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, August 31, 1965, at 9:30 a.m.

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

Messrs. Bopp, Hickman, and Clay, Alternate Members of the Federal Open Market Committee

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

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

Mr. Cardon, Legislative Counsel, Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Associate Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Mr. Patterson, First Vice President of the Federal Reserve Bank of Atlanta
Messrs. Sanford, Mann, Ratchford, Brandt, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of New York, Cleveland, Richmond, Atlanta, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Meek, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
Messrs. Rothwell and Duprey, Economists at the Federal Reserve Banks of Philadelphia and Minneapolis, respectively

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 10, 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 conditions and on Open Market Account and Treasury operations in foreign currencies for the period August 10 through 25, 1965, and a supplemental report for August 26 through 30, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Sanford said that the U.S. gold stock should be unchanged for the current statement week, the fifth consecutive week without any change. The Stabilization Fund was acquiring $50 million of gold today from the United Kingdom, which would bolster the quite low holdings of the Fund, and within a few days the U.S. should be receiving its share

of a moderately sizable distribution of gold from the gold pool operations in August. The only September order for gold received so far had been from Austria, for $12.5 million. At the moment it appeared that French takings might be quite moderate in September because of that country's apparently moderate gain of reserves in August.

In the London gold market, Mr. Sanford continued, turnover continued generally heavy until about mid-August. On August 17, however, the Communist Chinese finished their buying, for the time being at least, with a total of $55 million which, together with $45 million they had purchased earlier, gave them a total of $100 million of gold acquired this year. Also, the announcement of the Russian wheat purchases and their subsequent actual sales of gold--amounting to nearly $100 million--greatly dampened the speculative demand for gold. After reaching nearly $35.19-1/2 earlier in the month, the fixing price dropped as low as $35.10-5/8 by the 20th. Subsequently, it had tended up again--today it was $35.1209--as demand picked up once more. As it had for some time, the demand reflected the general uneasiness concerning sterling and developments in Vietnam. The gold market now was reporting rumors that Russian sales might be resumed this week, which seemed plausible in view of the size of the $450 million Russian-Canadian wheat deal.

The foreign exchange markets continued to be highly nervous regarding sterling, Mr. Sanford observed. The better United Kingdom

trade figures for July evoked only passing recognition and sterling came on offer prior to each weekend. However, the weekend offerings became decidedly less as August progressed. Contrary to the worst expectations for the latest long weekend (Bank Holiday), the selling, which had developed in moderate degree last Thursday (August 26), did not carry over into Friday. Nevertheless, the month's support operations had made substantial inroads into British reserves. In order to offset some of the month's losses the Bank of England had availed itself of the remaining $225 million under its $750 million swap facility with the System, drawing $60 million on August 24 and $165 million on August 27. Furthermore, a $140 million overnight purchase of sterling on a covered basis from the Bank of England was being made today for Treasury and System account--$100 million for Treasury account and $40 million for System account. That operation would be reversed tomorrow. Without those transactions the figure for the August U.K. reserve change, which would be released on September 2, might well have been a decline of over $450 million, of which about half was suffered in the first week of the month.

Among the other principal currencies, Mr. Sanford continued, the Canadian dollar had been in heavy demand in connection with the forthcoming Canadian wheat shipments to Russia, and the Bank of Canada had acquired some $125 million of U.S. dollars during this period. The immediate impact of those acquisitions on reserves had been reduced somewhat by forward swaps. On the continent, the Dutch

guilder was initially strong in connection with uneasiness regarding sterling, and the System absorbed $25 million from the Netherlands Bank on August 11 with guilders drawn under the swap facility with that Bank. The next day the System resumed selling three-month forward guilders to the market through the intermediary of the Netherlands Bank. The extent of such forward sales--$1.3 million equivalent--was limited, as the inflow of funds into the Netherlands tapered off and the Dutch money market eased. The System also activated its swap arrangement with the Bank of Italy by drawing $100 million equivalent of Italian lire to absorb dollars from that Bank, which had been gaining heavily in recent weeks. The System also absorbed $55 million from the National Bank of Belgium's holdings by using Belgian francs available under the Belgian swap lines.

In the area of third-currency swaps, Mr. Sanford said, the System prepaid its remaining $5 million equivalent sterling-guilder swap with the Bank for International Settlements by entering into a German mark-guilder swap for the same amount with that institution. A similar transaction was made for Treasury account, in the amount of $7.5 million. As a result, all of the sterling which had been used in third-currency swaps with the BIS had now been released.

Mr. Sanford reported that, pursuant to the approval of the Committee at its August 10 meeting for renegotiation of interest rates applicable to drawings under the swap arrangements with the central

banks of England, Canada, and Japan, the arrangements with the Bank of England and the Bank of Canada now provided for interest rates to be computed on the basis of the 90-day U.S. Treasury bill rate, as was the case with most of the other swap arrangements. He also had discussed the matter with the local representative of the Bank of Japan, who in turn had been in touch with Tokyo, but as yet there had been no final decision concerning revision of the rate applicable to drawings on the arrangement with the Bank of Japan.

In reply to Mr. Robertson's question, Mr. Sanford said that the existing arrangement with the Bank of Japan called for a flat 3 per cent interest rate on drawings. In the case of the Banks of England and Canada, the rate prior to renegotiation had been 2 per cent. If the Japanese agreed to an adjustment, practically all of the System's swap arrangements would be on a U.S. Treasury bill rate basis. The Belgian arrangement still involved a fixed rate, but there had been several adjustments that kept it close to the prevailing Treasury bill rate.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period August 10 through 30, 1965, were approved, ratified, and confirmed.

Mr. Sanford then recommended that the $100 million swap arrangement with the Netherlands Bank, which matured on September 15, be renewed for a further period of three months, in agreement with that Bank.

Renewal of the swap arrangement with the Netherlands Bank for a further period of three months, as recommended by Mr. Sanford, was approved.

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 August 10 through 25, 1965, and a supplemental report for August 26 through 30, 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 past three weeks have not been particularly joyful ones in the Government bond market. Bond prices, after edging lower in the first few days of August, turned more decisively downward in the past few weeks as dealers concluded that their inventories were too high but found little appetite among investors apart from the official accounts. On the plus side, there has been a significant reduction in dealer holdings of issues due in more than five years--from about $490 million on August 9 to $285 million on August 27--but the decline has been largely traceable to purchases for the System Account or Treasury investment accounts with little evidence to suggest that prices have reached an attractive range for other investors.

The price declines during the past three weeks, ranging from about one-half point to nearly a full point for a number of long-term issues, have provided no fewer than 16 Government securities with a yield of 4.25 per cent or higher (based on the dealers' bid quotations). Thus, the 4.25 per cent interest rate ceiling has once again become an effective constraint on Treasury debt management policy.

To reiterate briefly the factors underlying the market adjustment, the main reason seems to be a continued display of strength in the economy and the prospects for further gains ahead. These prospects stem partly from anticipations

of increased military outlays in connection with Vietnam, but they also reflect a generally more buoyant mood in the economy. Bond market participants are keenly aware of the strength of bank loan demand, of business demands for credit in general, and of the possibilities implicit therein for a somewhat firmer monetary policy. Indeed, one of the more obvious depressants of Treasury bond prices is the higher yield now required to market high-grade corporate bonds--apparently in the neighborhood of 4.70 per cent for AA-rated utility bonds, compared with about 4.45 per cent earlier this year. Moreover, the corporate bond market itself has generated little enthusiasm among investors even after moving to higher rates as a feeling has persisted that still further increases may lie ahead. Several large issues will reach the market during the first half of September, providing a good test of the market's distributive capacity.

Treasury bill rates have also adjusted higher on balance during the past three weeks with weakness most pronounced in the longer bill maturities. The average issuing rates of 3.89 and 3.99 per cent for the three- and six-month bills in yesterday's auction compared with rates of about 3.85 and 3.95 per cent three weeks ago. The latest one-year bill, auctioned last week at an average rate of just over 4 per cent, was up 13 basis points from the auction rate a month earlier. In part, the rise in bill rates is seasonal in nature. For one thing, the demand from the auto companies is light at this time of the year. But beyond this the rate rise probably reflects an abatement of demand that may be related more generally to increased corporate needs for funds.

The money market has been steadily firm in the past three weeks with Federal funds trading mainly at 4-1/8 per cent on all but a few days. Sporadically, some Federal funds trading has occurred in modest volume at 4-1/4 per cent. While the volume of such trading has not been large, it seems to have had a fairly pronounced effect on the funds market--tending to dry up the selling of funds before calendar weekends. In turn, this has helped to produce a bulge in member bank borrowing over recent weekends, which has been mitigated but not entirely offset by the System's use of short-term repurchase agreements. Even so, member bank borrowing in the recent period averaged about the same as in the several preceding weeks--roughly $1/2 billion.

System open market operations withdrew reserves seasonally during the last three weeks, chiefly through the net maturity of holdings under repurchase agreements. Outright holdings declined by a net of $62 million as a reduction in Treasury bill holdings in the early part of the interval was only partly offset by coupon purchases in the latter part.

Looking ahead, it would seem appropriate to meet part of the remaining reserve need in the Labor Day week through additional purchases of coupon issues. Shortly thereafter, it presumably will be necessary to absorb reserves again with the approach of the mid-September float bulge. The next major reserve position--and if past history is a guide, it could be a very substantial one--would not come until the very end of September or early October.

Mr. Mitchell asked whether the recent levels of dealer holdings of long-term Governments were much in excess of the amounts needed for the dealers to perform their function of making a market.

Mr. Holmes replied that markets could be made at any level of dealer holdings. In his judgment, however, the size of their holdings of long-term Governments over an extended period earlier this year was related to their market-making function. Until recently dealers anticipated that long-term rates would be stable or declining, on the basis of their expectations that savings would continue at the earlier high rate and that the pace of economic expansion would slow. Accordingly, for the time being they had been willing to acquire and hold a large volume of longer-term issues, and that could be considered to be part of their function.

Mr. Mitchell then asked whether net sales of longer-term Governments recently had not been almost entirely to official accounts. Mr. Holmes replied that that had been the case most recently. Earlier

there had been some periods of net investor demand in the 5-10 year maturity area, but at that time the dealers had been interested in building up their portfolios, believing that that would be profitable. At the moment dealers probably would not be able to lighten their holdings substantially further through sales in the market; at present rate relationships investors preferred corporate securities to Governments. Knowing that the demand was light, the dealers were not pressing their holdings of Governments on the market, since the only effect of such action would be to push prices lower.

