to reduce the System's short position in Swiss francs. Because the transaction was a covered one there remained an obligation to pay Swiss francs to the BIS in three months, but on a balance-sheet basis an offsetting asset now existed in the form of a liability of the BIS to pay the System an equivalent amount in marks at that time. The need for transactions of this type arose mainly because, while other countries could settle debts to third countries by transferring dollars, the U.S. could not directly pay a debt in, say, Swiss francs by use of another currency such as the mark.

In response to questions by Mr. Hickman, Mr. MacLaury said that under the arrangement made the System was exposed to the risk of loss in the unlikely event of devaluation of the mark. Since there was a similar risk in connection with outright holdings of marks, however, the System's exposure in this respect had not been increased by the transaction. Dollar limits were, of course, set both on the System's spot holdings of foreign currencies and on forward transactions by the Committee's continuing authority directive for foreign currency operations.

Mr. Shepardson noted that at the previous meeting of the Committee there had been some discussion of System drawings under the swap line with the National Bank of Belgium. At that time Mr. Coombs had indicated that the one-year period in which drawings were to be fully liquidated, under the terms of the Committee's guidelines, in the Belgian case would elapse in August. Mr. Coombs also had expressed the hope that the account with the Belgian Bank would be cleared up in the first week in July. However, in the Special Manager's supplementary report, distributed this morning, it was indicated that a maturing $5 million drawing on the Belgian Bank had been renewed yesterday for three more months. He asked whether that renewal implied that the Belgian account would not be cleared up shortly.

Mr. MacLaury responded that the three-month period of the renewal was a technical matter--all drawings and renewals under the standby swap lines had three-month terms--and it did not imply that the drawing actually would be kept on the books for that period. The Account Management hoped to have the Belgian drawings liquidated by the end of July, but the precise timing depended on the date of the prospective U.S. drawing on the IMF. It was his understanding that for technical reasons the Treasury had postponed the planned Fund drawing, but was still expecting to make it in the month of July.

Mr. Shepardson then asked what would be done about the drawings on the Belgian line in the event that the Treasury decided not to draw on the IMF.

Mr. MacLaury replied that if it were not possible to acquire the Belgian francs necessary to repay the drawings within the one-year limit the ultimate means of settlement would be by sale of gold. In his opinion, however, the Treasury would prefer to arrange for settlement through an IMF drawing.

Mr. Shepardson commented that when the Committee began its program of reciprocal currency arrangements the understanding had been that drawings would be used to counter temporary flows that were considered likely to be quickly reversible. While he realized that the one-year limit established in the guidelines had not yet elapsed in the case of the present drawings on the Belgian swap line, in his judgment those drawings were being extended beyond what had been originally contemplated.

Chairman Martin remarked that it would be desirable for the Committee to continue to watch the situation with respect to the Belgian swap line closely.

Thereupon, upon motion duly made and seconded, and by unanimous vote the System open market transactions in foreign currencies during the period June 15 through July 12, 1965, were approved, ratified, and confirmed.

Mr. MacLaury then asked the Committee's approval of renewal of four standby swap arrangements that would mature soon, with no changes in size or maturity. The arrangements in question were those with the Austrian National Bank, maturing July 26, 1965, in the amount of $50 million, for a term of 12 months; with the Bank of Japan, maturing July 30, in the amount of $250 million, also for a period of 12 months; with the German Federal Bank, maturing August 9, in the amount of $250 million, for six months; and with the Bank of France, maturing August 10, in the amount of $100 million, for three months.

In response to questions by Mr. Mitchell, Mr. MacLaury said that one drawing had been made on the Austrian swap arrangement since its initiation, and that the Austrians had been following a program of regular gold purchases from the U.S. since February, buying $12-1/2 million of gold each month. He understood, however, that their gold purchase program would be completed within a month or two.

Mr. Mitchell then remarked that he had had some question about the desirability of a swap arrangement with Austria, and his doubts were reinforced by the fact that the Austrians were buying gold rather than utilizing the swap line.

Mr. MacLaury commented that, as Mr. Shepardson had indicated, the initial intent was to use swap drawings to deal with temporary and reversible flows. The one drawing the System had made on this swap line had proved not reversible, and accordingly had been settled in gold; and the Austrians' program of gold purchases this year was related to earlier dollar accruals that did not appear to be reversible. In his judgment there was no conflict between the existence of the standby swap arrangement and the gold purchases Austria had been making.

Mr. Daane remarked that he thought there was an advantage to the United States in the System's swap line with the Austrian National Bank.

> Renewals of the standby swap arrangements with the Austrian National Bank, the Bank of Japan, the German Federal Bank, and the Bank of France, as recommended by Mr. MacLaury, were approved.

Mr. MacLaury then recommended renewal for three months of a swap drawing on the Bank of Italy, in the amount of $50 million, that would mature on August 18. Such approval would be a precaution in the unlikely event that the prospective U.S. drawing on the IMF was not made; he contemplated that the drawing on the Italian swap would be paid off before the end of the month.

> Possible renewal of the $50 million drawing on the Bank of Italy was noted without objection.

Chairman Martin then invited Mr. Daane to comment on developments at the three meetings he had attended in Paris the past week.

Mr. Daane said he would not do more than touch on the highlights of the meetings, which were of the Group of Ten Deputies, Working Party 3 of the Organization for Economic Cooperation and Development, and the Economic Policy Committee of the OECD, taking place in that order. Only two substantive issues were discussed at length at the Group of Ten Deputies meeting. The first concerned the question of renewal of the General Arrangements to Borrow; and the second involved the disposition to be made of the so-called "Ossola report"--the report of the Study Group on Creation of Reserve Assets.

As he had mentioned on a previous occasion, Mr. Daane said, the General Arrangements to Borrow expired in October 1966 but their renewal was required by October 1965. It had been obvious in the preliminary discussion by the Deputies at their meeting in May that while the general sentiment was in favor of an extension, there was considerable dissatisfaction with the structure of the GAB. In particular, opinions had differed with respect to duration. Those divergencies in view were carried forward to the recent meeting; all of the Deputies agreed that the GAB should be renewed, despite some dissatisfaction with certain technical aspects, but there was a sharp division on the question of duration. The original GAB had a four-year term, and the United States, Britain, Canada, Japan, and Sweden favored renewal for another four years. France, Germany, the Netherlands, and Italy favored renewal for only two years, on the grounds that the longer term would imply too great a degree of permanence to the GAB and would inhibit technical changes in the Arrangements themselves. More directly, Deputies from the latter countries thought it would be unwise to extend the GAB for more than two years since a study was under way of possible reforms of the international monetary system. Under Secretary Deming and others presented the view that the Arrangements were not permanent since they could be amended or terminated at any time, and could lie dormant if not needed. One of the major reasons advanced for a four-year term was the possible effect on confidence of a shorter renewal. The U.S. representatives directly rejected the view that there was a tie between the term of the GAB and possible monetary reform. Mr. Deming indicated that such a view implied much too inflexible a timetable; it suggested that "new" monetary arrangements would be in effect within two years.

Mr. Daane noted that the question of renewal of the GAB would now go forward to the Ministers of the Group of Ten when they met in Washington in September in connection with the World Bank-Fund meetings. The IMF view, as expressed by the Managing Director, favored a four-year extension, on the grounds that the GAB demonstrated the existence of collective support for the international monetary system and, more importantly, it made $6 billion of additional resources available for the Fund.

On the question of the disposition of the Ossola report, Mr. Daane said, there was virtually unanimous agreement that the report should be published, with France alone dissenting. It was decided to have the Secretariat group, including Robert Solomon of the Board's staff and George Willis of the U.S. Treasury, work out some minor changes in the format of the report, and to have each country give its assent or not on the question of publication by July 26. Mr. Daane's personal expectation was that the report would be published and available no later than sometime early in the fall.

At the WP-3 meeting, Mr. Daane continued, the principal focus was, of course, on the situation of the United Kingdom. The Working Party was unanimously of the opinion that the time had come for Britain to consider implementing the earlier commitment by Chancellor Callaghan, in his letter to the Managing Director of the IMF, to the effect that further measures would be taken if needed. There was a growing lack of confidence in the private financial community with respect to the measures taken thus far. Even the British Government's own forecasts now indicated a larger deficit in the U.K. balance of payments this year than had been expected. British foreign trade developments were disappointing and today's announcement showed that exports had declined further in June. Internally, wage and employment developments were not satisfactory.

The British representatives seemed to be somewhat surprised by this Working Party attitude, Mr. Daane remarked. They felt that it was too early to expect substantial results from the measures that had been adopted, and they thought there were indications that those measures were beginning to take hold. In that connection they noted the flattening in the trend of retail sales, evidences of a slowdown in industrial production, declines in housing starts, and a return of unemployment to its January level. In their judgment the U.S. voluntary restraint program was having an adverse impact on Britain's situation. In any case, it was the clear conclusion of the Working Party that the British should be reviewing their situation and measures, and the British indicated that they were currently doing so.

There was considerable discussion at the WP-3 meeting of the effects of the U.S. balance of payments program on international liquidity, Mr. Daane said. The Germans and the Swiss, in particular, noted that they were pleased with any resultant reductions in liquidity that were occurring, and the Germans thought that the U.S. goal should be to attain a surplus in its international payments. There was some puzzlement expressed regarding the effect of the program on liquidity in this country; the continental representatives found it hard to understand why the repatriation of U.S. funds had not added significantly to credit availability in the United States.

Mr. Daane went on to say that there were the usual country reviews at the WP-3 meeting. The paper by the OECD Secretariat projected a surplus in the Italian balance of payments this year of $1.4 or $1.5 billion, and a French surplus of around $3/4 billion. The Italians were quite unhappy about the estimate for their country; they indicated that they expected a substantial surplus but not one as high as predicted. The French, on the other hand, not only accepted the Secretariat's estimate, but conceded that there also would be a surplus in the franc area, of about $250-$300 million, leading to a total surplus on the order of $1 billion.

The most interesting country presentation, in Mr. Daane's judgment, concerned Germany. It was clear that the Germans were still struggling with an overheated economy and that they had no intention of diminishing the degree of credit restraint being exerted. On the other hand, there was no intention of increasing restraint either, although there was some indication that if any change were to be made it would be in the direction of further tightening.

The discussion at the meeting of the Economic Policy Committee of the OECD was, as usual, more formal than at the WP-3 meeting since the group was considerably larger, Mr. Daane remarked. The theme was the general slackening of growth rates. For most of the countries represented, the 1965 growth rate was projected to be below that of 1964. Overall, the projected 1965 rate still averaged about 4-1/2 per cent, but projections for 1966 indicated further slackening. A great deal of concern was expressed by speakers, including Mr. Ackley of the U.S., as to whether sufficiently expansionary policies were being followed. For the first time in the FPC in Mr. Daane's experience, France was roundly criticized on that score; there was considerable discussion of so-called stagnation in the French economy. The representatives of that country felt that their economy was recovering and that a number of policy actions had been taken to assure recovery. The general tenor of the discussion, however, was contrary to that view. There also was a feeling that economic growth in the U.S. would be slowing down, and that this country should follow a more expansionary fiscal policy. Indications that the U.S. authorities stood ready to take additional budgetary actions to stimulate the economy if necessary were noted with approval. As to monetary policy, as usual the U.S. was urged to tighten further. The Germans in particular felt that a firmer monetary policy now would give U.S. monetary authorities additional elbowroom if it became necessary to move toward ease before the end of 1965 or in 1966.

The discussion of the British situation at the EPC meeting was simply an echo of that at the WP-3 meeting, Mr. Daane said. The British were urged to take any further measures needed "in good time" to achieve equilibrium in their balance of payments by the end of 1966.

Following Mr. Daane's remarks, Chairman Martin reported briefly on discussions that had preceded the proposal for an international conference on world monetary reform made in a speech by Secretary of the Treasury Fowler on the preceding Saturday (July 10), on a draft of which the Chairman had been invited to comment. He went on to note that the advisory committee on monetary reform recently appointed by President Johnson would meet for the first time on Friday, under the Chairmanship of former Treasury Secretary Dillon. Discussions of the matter would be proceeding in coming weeks, Chairman Martin observed. As he had advised Secretary Fowler before the latter's speech, he was sure that the System would be as helpful as it could in assuring that they proceeded in the best way possible.

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 June 15 through July 7, 1965, and a supplemental report for July 8 through July 12, 1965. Copies of both reports have been placed in the files of the Committee.

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

The money market was active in the past four weeks as the banking system responded to heavy credit demands over the June corporate tax date and beyond, passed through the June 30 statement date, and met the large currency needs associated with the July 4 holiday. The major money market banks came under increased reserve pressure, and their strong bid for Federal funds kept the rate at 4-1/8 per cent on most days. Indeed, given the magnitude of reserve needs and the uncertainties of a period of large financial flows, there was some trading of nominal amounts of Federal funds for the first time at 4-1/4 per cent, and member bank borrowing from the Reserve Banks rose above $1 billion on two days. Federal funds became redundant on one occasion as well, and relatively large reserve excesses remained unused at money center banks at the close of each statement week, attesting to the complications banks experienced during this period in managing their reserve positions.