In reply to a question by Mr. Hickman, Mr. Holmes said that there had been little speculative unloading of intermediate- and long-term securities acquired in the last two Treasury refundings.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period August 10 through 30, 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:

> With the outcome of the steel negotiations unknown, the dimensions of the Vietnam buildup uncertain, and the future of sterling in doubt, it seems almost futile to attempt to draw any conclusions from the things that have actually happened this summer. But, in fact, some of our doubts have been

resolved. We were concerned at the beginning of the year about the prospects for business investment in the second half, and about the possibility that private construction activity could not be maintained. The adjustment from the extremely high post-strike rates of auto sales carried at least a troublesome potential, as did the reduction in the stimulus from Federal fiscal policy in the first half.

All these things added together suggested the possibility, if not the likelihood, that overall activity might well level off this summer, and that we might even see declines in some important sectors before the end of the year. Even as late as July 13, I was reliably informed, and so advised the Committee, that GNP would be up about $7 billion in the second quarter and that industrial production had leveled off at the advanced 141-142 rate. I might well have added that the relatively favorable 4.7 per cent unemployment figure for June reported at that meeting, was due in part to an unexplainably small increase in the labor force in that month and that we expected a rise in July.

As you are all already well aware, the kindest thing one might say about this information is that it was unduly conservative. GNP was up $9.5 billion, industrial production hit 144 in July, and unemployment dropped to 4.5 per cent and maintained that rate in August.

On the other hand, the rather mild concern I expressed about price developments seems to have been just about right. On average, wholesale industrial prices have neither advanced further nor retreated from the level they reached in mid-June, and the rate of advance of agricultural commodities has slackened, at least.

At the same time, there is very little basis for hoping that we will return to the unusual stability in wholesale prices that prevailed for five years, until just about a year ago. New wage settlements in the first half have averaged 3.8 per cent, with above guidepost settlements in such important industries as aerospace, aluminum, cement, and glass. I have no idea how the reported differences between the companies and the steel workers will be resolved--with or without a strike--but it seems almost too much to hope that the package will be truly within the guidelines. In these circumstances, at least a continued upcreep in wholesale prices seems the most realistic expectation.

The consumer price index has few friends, and I have no desire to argue the significance of a change in it of one-tenth of a point, but it is up again for July to 110.2 per cent of the 1957-59 average and would have been up another two-tenths had it not been for the excise tax reductions.

It does not seem to me that any of these developments can be fairly characterized by the much overused and abused word "inflation." I would prefer simply to say that the economy is continuing to show, in prices as well as in other areas, some of the typical characteristics of the expansionary phase of a business cycle. This, in itself, is cause enough for concern.

I cannot conclude without mentioning once more the inventory situation. We have just learned that the book value of manufacturers' inventories increased by over $700 million in July--the largest monthly increase since last October, and considerably more than double the average monthly rate for the first half. This is on top of the three quarters of overall inventory accumulation which the revised GNP figures show to have averaged at an annual rate of $8 billion. It is hard to see how we can make the necessary inventory adjustment, whenever it comes, without far-reaching repercussions throughout the economy. A major problem for all Governmental stabilization policies looms ahead if we are to cushion this adjustment. How far ahead I cannot say, except that it is almost certainly more than four weeks.

It is obvious, I think, that I have consciously tried to avoid belaboring the immediate uncertainties that are so much on all of our minds today. But just as we should not exaggerate their importance, it would be foolhardy to ignore them. Until we know whether there is to be a steel strike, a settlement within the guidelines, or one well above them, it is impossible to say anything very meaningful about the economic climate in which monetary policy will have to operate in the weeks immediately ahead. This would seem to me to counsel against a change in policy at this time, even if such a decision might necessitate more drastic action later.

Mr. Holland made the following statement concerning financial developments:

The credit review could be crowded into one sentence this morning: Bond markets have turned weaker, even while

the money market on average has remained roughly stable, and credit flows have continued apace This statement is correct in broad outline, and it sums up the dilemma of sorts that current events pose for policy; but there are some details submerged in these simple generalizations that I think can help to illuminate the appropriate path for resolving today's policy questions.

First, I have been struck by the pressing size of business demands for external credit to help finance large inventory and capital outlays. Corporate bond flotations have been unseasonably large all summer, and as such have compounded the recent bearishness of dealer and investor expectations. Moreover, such flotations have not served to replace bank loans, but are in addition to a persisting rapid business loan expansion. To be sure, we should anticipate that some moderation of business loan expansion will take place whenever the steel-using industries shift from piling up to drawing down their heavy stocks of steel; but the dimensions of that turnaround may not turn out to be so great, if purchasing agents come to expect, say, a procession of selective steel price increases over time and/or a substantial increase in metals consumption by the military.

Enlarged business borrowing is significant because of the extent to which it is supporting business investment outlays that are growing disproportionately relative to overall economic expansion. As the year has progressed, there has been a breaking away from the more balanced relation between business equipment and consumer goods output that previously had been a feature of this longest of peacetime business expansions.

An analyst concerned with this developing imbalance might regard some rise in corporate bond yields as being therapeutic, and he might also favor some firming of bank lending terms to businesses and be disappointed at how little hard evidence of the latter is at hand. But this may be more a commentary on the deficiencies in our information network than a confirmation that bank lending terms are unchanged. As compared with before June, banks are borrowing more at the discount window, paying more for Federal funds, spending more money to attract time deposits and even long-term capital funds; and unloading Governments at lower prices. Adding all these factors together, they seem to me to suggest an appreciable and slowly cumulating marginal pressure on the banking system. It would be surprising if banks were not moving gradually to pass some of

the pressures on to their customers, in the form of higher interest rates and stiffer lending conditions. It would also be typical for banks, however, to accompany such action with further securities liquidations, even at increasing cost.

Here a more generalized difficulty begins to take shape. Further bank sales of Government securities--and, for that matter, also any bank backing away from the municipal market--would put added pressures on capital markets that are already strained by bearish dealer and investor expectations. Discussion this morning and the staff comment on question 5[1/] have already amply detailed the sources of the changed market psychology. Suffice it to say that banks may be gradually moving into a position to make that market atmosphere still worse--not likely by massive sales but by a continual dribbling in of selling pressures.

In such circumstances, the capital markets, left to their own devices, would almost surely lack the resilience to recoup much of the price losses of the last month, and could easily generate some further interest rate increases. There could also be some arbitraging of past rate advances across other markets not yet much affected by yield adjustments, thus applying an element of interest rate restraint to a number of economic sectors where no major imbalance of resources and demand now exists.

Is such a development desirable, or at least tolerable? The answer to that question, of course, is bound up in the consequences of the steel settlement, the Vietnam build-up, and the sterling crisis--all events which are still very much uncertain but which key financial markets have already discounted importantly. In effect, once again the workings of securities market expectations have managed to get the financial cart in front of the economic horse.

At this juncture, monetary policy would seem to be facing two broad alternative courses. One would be continuing to hold money market conditions stable, pending a clarification of the economic outlook. Under this approach, some bank adjustments would probably proceed, and the long-term markets would remain depressed, and by the time of the next Treasury financing, around the end of September, I would think a somewhat firmer atmosphere of financial restraint would probably have percolated through the economy. The contrary approach--to reverse the spread of

1/ Certain questions suggested for consideration by the Committee, and staff comments on them, are given at a later point in these minutes.

a somewhat more restrictive atmosphere--would necessitate an overt easing of reserve pressures on the banking system, and probably also aggressive official buying of coupon issues to remove what is left of the overhang in the market. If the latter seems to go too far toward market "rigging," a variation of the "no change" directive that would embody at least some solicitude for the struggling bond markets would be to continue to keep money market conditions on the average fairly stable, but to operate the System Account in ways which (a) would lighten pressure on the long-term market relative to the short market, and (b) within the money market, would increase pressure on the dealer financing market relative to the banks. This, for example, would imply emphasizing purchases of coupon issues whenever reserve additions are called for, and bill sales when reserve absorption is necessary.

Financial conditions by themselves, of course, cannot indicate which one or variant of these alternatives is the right choice at the moment. That has to depend basically upon one's own presumptions as to how the current major uncertainties in the economic picture are likely to be resolved.

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

Since mid-year, the U.S. balance on "regular" international transactions has reverted to deficit, as everyone expected it would. Indeed, this seems to have happened as early as July, contrary to the impression we had 3 weeks ago from incomplete data. The size of the deficit is not particularly large on a seasonally adjusted basis--perhaps $200 million for July and August together according to the data so far available, or about the same $1-1/4 billion annual rate as in the first half-year. Nevertheless, it is a deficit.

On the official settlements basis, on the other hand, there appears to have been a continued seasonally adjusted surplus in July and August, since there was a very large inflow during those months of foreign private liquid funds. Usually a development of this kind would be encouraging. But this time, as at the end of 1964, a large part of the inflow may represent the other side of the renewed run on sterling, and may prove temporary. Whenever sterling finally turns the corner, we should expect to see some foreign private funds flow out of dollars again and back into sterling.

The detailed information so far available does not help at all to explain the deterioration since mid-year in transactions other than inflows of foreign liquid funds. On the contrary. During July, there was a further large reflow of U.S. bank credit. Outstanding bank credit to foreigners is now not only far below the ceilings set by the voluntary restraint program, but is also lower than at the end of 1964. As the staff comment on question 3 points out, there is reason to think that other factors in addition to the program may be restraining bank lending to foreigners this year. In particular, the IET, firmer domestic credit conditions, and easier conditions abroad in Italy and Japan, seem to be playing a useful adjusting role.

Merchandise imports dropped sharply in July, another superficially favorable development. However, one-third of the drop resulted from a change in the way the statistics are compiled, and most of the rest is thought to have resulted from the seamen's strike on American ships, which lasted from June 15 through today (August 31). Exports will probably also prove to have been affected by the strike. So we seem doomed to another several months of uncertainty about recent trade trends, although it remains clear that, for the year to date, exports have been much less buoyant and imports more buoyant than in 1963 and 1964.

Finally, sales to U.S. residents of new issues of foreign securities were not particularly large in July-August. They will be much larger in the third quarter as a whole than in the second quarter, but most of the increase is scheduled for September.

Thus, the July-August deterioration must be attributed to changes in the wide variety of items that we cannot yet measure, and most of which have not yet been measured even for the second quarter. Nevertheless, the deterioration comes as no surprise, since temporarily favorable factors were known to have played a large role in the second-quarter payments surplus.

Most analysts, I think, would still expect a "regular" transactions deficit of the order of $1-1/2 billion for the year as a whole, implying some moderate further deterioration during the remaining four months. Outstanding bank credit to foreigners seems likely at least to stop declining. New securities issues will be large, as I mentioned (although Canada may have to take some action to damp down Canadian borrowing here, now that wheat sales

to Russia have improved its payments outlook). Finally, while steel imports should ultimately decline, total imports are likely to stay high for the rest of the year, and there is little in foreign business developments to suggest an early expansion in exports.

Also, it still seems to me that we should expect some appreciable deficit on the official settlements basis for the year, even though there has been none to speak of during the first 8 months, since this pleasant and unexpected result seems to have depended on the prolonged sterling crisis that must sooner or later subside.