The uncertainties, stemming from the large and, at times, unexpected ebbs and flows in demands placed upon the money market during the period, also posed difficulties for the System in meeting the substantial reserve needs that emerged. Nevertheless, the System was able to meet these needs with only limited recourse to purchases of Treasury bills in the market. The Treasury's willingness to run its balances at the Reserve Banks below the $900 million level that ordinarily prevails was a major help in supplying reserves, and, fortuitously, various foreign operations turned out, on balance, to supply reserves when they were most needed. Even so, open market operations still had to supply $564 million reserves net over the four weeks, and day-to-day operations involved transactions of much greater magnitudes as the System sought to avoid placing downward pressure on Treasure bill rates.

Over $2.3 billion repurchase agreements against Government securities and bankers' acceptances were made and terminated during the interval, and a total of $280 million Treasury bills were purchased directly from foreign accounts. In addition, the good availability of coupon issues throughout the period enabled the System to provide $245 million reserves through this medium, mainly during periods when prices were steady or declining slightly. In fact, availability was such that the largest daily amount of purchases ($81 million) could be accomplished by means of a full market-go-around. Purchases of about $250 million Treasury bills were made in the market on June 16, but part of these acquisitions represented weekly and tax anticipation bills which were permitted to mature soon thereafter, and no bills were purchased in the market after that date.

Treasury bill rates moved generally lower in the first part of the period, as reinvestment demand arising from maturing June tax bills was augmented by commercial bank demand for bills prior to the June 30 statement date. The 3-month bill declined to 3.77 per cent bid at one point. Subsequently, the return flow of bills from banks, higher dealer financing costs, and disappointment at the lack of expected large-scale System buying caused bill rates to back up about 10 basis points. The absence of System demand at this time was all the more important since dealers had built up inventories in anticipation of such buying. With inventories high, dealer bidding in the last few weekly bill auctions was more cautious. Rates for the 3- and 6-month bills in yesterday's auction were set at about 3.88 and 3.93 per cent, 9 and 6 basis points higher than four weeks earlier.

In the capital markets, the period was marked by a further decline of stock prices and a subsequent recovery. In contrast, prices of Treasury notes and bonds were narrowly mixed. Quotations tended to move higher at times when investment buying appeared but tended to recede whenever activity receded. There has been an underlying confidence among market participants, however, in the viability of current interest rates--a feeling that drew strength from the uncertainties reflected in the stock market. Dealers have generally acted to maintain their positions in coupon securities at a high level.

The tone in the corporate and municipal bond markets has improved somewhat since the last meeting as a large volume of business has been transacted around recent price levels. More recent additions of new corporate issues to the calendar, and the possibility that new offerings of bank capital notes may be in the works, have prevented any major improvement in corporate bond prices, however. Tax-exempt bonds remain in plentiful supply, and while investors appear willing to place funds around current levels, they do not seem ready to chase prices higher.

I might mention at this time that the Treasury's August refinancing, involving somewhat over $3 billion public holdings, will be undertaken before the next meeting of the Committee. The advisory groups will convene in Washington on July 27, and an announcement of the terms might be expected the following day.

Market participants feel that the operation will be routine. In view of the still-sizable supply of longer bonds undistributed, the market expects the Treasury to confine its financing to the short-term area--possibly a single issue in the 2-year range.

As was reported to the Committee in the written reports, we have ceased trading with C. F. Childs & Company, which terminated its operations in Government and certain other securities on June 30 after more than half a century of activity. This withdrawal followed capital losses in recent years in activities unrelated to the Government securities market. The withdrawal was accomplished gracefully and had no impact on the market or its operations.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period June 15 through July 12, 1965, were approved, ratified, and confirmed.

Chairman Martin called at this point for the staff economic and financial reports, supplementing the written reports that had been distributed prior to the meeting, copies of which have been placed in the files of the Committee.

Mr. Noyes made the following statement on economic conditions:

You have probably seen, as I have, quite a bit lately in the press and elsewhere about the "new economics." Let me suggest that we have a "new semantics" to go along with it. In this new semantics we refer to things as unchanged when they are increasing at the same rate as they were in the previous period, and as going up only when they are going up faster than they were going up before.

There is nothing wrong with this, so long as we are careful to be sure that we understand one another. It should be clear that when we say things were down a bit from the first to the second quarter what we mean is that they were up less, and when we say they were substantially unchanged from May to June, we mean that they were expanding at about the same pace.

In the day-to-day production and distribution of goods and services, we have not seen any of the pyrotechnics that turned up in the financial and international areas in the last four weeks. In fact, the broad aggregate measures of income, expenditure, and physical output are almost all continuing to move frighteningly close to the rates projected around the turn of the year by our own staff, and by most other careful analysts of the economic outlook.

This is true of GNP, which we now expect to be up about $7 billion in the second quarter; of industrial production, which has leveled off at the advanced 141-142 rate; of personal income, which is actually running a bit ahead of expectations; and of unemployment, which is a bit lower--that is, better than--expected. As with the balance of payments, however, we are warned that at least a part of the improvement in unemployment is not basic. "Basic" is another word that occupies a prominent place in the new semantics, but I must confess I am not able to define it satisfactorily for you.

The "on track" performance by the real economy might be presumed to provide some grounds for confidence--if not downright optimism--as to the future. But, in fact, one does not even have to venture out into the turbulent financial markets or the troubled international waters to lose any complacency he might have mustered. Both the recent behavior of prices and apparent rate of inventory accumulation are enough to give one pause.

I have spoken about both of these troublesome areas on several occasions in recent months. I do not want to seem to be crying a wolf that never comes, but they continue to be a cause for concern, if not alarm.

Despite the slowdown in the economy (note that here again I am employing the new semantics referred to earlier), prices have continued to creep up. From time to time, there have been signs that the advanced prices of some of the basic industrial materials, especially the nonferrous metals, might have reached their peak and be about to move down a little, but significant declines have failed to materalize.

As Appendix C to the green book 1/ points out, the upward pressure on prices has not yet been diffused

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

through the whole structure of prices and costs. One important reason that this has not occurred has been the general absence of inflationary expectations. The restoration of a climate of stable price expectations is much to be desired, and, is at least one benefit that we can hope will flow from current moderation in the pace of expansion.

The other major concern to which I would draw your attention is that we have had, even in the official statistics, a considerable inventory buildup, and there is impressive evidence that even a greater share of recent output than these data indicate remains in the hands of processors and distributors. Like price stability, the absence of rapid inventory buildup had been, until last winter, an unusual feature of this period of expansion, and one which contributed importantly to its sustainability.

It is very hard for me to ascribe either recent price behavior or the recent pace of inventory accumulation to a maladroit monetary policy. It is equally difficult for me to find convincing evidence that there is any cause-and-effect relationship between the modest restriction of reserve availability earlier this year and the slower rate of increase in real output since April, especially in the light of the latest credit developments which Mr. Koch will discuss.

Under present policy, I think it is not unreasonable to hope that the recent upward price movements will turn out to be only a flurry and that we will return to the more stable pattern which characterized this expansion up to the third quarter of 1964. We can also hope the accumulated inventory may be absorbed without untoward repercussions. It is hard for me to see that a change in policy in either direction at this time would significantly increase the chances that either of these things will happen. I am reasonably certain that a change now would get more blame than it deserved if we subsequently find ourselves in either an inflationary spiral or the downphase of an inventory cycle.

Mr. Hickman asked whether Mr. Noyes had May developments in mind when he referred to the "recent" upward movement of prices. Mr. Noyes replied that his thinking had been based primarily on appendix C of the green book, which generally included data through May. However, some estimates of price developments in June were given in the appendix and also in the body of the green book. The June estimates had struck him as being neither more disturbing than those through May nor particularly reassuring; they indicated that average prices were continuing to rise.

Mr. Hickman said he thought that June price developments definitely were not disturbing. Omitting meats and livestock, which were responding to supply conditions, price movements in June appeared in the main to be down rather than up; yet the discussions in the press, like Mr. Noyes' comments, suggested a continued bubbling up of prices. He did not see such a situation in the latest figures although, of course, it might appear in data for subsequent months.

Mr. Noyes said that price movements in June evidently were mixed, but he agreed that the rise in the overall index probably would be due largely to increases in the agricultural components. It was true the most recent flurry of increases was a May rather than a June phenomenon, but the uptrend in average industrial prices actually had been in process since the third quarter of 1964. He certainly hoped that this trend was flattening out.

Mr. Swan asked whether Mr. Noyes felt that rapid inventory accumulation was still concentrated primarily in a few areas or was becoming more widely diffused. Mr. Noyes replied that the official inventory data were difficult to interpret; among other problems, they were reported late and the original figures often were revised substantially. As a result, there was some risk of over-interpretation. Unquestionably, accumulation had been rapid at steel and durable goods manufacturing industries and, recently, at automobile dealers. Members of the Board's staff agreed that inventory growth recently had been rapid in the aggregate and reasonably widespread, but there were differences of view about degree. Some thoughtful analysts on the staff felt that the accumulation had been much larger and more widespread than the official figures indicated.

Mr. Ellis noted that there was a reference in the staff materials to the large additions to industrial capacity coming on line as capital expenditures continued high. He asked whether an estimate was available of the current rate of capacity utilization in manufacturing.

Mr. Noyes replied that present guesses of the rate of capacity use were in the neighborhood of 90 per cent. However, here also he was highly skeptical of the advisability of pressing the figures very far. The margins of error in capacity figures were quite large, particularly relative to the sizes of the changes that might occur in the short run. From what was known about additions to capacity and changes in the rate of production, it seemed to be a reasonable presumption that presently and for some time to come capacity would be growing faster than output; that was about as far as he was prepared to go.

Mr. Hickman commented that business cycles often originated in inventory developments, and in his judgment the inadequacies of present inventory statistics placed the Committee in the dangerous position of having to guess about the nature of actual events. He noted that the Federal Reserve was in process of discontinuing data collection for department stores, and indicated that it might be desirable for the System to undertake to learn more about inventory developments than presently available data revealed. Perhaps the Board's staff might explore the possibilities of such a program and make recommendations.

Mr. Noyes observed that the inadequacies of present inventory data did not result primarily from lack of resources for compilation--the Government was devoting a substantial volume of resources to that purpose--but from the intransigence of the statistical problems. Thus, there was some doubt in his mind about the amount of improvement that could be achieved by the addition of System resources to those presently available. However, he would be happy to ask the Board's Division of Research and Statistics to make some preliminary investigations of the possibilities for data improvement.

Mr. Hickman remarked that the System might have one possible advantage in that businesses frequently were willing to report information to it that they were reluctant to reveal to others.

Chairman Martin noted that inventories had long been recognized as one of the most seriously deficient areas in the body of available statistics. He recalled that in the mid-1950's the Board had sponsored a study by a consultant committee of the problem in that area, as well as in certain others, at the request of the Subcommittee on Economic Statistics of what was then known as the Joint Committee on the Economic Report of the Congress. He agreed that it would be desirable to continue work in the area.

Mr. Koch then made the following statement concerning financial developments:

> Several months have now elapsed since the two modest moves in the direction of monetary restraint taken in February and March. Therefore, I should like to address my brief remarks this morning to three questions: (1) What have been the apparent results of these moves; (2) with the benefit of hindsight, have these results, on the whole, been appropriate; and (3) what do they suggest as to the most appropriate posture for current policy.
>
> Recent policy can appropriately be characterized as one of moderate restraint. The oft-maligned but still useful short-run guide to policy, free or net borrowed reserves, has changed from a positive figure of about \$100 million on average over the three months ending with January to a negative figure of between \$150 and \$200 million recently. Member bank borrowings have risen from about \$300 million to almost \$600 million. Changes of almost \$300 million in these indicators are large ones for such a short period of time.

This rather sharp increase in the degree of pressure on bank reserve positions has been occasioned by a desire to achieve tauter money market conditions, conditions more consistent with the 4 per cent discount rate adopted last November. Even so, we have seen the Treasury bill rate become quite disassociated, for a time at least, from more restrictive bank reserve positions and other indicators of the tone and feel of the money market. Most recently, though, bill rates appear to be rejoining the money market team.

Turning to the more basic financial indicators of policy, events of the recent past indicate once again how much financial developments depend not only on monetary policy but also on market forces as well as other policy measures. With the liquidity of business corporations becoming more limited relative to financing needs, their demand for bank loans has continued strong, and they have stepped up the volume of their capital market financing in recent months. This has occurred at a time when banks have been under somewhat more reserve pressure, when their liquidity has declined to a relatively low level, and when time and savings deposit growth has slackened, following the initial rapid inflow last winter when interest rates on these deposits were raised.

Banks have had to liquidate Government securities and on balance have apparently reduced their rate of acquisition of other securities in order to meet the strong loan demands. There was a sharp rise in bank holdings of securities other than U.S. Governments in June, but the rise was concentrated at New York City banks and was no doubt associated in large part with a temporary and unusual spurt in Federal agency and municipal tax warrant financing.

The end result of all of these banking developments has been a continuing quite rapid rate of expansion of total reserves and credit, but with a larger proportion of the reserves having to be obtained by borrowing and with credit obtainable only at somewhat higher costs and under somewhat more restrictive lending terms. Money supply growth has been quite moderate for the year to date, about 2-1/2 per cent, almost all of which was concentrated in June.

The cost and availability of most types of capital market financing, as well as bank financing, has become a little more restrictive in recent months, due in the main to a large increase in new flotations of corporate and municipal bonds, and to the public's reappraisal of stock values. Thus, yields on both new corporate bonds and on outstanding State and local government bonds have risen about 25 basis points above the early year levels. Average stock prices are down about 5 per cent from their mid-May peak, and therefore dividend yields are up about 20 basis points.