Views about the outlook for sterling seem to have become less pessimistic in recent weeks. The July export figures helped, but there has also been a more fundamental reappraisal, symbolized by the fact that Britain's National Institute for Economic and Social Research now believes that the planned elimination of the basic deficit by the end of 1966 will come about, whereas it did not think so in May.

It has become increasingly evident that the anti-inflationary actions of the Government are taking hold. The labor market has become a shade less tight, though it is still tighter than it was a year ago. Price increases have slowed down a little; much of the increase in the retail price index since February seems to be attributable to increased excise taxes. Bank loans have expanded very little since the end of 1964.

It has also become increasingly evident that there has been more spirit in the British economy than was earlier believed, and also more need for anti-inflationary policies. Real GNP continued to rise pretty strongly into the first quarter, when it was 4 per cent higher than a year earlier--a performance comparable to that of the United States when account is taken of slower labor force growth in Britain. Plant and equipment outlays in manufacturing increased about 14 per cent in real terms during this period, even after one discounts some inflation of the first-quarter figures by companies anticipating an adverse change in tax treatment. Even if plant and equipment outlays now level off, the total for the year will be up substantially.

Thus, while market views about sterling may continue unsettled for some time, there seems to be a feeling in the air that an adjustment of the right sort is underway, even though no one can feel certain of its speed or extent.

> The National Institute is much more pessimistic about the longer-run outlook, foreseeing great difficulty in earning a sufficient payments surplus to repay debt and rebuild reserves without an unconscionable dampening of growth at home. But several features of this gloomy prognosis raise questions, and the margins of error are wide. First, the Institute assumes (admittedly arbitrarily) that there will be no net short-term capital movements over the period of its projection. This seems an excessively cautious assumption; I would think some considerable part of the capital that has fled during the past year of crisis might later return. Second, the Institute regards any level of unemployment above 2 per cent as profoundly unsatisfactory (in much the same way that some people feel the U.S. economic performance has been poor because the unemployment rate here is above 4 per cent), and its projections, being based on past trends, allow nothing for the success of new efforts to increase the flexibility of the economy. In fact, of course, the point of the projections is to emphasize the need for such new efforts.

Mr. Ellis asked what Mr. Reynolds thought the effects on the position of sterling would be if the leve of U.S. interest rates increased further and the rise was eventually confirmed by an increase in Federal Reserve discount rates.

Mr. Reynolds replied that such effects were difficult to predict, but on the whole he did not think they would be very great under present circumstances. The situation had been different earlier in the summer, when there as yet was little statistical evidence to indicate that the necessary adjustments in Britain's situation were underway, and when there were rumors that the U.S. had decided not to assist the British further. A rise in U.S. interest rates then probably would have been taken as confirmation of such rumors, and

might have had substantial repercussions on the position of sterling. He would add, however, that his belief that there would be no significant effects now was only a guess, and one about which he felt particularly unsure.

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 are the implications of the renewed rapid increase in industrial production in June and July for developments later in the year?
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> The renewed rapid increase in industrial production in June and July--seasonally adjusted--reflected mainly further advances in output of business equipment and materials to levels about 10 per cent above a year earlier. Consumer goods output recently has continued to show little change at a level on the average only 5 per cent above a year ago. Unless demands for output are greatly stimulated by military developments or accelerated consumer spending, the rate of advance in industrial production will probably slow in coming months.
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> One special factor this summer has been the continued high output of steel and steel products to build up stocks further for protection against a possible strike September 1. With output of some other materials already at or near capacity rates, curtailment in steel can be expected at least to slow down the advance in the materials component of the index.
>
> Backlogs of orders for business equipment have continued to rise and developments in Vietnam may provide some further stimulus to equipment output. The rise recently--and over all of the past year--has been very rapid, however, and no substantial acceleration appears likely. Industrial capacity continues to grow as the large amount of equipment ordered and produced earlier comes into full use, and capacity might begin to appear excessive fairly soon unless consumer takings accelerate.

Whether the rate of increase will be adequate, however, is questionable. Retail sales have been high, and expected advances in income--including the higher Social Security benefits--should sustain further rises. But auto sales would need to increase from their recent annual rate of 8.8 million units to a rate of 9-1/2 million even to maintain the level of auto output expected to prevail through September. Retail stocks of home goods and apparel have been rising even though output has not increased from the record levels reached at the beginning of the year.

To date, developments with respect to Vietnam have not been such as to give any sharp direct impetus to buying by either consumers or businesses. It seems increasingly likely that the economic stimulus from stepped-up Vietnam activities will be imparted more gradually over time, as actual military outlays and orders grow. The precise timing and dollar amount of the increases in military expenditures, however, are still highly uncertain.

(2) Prices.--Considering demand and supply developments over the past year and price behavior during this period, what are the prospects for stability in industrial commodity prices in the months ahead?

Increases in industrial prices over the past year have been selective and for the most part limited. Unless the wage settlement results in a significant steel price rise, and unless activities in Vietnam are stepped up sharply, continuation this autumn of the recent pattern of price performance would seem to be more likely than any appreciable general increase in price levels.

As earlier in this expansion, increases over the year were largest for nonferrous metals, which were up 8 per cent in response to further world-wide increases in demands that strained available sources of supply even when supplemented by withdrawals from U.S. stockpiles. For steel, changes in prices have been small so far despite heavy inventory demands, partly because of growing competition from abroad on an increasing range of products.

One important factor limiting the advance in industrial prices over the past year has been continued stability in labor costs per unit of output. With rapidly increasing volume of output and continuous modernization of plant, productivity

has increased about as fast as hourly wage costs. Profits have risen sharply, even in many industries where prices have not risen. A slowing in the rise in industrial production in this country probably would also retard further gains in productivity. If at the same time wages should rise more rapidly, unit labor costs would come under upward pressure.

On the other hand, some of the influences tending to hold prices in line this past year will still be operating in the months ahead. New and more efficient plant is continuously coming on stream and the work force is expanding--although in the younger and industrially untrained age groups. Demand abroad for materials may continue to show somewhat less growth than earlier.

At the moment, attention is focused on the steel settlement, which may be followed by some price advance. An important question would be whether price advances that might be initiated would hold. Demand for steel will be considerably reduced for some months after a settlement and any price advances announced will be subject to test during that period.

(3) Balance of payments.--To what extent is U.S. bank lending to foreigners being limited by factors other than the voluntary restraint program?

During the first seven months of 1965, U.S. banks actually reduced the amount of credit outstanding to foreigners by $100 million, whereas for the year as a whole a net increase of nearly $500 million would be consistent with the 105 per cent VFCR ceiling. If outflows are being significantly restrained by forces other than the voluntary restraint program, they may remain small for some time; but if the program is the dominant restraining influence, renewed outflows of more than $500 million might be expected during the remainder of the year without the banks exceeding their ceilings.

The voluntary program presumably is the main constraint for some 40 banks that were still above their ceilings at the end of July. It probably also dominates the foreign lending behavior of a few large banks that have cut back below their ceilings in order to make room for scheduled loan disbursements or anticipated use of credit lines later this year, particularly those banks that have sold off loans to their foreign branches at some cost. Furthermore, seasonal influences would normally

reduce bank credit outflows by roughly $150 million in the first seven months of the year. But these considerations do not explain the absence of any net bank lending to foreigners so far this year; additional factors must also be acting to restrain outflows.

At least three such factors may be at work on the supply side. First, having made very large foreign credits last year, partly in anticipation of the IET and controls, some U.S. banks may be wanting to go slow for a time on further foreign lending. Second, new economic difficulties in Japan and some other countries, and recent failures like that of the Atlantic Acceptance Corporation in Canada, may have reduced the credit-worthiness of many potential foreign borrowers in U.S. eyes. Third, strong domestic loan demand, and a slight firming of U.S. credit conditions, may have reduced the eagerness of banks to lend abroad.

On the demand side, application of the IET to medium- and long-term bank loans to borrowers in developed countries, for purposes other than financing U.S. exports, has made this country a less attractive source of funds for those borrowers. Secondly, the leveling off of U.S. exports this year probably has been accompanied by a decline in new financing needs. (When U.S. exports last leveled off, in 1962, outflows of U.S. bank-reported capital dropped to $450 million from $1,260 million the year before.) Third, a marked easing of credit conditions in Italy and Japan, which borrowed heavily here last year, may have reduced demand in those countries for U.S. funds as compared with domestic funds.

It is too early to assess statistically the relative importance of such factors, although much light might be shed by the explanations that might be elicited from individual bankers. It is clear, however, that U.S. bank lending to foreigners currently is being significantly restrained by economic forces and by the IET, as well as by the VFCR program.

(4) <u>Bank credit</u>.--What accounts for the accelerated growth in bank time deposits since mid-year, and what are its implications for continued bank credit expansion?

Time and savings deposits grew at a seasonally adjusted annual rate of 15.0 per cent in July, and appear to be increasing at a 20 per cent rate in August. The growth of time deposits since midyear thus has approached the high rates of early 1965, after slowing to an 11.5 per cent rate during the second quarter.

Three main factors seem to be important in explaining this development. First, the unusually large increase in savings accounts at weekly reporting member banks--and most likely at other banks also--probably stems in part from the substantial increases in nonfarm personal income and private financial savings generated by the vigorous pace of economic expansion this summer.

Second, there is some evidence in July of another shift in financial asset preferences of the public from savings and loan association shares to commercial bank time deposits. According to preliminary estimates savings and loan shares rose only $0.4 billion (seasonally adjusted) in July, one-half the gain of July 1964 and the smallest increase since January. While information now available on yield relationships does not fully explain the shift of saving flows from associations to commercial banks, trade sources attribute it to more aggressive promotional efforts by bankers.

Finally, facing a continued and pervasive increase in loan demands, banks have been more willing to bid for CD money since midyear. Large increases in outstanding CDs at banks outside New York City took place in July, when interest rate relationships allowed these banks to be aggressive issuers, and in August major New York City banks returned to the market in size.

Looking ahead, time deposit growth might not continue to keep pace with a strong fall loan expansion, since returns on competing market instruments have moved slightly higher and the attraction of funds away from savings and loan associations that developed in July may not persist. Assuming no further change in interest rate relationships, however, and a continuing rapid growth in incomes, interest-bearing deposits at banks should continue to increase at rates higher than in the second quarter, thus contributing to further substantial expansion in bank credit.

(5) Capital markets.--To what extent does recent price weakness in the bond markets reflect current supply-demand considerations as opposed to psychological factors?

Declines in U.S. Treasury bond prices since late July seem to reflect primarily a shift in dealer and investor expectations. In other bond markets, while changed expectations have exerted their influence, price movements have

reflected changes in the volume of current offerings as well. In the case of corporate bonds, for example, an unseasonably large calendar of new offerings has tended to confirm changed expectations and has reinforced their price-depressing effects. In the case of municipals, on the other hand, a marked--albeit essentially seasonal--cut-back in August offerings has helped to keep prices relatively stable.

Earlier in the summer, although uncertainties concerning Vietnam and sterling were recognized, market psychology was dominated by a general presumption that the pace of economic expansion would slacken following a steel settlement. While it was felt that the momentum of the economic expansion already prevailing would continue to generate unusually heavy business demands for external financing through the summer, questions were being raised whether these demands would persist so strongly later in the year.

Escalation in Vietnam, coming on top of the unexpectedly strong summer economic performance, has erased market doubts concerning a possible economic slow-down, and instead has given rise to concern that the combined pressures from a continuing capital boom and rising Federal expenditures might trigger more widespread commodity price increases.

With this change of perspective, investors have revised their judgments both as to future supplies and future demands for funds. Demands of businesses for external financing are now expected to be maintained at levels well above normal, and some--as yet indeterminant--increase in Treasury borrowing is generally assumed. At the same time discussion has intensified as to the chances for a shift to a more restrictive monetary policy and a further increase in Federal Reserve discount rates.

During this same period, the markets were swept by a wave of pessimism about sterling. While this attitude was later moderated by the improved British trade figures for July, investors are still highly sensitive to the possibility of renewed deterioration in the payments positions of both Britain and the United States.

In short, price weakness in Treasury bonds over the past month has been the result chiefly of expectations which events have not yet confirmed or disproved. In response to these expectations, dealers have pressed to reduce their inventories

of longer-term issues, and investors have tended to hold back from bond purchases at prevailing prices. Price softness in the market has also been abetted from time to time by some bank selling and by a tendency for some investors to switch out of Governments into corporate bonds in response to the recently more attractive yield spread in favor of the latter.

In the corporate bond market, expectations of heavy fall financing have been an important factor in recent price declines, but it remains difficult to sort out the extent to which market reports of prospective new issue volume represent firm plans for financing as opposed to mere conjecture. Some unexpected additions to the August calendar already scheduled for September is sizable. However, it is not yet clear whether total September offerings--including private placements--will run much ahead of the $1.1 billion average monthly volume for the year to date.

Finally, although a substantial, partly seasonal, increase is expected in new municipal offerings after Labor Day, there is no firm indication that this volume will run significantly ahead of the average monthly volume prior to August. Even though the August new issue volume has been well below July, municipal dealers' inventories since mid-August have climbed back around the $800 million level. Such an inventory build-up could be evidence of a less active bank interest in the face of current and expected loan demands; alternatively, it may merely be a reflection of investor caution associated with the recent shift in expectations. Nevertheless, the combination of the change in market psychology and the larger September calendar could conceivably lead municipal dealers, like Government dealers, to press to lighten their inventories, thereby spreading recent price weaknesses to the tax-exempt market as well.

(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 August weeks net borrowed reserves and member bank borrowings have averaged around $170 million and $550 million respectively, not much changed from their June-July averages. The rate on 3-month Treasury bills has fluctuated in a 3.80 to 3.87 per cent range, moving to the upper end of that range most recently as market demand for bills has tapered off

seasonally. Federal funds have continued to trade mainly at 4-1/8 per cent, with trading below that rate more infrequent than earlier and a small amount of trading at 4-1/4 per cent reported. Despite the consistently firm atmosphere in the funds market, dealer loan rates in New York have been maintained at the lower end of their 1965 range, as major banks in the City have remained in relatively comfortable reserve positions and dealer financing requirements have declined.

Assuming a continuation of current monetary policy and no new disturbances from international developments, net borrowed reserves could remain in a $150 to $200 million range in the weeks ahead, but with bill rates fluctuating over a somewhat wider and higher range than recently. The 3-month bill could fluctuate between 3.85 per cent, or a little below, up to around 3.95 per cent. Seasonal contraction of bill demand in August will be followed by money market pressures during the mid-September tax and dividend period and a Treasury financing in the bill area in late September or early October. Temporary declines below current levels are also possible, on the other hand, especially if the System should meet a sizable portion of its reserve needs around Labor Day through purchases of bills in the market and if public fund demand expands seasonally in early September.

As noted under question 5, yields in the U.S. and corporate bond markets have risen recently. Since this rise has reflected more a change in market expectations than changes in current supplies and demands, these markets could be entering a period of pause as participants wait for developments to confirm or deny their changed outlook. Some further rise in Treasury bond yields should not be ruled out, however, particularly if banks begin to press securities on the market more and more in order to make room for expected fall loan demand or if dealers encounter difficulty in reducing further their still sizable bond positions. Municipal yields could come under some upward pressure as fall approaches, if strong bank loan demand results in curtailed commercial bank purchases of these bonds and/or municipal dealers try to lighten their large inventories.

In the environment described, continued vigorous bank credit expansion is to be expected. Loan demands appear considerably greater than seasonal, and banks will be helped

in accommodating loan requests by the strong growth in their time deposits (as indicated under question 4). The growth in money supply will probably continue erratic, aggravated by sharp swings in the Treasury's cash balance in August, September, and October. On the average, however, the demand deposit component of the money supply might expand at an annual rate in the neighborhood of 4 per cent over the months ahead.

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:

The domestic economy has continued to advance vigorously on a broad front. The most recent data on industrial production, new orders for durable goods, personal income, retail sales, employment, corporate profits, prospective capital spending, and other factors add up to a distinctly buoyant current picture. The prospective step-up in spending, triggered by the developments in Vietnam, has added to the buoyancy.

The wage negotiations in the steel industry have not yet produced a settlement, and the President has intervened to press the parties for a settlement without a strike. Thus, a long strike does not appear likely. Some reduction in customers' steel inventories appears in prospect for the remainder of the year. Such inventory reduction, plus a continuation of a sideways movement in residential construction, may be blessings in disguise as tempering factors in a rapid economic expansion.

Pressures on prices are a cause for increasing concern, as added demands for goods and services press against the more limited availability of unused resources. Increases have been announced recently for a number of important industrial materials. Some reduction in wholesale prices as well as consumer prices might have been expected in view of the reports that about three-fourths of the recent excise tax reduction had been passed on to consumers; yet such prices failed to decline in July and may have risen in August. Some selected increases in steel prices appear probable regardless of the nature of the wage settlement in the steel industry.

Recent balance of payments figures underscore the temporary nature of the second-quarter improvement. The underlying tide in payments is clearly against us. So far

in the third quarter we have seen a greater than seasonal decline in the trade surplus and increase in the tourist deficit, and a noticeable rise in the volume of new foreign securities issues placed here. In the absence of clear prospects for offsetting developments, a poor balance of payments record for the third quarter seems inevitable.

Since our last meeting, there has been some improvement in international financial sentiment with respect to sterling, but the situation is still delicate. A renewed deterioration in sentiment, or other international developments, could bring pressure on the dollar in international markets and on our own sensitive domestic markets.

The demand for bank credit continues to be strong. There is no clear evidence that the growth of bank credit, or of all credit in use, has slackened from its rapid second-quarter pace or that it has declined to the rate of growth in overall production.

The most recent figures for the New York City banks show further substantial strength in total credit and in business loans. Bank liquidity has continued to decline. The moderately tighter lending terms gradually put into effect by many banks, particularly those in the major centers, over the first half of the year apparently continue as these banks still foresee possibly stronger than seasonal fall loan demands. As the yields on new issues of top-quality corporate bonds have risen to levels above the prime rate some sentiment is now being expressed for a rise in the prime rate, which has not been changed since it was reduced from 5 to 4-1/2 per cent in August 1960. With higher yields on corporate bonds and continued heavy demand for bank credit, some upward move in bank rates is logical.

Although expenditures of the U.S. Government are expected to rise, its income is also likely to be higher; it is probable that the Treasury's borrowing needs during the remainder of 1965 will be modest, and could be satisfied through the sale of Treasury bills. The auction sale of such additional bills should serve as no constraint on System policy and its implementation. Since the last meeting of the Committee, market prices of Government bonds have drifted lower as dealers have reduced their inventories. There is still considerable uncertainty in the market stemming from discussions about the future of sterling and the implications of the Vietnam situation coming at a time when domestic economic activity is buoyant and moving strongly upward.

In my opinion some restriction in domestic credit availability is now called for. Domestic considerations counsel

> such a move before inflationary pressures gain further momentum; and the need to bring about a fundamental improvement in our international balance of payments is still pressing. The approach should be cautious in view of the uncertainties in international financial markets and the U.S. Government securities market.
>
> As evidence of firmer conditions in the money market flowing from such a move, somewhat higher net borrowed reserves and somewhat greater member bank borrowing from the Federal Reserve Banks would seem appropriate. Federal funds might be expected to trade predominantly at 4-1/8 per cent with more frequent trades at 4-1/4 per cent, and the yields on Treasury bills might be expected to rise moderately. As for the form of the directive, I favor alternative B.[1/]
>
> I would not favor an increase in the discount rate at this time. If a firmer open market policy is adopted and money market rates move higher, careful consideration of an increase in the discount rate may well be appropriate before long.

Mr. Ellis reported that the prevailing business situation in New England was one of high, if not record, activity. Summer business had generally equaled or surpassed expectations. Barring the unpredictable effects of steel developments on regional activities, the general expectation was for a vigorous fall season.

The essential outlines of present conditions, Mr. Ellis continued, were provided by summary statistics: In July, manufacturing output was up from June, and 8.1 per cent above a year ago; employment also was up over the month, and 2.2 per cent higher than a year earlier; unemployment, seasonally adjusted, about held its own relative to June, and insured unemployment was down 19 per cent in the year to a low not reached on a comparable basis since July 1956.

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

Those bare-bone statistics were fleshed out by recent news stories that gave some flavor of events. The furor about special requests to Secretary of Labor Wirtz to allow 500 experienced Canadian apple pickers into New England emphasized that there was a crop to be picked, even though its quality had certainly been affected by the extensive drought this summer. Seventeen counties in New England had been officially classified as disaster areas because of the drought, thereby entitling farmers to special access to Federal loans and reduced feed costs. Meanwhile, tourist attraction centers were having a good season, with an average attendance increase in July of 7 per cent over July 1964. Several of the District's shoe manufacturers had announced price increases on their spring lines that would average about 5 per cent.

The financial counterpart of those trends continued to be sharp expansion, Mr. Ellis remarked. Deposit balances at monthly-reporting mutual savings banks in the District increased only 0.5 per cent in July compared with plus 0.7 per cent in July 1964, primarily because withdrawals were heavier and new deposits lighter than last year. In contrast, savings deposits at the reporting member banks increased 1.7 per cent on average in the three-week period ending August 28, to record a 16 per cent year-to-year gain. Even that growth apparently did not satisfy the banks' objectives, however, since they reached into the negotiable certificate of deposit market--

in some cases with higher rates--to achieve a sharp expansion in "all other time deposits" that brought the year-to-year gain to 27 per cent. The weekly reporting bank sample indicated that those funds had been flowing principally into business loans, which showed a 19 per cent year-to-year gain, and into real estate loans, where the gain was 22 per cent, about twice the national average.