So much for what has happened. Has this been appropriate? I think so. We have permitted sharp expansion in bank reserves and bank credit to occur, but have allowed these expansions to have some self-limiting effects, through pressure on member bank borrowings in the case of reserves and on interest rates and other lending terms in the case of bank credit.

Some of the recent credit expansion has been due to temporary factors such as the prolonged steel strike threat. Moreover, most of the expansion is but one side of a financial coin, the other side of which is savings--savings the holders of which wish to hold in liquid form. We need much more information and analysis of who owes the increasing volume of credit and the resources they are likely to have to service and repay it, before we can conclude from the total credit figures, or from the bank proportion thereof, that the recent large credit rise poses a threat to further sustainable economic growth.

As for the relationship of recent policy to international financial flows, whatever domestic credit easing effects might have resulted from reduced U.S. foreign lending and investing and the repatriation of liquid funds previously held abroad have been more than offset by the combined restraining effects of our policy and strong domestic credit demands.

Finally, what does all this suggest as to the most appropriate policy under current conditions? In my view, the restraining effects of past policy changes and market developments have not yet all been felt. For some time business and bank liquidity have been declining gradually but steadily; now bank credit terms and terms for long-term financing are becoming more restraining. These are the financial terms that most directly affect decisions to spend and invest.

Under these circumstances, my own preference is for no change in policy at the present time. I say this with recognition of the facts that the full effects of policy come only after substantial lags and that we may be in the later stages of the current economic expansion. Further restraining action strikes me as too risky, both because of the uncertain basic strength of the domestic economic situation and because of the uncertainties, at least for the short-run, created by recent stock market developments. In any case, because of the upcoming Treasury financing, any further restraining move would have to be prompt in timing and moderate in nature.

Easing action also seems to me to be premature. With lasting balance of payments improvement still a hope rather than a reality, the domestic economic situation should more clearly call for easing before we actively seek it through monetary policy.

Mr. Hersey then presented the following statement on the balance of payments:

In evaluating the present state of the balance of payments, the two chief considerations to bear in mind are that the initial impacts of the President's program have been large, and that a very substantial deterioration has occurred since last autumn in the current account--specifically, a shrinkage in the merchandise trade surplus.

Just because the initial impacts of the President's program on the capital account have been large, the program cannot be expected to hold down the deficit later in the year in anything like the degree it has done so up to now.

The shrinkage in our trade surplus since last autumn, which amounts to more than $2 billion at an annual rate, has been hidden from casual view by the distortions of foreign trade movements caused by the dock strike. These distortions made the second-quarter trade surplus larger than it would otherwise have been, and, along with the reflux of bank credit, this produced a balance of payments surplus in the second quarter instead of a deficit.

With data now in for the six-month period December through May, it is evident that the shrinkage of the trade surplus has gone farther and faster than was anticipated in projections of the balance of payments made by an interdepartmental group not very long ago. Imports have been rising sharply. In the second quarter, after adjustment for the strike distortion, they were probably already above the $20 billion annual rate projected for the year. Exports, on the other hand, have remained near last autumn's high level, and below the lower edge of the wide range that was allowed for in the export projection.

The various considerations I have mentioned make it likely that the balance of payments deficit for the full year 1965 will be nearer $1-1/2 billion than $3/4 billion. (These were the two ends of the overall deficit projection.) With a seasonally adjusted net deficit of $1/2 billion behind us in the first half, a seasonally adjusted deficit of the order of magnitude of $1 billion lies ahead in the second half.

It would be premature to interpret the leveling off in our exports since the autumn of 1964 as a sign of a deteriorating competitive position for the United States. In part, it has been due to agricultural rather than manufactured exports. In part, like the British, we are being affected by the leveling off in import purchases of nonindustrial countries. A sign of more fundamental trouble may be the sharp rise in our imports of consumer goods and capital equipment, as well as of steel and other materials.

As the autumn period of seasonal strain on sterling approaches, the question of its possible impact on the U.S. balance of payments is going to become acute. I should like to say a little about this.

Whatever shadings of views there may be about Britain's problems--whatever the degree of pessimism about Britain's ability to work out of its difficulties in the longer run, and whatever the degree of optimism that Britain's present policies will deal successfully with the immediate crisis--everyone can agree on one thing, and that is that British imports are going to fall significantly before long. Hopes of a marked acceleration in British exports are diminishing in the present world trade situation, and the urgently needed short-run adjustment in Britain's trade balance must therefore be made mainly in imports. British imports are either going to fall as a result of present policies, or, if not, then as a result of more drastic measures which will become necessary.

The fall in British imports may come at a time when U.S. imports may be leveling off after the steel settlement has been reached, French and Japanese imports may not yet be rising, and anti-inflationary policies may be having increasing success in Germany and other countries. Under such conditions, a large fall in British buying abroad, no matter how it is produced, will have a depressing influence in the world economy. An apparent dilemma will then be posed for U.S. monetary policy: it will be more evident to everyone than it is right now that the U.S. balance of payments needs strengthening yet drastic anti-inflationary measures by the United States at that time might cause still further retardation of economic expansion throughout the world, and even more difficulty ahead for our exports.

It seems to me that that will be a time above all for us to accept a temporary further worsening of our balance of payments, if it comes, without precipitate counteraction. Under such circumstances we should rely primarily on inter-central bank cooperation for defense of the dollar, rather than on drastic restriction of credit. I would like to add to this one other observation. Our experience of a massive outflow of direct investment and bank loans last January and February shows how important it is that we definitely rule out exchange controls from our thinking and that changes in the I.E.T. be completed and go into effect before they are needed, lest anticipatory capital outflows be provoked again. And still one more thing should be added. If, despite all expectations and intentions to the contrary, sterling devaluation is forced upon the British Government and British imports are reduced in that way instead of some other, our dilemma would still be essentially the one I have outlined, though heightened by chances of speculative outflows; and the dangers for the world, and for ourselves, of resolving the dilemma by drastic credit restriction might be even greater.

I do not think that future possibilities of deflationary strains in the world economy should influence Federal Reserve policy in the meantime. How the British pull through depends now primarily on what happens to the current account in their balance of payments. Small interest rate variations are of very minor consequence at present for capital movements to or from sterling. What happens to their current account depends primarily on themselves, in the short time-perspective with which we are now concerned. So it seems to me that Federal Reserve policy should be determined now, as at any time in the last several years, by the possibilities of gaining long-run benefits from moderate slowing of bank credit expansion: benefits for price stability, for economic growth uninterrupted by boom or recession, and for the gradual approach of international equilibrium. This way of looking at the policy problem will continue to be relevant, it seems to me, until a time when it becomes clear that business cycle forces are in a position such that continued restraint would precipitate an otherwise avoidable recession.

Mr. Ellis said he gathered from Mr. Hersey's remarks that the surplus in the U.S. trade account in 1965 would be less than the $6.7 billion recorded in 1964. He asked whether Mr. Hersey would hazard a guess as to what the 1965 figure would be.

Mr. Hersey replied that he would expect the trade surplus this year to be on the order of $5 billion. In his statement he had noted that the shrinkage thus far this year from last autumn had been over $2 billion at an annual rate, but the surplus in the autumn had been at a higher rate than in 1964 as a whole.

Mr. Balderston commented that, as he understood Mr. Hersey's remarks, he (Mr. Hersey) thought that domestic goals should be stressed in formulating current monetary policy; that selective controls should be abjured in dealing with the balance of payments problem; and that in the event of devaluation of sterling or a worsening in the U.S. balance of payments, main reliance should be placed on cooperation among central banks for the defense of the dollar. If that was an accurate summary, how did Mr. Hersey think it would be possible to obtain the cooperation of foreign central banks if they already held all of the dollars that they wanted?

Mr. Hersey responded that he had not meant to imply that U.S. monetary policy now or in the near future should be determined solely on the basis of domestic considerations. In his judgment it was important to continue to work toward states of credit availability and capital market conditions that would facilitate approach to equilibrium in the country's international payments; and he believed that domestic price stability was of crucial importance to the balance of payments.

As to inter-central bank cooperation in the hypothetical event of sterling devaluation, Mr. Hersey continued, he thought two factors should be borne in mind. First, sterling presumably would be strong after devaluation, and Britain would be among the countries able to assist in the defense of the dollar. Secondly, much of the reflow of funds to Britain that probably would develop would be from the continent, and insofar as it involved dollar holdings it would come, to a great extent, from the Euro-dollar market. Accordingly, even though foreign commercial bank holdings in the U.S. might tend to be drawn down, the Euro-dollar market would be tight and that tightness would be communicated to national money markets on the continent. Given the kind of world outlook at that time that he had outlined and that had been pictured at the recent Paris meetings, he thought it would be not impossible to get the continental central banks to agree that a tighter U.S. monetary policy was an improper prescription for dealing with the situation that would then face the United States.

Mr. Maisel asked whether Mr. Hersey would agree that the kinds of price increases that had occurred recently, such as in industrial materials, served to improve the competitive position of the United States and thus were favorable to the U.S. balance of payments.

Mr. Hersey replied that increases in prices of steel and machinery would not help the U.S. payments balance. Mr. Hickman remarked that price increases for nonferrous metals presumably would be helpful to the extent that this country was a net exporter of such metals. Mr. Hersey said he doubted that the U.S. was a net exporter of nonferrous metals at present.

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

(1) Business conditions.--What, on balance, are prospects for economic activity in the second half of the year, taking into account such influences as the recent behavior of the stock market, the continued accumulation of steel inventories, and Federal fiscal measures?

On balance, the most likely prospect continued to be for a moderate rate of expansion in aggregate output in the second half of the year. GNP appears to have increased some $7 billion in the second quarter to an annual rate of about $656 billion. As demand forces can now be assessed, gains in the next two quarters may be a little larger than this, but are not likely to be large enough to prevent some increase in the unemployment rate and some decline in the rate of capacity utilization in manufacturing.

The recent stock market decline apparently has had little effect on business activity. Consumer purchases of autos rose sharply in June and total retail sales remained strong. No important reappraisals of business plans for fixed capital expenditures have been reported.

Recent inventory developments continued to be dominated by the buildup of stocks of steel and autos. The rate at which steel users are accumulating stocks of that metal has slowed markedly since April, but total steel stocks continue to rise rapidly as mills restore inventories depleted earlier. Steel inventories are now as high in relation to consumption as at the peaks of both the 1962 and 1963 buildups, and are considerably higher in absolute terms. The prospective sharp decline in steel output after the conclusion of present wage negotiations will be a contractive influence on the economy, but its effect on the rate of overall expansion should be moderated by a more expansive fiscal policy and continued strength in other areas.

In this connection, recent surveys suggest continued high levels of consumer spending for durable goods and rising business expenditures on new plant and equipment; and outlays by State and local governments no doubt will continue to advance at a steady pace. Consumer spending will be stimulated by fiscal policy measures, including the large and retroactive increases in social security benefits expected to be enacted shortly and the recent reduction in excise taxes. The Federal budget position on a national income (annual rate) basis is likely to shift from a surplus in the second quarter estimated at $1.3 billion to a deficit in the second half of the year of almost $4 billion. Similarly, the full employment surplus will show a large decline.

(2) <u>Productivity and costs</u>.--What do recent and prospective developments in productivity and costs portend for prices and profit margins in the next few months?

Recent tendencies in productivity and unit labor and materials costs have been a little less favorable than earlier this year. These tendencies as well as prospective developments, however, do not in themselves appear to foreshadow widespread increases in costs and prices, or any appreciable lowering of corporate profits and profit margins from the high levels reached in the first quarter and probably in the second quarter also.

The advance in productivity in manufacturing may have slackened somewhat in the second quarter as growth in output slowed. Meanwhile wage rates continued to advance at about the same pace as earlier. As a result, the sizable further decline in unit labor costs which occurred in the first quarter may not have been extended in the second. Costs of some industrial materials rose further but large increases were confined mainly to nonferrous metals and mill products.

On the assumption that output will continue to expand moderately in the near future, productivity should continue to rise, although probably less sharply than earlier in the expansion. Unit labor costs are expected to be relatively stable. Although future wage increases cannot be predicted, there is a chance of a larger-than-guidepost settlement in steel, which might firm labor demands in other contract negotiations. Recent settlements, however, continue to show substantial diversity, reflecting variations in specific industry conditions, with little spreading of the larger-than-guidepost increases that have occurred in some industries.

Wages, particularly of the 2 million workers covered by escalator clauses, also will be affected by the step-up in consumer prices arising mainly from reduced supplies of meats and of some fruits and vegetables. Some of these supply and price developments are temporary, but higher meat prices could persist into next year. To some extent, the rise in consumer prices is being moderated by the recent excise tax reduction.

With competition continuing active, management has held a fairly tight rein on both overhead and direct costs. The high and rising level of expenditures for new plant and equipment this year will result in larger additions to industrial capacity than last year. With the labor supply expected to grow more rapidly, manpower supplies should be ample except for a few specialized skills.

In the steel industry, a package settlement above the guideposts is possible, and the companies have indicated that an increase as large as that in aluminum would be followed by a price rise. There is a real question, however, whether such a price increase could stick under the market conditions that are likely to prevail for some time after a settlement; production will be curtailed as large inventories are liquidated, and foreign competition will continue.

(3) Foreign trade.--In the light of current economic and financial trends in other countries, what can be said about the outlook for world trade, and for U.S. exports in particular?

Key questions about the outlook for world trade and U.S. exports concern the extent and timing of the adjustment of Britain's payments position, the pace of economic advance in other industrial countries, and the payments positions of the nonindustrial nations. Common Market imports in the near term are not likely to be affected by the controversies recently in the news.

On the whole, the probability of rapid growth in world trade over the rest of the year appears small. Strengthening of demands in a number of industrial countries may be counterbalanced by reduction of demands in Britain, necessitated by its payments deficit, and perhaps also by slowing of import growth in non-industrial countries. In the circumstances, prospects for significant increases in U.S. exports in this period seem poor. The gain over 1964 levels may well be substantially less for exports than for imports.

From the end of 1962 through 1964 world trade expanded by 25 per cent and U.S. exports by somewhat more. Behind this rapid expansion of trade lay an upsurge in activity in all industrial countries, beginning in 1963, which contributed also to higher export earnings of the nonindustrial countries. In 1964, growth in aggregate world trade and in U.S. exports owed a good deal to expanded purchases by the nonindustrial countries. Slower growth of activity in industrial countries abroad during 1964--with recessions in Italy and France and a slowing of the previously very rapid Japanese expansion--was accompanied by less rapid expansion of trade among the industrial countries; purchases by these countries from nonindustrial countries also rose less rapidly.

Britain has now taken measures restricting demand but the impact of these measures on domestic activity and the external position has so far not been large. Imports in the three months March-May were not much changed from the rate of the fourth quarter of last year, and the trade deficit remained large. Existing measures may reasonably be expected to have an increasingly restrictive impact on imports as the year goes on, but more drastic measures may still prove necessary.

In continental Europe, recovery from recession was firmly established in Italy by the turn of the year and guarded optimism about future trends of activity in France began to appear in early spring. Stimulative policy measures taken by these countries in the past three months should help assure a stronger demand situation in the latter half of the year. Elsewhere on the continent, demands have on the whole continued to press on plant capacity and labor supplies, and little alteration in these conditions is in prospect.

Anti-inflationary efforts, aided by higher imports from North America, have been having some success; export price advances may be slowing down in Europe whereas U.S. export unit values were beginning to show increases late last year.

In Japan, activity leveled out around the end of 1964 after monetary policy had been tightened because of payments difficulties and overbuilding of inventories and fixed investment. However, Japanese exports began to rise rapidly during 1964 and monetary policy has been eased this year; these developments should eventually lead to renewed rises in activity and in imports.

In the nonindustrial countries as a group, imports had by late last year caught up with the earlier expansion of their export earnings, and reserve positions began to weaken, particularly in Australia and South Africa. Imports of nonindustrial countries can now be expected to level out. One possible indication that a leveling out has already begun is that recent U.S. exports to this group as a whole apparently have been below the advanced levels of last autumn. At best, the nonindustrial countries are not likely to be adding much to total world demand in the second half of 1965.

(4) Federal finance.--What will be the likely implications of Federal cash needs and debt management for credit markets in the second half of 1965?

The Federal Government's demand on credit markets are likely to be relatively moderate in the second half of 1965. Because of the large cash balance at the end of June, the Government probably will need to raise less new cash this year than it did in the second half of 1964, even though the cash deficit may be little different.

As in 1964, most of the new cash is likely to be raised in the bill area, principally in the form of tax bills which can be paid off out of the relatively large cash surplus expected for the first half of 1966. However, the net increase in outstanding bills from Treasury operations in the second half of 1965 may turn out to be somewhat smaller than in the same period of last year, when it was $5.5 billion. Nevertheless, the effect of the increase will probably be sufficient to exert at least seasonal upward pressure on bill rates from the supply side as the year progresses.

With respect to long-term markets, the Treasury accomplished enough debt lengthening through its January advance refunding and May refinancing to keep the average maturity of the debt at the end of this year about the same as at the end of 1964. Therefore, the pressure to engage in further debt lengthening is not as great currently as it has been in the past. This does not, of course, preclude such an action if market conditions are propitious. In view of the present state of the bond market, including relatively heavy dealer inventories of bonds, however, the Treasury is unlikely to consider major debt lengthening operations in the period immediately ahead. In the relatively moderate-sized August refunding (the public holds only $3.2 billion of the maturing securities), it seems likely that the Treasury will stay in the short-or short-intermediate-term area.

(5) Bank credit and money.--What factors lie behind the sharp increases in bank credit and money in June, and are such factors likely to continue to operate over the near term?

The sharp June increases in bank credit and money stemmed in part from temporary or unusual circumstances. Nevertheless, the underlying forces influencing both series clearly appear expansionary. The unusually heavy June borrowing by business is one indication of the current strength of loan demand. However, owing to liquidation of the June 30 loan bulge and in the absence of Treasury financing, the end-of-month bank credit series is likely to show little change or decline on a seasonally adjusted basis in July.

Part of the $3.5 billion bank credit rise in June was accounted for by temporary loan expansion in the last week of the month. This included substantial borrowing by securities dealers to cover redemption of maturing RPs held by nonfinancial businesses. As usual, these borrowings were repaid within a short period; nearly all of the security loan increase had been liquidated by July 7. In addition, there was a sharp and unusual rise in bank holdings of securities other than U.S. Governments in June. The rise was concentrated at New York City banks and was no doubt associated in large part with two large new Federal agency financings and the issuance of a sizable New York City tax note.

The strong upward trend in business demands for bank loans could moderate somewhat over the near term; corporations may divert more of their external financing from banks to the capital markets. This possibility is suggested by the fact that bank financing has been used to a far greater extent than might normally have been expected to finance this year's growing external needs, particularly in view of the continued firming in interest rate and other lending policies at the large city banks. Prospective declines in steel and auto inventories, and possible further reductions in the rate of accumulation of other stocks, also would tend to moderate demand for bank loans.

With respect to the money supply, the sharp June rise helped to meet the need to add to cash balances in view of the steadily increasing volume of money transactions. Money supply growth was limited early in the year by a large buildup in time and savings deposits and subsequently by higher than usual Treasury balances at commercial banks.

The projected rapid drawdown of Treasury balances in late July and early August will tend to increase private money holdings. Even with the sharp rise in June, growth in the money supply in the first half of the year as a whole, at about 2-1/2 per cent, was at a considerably lower rate than the increase in GNP. This suggests some further need to rebuild cash balances for transactions purposes in the months ahead.

(6) Money market relationships.--Assuming a continuation of current monetary policy, what range of money market conditions, interest rates, reserve availability, and reserve utilization by the banking system might prove mutually consistent during coming weeks?

In recent weeks net borrowed reserves have remained within the $150 million to $210 million range that has prevailed since early May. But during the past two weeks Treasury bill rates and dealer loan rates have risen, and Federal funds have traded persistently at 4-1/8 per cent, with occasional trades at 4-1/4. The 3-month Treasury bill has moved above 3.85 per cent, up from 3.77 per cent in late June, as relatively heavy bill inventories pressed against smaller than expected public and official demands. In the past week New York City banks have returned to a basic reserve deficiency position of more usual size.

Assuming net borrowed reserves continue in the recent range, bill rates seem likely to remain between 3.80-3.90 per cent, with the odds favoring the upper end of the band. At present, no substantial downward bill rate pressures appear in the offing. The early summer period of heavy needs for reserves has passed and the System is not likely to be a major market factor over the next four weeks. The Treasury's August refunding is likely to be routine and to have little effect on bill rates. The exceptional recent tautness in the Federal funds and dealer loan markets may lessen in the period ahead, but these markets may be expected to show more tightness than in June.

The money market conditions specified above are not likely to be associated with significant pressures on long-term interest rates, although the municipal market remains heavy and upward yield pressures there may persist. Congestion has eased in the corporate market, at least temporarily. The Treasury will probably not test the long-term Government market in the August refinancing.

The rate of expansion in bank credit and money over the next few months probably will fall off from the high June rate, as discussed under Question 5. Private demand deposits, which showed little net change during the first 5 months of the year, are likely to increase, but much less rapidly than in June. Perhaps, on balance, a growth rate of around 4 or 5 per cent would be a reasonable expectation for the July-September period. In the same months last summer private demand deposits grew at a 7 per cent rate.

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

> Business activity continues to expand, and further growth is in prospect. We have been seeing a more cautious reassessment of future prospects, and in some quarters a considerable amount of pessimism. But in our view the underlying sources of strength in the economy remain intact despite the prospect of some inventory liquidation later in the year. The positive factors include good business profits, business plans for further increases in plant and equipment spending, the stimulus to consumer spending expected from the recent excise tax cut, and a further expansion in combined spending of Federal and State and local governments on goods and services in the months ahead.
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> Even though the statistics on gross national product show a much higher rise in the first quarter than in the second quarter of 1965, after adjustments are made for special factors related to the steel and automobile industries the advance in the second quarter was probably as great as that of the first quarter. It appears probable that the overall performance of the economy during the second half of 1965 will be in line with the projections made by the Council of Economic Advisers and our own expectations at the beginning of the year.

Trends in domestic prices, both wholesale and retail, are disturbing. There continues to be a noticeable upcreep in prices for industrial commodities; while the rate of advance is still modest in comparison with the inflationary surge of the mid-1950s, it contrasts with the stability achieved during the early portion of the current expansion. Labor costs per unit of output in manufacturing are still below a year ago but they have not been declining for the last several months. Against this background the wage negotiations in the bellwether steel industry are highly important. A settlement that would increase costs could have serious repercussions on the overall cost structure at home and on the international position of the dollar.

On the international side, an unusually favorable second quarter has followed an unusually unfavorable first quarter. For the first time in many years we are seeing a quarterly balance of payments surplus. But this second quarter surplus rests largely on special, and nonrecurrent, factors. There is little evidence of a fundamental improvement in our basic balance of payments position. A slowing down in the rate of economic expansion in some industrial countries and balance of payments problems in a number of nonindustrial countries make it difficult to expect our exports to grow at the rate they have in recent years. On the other hand, our imports have been increasing more rapidly in the light of the high general demand at home, augmented by a special demand for steel. Indeed, so far this year our trade surplus has been considerably less than last year. It is not clear how much the reduction is due to the dock strike, but it is clear that our costs at home are a basic factor in the effort to improve our balance of payments position.

As for the credit situation, banks have been meeting heavy loan demands somewhat more selectively and on moderately tighter terms. Rising loan-deposit ratios, declining holdings of Government securities, and substantial net borrowings from the Reserve Banks are indicative of pressures on bank liquidity positions. So far, however, the continuous deterioration of those indicators of bank liquidity does not seem to have materially affected the willingness of the banks to accommodate customers. Banks have been adding to their loan portfolios without reducing total investments. Bank credit has continued this year, as it has in recent years, to expand more rapidly than has overall production. In fact, the rate of expansion so far this year has been faster than in the preceding years.

It seems to me that in view of the continued strength of domestic business accompanied by further price advances, the absence of signs of a fundamental improvement in our balance of payments, and an excessive growth in bank credit, monetary policy should move toward a somewhat firmer tone. The Treasury will be announcing a refunding in the last week of July. This should be a routine operation, and therefore should not inhibit any change in monetary policy now. In view, however, of the need for an "even keel" policy in connection with the financing, any change in monetary policy should be modest.

Mr. Ellis said that, to borrow Mr. Noyes' new semantics, the most noteworthy economic news in New England was of "no change" in employment--that is, a steady and strong employment expansion. Commencing last fall, jobs in durable goods factories expanded right through the period of the automobile shutdown and had continued upward ever since. Expanded operations in shipbuilding and aircraft engine manufacturing had lifted the regional transportation equipment index some 20 points in 12 months. The durables index was up 15 points in eight months.

Quite naturally, Mr. Ellis continued, that strength had been translated into lower unemployment and longer work weeks. In May the work week, at 41.1 hours, just matched the U.S. average. Unemployment rates in May ranged from 2.6 per cent in New Hampshire to 4.6 per cent in Massachusetts, with a 4.2 per cent regional average. Insured unemployment at mid-June reached the lowest point recorded since November 1956. Also reflecting the employment expansion were the reclassifications of three New England cities, leaving the region with only one city in the "labor surplus" category of 9 per cent or more unemployed.

Mr. Ellis remarked that the aggregate regional measures of consumer income, consumer spending, orders to manufacturers, manufacturing output, and construction had "fallen off" in terms of the new semantics--they all continued to move upward, according to the latest data, but generally at more modest rates than typical of the first-quarter trends. The financial counterparts of the trends also continued to show substantial expansion rates, all reflected in some way in the single statistic that total loans and investments of First District weekly reporting banks during the three weeks ending June 30 averaged a plus 9.5 per cent in year-to-year comparisons. Evidence of how the District's banks were using the reserves being created showed up in the 21 per cent year-to-year gain in real estate loans at weekly reporting banks.

Turning to issues of policy, Mr. Ellis offered the view that one of the most critical elements of the economic outlook was the rate at which additional industrial capacity would come effectively on line in the next 6-9 months. Although the country was entering the fifth year of rising capital goods outlays, capacity utilization rates had continued to rise to their present level of 90 per cent or higher on average. Of course, that implied that specific and important individual industries had been running measurably above 90 per cent.

Mr. Ellis noted the long awareness of the historical evidence that cost-push inflation pressures edged prices upward at such utilization levels. The pervasiveness of industrial price advances since last fall and the strengthening in their trend--as shown in the green book appendix--offered evidence that the economy might well be traversing the jagged edge of inflation. He noted that, on page 11 of part II, the green book said: "The index for industrial commodities, which had risen 0.2 per cent in May, edged up another 0.1 per cent in June. The increase through the first half of the year amounted to 0.7 per cent--almost the same as the rise in the fourth quarter of last year." All of this emphasized the critical importance of new capacity coming on line faster than the foreseeable increases in demand stemming from the effect of the social security program superimposed on steadily rising consumer spending, which already was running 7 per cent above year-ago levels.