Because monetary policy operated with a substantial time lag between actions and their ultimate effect on the economy, Mr. Ellis said, it was inevitable and proper that policy be shaped in light of business prospects on the immediate horizon. Last spring the prospect of a substantial slowdown in business activity in the fall influenced the Committee's decisions to make no further probing moves. Now, on the threshold of the fall season, although details were still clouded by the uncertainty of the steel negotiations, there seemed to be a much more general expectation that further substantial advances would occur this fall. Assuming that the Vietnam buildup would continue at about the present rate and that the steel production interruption, if any, would be of short duration, it seemed likely that industrial production would continue to rise.

In Mr. Ellis' judgment there was little prospect for stability in industrial commodity prices in the next few months; the uptrend that started in late 1964 would probably continue. A number of forthcoming price increases for this fall had been announced, in such items

as machine tools, paper, rubber products, yarn, cement, and sulphuric acid. With the economy continuing strong, there was no reason to think those plans would be cancelled.

Coupled with those developments, Mr. Ellis continued, were reports from bankers that they anticipated that fall credit demands would match or exceed seasonal patterns. It was understandable if bankers, faced with such expectations and with their own reduced liquidity, were contributing to the market pressures that were reducing the prices of long- and intermediate-term Governments. Furthermore, the yield spread between new corporates and Governments of about 40 basis points was high by recent standards, and had begun to stimulate switching from Governments. Although many banks held few Governments, prospective strong loan demand could be expected to reduce further holdings of Governments where feasible.

In that context, Mr. Ellis asked, what was the proper role for monetary policy? It seemed clear that, with continuing strong loan demands, even a modest probing action such as he had been advocating in recent meetings would lead to an upward movement of interest rates; indeed, it was possible that the present posture of policy would lead to rate increases if demand strengthened. The changes might include upward movements in yields on all maturities in the Government list, an advance in the prime rate, and, in due course, a confirming rise in the discount rate. In short, if the

Committee started on that path, its course was not likely to be reversible in the near future.

Were sterling not in its present weak and sensitive position, Mr. Ellis said, he would have no hesitation in advocating that the price of money be allowed to rise in response to domestic demands this fall, despite the immediate uncertainties. But sterling had to be considered, and during this critical fall period it was difficult to judge what expectational effects might flow from general rate increases in the United States, including a discount rate increase. Perhaps he exaggerated the possibilities of repercussions on sterling; his analysis might be two months behind that of Mr. Reynolds. He would like to hear how others would appraise the alternative possibilities. Meanwhile, he was persuaded that policy should not be materially altered during the next four weeks. That interval should provide more insight on the steel labor negotiations as well as on the significance of the present peace feelers concerning Vietnam. And the market would have been allowed to settle down, if other events led in that direction, without having been tilted by a policy move.

His own definition of "no change," Mr. Ellis observed, would involve a target for net borrowed reserves centered at $150 million, with the expectation that borrowings would continue to average over $500 million. Three-month Treasury bill rates might fluctuate near the top of their recent range, and Federal funds rates might hold

generally at a 1/8 per cent premium. He would accept alternative A of the draft directives, but would interpret it in terms of the third alternative that Mr. Holland had described--to call not for easing actions but for operations designed to help stabilize the long end of the market, by providing needed reserves through purchases of longer-term issues and withdrawing reserves, when necessary, through sales of short-term issues.

Mr. Irons reported that business activity in the Eleventh District, as in the nation as a whole, continued at a very high level. Industrial production was up, construction was strong, new car sales were high, employment continued to rise, and unemployment remained at the low rate of 3.3 per cent. The situation in agriculture was highly favorable this year; the weather had been excellent throughout the District, and there would be increased cotton yields and higher output of wheat and other crops. Cattle prices were holding steady at the improved levels of three months ago. In sum, District economic conditions were unusually good--in some respects almost startlingly so.

With respect to financial developments, Mr. Irons continued, bank loans continued to rise, particularly in the commercial and industrial and consumer loan categories. Banks were continuing to reduce their Government securities holdings and at the same time were increasing their holdings of other securities. Time and savings

deposits had risen; so had demand deposits, although by a smaller amount. Purchases of Federal funds were rather high, averaging about $800 million in the past three weeks, with sales averaging about $650 million. Borrowings from the Reserve Bank had been low; banks had been obtaining money from other sources. Bankers were expecting heavy loan demands over the rest of the year, in excess of usual seasonal requirements. Bankers and businessmen generally thought that the business outlook was strong and that some further price rises were possible, although they were concerned about the same kinds of uncertainties that had been mentioned today.

Turning to the national situation, Mr. Irons said that the question facing the Committee was whether the elements of strength in the economy were sufficient to prevail over possible unfavorable developments; or, in other words, how much weight should be placed on the present uncertainties in deciding on policy. In his judgment, the Committee should place a considerable amount of weight on them. One might conclude that some moderate firming was in order, along the lines Mr. Treiber had mentioned, in view of the very high level of economic activity, the somewhat less favorable balance of payments situation, the likelihood of increased Federal expenditures as a result of Vietnam, the continued inching up of prices, the optimism of businessmen, the rapid expansion of credit, and the ability of banks to obtain the funds they needed for further credit expansion.

It seemed to him, however, that this was not a good time for firming action. With the steel negotiations still in process, the problems of sterling still unresolved, and other uncertainties, it was preferable, in his judgment, not to change the posture of policy significantly. He would hold a steady course while watching developments over the coming four weeks closely, and reconsider the situation at the next meeting.

Perhaps, Mr. Irons observed, it would be desirable to reduce the pressures on long-term Governments by purchases of coupon issues, with some offsetting sales of Treasury bills, as had been suggested. It might be charged that such actions would savor of a pegging operation, but he thought they could be carried out short of that point.

Mr. Irons thought that the time was approaching at which the Committee would have to begin moving toward a firmer policy. When that time arrived he believed it would not be long before an increase in the discount rate would become inevitable. At the moment he would be reluctant to see a discount rate change.

In accordance with his policy views, Mr. Irons continued, he preferred alternative A to B for the directive. He thought, however, that there should be more emphasis on the existing uncertainties than in the staff's draft. As he had indicated, it was because of those uncertainties that he preferred no change in policy; if they had not been present he certainly would have favored alternative B. Consequently, he would prefer language that indicated the dominance of the

uncertainties over the evidences of strength in the economy, if the Committee decided not to change policy today.

Mr. Swan reported that the economic situation in the Twelfth District was somewhat mixed. Aerospace employment was up in July and the industry's July forecast was for further increases over the next four months. On the other hand, the unemployment rate for the District rose rather sharply in July, in contrast to the national figure. Not enough details were available as yet to indicate definitely where the unemployment rise occurred, but it seemed to be related primarily to the situations in agriculture and construction. District housing starts in July were at the lowest level in five years. Nevertheless, the demand for lumber had remained rather strong, with further scattered price increases. Nonresidential construction continued at high levels. There had been a number of strikes in the building trades that, for the most part, were relatively short and were settled on terms rather favorable for labor.

Mr. Swan commented on the adequacy of the labor supply for harvesting the tomato crop that he had mentioned at the previous meeting. The growers estimated that they needed 23,000 workers, and Secretary of Labor Wirtz's committee had now certified about 18,000 or 19,000. The canners were faced with reduced acreage and prospects of a shortage of labor for harvesting, but earlier in the year they had held very substantial inventories of tomato products. In the

second quarter, however, the canners had shipped some thirteen million cases, as compared with nine million in the same period last year. Thus, the canners would start the new season with smaller than usual inventories, and substantial price increases on canned tomato products were expected.

As to banking developments, Mr. Swan continued, the general impression in the District, as elsewhere, was one of strong demand for loans. The fact remained, however, that in the three weeks ending August 18, the rate of expansion in bank credit at District weekly reporting banks was considerably less than in the rest of the country and also less than in the District a year ago. Much of the rise that did occur was due to the increase in holdings of securities other than Governments, which was greater at District reporting banks than in the rest of the country. The increase in holdings of other securities seemed to be related in considerable measure to a policy decision by one of the District's larger banks to shift a substantial volume of funds from the Federal funds market into short-term municipals in light of current interest rate relationships. Despite the smaller than national increases in both total bank credit and loans, District banks were still borrowing in substantial volume at the Reserve Bank, and they remained in rather tight reserve positions.

Turning to policy, Mr. Swan said that he, too, had been impressed by the uncertainties in the present situation. As to the steel negotiations, along with Mr. Holland he wondered whether, if a

settlement was reached quickly, the following inventory liquidation might not be much smaller than had been expected in light of probable military requirements for steel and the possibility of a price increase. In any case, given the present uncertainties, he did not think that this was an appropriate time for the Committee to change policy. He was in complete agreement with Mr. Ellis' interpretation of "no change."

Mr. Swan went on to say that he shared Mr. Irons' feeling with respect to the directive. Perhaps the problem could be met without any elaborate change in alternative A by referring to the existing uncertainties in the first sentence, before the statement that "the domestic economy expanded further." He also questioned the desirability of retaining, without qualification, the phrase "gold outflows have continued" in view of the recent reduction in the rate of outflow.

Mr. Galusha reported that the Ninth District continued to move forward at a rapid pace. The extraordinary levels of agricultural production had engendered a high degree of optimism among District banks. There was, however, less optimism as to prices. Nonfarm employment was high, with Minnesota reporting a June-July gain larger than in any year since 1957. Tourist income and travel had also broken records where figures were available.

Credit demand at District banks appeared to be on a plateau, Mr. Galusha said. No Twin City banker anticipated a resumption of

the excessive demand of the second quarter. Credit was becoming increasingly selective, with the major banks attempting to assert rate pressure where they could. There reportedly had been no change in the quality of credit.

Mr. Galusha said that he would confine his comments on the staff questions to the first, second, and fifth. Optimism about the nation's economic performance in the second half of 1965, and in 1966 as well, seemed to be increasing. He, for one, was more optimistic than he had been a few weeks ago. The third-quarter increase in money GNP might turn out to be about as large as was recorded in the second quarter. Some slowing down in the rate of economic growth would seem to be on the horizon; more particularly, he expected smaller quarterly increases in money GNP in the fourth quarter and for a while thereafter than had been recorded lately, in spite of the recently announced Vietnam buildup.

The numbers would indicate that the buildup actually had started several months ago, Mr. Galusha said. He directed the Committee's attention to second-quarter 1965 Federal purchases; the increase between the first and second quarters was impressive. There probably would be a further buildup and further increases in GNP over what it would have been in the absence of a larger war. However, he could not see the coming buildup as doing more, at least in the fourth quarter, than offsetting the likely reduction in inventory accumulation.