In that context, Mr. Ellis said, perhaps he should feel somewhat relieved by his own judgment that the U.S. trade balance this year was likely to fall substantially below the $6.7 billion level of 1964. That would help in a small way to relieve domestic supply pressures. Such a result would be of little comfort, however, in view of the country's need to maximize the trade component of its balance of payments.

As usual, Mr. Ellis remarked, a choice of monetary policies for the period ahead had to recognize two major unknowns: (1) the strength of credit demands that would emerge, and (2) the lag in impact of existing and recent monetary policy. Concerning future credit demands, bankers had reported in the credit survey that they saw no letup in the recent unusually strong demands. Coupled with that was some evidence that business liquidity had reached a point requiring increasing reliance on bank financing, as Mr. Koch had noted.

Concerning the lag in policy impact, Mr. Ellis noted that that constraint gained importance the closer in time the cyclical inflection points in the trend of the economy were approached. That fact in turn seemed to reinforce a natural tendency to make no policy change--to wait and see.

In that context, Mr. Ellis found both reassurance and some guidance by looking at the course of the Committee's policy over the past twelve months. In successive probing actions, the Committee had moved from a posture of slight monetary ease, characterized by net free reserves of $78 million and member bank borrowing averaging $278 million, to slight restraint, with net borrowed reserves of $174 million and borrowing of $539 million, using 4-week averages. Except for the discount rate move timed with the U.K. rate action last fall, at no single point had it been clear to all that an overt, major policy move was appropriate; but, as Mr. Koch had observed, the small incremental moves the Committee had made added up to a significant total change. He concurred in Mr. Koch's judgment that those policy moves had been appropriate; the Committee's position was much better today than it would have been if it had not made successive small moves in the past twelve months. By the same token, he believed the Committee would be in a sounder position six and twelve months hence if it continued that basic probing action.

It was Mr. Ellis' understanding that within the framework of unchanged money market conditions the Account Manager was working with a net borrowed reserve target range centered at $150 million, a target first adopted at the Committee's May 25 meeting. In his judgment it was appropriate to make a further slight step along the path the Committee had been following. Accepting the staff's description of the recent money market relationships in which net borrowed reserves had remained within a $150-$210 million range for nine weeks and, therefore, not expecting substantial impacts on money rates or money market conditions, Mr. Ellis recommended establishing a net borrowed reserve target centered at $200 million. Over time, member bank borrowing should be expected to average around $550 million if credit demands continued to show their recent strength.

The real objective of such a move, Mr. Ellis said, was to continue the course of gradual probing the Committee had followed.

If credit demands strengthened in the fall, the Committee's policy would have been firmed slightly to hold the surge within bounds. If credit demands weakened in the fall, it would have established a base from which a sharp policy move could be expected to have more impact.

Mr. Irons reported that there had been further expansion of economic activity in the Eleventh District recently and business conditions were strong. The index of industrial production for the District was up more than one percentage point from May to June, and a further increase was expected in July. A substantial part of the rise was due to increased output of crude oil; gains in manufacturing production were moderate. Construction contract awards continued to rise and were at a new high despite some weakening in residential contracts. Employment and unemployment were little changed, showing only slight gains. Department store sales and new car sales were strong. The outlook for agriculture was generally reported to be good after re ent rains. On the whole, according to most of the major economic indicators, the District economy was operating at a level that on almost any basis other than comparison with the first quarter would be considered very high.

Financial conditions in the District were tight, Mr. Irons said, and District banks, including some of the smaller banks, were much less liquid now than they were not too long ago. Bank loan demand was very strong, especially in the commercial and industrial categories. Both demand and time deposits were up substantially. Banks were attempting to maintain their reserve positions by buying Federal funds when they were available, but coming to the discount window when funds were difficult to obtain and, in some cases, when the rate on Federal funds was above the 4 per cent discount rate.

At the national level, Mr. Irons continued, the outlook for the next few months seemed to be expansionary. Gains would be stimulated by rising consumer, Government, and business spending. The advances would be accompanied by some dangers, of which the most important were possible developments in Viet Nam and in the balance of payments situations of the United States and Britain. Adverse developments in those areas could change the outlook substantially. Also worrisome were inventory developments and the accumulation of wage and price increases.

On the whole, barring unfavorable developments in Viet Nam, the U.S. balance of payments, or the position of sterling, Mr. Irons felt that the economic situation would be strong in the next six months. Banks were making every effort to meet, and perhaps to foster, strong loan demands, despite their general lack of liquidity. They were seeking funds from various sources and, in the Eleventh District at least, were employing various devices to attract time deposits. Certificates of deposit were being sold on a considerable scale in both the District and the nation, and borrowings from the Federal Reserve were high.

It seemed to Mr. Irons that except for Treasury bill rates money market conditions had been reasonably firm, and even bill rates had moved up recently. Other short-term rates probably gave a better picture of conditions in the money market, and it was possible that those conditions were firmer than had been thought. But with banks willing to pay the price necessary to get funds, and continuing to solicit loan business, net borrowed reserves probably were not very meaningful at present for policy target purposes. As banks made loans required reserves increased and net borrowed reserves rose; the System supplied additional reserves which the banks put to work; and the cycle continued. The Committee's present policy was supposed to be one of moderate restraint, but in fact it did not seem to be working out that way.

In such circumstances, Mr. Irons doubted that a small increase in net borrowed reserves would be very effective. He thought the point was approaching at which the discount rate would have to be raised if further restraint was considered necessary. For the time being, he would continue present policy without significant change and without too much concern about the level of net borrowed reserves. Meanwhile, the Committee could continue to watch the situation closely.

Mr. Swan reported that business activity in general seemed to be continuing to advance in the Twelfth District. In May employment rose somewhat more rapidly in the District than in the country as a whole. Tentative figures for the June rate of unemployment in California showed a rise of one-tenth of a percentage point--as the national figures did--but basically the economic situation in the District seemed to be much the same as a month earlier.

District savings and loan associations recently had been advertising extensively, Mr. Swan said, especially those that earlier had raised the rates they paid and then had brought them down under prodding by the Federal Home Loan Bank Board. Most of the associations reducing rates recently had adopted other procedures to the advantage of the shareholder, such as compounding interest daily and crediting deposits to the date of withdrawal. In their advertising they were attempting to demonstrate that the overall interest return to the shareholder was now a few basis points higher than before the rate reduction. Those actions suggested that the associations were making an effort to regain the ground they had lost to commercial banks in the competition for savings deposits, at least in a relative sense.

In the four weeks ending June 30, Mr. Swan continued, there was a substantial increase in bank credit at weekly reporting banks in the District. As had been the case through most of 1965, the percentage gain was somewhat less than at all weekly reporting banks in the country. However, there still was considerable evidence of pressure on reserve positions. District banks were net buyers of Federal funds and were still borrowing in substantial volume at the Reserve Bank.

With respect to the national economic situation and policy, Mr. Swan's conclusions were about the same as Mr. Irons'. In the immediate situation, and given the expected Treasury financing, it seemed to him that even a slight degree of firming was not indicated. With the recent increase in Treasury bill rates and some continuing uncertainties in capital markets and the stock market, he was inclined to think that the Committee should not make any policy change at this point.

Having said that, Mr. Swan remarked, he would add that a number of things were of considerable concern to him, including the sharp increases in reserves and bank credit in June in the face of somewhat higher member bank borrowings and net borrowed reserves, the expected shift in the position of the Federal budget from surplus to substantial deficit in the third quarter, and the fact that the prospects were not bright for further improvement in the U.S. balance of payments in the months ahead. He found it surprising that nonborrowed reserves, which had declined at an annual rate of 1.2 per cent in May, rose at an 8.4 per cent rate in June despite the fact that borrowings and net borrowed reserves were higher in the latter month.

In view of the factors he had mentioned, Mr. Swan said, he was somewhat closer to the conclusion that it would be desirable to move to a tighter policy than he had been before. Like Mr. Irons, however, he had questioned the value of a very limited move at this point. He would prefer to wait to see whether the views expressed in the staff comments on questions 5 and 6 proved justified; namely, that "The sharp June increases in bank credit and money stemmed in part from temporary or unusual circumstances" and that "The rate of expansion in bank credit and money over the next few months probably will fall off from the high June rate." If the staff's expectations were fulfilled, he would feel somewhat differently; but if they were not he probably would be inclined to pursue the possibility of a firmer policy at a subsequent meeting.

Mr. Galusha commented that the Ninth District economy, buoyed by sharply higher levels of residential and commercial construction activity, seemed to be growing at a more rapid rate than the national economy. And the outlook was that the present rate of growth would be sustained, at least over the coming few months. District banks, city and country alike, increased their loans outstanding quite sharply during June. Country banks were presently more fully loaned up than at any time in the last five and a half years. And the average loan-deposit ratio for city banks was down only very slightly from the record high established last April.

The outlook for the national economy appeared to Mr. Galusha to be for some slight lessening of resource utilization over the last half of 1965. He believed that a moderate increase in the unemployment rate--to, say, 5 per cent at year end--was likely. So was a slight decline in average capacity utilization rates; the odds were not great that manufacturing output would grow as rapidly as capacity during the third and fourth quarters of 1965.

It therefore was Mr. Galusha's guess that economic expansion would certainly continue and at an impressive rate, but not at a rate sufficient to prevent some slight lessening of pressure on resources. Accordingly, he saw upward pressures on prices as moderating somewhat in coming months, even assuming no change in monetary policy. There might continue to be some very modest increases in prices, particularly during the third quarter of this year. Money wages evidently were rising a bit more rapidly at present than they had earlier in the recovery. And no doubt the record corporate profits of the first half of the year would continue for awhile to take their toll. Against whatever upward pressure on money wages existed at the moment, however, it was necessary to set the downward pressure generated by some reduction in resource utilization which he, at least, saw coming in the immediate future.

Mr. Galusha complimented the Board's staff on the excellent appendix on prices contained in the current issue of the green book. He had found it most helpful, and, to a point, reassuring. It was interesting to note that price increases of the recent expansion had so far been smaller than those experienced in the recovery of 1959-60. It also was interesting to note that, in the nonagricultural sector at least, the most dramatic of recent price increases--in nonferrous metals and elsewhere--had not only been selective, as many had observed, but also were of the sort that would give the United States' international competitors little if any advantage. Adjusting for those dramatic price changes, he saw not too pessimistic a price performance.

Of course, Mr. Galusha said, were the fundamental economic outlook for greater expansion than he foresaw, he would have to favor some increase in the degree of monetary restraint. His expectations about coming months, however, made him favor no change in policy at this time.

Nor did Mr. Galusha think that the U.S. balance of payments position, superficially so much improved, would in present circumstances benefit perceptibly from a modest move in the direction of greater monetary restraint. Beyond the boundaries of the United States the most pressing problem remained sterling, but he did not see the Committee's monetary posture as offering immediate help.

Going to the Board staff's unanswerable final question, Mr. Galusha remarked that what little evidence he knew of suggested that if free reserves remained in the range of recent weeks and if discount rates remained unchanged, the bill rate would locate in the range of 3.80 to 4.00 per cent, and most likely around 3.90 per cent. Putting his view differently, he knew of no special circumstances that would suggest a marked change in the bill rate, assuming the level of free reserves was not altered sharply.

Mr. Scanlon reported that economic prospects in the Seventh District for the rest of 1965 remained favorable. A strong demand for workers was reported in nearly all District centers, reflecting the boom in autos, steel, and machinery. In some areas labor markets were the tightest in a decade or more, with unemployment at very low levels (2.7 per cent of the work force in the Chicago area for May) and business firms making intensive efforts to recruit workers. Unemployment compensation claims continued to decline in all District States.

Current worker recruitment problems were increased by the decision of some firms to forego usual plant-wide shutdowns in July or August because of present demand pressures, Mr. Scanlon said. Because of liberal vacation plans for their permanent work force, many of those firms were taking on temporary summer workers as well as seeking permanent additions to their payrolls.

Mr. Scanlon remarked that declines in new orders in the District for some types of capital goods in the past month or two and slower increases in shipments were related to stretch-outs in promised delivery time as well as to shifts in orders for defense and steel. In some cases there had been a spillover of demand into the used equipment market; sales of used machine tools had been reported at prices close to original cost. Orders of structural steel fabricators were at a record high in May, and demands were pressing on capacity to an extent that work in progress at some District plants was falling behind schedule.

Demands upon men and resources had been accompanied by an upward creep in prices, Mr. Scanlon said. People with whom he talked felt that in those circumstances labor was probably becoming less efficient on the average, with an accompanying slowing of productivity gains. There was little evidence, however, that profit margins were being eroded appreciably. Of course, to the extent that the pressure upon resources was related to the abnormally high rates of production of steel and motor vehicles, relief from current stringencies should be noticeable during the second half of 1965.

Farm cash receipts in the District States were expected to continue the 4 to 5 per cent increase over a year ago, Mr. Scanlon observed. That expectation reflected higher prices for meat animals, corn, and soybeans, and an increase in production of crops.

Mr. Scanlon went on to say that the rate of savings increase at financial institutions, while below last year's high rate, did not compare unfavorably with years prior to 1964. Consumer spending apparently was about in line with income increases this year.

In June, Mr. Scanlon continued, bank credit expansion in the District was somewhat less vigorous than in the nation but was moderately larger than in June 1964. A 3 per cent rise for business loans in June indicated a resurgence in credit demands, at least temporarily. The District loan increase had been less broadly based than that of the nation, with large increases in the metals category--doubtless reflecting inventory accumulation--and in the public utilities group, where changes tended to be related to the timing of security issues.

The Chicago Reserve Bank's June quarterly survey showed a slight rise from March in average interest rates on business loans for all size groups and for term loans, Mr. Scanlon reported. Four of the eight banks in the lending practices survey stated that their rates were firmer than three months ago. Four reported that loan demand was stronger than three months ago and seven said it was stronger than a year ago. "Increased loan demand" had been cited more frequently as a reason for using the discount window in recent weeks. Although the major Chicago banks had been meeting credit demands without severe strain, their basic positions had declined rather sharply over the past two weeks. They had replaced only part of the CDs that matured in June. Borrowings by other reserve city banks had been rising noticeably, with some indication, he believed, of reluctance to pay 4-1/8 per cent for Federal funds.

As to policy, Mr. Scanlon said he found the choice between the two suggested alternatives for the directive a difficult one today.1/ He believed that the possible change in policy under discussion was a very small one. Conditions in the Seventh District would certainly encourage his support of such a move. On the other hand, like Mr. Irons, he doubted that a small increase in net borrowed reserves would be very effective in restraining the rate of expansion in bank credit. Moreover, he felt that any further firming would move the Committee a step closer to forcing a technical adjustment of the discount rate. Indeed, it might be that a Federal funds rate consistently at the 4-1/8 to 4-1/4 per cent level might, in itself, force that adjustment. It seemed to him that it would be desirable to make no change in policy today and to see whether the trends indicated by the June figures continued. On that basis he would prefer alternative A of the staff drafts of the directive.

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

Mr. Clay commented that, in general, the domestic economy continued to perform in accordance with the pattern of activity that had been anticipated. As such, it involved a pace of expansion that was considerably slower, and that probably would continue to be considerably slower, than the pace of the first quarter. While the rate of expansion was more moderate, the growth of manpower and industrial capacity continued to make productive resources more available. That combination of developments should be a restraining factor on nonagricultural commodity prices, tending to prevent any marked upward movement of prices in the period ahead. Price developments on both the demand and cost sides would bear watching, however.

Bank credit expansion, including the growth in business loans, had been large, even though less than early in the year, Mr. Clay noted. The rate of growth in business loans should moderate from the June pace. On the other hand, business loan expansion in recent months might reflect a greater dependence on outside funds on the part of business, leading to larger credit requirements to cover its needs, including receivables, inventories, and capital outlays. Under those circumstances, a given pace of economic growth might require a larger increase in business credit than earlier in the upswing when internally generated funds were more adequate.

The international payments record obviously was better than earlier, Mr. Clay said. That did not mean that the payments problem had been solved. It did afford an opportunity to await further payments developments and to devise additional methods of dealing with the problem.

At the present time, it appeared best to Mr. Clay to continue essentially the recent monetary policy. In his opinion, the present and prospective rate of economic expansion did not merit monetary policy restraint. The increases in agricultural commodity prices were not business-cycle oriented, and other price movements were not sufficient to call for a more restrictive policy under present economic circumstances. The growth in bank credit also needed to be interpreted in terms of the outlook for a moderate rate of economic expansion in the months ahead. In Mr. Clay's judgment, the international payments situation also facilitated the continuation of recent monetary policy. Alternative A of the staff drafts appeared appropriate for the current economic policy directive.

Mr. Wayne said the current business picture in the Fifth District looked quite similar to that in the nation. High level activity continued in all major industries, but the rate of expansion apparently had slowed somewhat and business optimism had dimmed noticeably. Responses to the Richmond Bank's latest business survey were less optimistic than at any time this year.

Generally, the outlook for the second half was favorable, Mr. Wayne remarked. He expected the rate of improvement to resemble the moderate pace of the second quarter, with business capital outlays, consumer demand, and the government sector providing the principal strength. Business optimism had quite definitely been dampened in recent weeks, owing in part at least to the recent stock market break.

It seemed to Mr. Wayne that recent productivity and cost developments would indicate continued high level business profits and little pressure on product prices from the cost side. Because of productivity gains stemming from increasing capital spending, labor cost per unit of output in manufacturing was lower now than at the beginning of the current upswing. Even in recent months, following rather generous wage settlements in a number of industries, the index of labor cost had moved up only fractionally.

Recent economic and financial developments in other countries had resulted in a less favorable outlook for world trade and for U.S. exports, Mr. Wayne noted. The rate of expansion over much of the continent had leveled off and the United Kingdom might well be forced into measures which could hurt U.S. sales abroad. The uncertainties in the current situation, coupled with the recent increase in U.S. imports, raised doubts respecting the contribution of the trade surplus to a solution of the country's overall payments deficit.

Mr. Wayne remarked that the sharp increases in bank credit and the money supply in June were due primarily to heavy mid-year business borrowing and to changes in Government deposits. Short-run fluctuations of that kind were to be expected. He was more impressed with the fact that, despite the large June increase, bank credit in the second quarter expanded at a rate somewhat below that in the first quarter. He anticipated that continuing high levels of business activity and consumer spending would result in strong demand for bank credit over the near future, although he would expect this demand to be less robust than in June.

Mr. Wayne saw nothing in either the domestic or the international picture that warranted a change of policy at this time. Therefore, he favored maintaining the present posture, seeking neither more firmness nor more ease. He would expect the seasonal need to absorb reserves over the next two weeks to put upward pressure on bill rates, but he believed that somewhat higher rates were desirable. Mr. Wayne preferred alternative A of the draft directives.

Mr. Robertson then made the following statement:

> The domestic economy, all things considered, has performed pretty well in the second quarter, certainly as well as might have been expected. We have not yet seen any serious maladjustments arising out of the rapid first quarter expansion. And taking the first and second quarters together, the expansion in gross national product appears to have been not far from the reasonably rapid pace that developed after mid-1963.

Whether such a pace can persist, I do not know. There are cautionary signs, apart from the stock market, which at the moment appears to be settling down. For instance, steel inventories are still at advanced levels, and they may begin exercising some downward pressure or steel output in the months ahead. Also, whether the still high level of automobile sales will continue is certainly a questionable matter.

The excise tax cuts might help some in that respect. However, their full effect on the economy will depend not merely on additional car sales, or jewelry sales, but also on increased spending throughout the whole range of consumer goods and services generated by the money saved when people purchase that second car or that anniversary present which it is very likely they were going to buy anyhow. And how this will work in practice as a stimulus to production and employment is something that is especially difficult to foretell.

In the period ahead, the impact of excise tax cuts on spending will be reinforced, however, by the new social security program. And the two combined could serve as an important expansionary force. At least the full employment surplus data presented by the staff indicate that an additional fiscal stimulus in the order of $6 billion can be expected in the third quarter of the year, and without much ground being lost in the fourth.

While the economy in the second quarter has performed well in the sense that it seems to have been freer than we might have hoped of inventory maladjustments leading to a decline in economic activity, it has also performed well with respect to inflationary pressures. Prices have continued to rise slightly on average, it is true, but supply factors in agriculture have been a major element in that respect. Industrial prices have continued to creep upwards, and while this has not yet signalized any substantial build-up of inflationary forces, such price rises do represent a possible trouble spot if they accelerate in a rapidly expanding economy. This would be especially true if we enter a period when our balance of payments no longer reflects the initial (and, to a degree, one-time) benefits of the voluntary credit restraint program and when, therefore, we will have to look more searchingly at such factors as our export performance if the improved payments position is to be sustainable.

My reading of present economic developments does not lead me to suggest any change in the stance of policy now--of either an easing or a tightening nature. The forthcoming Treasury financing, though it seems as if it may be a routine affair, is a further consideration leaning toward no change.

But with respect to policy, I would like to note that net borrowed reserves have consistently run above $150 million in the past few weeks--averaging about $175 million in June and coming in at $185 million (before revision) in the first week of July. I have somewhat mixed feelings about this. In general, I would prefer to see them fluctuating on either side of $150 million. However, in the past several weeks we have had a rapid growth in money supply and in required reserves. Under those circumstances, it is understandable if some of the above normal or above expected growth in required reserves absorbs additional free reserves as banks satisfy rapidly expanding credit demands.

This being so, I would also anticipate that if required reserves begin to grow at a slower rate than expected, net borrowed reserves would begin to come in at less than $150 million. In other words, it would be only prudent then, with credit demands weakening, not to exert quite as much restraint on bank reserve positions.

Mr. Robertson added that he favored alternative A of the draft directives, calling for no change in policy.

Mr. Shepardson said that the staff's reports and other information seemed to indicate strength in the economy and a healthy outlook. He thought that the policy the Committee had been following, of gradually moving to a somewhat firmer position, had been a constructive one. In his judgment, prospects for prices and for the balance of payments indicated the desirability of further probing in that direction. Thus, he agreed with Mr. Ellis' recommendation for moving toward some further lessening of ease.

However, Mr. Shepardson continued, there was merit in Mr. Irons' observation that such probing probably would not have a great effect and that at some point it might be necessary to implement a move toward less ease by a discount rate increase. He would favor discount rate action if credit expansion continued at its recent rate. Meanwhile, a modest move toward a slightly firmer policy would provide a more solid basis for a possible discount rate change if that proved necessary. On the other hand, if a definite downturn should develop, he felt that the Committee could move much faster toward easing than it had toward restraint. He favored alternative B of the draft directives.

Mr. Mitchell said that at nearly every recent meeting of the Committee at least one person had referred to bank credit expansion in the United States as being "unsustainable," and some had implied that the economy would ultimately have to pay for this credit binge. He had borne the drip of this argument, which he considered specious, in silence for a long time but today would make a mild remonstrance.

Mr. Mitchell started with the comment that if the word "unsustainable" was used, it ought to be associated with this Cassandra-like condemnation on the consequences of credit or growth, not with the growth of bank credit itself. To him, it seemed clear that much of the surge in bank credit over recent years was a one-shot affair and simply the result of enhanced competitiveness of banking institutions. The ability to buy deposits under current Regulation Q ceilings enabled banks to out-compete other financial intermediaries, and many money and capital market instruments as well. Thus, to a large extent, what was being witnessed was a substitution of bank credit for other forms of credit rather than a net addition to credit available to the economy.

If the System should truly be concerned about the growth in bank assets, Mr. Mitchell continued, an antidote was at hand; it was certain to work and it would show immediate results. The remedy was a reduction in the ceiling interest rates payable on deposits under Regulation Q--a reduction below present market rates. That action would slow bank asset growth based on purchased deposits to a whisper.

Mr. Mitchell did not recommend such action even though he was sure that not all recent bank investment had been wise or conducive to stable economic growth for the United States. However, banks as generalized lenders had, and by and large exercised, the potential for putting such savings of the economy as they could attract to a greater range of alternative uses than most intermediaries. For that reason, he was prepared to see banks exploit the competitive advantages that higher Regulation Q ceilings provided.

Nor should the Committee use monetary contraction to curb bank credit expansion, Mr. Mitchell said, if it was mainly a substitution for other forms of credit--a substitution that occurred as funds were channeled to commercial banks that would otherwise have flowed to other financial institutions or directly into market securities.

To spell out his reasoning a bit, Mr. Mitchell said he would start by noting two changes in the rules of the game: (1) increases in allowable time deposit rates (effective dates of change after 1936 were: January 1, 1957, January 1, 1962, July 17, 1963, and November 24, 1964); and (2) the recent development of negotiable CDs. Those changes had made possible the accelerated growth of time accounts on the books of commercial banks. From where did those funds come? Here it was useful to recognize both the immediate and the subsequent effects. Right after a change in Regulation Q there was some switching from other assets to the now more attractive time accounts; for example, holders of demand deposits might convert to time deposits or holders of Treasury bills might sell them and acquire time accounts. As time went on, the flows of funds also would be altered. Funds that would have gone into market securities or to savings and loan associations or into demand deposits went instead to time deposits at commercial banks.

Thus, Mr. Mitchell said, the faster growth of time deposits represented a diversion of funds from demand deposits, from other savings institutions, and from market instruments. The Committee's problem was to try to estimate how much came from demand deposits and how much from the other two flows. Suppose, to take an extreme assumption, that the faster growth of time deposits had come completely from demand deposits. Since at any given time that represented simply a change in the form of bank liabilities rather than a diversion of funds from other institutions or market instruments, it would not in itself entail any change in the rate of growth of bank assets. In that extreme case, it would, of course, free reserves proportional to the difference in requirements and induce subsequent asset growth.

On the other hand, Mr. Mitchell went on, suppose that all the additional funds going into time deposits represented a diversion from Treasury bills and other market securities. In that case, banks would be purchasing the additional Treasury bills (and other financial assets) that the time depositors previously would have acquired directly. The accelerated growth of bank time deposits would be necessary just to maintain the status quo in credit markets.

Similarly, Mr. Mitchell said, the additional time deposits representing funds which otherwise would have gone to savings and loan associations should be reflected in expanding bank assets. Otherwise, the smaller acquisitions of assets by savings and loan associations--made necessary by the smaller inflow of funds--would exert a restrictive influence. Thus, in general, the extent to which the more rapid bank credit expansion was stimulative or merely accommodating to a shift in the structure of financial flows depended upon the mix of the sources of funds from which the additional time deposits came.