In sum, Mr. Galusha's feeling was that the third quarter could well witness an increase in money GNP of the order of magnitude of that recorded in the second quarter; and that the fourth quarter would witness a smaller, if still impressive, increase. At the moment, therefore, it appeared plausible that the economy would pretty much hold its own in terms of resource utilization over the remainder of the year. Unemployment and utilization rates might move a bit one way or the other in coming months, but not, he thought, greatly in either direction. And he was inclined to believe that whatever general price pressures existed earlier this year would continue to moderate over the remainder of the year.

In that connection, Mr. Galusha noted that the changes in straight-time hourly earnings in manufacturing reported in the "green book"[1/] seemed to him surprisingly small. In light of the recent decline in unemployment rates and, more importantly, the record corporate profits, he would have expected a considerably larger increase. But no doubt it was too much to hope that there had been a lasting change in the behavior of money wage rates, a change hinting of less cost-push pressure in the future. He also was encouraged, incidentally, by the green book report that, after all, unit labor costs had not been rising.

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

If Mr. Galusha's view of basic economic developments led him to favor no change in monetary policy at this time, so also did technical market conditions. Recent experience strongly suggested that financial markets were a bit nervous; perhaps "apprehensive" would be a better word. The implication was that a modest change in policy--a probing operation, if one preferred--might not at this moment be possible. An expression like "slightly firmer" connoted a stable, disciplined market which did not appear to exist at present. There was considerable risk that a small change in marginal reserve measures would be transformed by market expectations into a disproportionately large rate adjustment, in long-term rates as well as short, and possibly even in bank lending rates. Adjustment in those rates was overdue, and could come even with no perceptible change in the Committee's policy. Nor, finally, did he see anything in balance of payments developments sufficient to warrant a change in policy at this time. In brief, he still favored alternative A of the draft directives.

Mr. Scanlon reported that the Seventh District economy had moved through the midsummer months without losing momentum. The only weak spot was steel, where strike prospects remained uncertain. On balance, he believed that unless there was a prolonged strike the impact of a cutback in steel probably would be confined largely to that industry and to associated transportation and materials-supplying firms. The final demand for goods and services appeared to be strong

and getting stronger. Continued strength in new orders for capital goods, together with announcements of long-range capital expenditure programs of firms in the steel, auto, chemical, and petroleum industries, indicated the continuance of high and perhaps accelerating rate of outlays well into 1966.

A considerable number of machine tool producers, encouraged by growing backlogs, had raised prices by 2-1/2 to 12 per cent, Mr. Scanlon said. A moderate uptrend in average wholesale prices continued. In part, that was related to the escalation of military operations in Vietnam. There still appeared no indication that the general price uptrend was accelerating.

Mr. Scanlon noted that District labor markets appeared to have tightened further. There was no major area with a substantial labor surplus in the District, now that South Bend had been reclassified.

Figures for District banks indicated relatively greater slowing in growth of total bank credit in July and August than did national figures, Mr. Scanlon said. The banks had continued to reduce broker and dealer loans and holdings of Government securities, although their business and real estate loans and other securities had increased further. Business loans had risen faster in the District than at all weekly reporting banks, and larger gains than in the same period last year were reported for most of the major industrial categories. Bankers generally reported that loan demand was

strong, but there was some difference of view as to whether it would be strong enough to provide upward pressure on interest rates.

The basic deficit position of the Chicago banks had continued to grow somewhat larger despite reductions in their holdings of Governments and dealer loans, Mr. Scanlon continued. CDs outstanding at those banks had declined since the end of July. Borrowings at the Reserve Bank's discount window had risen somewhat over the past three weeks, although the number of banks borrowing--both reserve city and country--had declined, and total borrowing was relatively small.

While Mr. Scanlon interpreted the available evidence as indicating a continued expansion in business activity and probably a further reduction of the now small supply of unused resources in the Seventh District, the magnitude and duration of the adjustment in steel remained uncertain. Therefore, he would favor no change in policy posture at this time. He recognized that that might be erring on the side of excessive ease, but he did not favor additional probing actions because he questioned whether even a slight firming was possible at this juncture without a rather prompt increase in the discount rate. It would seem to him that any firming would, for example, result in Federal funds trading at 4-1/4 per cent quite regularly. He doubted whether the Committee could have that situation for more than a very limited period of time without encountering difficulty in administering the discount window. Accordingly, he did not favor a change in

policy unless the discount rate was changed, and he would prefer to wait a bit longer before making that move. He preferred alternative A for the directive to be adopted today, with the same reservations that Mr. Irons had expressed.

Mr. Clay said that the national economy continued to exhibit an impressive performance in terms of both expanding activity and increasing employment of manpower. The pattern of activity in the Tenth District was quite different from that nationally, as was evidenced by the fact that nonfarm employment, seasonally adjusted, had failed to increase this year. The contrast between District and national growth was attributable largely to smaller cyclical variability in District manufacturing, as a result of relatively heavy concentration in nondurable goods manufacturing. Reductions in defense-oriented industries had been a factor in the District's employment pattern. By contrast, some defense plants in the District would now experience increases in employment before the end of the year, as a result of the expanded military program in South Vietnam. Those included both stepped-up activity in going facilities and reactivation of facilities that had been on a stand-by basis since the Korean war period.

A contrast between the nation and the Tenth District was apparent also in banking developments, Mr. Clay continued. The rates of expansion in bank credit, total loans, business loans, and consumer loans at District banks this year all had been less than the national

rates of increase. Growth in those categories had been somewhat larger at District country banks than at District city banks, however. The growth in bank credit relative to available funds in many country banks was such that they were making extra efforts to attract and hold deposits by increasing their interest rates paid on time deposits to 4-1/2 per cent. Competition with savings and loan institutions was a factor in that competitive effort. For the most part, rural banks did not increase their time deposit rate to the 4-1/2 per cent level at the time of the modification in Regulation Q permitting it, and the Reserve Bank had no organized data as to the proportion that were at that level now. His impression was gained from reports of Reserve Bank representatives calling on banks.

Mr. Clay went on to say that as long as the improvement in the national economy took place in an orderly fashion, as it had thus far, it was a further step toward the achievement of national economic goals. The staff analysis carefully reviewed the factors involved in the prospective situation and, it seemed fair to say, gave evidence that further advance in the months ahead likely could continue to take place in an orderly fashion. The qualification concerning the uncertainty as to the amount and timing of military expenditures set forth in that analysis was a very important one, however. Moreover, it was difficult to know what effect changing attitudes and expectations growing out of recent developments might have on private economic decision-making.

Added to that was the crucial decision being awaited in the current steel wage negotiations.

The logical thing to do in terms of monetary policy, it seemed to Mr. Clay, was to continue essentially the current policy and to watch closely both domestic and international developments. Money and capital market forces influenced by expectations already had placed upward pressure on yields and had led to somewhat uncertain money and capital markets. Obviously, that policy position would need to be modified by any sudden developments in the military or international fields requiring monetary policy action. Alternative A of the directive drafts appeared satisfactory to him.

Mr. Wayne commented that in the Committee's policy discussions from time to time there had been references to the market's tightening itself. That had rarely happened because the Committee had usually intervened to affect the situation one way or the other. But it seemed to him that it had happened in recent weeks. With no change in monetary policy, a firmer tone had developed in both the money and capital markets, whether for financial or psychological reasons. Of course, that might be a delayed reaction to the Committee's firmer policy of the past six months.

In any case, Mr. Wayne said, he was content to see the development continue for the present. He would favor maintaining reserve availability at about its present level. If recent market trends continued, that would probably mean somewhat firmer money market

conditions and higher short-term interest rates. Those conditions would be appropriate in view of the vigor with which the economy was moving forward, the uncertainties on the military front, and the fiscal stimuli the economy would be receiving in the next few weeks. Also, some additional firmness here would be helpful to Canada in coping with inflationary pressures. On the other hand, he believed that any overt move toward tighter credit, and especially an increase in the discount rate, would be unwise now in view of the weakness in the capital market and the position of sterling.

Mr. Wayne noted that recent increases in industrial production had centered chiefly in equipment and materials, and had apparently been associated with rising defense procurement, steadily expanding business capital outlays, and metals stockpiling. While the metals stockpile was likely to be reduced, he anticipated that defense orders would probably continue to increase and recent reports indicated that businessmen had once again raised their sights on plant and equipment outlays. On balance, he expected industrial production to increase over the remainder of the year but at a rate somewhat more moderate than in June and July.

Despite steadily expanding capacity, Mr. Wayne said, prospects for stability in industrial commodity prices did not look encouraging. Private demand continued to rise and public outlays were moving up in several major areas. A wage settlement was forthcoming in steel which, if it followed patterns already set this year, might well place additional pressure on the industrial wage structure. In brief, strong

demand and higher wages seemed likely to keep industrial prices under some upward pressure through the remainder of the year.

On the basis of contracts with District banks and given the international rate structure, Mr. Wayne believed that foreigners were still prepared to step up their borrowing here and that the banks would expand their foreign lending substantially were it not for the voluntary program. Application of the Interest Equalization Tax to bank loans had probably effected some restraint, but he thought that the voluntary program was at the moment the most significant restraint preventing a sizable increase in bank lending to foreigners.

Mr. Wayne observed that the growth rate of time deposits at weekly reporting banks thus far in 1965 had been about equal to the average for the past four years. On an unadjusted basis, the recent acceleration in the growth rate did not appear to be more significant than other fluctuations which had occurred during that period. First, the rate in the second quarter was probably depressed appreciably by heavy tax payments; payments of individual and corporate income taxes were approximately $4 billion more in the second quarter than in the first, whereas last year the difference was only $800 million. Secondly, the recent rise was probably stimulated by the reportedly heavy loss of savings at savings and loan associations in July. The recent buildup in time deposits suggested that banks were in a position to continue lending and investing at a good pace. When they had taken

care of the demand for business and consumer loans they would probably put most of the remaining funds into municipals and mortgages, as they had been doing.

Mr. Wayne thought the current price weakness in the bond markets was attributable in large part to psychological factors and those, in turn, appeared to stem from a reappraisal of domestic economic conditions and from continued uncertainty over the future of the pound. The market now apparently saw some possiblity that the economy might become overheated in the coming months instead of easing off, as had been widely predicted. Speculation regarding the coming steel settlement also was causing some apprehension. As a precaution against the possibility of higher interest rates and a tightening of monetary policy, dealers had been reducing their positions in longer-term Government securities while investors had been shying away from long-term commitments.

Fifth District business continued to advance in line with national trends, Mr. Wayne said. The latest survey reflected some improvement in business sentiment, with expectations now about evenly divided between further improvement and stability at present levels. The statistical record also indicated continuing strength, with substantial gains in nearly all sectors of nonfarm employment and rising man-hours in most of the principal manufacturing industries. The textile business, in particular, remained in an unusually strong

position. At this early stage in the tobacco marketing season the average price of flue-cured was 18 per cent higher than a year ago and dollar sales were up 30 per cent.