As Mr. Mitchell looked at and analyzed the data, it appeared to him that that mix was such that a relatively small part of the extra build-up of time deposits in recent years had come from demand deposits; most of the accelerated growth of time deposits in the hands of the public had been at the expense of holdings of securities and of accounts with savings institutions. To that extent, the accelerated growth of bank credit was necessary to prevent a tightening in the availability of credit, in all forms together, to the economy.

Further systematic work on those substitution relationships needed to be done, Mr. Mitchell said, and when results were available the Committee needed to study them carefully. Meanwhile, he hoped it was clear that, by themselves, data on the annual rate of growth of total bank credit as compared with, say, GNP gave little guide to what monetary policy was or should be.

Turning to policy for the next month, Mr. Mitchell concurred with statements that had been made that alternative A was appropriate for the directive. Briefly, his reasons for favoring no change in policy were that the present international situation did not call for action, and that the domestic outlook was quite uncertain. He was becoming increasingly of the view that a downturn in activity was likely in the latter part of the year; if any change was to be made in policy, he would favor a shift toward ease.

Mr. Mitchell noted that the first sentence of alternative A, as drafted by the staff, read: "The economic and financial developments reviewed at this meeting indicate continuing expansion of the domestic economy, although at a somewhat slower pace than in the first quarter." He would revise the second clause to read, "although at a considerably slower pace . . ." in view of the facts that the second-quarter increase in GNP was now estimated at about $7 billion, only half the first-quarter rise, and that the industrial production index apparently would rise only by about one point in the second quarter, after averaging an increase of about a point per month in the first quarter. It might also be well to work into the directive an acknowledgment of what, he thought, was the most likely source of disturbance to the economy--the inventory adjustment which he felt was in the offing. However, he had no specific language to suggest in that connection.

Mr. Daane said he favored no overt change in policy at this time and would certainly prefer alternative A of the draft directives. Having said that, however, he would note that he had some sympathy with those who expressed uneasiness about the price developments, both recent and prospective, and--despite Mr. Mitchell's analysis, to which, he thought, the Committee would want to give careful attention--with recent developments in the bank credit area. To some extent his uneasiness had been reinforced at the Paris meetings, where he had first described the Committee's policy as being "mildly restrictive" and then had found himself adding that the current pace of U.S. bank credit expansion, while below the first-quarter rate, was still above last year's high rate.

Mr. Daane thought that it had been useful for Mr. Irons to remind the Committee that the maintenance of any given level of net borrowed reserves implied accommodation of whatever demand for bank credit emerged--whether that demand was strong or weak. In view of that fact, he preferred in his own thinking not to characterize an increase in net borrowed reserves of, say, $20 million as a shift in policy. In operational terms, however, he would still say that he would accept some increase in net borrowed reserves if the demand for bank credit continued strong. He would not recommend any specific figure as a target for the Desk's operations, but he would not favor action to prevent a higher level of net borrowed reserves from developing if it resulted from strong credit demands.

Mr. Maisel said it appeared to him that, in contrast to this morning's presentation, the green book gave a story that was mixed, both more optimistic and more pessimistic than the staff interpretation. He disagreed particularly with the interpretation given to the price story of the green book, seeing in that excellent study more of what Messrs. Galusha and Clay did.

The study of industrial prices seemed optimistic to Mr. Maisel. While prices had risen, the types of rise appeared normal for a period of active demand. There was no indication that they were moving up as a result of any structural shift; rather, the opposite was the case. The economy appeared to be in a period of fluctuating prices around a very stable base, and the long-run price level gave no sign of an upward movement.

From the point of view of the balance of payments, Mr. Maisel continued, the rise in prices appeared even better. Most of the increase in recent periods had been in industrial materials. Given the structure of U.S. foreign trade, those increases which were international in nature almost certainly had improved the competitive situation of the United States. Thus, the wholesale price situation seemed particularly favorable, and in his judgment it offered no constraint on any type of desired monetary action.

Also optimistic, Mr. Maisel continued, was the fact that the country had been able to increase its output at approximately the rate of growth of supply while decreasing its relative liquidity in terms of banks' position and of the money supply. He agreed that it was important to note that a considerable part of the recent increase in bank credit had resulted from a slower rate of growth in other liquid assets.

Less optimistic and more serious were the warnings of potential danger, Mr. Maisel said. Inventories, the Committee was told, might have been increasing at a rate which in the past had proved not to be viable--a rate which usually had been followed by serious contractions. If that was so, it meant that even though the U.S. was still considerably below full utilization of its capacity, the expansion in demand--in contrast to output--had failed to equal the growth in productive capacity.

That failure of demand to expand as fast as potential production was serious in and of itself, Mr. Maisel remarked. More importantly, if too large a share of current production had gone into inventories, a recognition of that fact might well be seen. In the past such changes had been rapid and had led to needs for sudden and drastic shifts in monetary policy.

Mr. Maisel felt that small increments were preferable to sharp ones and that, therefore, the Committee should start to move towards greater ease. If the present directive was one of an average of $150 million in net borrowed reserves, he would prefer to stay with it. He would hope that during the period until the next meeting the shortfalls necessary to attainment of that average would occur. At the same time, the Committee could look forward at the next meeting to a new directive calling for less restraint.

Mr. Hickman remarked that business news in June was a mixed bag, but on the whole was better than he had expected earlier. A number of series had moved upward, including steel production, auto sales and employment. Nevertheless, he continued to expect a slower rate of expansion in GNP in the second half, and a leveling in the index of industrial production, including some individual months of actual decline. Such a pattern would reflect the liquidation of large steel inventories and associated factors, only partly offset by the stimulus of Federal fiscal measures. The recent adjustment in stock prices had probably been healthy; although it might contribute to some slowing in consumer spending and capital expansion, he did not believe its influence would be serious enough to alter the general path of business.

That general view of the business outlook had received strong support at a meeting of Fourth District business economists held recently at the Cleveland Reserve Bank, Mr. Hickman noted. Not a single one of the 24 economists attending expected that industrial production in the third quarter would average higher than in the second quarter. For industrial production in the second half as a whole, most of the economists foresaw a slight weakening.

Mr. Hickman commented that unit labor costs in manufacturing were likely to increase in the months ahead. While the April and May figures, which were the latest available, did indicate an inching up of costs between the first and second quarters, no clear change in trend was evident. Thus far this year, the adverse implications for profit margins had been offset by a slight rise in the ratio of prices to unit labor costs in manufacturing. The latest readings, however, suggested that price pressures were abating; that, coupled with a leveling of production, could mean lower profit margins.

With reference to the staff's question on world trade, Mr. Hickman thought the outlook would probably be influenced by two major adverse factors. The first was a leveling in business activity that was apparently developing in a number of major countries The second was the resurgence of mercantilistic measures in many countries in an effort to encourage domestic production and to decrease imports. The United States' own effort to discourage capital outflows would not stimulate, and perhaps might temporarily retard, expansion of world trade. For a variety of reasons, the U.S. trade balance was likely to be lower this year than last. U.S. exports in 1965 were unlikely to exceed last year's record volume, and imports might rise, perhaps by as much as 10 per cent. Thus the trade surplus could be reduced by as much as $2 billion.

The record of Federal debt management in the first half of 1965 was erratic and therefore difficult to extrapolate into the second half, Mr. Hickman said. There was a massive shift in ownership of the public debt to the Federal Reserve and to State and local governments, as well as a sharp reduction in the amount of short-term securities outstanding. In coming months, further demands for short-term issues might be expected from public funds, corporations withholding funds from overseas, banks experiencing slackening loan demands, and from the Federal Reserve in its seasonal program to supply reserves. It would be helpful if the Treasury would satisfy its second-half borrowing needs in the short-term market insofar as possible and if the Federal Reserve would participate by lowering reserve requirements rather than by absorbing part of the outstanding supply of bills. Such a joint effort would have desirable interest rate effects. Short-term rates would be likely to rise moderately, and long-term rates would show little change or perhaps even decline slightly. The balance of payments program would thus be reinforced and private capital formation would be encouraged.

With reference to the question on bank credit and money supply, Mr. Hickman said, the resurgence of bank credit in June, coupled with a reduction in U.S. Government cash balances, was reflected in a sharp rise in the money stock, reversing the combination that had contributed to an equally sharp decline in the money supply in May. Reduction in Government balances during the second half of the year, coupled with further growth in both bank credit and time deposits, should contribute to continued, but less erratic, gains in the money supply.

Mr. Hickman added that a recent study at the Federal Reserve Bank of Cleveland showed that the ratio of total debt to GNP had virtually a level trend recently, as had the ratio of total liquid assets to GNP. Those results indicated to him that bank credit growth had not been excessive recently, although he did think it had been excessive at times last year.

In view of uncertainties in the business outlook, Mr. Hickman favored a modest retreat from the current levels of net borrowed reserves and member bank borrowings. He would prefer to see net borrowed reserves in a range of $50 to $100 million and borrowings around $400 million, as he had suggested at the last meeting. Recent events indicated that rates on U.S. Treasury bills were more responsive to supply and demand factors than to changes in reserve factors alone, at least under present money market conditions. The bill rate should be maintained or increased slightly by appropriate actions by the Treasury and Federal Reserve. Alternative A was clearly preferable to alternative B for the directive, although he would prefer a third alternative calling for a roll-back to conditions prevailing in late March and early April. If the Committee adopted alternative A, he would suggest deleting the word "somewhat" from the first sentence. In his opinion that would be preferable to substituting the word "considerably," as Mr. Mitchell had suggested.

Mr. Bopp reported that credit extended by Third District member banks in June mirrored the sharp increase experienced in the nation as a whole. At all member banks in the District, total credit outstanding rose by 2.8 per cent, compared to an average monthly increase of only 0.4 per cent for the first half of the year and of 0.7 per cent for June of last year. Business loans at weekly reporting member banks rose by a little over 4.5 per cent, compared to a rate of only 0.6 per cent on average during the period January through May. The increase in business loans was spread throughout a wide range of industrial categories.

A discussion with District reserve city bankers, Mr. Bopp remarked, revealed that the June tax date had been responsible for a sizable part of the credit increase and that seasonal expansion in several District industries was also important. In the opinion of those bankers, prospects were for a more moderate rate of growth in credit in the near-term future.

Mr. Bopp went on to say that discussions during the past few days with several large manufacturing concerns in the District produced some interesting side-lights on recent and prospective trends in prices, profits, productivity, and costs. In chemicals and petroleum, nothing like a profit squeeze was in prospect, according to those discussions, although industry officials expected some slowing from the exceptionally good profit rates turned in during the first half of 1965. Two steel economists disagreed in emphasis; one thought no squeeze was in the offing for the industry, and the other put more emphasis on the probability of a wage settlement such that wage increases would outrun productivity increases. No one saw in his industry such pressures on capacity that increasing costs would be a problem because of production passing the optimum point for efficiency. In steel, one economist pointed out that some companies had gone outside for financing, and that could be a problem if expected rates of utilization of new facilities were not achieved. The only people who saw any problem at all with wage costs outrunning productivity were those in steel.

As for prices, Mr. Bopp said, chemicals and petroleum companies were getting increased prices in some staple lines--heavy chemicals and gasoline--that "would not have held a year or two ago."

There had been spotty increases in a few input commodities used by chemicals manufacturers. The general impression from the interviews was that input prices were not a worry, and that prices of final products were firm, in chemicals and petroleum.

With regard to policy, Mr. Bopp continued to feel that the degree of restraint prevailing at present was appropriate to the near-term business outlook. With the adjustment in steel inventories still to come and with a decline in automobile output a likely prospect, the increases in economic activity would probably slacken relative to the fast rate of the first quarter. Superimposed upon such a slackening expansion in demand, prospective increases in supplies of goods and in capacity to produce might serve to contain the selective upcreep in industrial prices which had occurred in recent months. On the other hand, an increase in prices in the steel industry might occur if the wage settlement was overly generous. Such an increase was by no means certain, however, and even if it came, competitive pressures might moderate it both in amount and with respect to the range of products affected.

Bearing those factors in mind and considering also the continued success of the voluntary restraint program, Mr. Bopp would make no change at present in the general posture of monetary policy. He favored alternative A for the directive, with the deletion of the word "somewhat" from the first sentence.

Mr. Bryan reported that economic activity had continued to expand in the Sixth District, judging by such data as those on employment, unemployment, consumer income, and consumer spending. The insured unemployment rate continued to decline. Spending plans for new and expanded manufacturing facilities announced in the second quarter of this year totaled $600 million, an all-time high for the District.

So far as the outlook for business expansion was concerned, Mr. Bryan said that he and his staff had discovered nothing significantly new in the period since the previous meeting of the Committee, and he had no basis for developing a conclusive answer to the question of the business outlook. He did have a rather intuitive feeling, however, that stresses should be developing when the economy came as close to full utilization of capacity as the U.S. had at present. But he could not prove the existence of strains. Available evidence seemed to suggest continued expansion in business activity over the rest of the year, although at a somewhat slower pace than in the first quarter. However, six months was relatively long in present times of rapid change, and he was prepared to be surprised.

Mr. Bryan went on to say that one reason he was dubious about the view that further expansion would be orderly was his belief that it would be difficult to avoid further pressure on prices and profits if expansion proceeded at the expected rate.

As the economy approached full employment some decline in output per manhour seemed inevitable. He was told that current rises in prices were attributable to temporary factors, including supply conditions for meat; nevertheless, the rise in consumer prices would have some permanent effects because many labor contracts took account of the consumer price index, often automatically. Admittedly, it was hard to find any major forces pushing up prices, but enough minor forces could have, and in his judgment were having, the same effect as single large ones.