Returning to his starting point, Mr. Wayne said he believed that the Committee's policy should be essentially one of no change, maintaining a level of reserve availability about equal to that of the past three weeks. Obviously, he would prefer alternative A for the directive. He questioned the desirability of placing additional emphasis on uncertainties since "no change" implied a continuation of the steady pressure to which the Committee had been committed for some months. In his opinion, the Manager should be authorized to provide additional reserves if market forces produced more than a moderate firming of money market conditions.

Mr. Robertson made the following statement:

> It seems clear that major factors are at work or in the offing that might well call for a reappraisal of all Government stabilization policies, monetary policy included. I have in mind, particularly, the steel wage-price picture and the escalation of outlays for Vietnam; but there is also the cliff-hanging exhibition being put on by sterling. In each of these areas, however, we do not yet know what is going to happen.
>
> In the absence of other impelling reasons for changing monetary policy, therefore, I favor holding a steady course until we have had an opportunity to better weigh the import of developments in these key sectors. So far as I can judge, no other factors are so compelling. Price performance continues restrained, and monetary expansion is not out of bounds. Commodity markets have been remarkably stable considering all the loose talk about the size of our Vietnam build-up and its possible consequences for the economy.

Such uncertainties in the outlook, however, have helped to give the financial markets a case of the jitters, and the resultant increases in long-term interest rates are running well ahead of the apparent changes in real demands. I recognize this bond market weakness has developed for reasons largely unconnected with the stable money market conditions being maintained by the Manager, but I think we also ought to recognize that a persistence of such higher long-term rates can exert a tightening influence on the economy, other things being equal, and that monetary policy needs to be framed with this in mind. I personally would not want to act overtly to create offsetting ease in reserve availability until and unless the steel and Vietnam pictures are resolved in a way that makes it likely that no added monetary restraint would be required this fall. But, at the same time, I would certainly not wish to move in the opposite direction and thereby compound the tightness already evident in some longer-term markets.

As I said at our last meeting, I would be prepared to see the bill rate work lower, if investor shortening of maturities produces any such tendency, but I frankly doubt that it will occur. With that qualification, I would direct the Manager to maintain about the same money market conditions as have prevailed since our last meeting. Accordingly, I would vote for alternative A of the current directive.

Mr. Shepardson said he concurred completely with the view that buoyant conditions existed throughout the economy. But he also was concerned about the uncertainties abroad with respect to the position of sterling and the Vietnam situation, and about those at home relating to the still-uncompleted steel wage negotiations. Like some others who had spoken, except for those uncertainties he would feel that conditions now called for a further move toward tightening. However, with the uncertainties--and particularly those concerning the steel negotiations, the outcome of which might or might not have a significant effect on developments--he thought it would be inappropriate to change policy at this time.

Mr. Shepardson shared Mr. Irons' views about the directive. The Committee, appropriately in his view, had been changing the wording of the first paragraph of the directive from time to time in an effort to make the language reflect current conditions as it saw them. He thought the staff's suggested alternative A needed modification if the Committee concurred in the view that it should not change policy today primarily because of the existing uncertainties.

He would begin the directive with the opening statements of alternative B, which in his judgment presented a better description of the current domestic economic situation than did the equivalent part of alternative A. He would then add language indicating that the Committee's policy was unchanged in view of the prevailing uncertainties, which he would describe more fully than the staff draft did. For the second paragraph, he would accept the language of alternative A, except that he would delete the phrase "over the next four weeks" and say that open market operations shall "continue to" be conducted in the manner described. That change seemed desirable because of the possibility that some of the present uncertainties would be resolved in a manner that would justify reconsideration of the Committee's policy posture before four weeks had elapsed.

Specifically, Mr. Shepardson proposed a directive along the following lines:

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, business sentiment has become buoyant, some prices have been under upward pressure, bank credit expansion has been vigorous thus far this year, and Federal expenditures are expected to increase in the months ahead as a result of the hostilities in Vietnam. Our international payments have reverted to deficit in August, and gold outflows have continued. However, in view of the continuing uncertainties in securities and foreign exchange markets, in military developments, and in the steel wage negotiations, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations shall continue to be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account the unsettled conditions in securities and foreign exchange markets.

Mr. Mitchell commented that he could heartily endorse a great deal of what he had heard this morning, but he would make a few observations with a different slant. He thought it was quite likely that the economy was on the verge of an inventory-cycle turning point. There was good reason to believe that inventory accumulation had proceeded more rapidly than was generally realized, not only in steel but also in the rest of the economy. As evidence of such a development, Mr. Gehman of the Board's staff had pointed to the differences in recent rates of output of materials and finished products. In any event, as Mr. Noyes had noted, the revised GNP figures showed a rate of inventory accumulation averaging $8 billion over the last three

quarters, and the book value figures for July indicated an exceptionally large further increase at manufacturers. Thus, the inventory situation probably had gotten out of hand, and a steel settlement undoubtedly would lead to some reappraisal of the levels of stocks.

Consumer spending, Mr. Mitchell continued, did not appear to be rising sufficiently rapidly to warrant real confidence in the outlook. Nevertheless business confidence was strong; businessmen seemed to be disregarding the possibility of a turning point in the inventory cycle. The economy might surmount the inventory adjustment by a further expansion in final takings, but it seemed clearer than it had earlier that such an adjustment lay ahead.

Mr. Mitchell shared the dissatisfaction others had expressed with the language of the directives the staff had suggested for this meeting. Perhaps it was not feasible to do anything about it; as Chairman Martin often had said, nineteen people could not write a directive without getting bogged down in questions of semantics. Nevertheless, he also had worked out some possible language, which read as follows:

> The economic and financial developments reviewed at this meeting indicate that the domestic economy has expaned further, but with increasing reliance on inventory accumulation. Business sentiment has become buoyant. The Government securities and corporate capital markets have experienced a significant rise in yield, with top-quality corporate bonds at their highest yield in four years. Our international payments have reverted to deficit in August, and uncertainties persist in foreign exchange markets. In this situation, it remains the Federal Open Market Committee's current policy

> to strengthen the international position of the dollar, to avoid the emergence of inflationary pressures, and to counter speculative pressures in the bond markets, while accommodating moderate growth in the reserve base, bank credit, and the money supply.
>
> To implement this policy, System open market operations over the next four weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account the need to cushion the unsettled conditions in the Government securities and foreign exchange markets.

In explaining his proposed revision of the second paragraph, Mr. Mitchell indicated that he thought purchases of coupon issues by the System Account would be useful in helping to tranquilize the longer-term bond markets.

Mr. Daane remarked that he had little to add this morning to what had been said; he agreed that no change should be made in policy, in view of the uncertainties existing in both the domestic and international situations. As to the uncertainties in the international area, he was impressed with the significance of the question that Mr. Ellis had put to Mr. Reynolds, and with Mr. Ellis' conclusion on the point. While Mr. Reynolds did not think the repercussions on sterling of higher U.S. interest rates would be great at present, he had indicated that he was unsure of his judgment, and had at least implied the existence of some risk for sterling in any firming of U.S. monetary policy. Mr. Daane was not sure of his judgment either, but was inclined to take a somewhat less optimistic view. In any case, a firmer policy in this country certainly would not help the position of sterling.

On the domestic side, Mr. Daane said, he agreed with Mr. Galusha's characterization of the atmosphere in financial markets as "apprehensive." Against that background, the consequences of any step that appeared to involve further firming--even if it were described as a "modest" move--were likely to run far beyond the intentions of those advocating it. Thus, on both international and domestic grounds, he would favor standing fast with respect to policy over the period immediately ahead.

On the directive, Mr. Daane said he had to confess to being a bit puzzled. At the previous meeting Mr Galusha had said that his (Mr. Daane's) reasoning involved a non sequitur, and perhaps it had. After further reflection he had concluded that the real difficulty arose in the attempt to spell out, within a relatively brief first paragraph, the reasoning underlying the Committee's policy decision. Within reasonable limits it was perfectly appropriate to recognize any substantial changes in the factual description of the situation but, because of the difficulties in attempting to satisfy everyone the Committee was likely to make its meeting intolerably long if it tried to spell out all the reasons for its policy decision.

Accordingly, Mr. Daane continued, he would temper his desire to suggest changes in the staff's draft. He agreed completely with Mr. Irons that the existing uncertainties were the primary reason for not changing policy today and, if the Committee was to explain

the basis of its policy decision, that those uncertainties should be highlighted in the first paragraph. As to the second paragraph of the draft, he disliked the final phrase, which read, "while taking into account the unsettled conditions in securities and foreign exchange markets." That construction implied that unsettled conditions were merely something for the Account Management to keep in mind; but as he sensed the Committee's views they were the major reason for the policy decision itself. Accordingly, he proposed replacing the words, "while taking into account" with the words, "and to take into account."

Mr. Maisel said he concurred with most of the observations that had been made, and would comment briefly only on a few points. He was somewhat concerned because the word "buoyant" was being treated as having an unfavorable connotation. He would be happy to see the economy become more buoyant under present circumstances, with less than full utilization of resources and with final demand growing no faster than capacity. There had been some reduction in the unemployment rate but primarily as a result of the inventory buildup; there was no indication that final demands had risen to appropriate levels. He agreed that demand would start moving up now as a result of Vietnam, and there was a possibility that it would move fast enough to offset the expected moderation in the rate at which inventories had been growing. But that expectation did not provide grounds for a basic change in policy, and he favored no change between now and the next meeting.

His second point, Mr. Maisel continued, concerned the long-term bond market. One reason for the prevailing uncertainty was that the market was unsure of the Committee's policy. The Committee should not accept the market's uncertainties as a given datum and reason for action. Instead, it should help to resolve those uncertainties, and reduce speculative expectations, by operating in the long-term market in a manner that would make its intentions clear. In short, the Committee ought to set the market straight.

Mr. Maisel said that he would accept alternative A, as drafted by the staff, for the directive. In his judgment the Committee would get into a great deal of difficulty if it tried to make extensive revisions around the table.

Mr. Hickman remarked that business news since the previous meeting of the Committee had been generally favorable, but the major question of whether or not the economy would continue to move upward in a balanced and orderly way remained unresolved. The sharp increase in the production index in July was unsustainable, and little further gain could be expected in August. Autos were unlikely to contribute further to gains in industrial output this year and a downdrag from steel would have to be faced. Defense spending would provide a countervailing boost to the economy, but its contribution to aggregate demand was indeterminate at this time.

A priori, Mr. Hickman said, the economy would seem to be closer to its potential than there had been reason to hope a month or

two ago, but even that was uncertain since the figures on the production potential were now being revised. The best bet now was that GNP would grow at an annual rate of $9 or $10 billion in both the third and fourth quarters, or about the same as the second quarter rate of gain. For the year, that would represent a gain of 6 to 7 per cent, in current dollars, which was the same as last year's gain.