Generally, Mr. Bryan remarked, it was assumed that the margin of unutilized capacity set the limit to economic activity. But there were many factors that could limit activity. At present, he thought, a limiting factor existed in the skills of those who currently were unemployed, unless the new plant and equipment coming on stream was of a type that required a lower level of skills. Despite all the talk of automation, it seemed to Mr. Bryan that the requirements increasingly were for higher levels of skill; and in his opinion the combination of that factor and the policy of increasing the minimum wage level would limit the gains in activity, regardless of the amount of fixed investment.

Mr. Bryan observed that Mr. Mitchell's analysis had not wholly reassured him about recent banking developments. In June, he noted, the seasonal increases in total, required and nonborrowed reserves were estimated at $64 million, $42 million, and $63 million, respectively. The System certainly had accommodated those seasonal needs; indeed, the actual increases in the three measures of reserves had exceeded the seasonal rises by $161 million, $164 million, and $139 million, respectively. Since March, total reserves had increased at a 6.1 annual rate, nonborrowed reserves at a 4.9 per cent rate, and required reserves at a 6.5 per cent rate. While he might be mistaken, he did not believe such rates were sustainable without developing an inflationary potential.

Mr. Bryan said that he wished the Committee's policy choice was not formulated in terms of the alternatives of "no change" and "firmer". What he favored might be called, for want of a better term, a "tight rein" policy. His difficulty with the concept of "no change" was that under it the Committee's policy had been simply one of supplying all the reserves demanded. That, in his judgment, was tantamount to having no policy at all. At the same time, he certainly did not favor an overt tightening action. It seemed to him that, contrary to Mr. Irons' view, it was necessary to put the banks into a somewhat heavier borrowing position--to have them obtain a larger proportion of their reserves through the discount window. Accordingly, if a free reserve target were to be used--and, as he had often noted, he did not like such a target--he thought the level of net borrowed reserves to be sought should be raised a little.

In sum, Mr. Bryan said, he advocated neither "no change" nor "greater firmness," but a "tight rein" policy. He did not favor a change in the discount rate at the present time because of the risk that it would have large undesirable reprecussions on the economy.

Mr. Shuford reported that growth in economic activity in the Eighth District during the first half of 1965 had been similar to that of the nation. There had been a strong rate of expansion, but with some evidence of moderation from the unusually high rate during last fall and early winter. Payroll employment had increased at a 2 per cent annual rate since December, compared with a 3.3 per cent rate from August to December. Manufacturing output had expanded at a 7 per cent annual rate since December, compared with an 18 per cent rate in the last four months of 1964.

In line with the national trend, Mr. Shuford said, loans and investments at District banks had expanded at a substantially faster rate since December than in late 1964. Business loans in the District had been especially strong, increasing at about a 20 per cent annual rate since last fall.

Since the beginning of May, daily average borrowings by member banks from the St. Louis Reserve Bank had been double the average for the first four months of the year, Mr. Shuford continued. Some of that borrowing had been secured by customer notes, and inquiries had been received from two others of the larger banks in the District regarding use of such notes for collateral. Those developments pointed up the fact, already noted in connection with another District, that bank liquidity was being reduced as the heavy demand for bank loans was being met.

Farm prospects in the District had improved in recent months, Mr. Shuford observed. Higher prices for livestock, primarily beef cattle and hogs, had been the chief factors. Crop prospects also were quite good, as timely showers had fallen over most of the area during the past month.

The moderation in national business activity since the first quarter of the year indicated to Mr. Shuford that the growth rate of the economy was returning to the trend which had prevailed during most of the current expansion. A continuation of that movement of activity back to the rate which had prevailed since early 1961 would seem desirable, for he thought there had been some indication of excessive total demand.

Mr. Shuford believed that the continued upward movement in prices was significant. Prices in recent months had been rising faster than their longer-run trend, and their movement could not be attributed entirely to seasonal forces or to supply conditions in the agricultural sector. The consumer price index rose at a 1.9 per cent annual rate from January to May, whereas the average rate of increase during the corresponding months of the past four years was 1.1 per cent. Wholesale prices rose at a 3.8 per cent annual rate from January to June, compared with an average rate of decrease of 2.1 per cent for the same period of the previous four years. The industrial price component of the wholesale price index rose at about a 1 per cent annual rate over the past five months, in contrast to an average decline at an 0.8 per cent rate during those months of the previous four years. The implications of such comparisons depended, of course, on the starting date used, but averages for the four prior years of the present expansion seemed to provide a fair basis for comparison with the changes this year.

Bank credit had continued to expand at a very rapid rate, Mr. Shuford said, although there had been some moderation since April. Money had risen at a 3 per cent annual rate since last November, compared with a 4.2 per cent rate in the previous 26 months. An upward movement in money could be expected during the balance of the summer as the Government reduced its deposits to normal levels.

As the economy moved into the second quarter of 1965, Mr. Shuford said, it would be necessary to continue to give recognition to the contribution of the Federal budget, which would add considerably to aggregate demand.

Mr. Shuford thought his position on policy was relatively close to Mr. Bryan's, and also, perhaps, to Mr. Daane's. In view of the recent turn toward moderation in the rate of economic expansion, he would not make an overt move toward additional firmness today. On the other hand, he would like to see further moderation and would favor resisting any excessive demand that might develop. Reserves should not be supplied to support unduly large increases in total bank credit, and while some increase in the money supply was desirable it should be at a rate less than the 4 per cent rate of the period from September 1962 to November 1964. This year, he noted, through June the money supply had been expanding at a 2-1/2 per cent rate.

Mr. Shuford commented that like some others he was reluctant to speak in quantitative terms; he shared the reservations that had been expressed about setting specific net borrowed reserve figures as guides for the Desk. But if references to specific figures were to be made, he would say that he would not be disturbed if the Treasury bill rate rose to 4 per cent or even a little higher, and if net borrowed reserves rose to above $200 million, as a result of the attainment of the goal he had indicated of resisting any excessive demand that might develop. Hedid not favor a change in the discount rate.

Mr. Shuford thought his position was not too far from one favoring no change in policy, and the first paragraph of alternative A of the draft directives was satisfactory to him. But, to emphasize the need to resist excessive demand, he would prefer to have the second paragraph of the directive revised to call for operations "with a view to maintaining at least as firm conditions in the money market as have prevailed in recent weeks, and to permit some tightening if demands for credit strengthen."

Mr. Balderston remarked that in the period of nearly twelve years that he had been a member of the Board he had observed that each time the steel industry had entered into wage negotiations, whether or not a strike ensued, the statistics for the industry had undergone large changes. This year was no exception. He found much of the economic data available to the Committee to be quite unreliable in many respects. Throughout the summer months the Committee was likely to suffer from some lack of visibility because of distortions in inventory and other figures.

Mr. Balderston said he noted a tendency to explain away what trends were in evidence as "temporary," or "self-correcting." He was concerned by the seeming rationalization of developments that might otherwise disturb the Committee. He was disturbed by a number of particular phenomena, and his concern was deep-seated because, not knowing what the future held, it was especially difficult to decide what the right policy decision was at present.

His first source of concern, Mr. Balderston said, was the possibility that recent inventory increases had been greater than the published figures indicated, as had been suggested by Mr. Gehman of the Board's staff. Secondly, the long-continued improvement in labor productivity, which certainly was unique, had now flattened out, with the result that unit labor costs were no longer declining. The impact of that development on prices, particularly of export goods, merited attention.

Third, Mr. Balderston continued, the balance of payments outlook for the year--and he would accept Mr. Hersey's guess that the adverse payments balance might approximate $1.5 billion--was a continuing threat that certainly could not be ignored by those responsible for either fiscal or monetary policy. Therefore, he disliked the form of the reference to the second-quarter surplus in the payments balance that appeared in both alternative A and alternative B of the draft directives.

Finally, Mr. Balderston said, the recent striking increase in bank loans could not go unnoticed. However, as he studied that development he found his conclusions supported some of Mr. Mitchell's. He recognized that the costs of borrowing from banks had been low relative to costs in the capital market and that the capital market had been congested at times. Also, trade concerns and metals manufacturers had accounted for about 40 per cent of the total increase in business loans at weekly reporting banks in the first half of 1965. That fact helped explain why commercial bank loans (other than to financial businesses) had risen by an average of $2.1 billion per month (seasonally adjusted) from November 1964 through

June 1965, as compared with an average rise of about $1.4 billion per month during the previous eight months. That increase of 50 per cent was large, but when allowance was made for the heavy borrowing by trade and metals companies the change was not as startling as it appeared at first glance.

Nevertheless, Mr. Balderston continued, like Mr. Bryan he felt that a commercial bank loan expansion of the type that had been witnessed over the past seven months was something that the Committee had to worry about and to watch continually. The essential point was to discover, if possible, whether bank lending was for purposes that were constructive in the long run or for speculative purposes. That was difficult to do. From all that he observed, he suspected that the ebullience of the first few months of the year had been carried over to some degree, and that some bank borrowing was being misused. In a related area, consumer credit continued high, not only for instalment buying of automobiles but for other purposes also.

Mr. Balderston agreed with Mr. Bryan that the Committee's policy should be one that would press banks to obtain the additional reserves they needed by borrowing from the Reserve Banks. He would, therefore, favor a slightly firmer policy, and accordingly preferred alternative B for the directive. But he would revise the wording of the second sentence to read, "Despite a surplus in our international payments in the second quarter, reflecting the large initial impact of the Administration's balance of payments program, the prospect is for a substantial deficit for the year as a whole, with gold outflows continuing."

Chairman Martin commented that the only important economic change since the previous meeting of the Committee, in his judgment, had been in psychology; he thought there had been a lessening of optimism about the economy.

The kind of policy change that had been suggested today, the Chairman continued, was so minor that he found himself questioning whether it would have any real effect. After turning over the alternatives for policy in his mind before this meeting, he had reached the conclusion that Mr. Irons had expressed today--that the Committee should either make an overt move, including a change in the discount rate, or should hold to the status quo. He also had concluded that an overt move was not desirable at the present time, and nothing that he had heard in the discussion this morning had altered that view. Although he agreed with Mr. Ellis that the Committee's earlier probing steps had been appropriate, he doubted that a further probing operation now would be effective, and he was not prepared to see the discount rate changed at this time. On the other hand, he did not favor a move toward greater ease.

There were many cross-currents at work in the economy at the moment, the Chairman remarked, as was suggested by the fact that good cases had been made in the discussion today for both of the suggested alternatives for the directive. One might say that the water in the economic radiator had been boiling earlier in the year, but was not boiling now. Whether it would be again later was, of course, another question. The Committee might have a better picture of the situation at its next meeting.

In his judgment, the Chairman said, monetary policy recently had been performing about as well as possible under the prevailing circumstances. While he recognized that the Committee might have to move in one direction or the other later, he favored the suggested alternative A for the directive today. He noted that deletion of the word "somewhat" from the first sentence of the draft had been suggested, and while the matter did not appear to be of great importance he was agreeable to that change. He then proposed that the Committee vote on a directive consisting of alternative A with the word "somewhat" deleted.

Mr. Shepardson commented that Mr. Balderston's proposed revision of the balance of payments reference in the draft directive seemed worthy of consideration even if the majority favored no change in policy. In the ensuing discussion it was pointed out that the proposed language implied a forecast of developments to come of a type not customarily included in the Committee's directives. After further consideration it was decided to revise the statement relating to the balance of payments from that in the staff drafts, without employing language that implied a forecast.

Thereupon, upon motion duly made and seconded, and with Mr. Ellis dissenting, 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 continuing expansion of the domestic economy, although at a slower pace than in the first quarter. Reflecting the large initial impact of the Administration's balance of payments program, there was a surplus in our international payments in the second quarter. In this situation, and with gold outflows continuing, 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, and taking into account the forthcoming Treasury financing, System open market operations over the next four weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Mr. Shepardson indicated that he had cast his favorable vote with some reservations.

Chairman Martin then read a telegram he had received from Senator Eugene J. McCarthy on June 25, 1965, in which the Senator had urged the Federal Reserve Board to reexamine money and credit policy "with the view of providing greater liquidity and relieve the tight credit situation." The Senator had expressed the judgment that, with continuation of present conditions, "to place critical pressure on the British pound would eventually result in economic slowdown in the United States."

It was agreed that the next meeting of the Committee would be held on Tuesday, August 10, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.

Assistant Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

July 13, 1965

Drafts of Current Economic Policy Directive
for Consideration by the Federal Open Market Committee
at its Meeting on July 13, 1965

Alternative A (no change in policy)

The economic and financial developments reviewed at this meeting indicate continuing expansion of the domestic economy, although at a somewhat slower pace than in the first quarter. They also indicate a surplus in our international payments in the second quarter, reflecting the large initial impact of the Administration's balance of payments program. In this situation, and with gold outflows continuing, 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, and taking into account the forthcoming Treasury financing, System open market operations over the next four 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 continuing expansion of the domestic economy, although at a somewhat slower pace than in the first quarter, with some upward pressure on prices and rapid growth in bank credit. They also indicate a surplus in our international payments in the second quarter, reflecting the large initial impact of the Administration's balance of payments program. In this situation, and with gold outflows continuing, 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 four weeks shall be conducted with a view to attaining slightly firmer conditions in the money market, while taking into account the forthcoming Treasury financing.