On the price front, Mr. Hickman continued, recent information added little to what was known three weeks ago. Recent movements had been minor and there still was no evidence of general price inflation.

In the financial sphere, Mr. Hickman said, developments of the past week or two had been mixed. Speculation in the London gold market was reduced by news of Canadian wheat sales to Russia. The wheat sales should improve the Canadian trade balance, which should reduce the amount of the Canadian deficit that would have to be financed in the United States. Nevertheless, the pound sterling remained under pressure, and the U.S. corporate and Government bond markets remained nervous and unsettled.

Until visibility improved, Mr. Hickman observed, monetary policy should continue to be moderately stimulative, as it had been at most times throughout the current business recovery. In view of the uncertain outlook, he thought the Committee should take particular care at this time to avoid a gradual creep towards higher net borrowed reserves. The Manager was to be congratulated for coming

very close to what he (Mr. Hickman) thought was the correct target of $150 million net borrowed reserves during the past two weeks. On the other hand, the original estimates of net borrowed reserves had become suspect because of an almost uniform tendency during the past several months to revise them to deeper levels. In view of that observed bias, perhaps an initial target of something under $150 million, say $125 million, might bring the revised figures nearer the desired goal.

Mr. Hickman was not particularly happy with either of the two draft directives because neither stressed the elements of uncertainty created by the steel situation and Vietnam, and had been clearly pointed out by Mr. Irons and Mr. Daane. With minor modifications, however, he would accept alternative A, as interpreted by Mr. Ellis.

Turning to Mr. Swan's question about the possible rate of liquidation of steel inventories, Mr. Hickman said he now suspected that liquidation would be less than had been anticipated earlier. Nevertheless, he was inclined to agree with Mr. Mitchell that the economy might be on the verge of an inventory adjustment. But the size of actual inventories of steel and other products was not known accurately. Because of the inadequacies of available statistics, it was difficult to reach firm judgments on such questions and to shape monetary policy. As he had mentioned at an earlier meeting, the System could usefully devote some resources to improving the quality of inventory statistics.

Mr. Bopp reported that discussions during the past week with officials of Philadelphia banks had revealed that the voluntary credit restraint program was the primary factor limiting foreign lending. Two of the banks which were slightly above their ceiling because of prior commitments were refusing loan applications in order to get within the limit. Banks below the limit were cautious in making new loans because they had lines of credit outstanding to good customers and were uncertain as to the amounts those customers would take down.

The voluntary credit restraint program was also a limiting factor in more indirect ways, Mr. Bopp continued. One banker estimated that as much as 50 per cent of the foreign demand for bank credit from September 1964 to February 1965 had been in anticipation of future needs and that some borrowers, finding they had borrowed more than they needed, had made prepayments. Several bankers reported that the restraint program had resulted in banks being more selective in foreign lending, favoring loans with higher compensating balances and higher interest rates. One bank reported raising rates to new borrowers and another reporting turning down some European applicants because the rates were too low. A few of the banks were working toward a better balanced loan portfolio geographically by limiting further expansion in certain areas, notably Japan.

With respect to the recent rapid upswing in time deposits, Mr. Bopp said, Third District weekly reporting member banks reported a substantial 20 per cent increase in total time deposits, on an

annual rate basis, from mid-year through the first two weeks in August. As in the nation, about one-half of the total increase was accounted for by an expansion in negotiable CDs. Inasmuch as CDs typically carried a rate in excess of other time deposits, there was a tendency toward increasing pressure on banks to employ their funds in higher-yielding earning assets and perhaps some upward pressure on loan rates.

Turning to policy, Mr. Bopp said that recent developments offered diverse guides to action. Some factors would appear to weigh on the side of slightly greater restraint, notably the situation in Vietnam together with some apparent worsening in the balance of payments in August, a slight rise in industrial commodity prices, and industrial utilization reaching an estimated 90 per cent of capacity. On the other hand, the moment of truth in the steel negotiations was approaching with the possibility of some slack resulting from a run-off of inventories, either with or without a strike. That slack, combined with increasing capacity coming on stream each month as a result of record capital spending, should help counterbalance the events in Vietnam. It should also be noted that recent industrial price hikes were still of a selective nature, that revised data showed continued stability in unit labor costs, and that the August balance of payments figures were as yet incomplete. In addition, considerable nervousness and uncertainty existed in financial markets at this time. After weighing those several factors, Mr. Bopp would recommend that no change be made at present in the general posture of monetary policy.

Mr. Patterson commented that at the last meeting he had reported reduced gains in Sixth District income and employment and even some old-fashioned declines, especially in housing. Although the Atlanta Bank economists did not think a recession was in the offing, it had seemed clear to them that the pace of activity had slowed down in the District. On the basis of the most recent figures, that was still basically true. Of course, significant changes could not have been expected to have occurred, as it would take time for the increased commitment in Vietnam to have a measurable influence on the economy. With one of every seven members of the armed forces stationed in the District States, however, the impact could come fairly quickly.

The District textile industry had already been affected, Mr. Patterson said. The Reserve Bank directors reported that in recent weeks the Government had placed heavy orders for sheets, shorts, and towels. Even before that happened, textile activity was high, order backlogs were large, and skilled labor was in short supply. Defense procurement could tax capacity in that industry fairly quickly.

As far as Mr. Patterson could tell, the mortgage markets had felt little influence of the higher corporate and Treasury yields. The prevailing mood seemed to be one of caution, and some increase in FHA and VA discounts was widely expected. The biggest real estate

news has been the purchase of 3,000 acres of land, at a price in excess of $5 million, in Southwest Atlanta. The buyer planned to develop that land for a $400 million industrial and amusement complex patterned after the "Six Flags Over Texas Amusement Park" between Dallas and Fort Worth. In the long run, the more important event had been the announcement of a national corporation, Anaconda Aluminum Company, that it would start the production of aluminum in Georgia, using porcelain clay or kaolin. That development could well lead to the beginning of other aluminum operations in the State.

In examining the influence of the Vietnam situation on banking, Mr. Patterson said, one had the benefit of later statistics than for any other sector of the economy. There had been a step-up in consumer loans at major city banks. However, it would be premature to conclude that customers were about to rush out to buy automobiles and other durables because of impending shortages. The acceleration in consumer financing did not carry into other bank lending activities.

The basic reserve position of large banks in the District so far in August had been slightly tighter than in July, Mr. Patterson remarked. But it was still difficult to find any solid indication that the modification in Federal Reserve policy this year had held back the strong credit expansion at District banks.

Mr. Patterson concluded with the observation that it might be months before the full impact would be seen of the Vietnam situation,

the steel settlement, and the sterling crisis. In his judgment any change in Federal Reserve policy would be inappropriate at this time.

Mr. Balderston made the following statement:

The Committee's consensus on policy seems clear but the situations at home and abroad are quite unclear. Rising above the turmoil and confusion of the moment is the sickness of sterling. Its plight, for the moment at least, seems to dominate the conflicting forces that tend to pull the economy toward inflationary price rises on the one hand and cessation of the boom on the other. In view of the struggle to save the pound and of the continued uncertainty as to the steel settlement, I favor a continuance of the present policy. For the moment a steady posture seems to be indicated until the uncertainties diminish.

The underlying forces threatening instability still need to be watched constantly; the Committee might be called upon to make a decision without having as much information as it might desire. Threatening the stability of prices is the fact that the U.S. is engaged in war. Dr. Roland Robinson, a former Board staff member, discovered that in 25 of the first 44 years following the birth of the Federal Reserve System the consumer price index was reasonably stable, showing changes of less than 3 per cent. If one were to exclude the two world wars and the period of Korean hostilities, that standard was met in 24 of the remaining 31 years. The cumulative price changes during the nonwar years just about balanced out, leading Dr. Robinson to suggest that, without the influence of war, the price level at the end of that period might not have been far different from that prevailing almost a half-century earlier.

But once again we are in a war serious enough to disturb stability in the overall price level and to generate lop-sided price expectations. In short, war-time price expectations are biased so that the two-way movement of prices is replaced by movement in one direction only--and that upward. Consequently, the five-year stability in the prices of goods, though not of services, which has so aided U.S. export volume, is now threatened not only by the current steel negotiations but by the even more pervasive pressures of wartime.

Not to be forgotten is the increased spending planned by the Federal Government in connection with the war against poverty, as a supplement to the steady growth in State and municipal spending. That increased emphasis upon fiscal stimulus also affects price expectations.

> On the other hand, the inventory buildup that Mr. Noyes has stressed would properly be regarded as a threat to the continuance of cyclical expansion were the U.S. not at war. Eventually, the inflated volume of inventories must exert a braking effect upon the rate of production. For example, the production of autos has exceeded sales since last February.

Despite his concern about those underlying forces, Mr. Balderston added, the international problem seemed to be dominant at the moment and, as he had indicated, he would favor continuing present policy. Like others, he was not happy with the language of alternative A, the draft calling for no change in policy. He noted, for instance, that it contained no reference to the firming of prices. In his judgment prices had firmed; with few exceptions, the changes that had occurred had been in an upward direction. Unless the Committee chose to accept Mr. Shepardson's proposal for a more general revision of the first paragraph, three fairly small changes might be made. First, the words "with some firming of prices but" might be inserted in the opening sentence, after the statement that the domestic economy had expanded further, and before that relating to international payments. After the first sentence might be added the statement, "For the moment, international problems appear dominant." Also, he would strike the phrase "and to avoid the emergence of inflationary pressures" from the final sentence of the paragraph. If the Committee made no policy change today, it would not be acting for the purpose stated in that phrase; its present policy was permitting business loans and total bank credit to grow at rapid rates. As for the second paragraph, Mr. Balderston liked Mr. Shepardson's suggested revision.

Chairman Martin remarked that he was in complete agreement with the consensus that had emerged for no change in policy, and he had nothing to add to the observations that had been made. The directive the staff had drafted seemed to be less satisfactory this time than usual. He suggested the Committee attempt at this point to arrive at a directive that would be reasonably agreeable to a majority. To begin the effort, he proposed that Mr. Mitchell repeat the directive wording he had recommended earlier.

After Mr. Mitchell had done so, Mr. Daane commented that he found Mr. Mitchell's proposal unsatisfactory on several counts. For one thing, it implied that the economic advance was resting on inventory accumulation and was running out of steam. That might be correct but he did not think it represented the judgment of a majority of the Committee. Moreover, there were no references to price developments, or to the implications of Vietnam. He was not sure that the Committee should try to use the first paragraph of the directive as a substitute for the text of the policy record entry. but if it was to make the attempt a more balanced statement seemed to be called for.

Chairman Martin then remarked that it might be desirable for the staff to attempt to develop a new draft of the directive on the basis of the comments that had been made this morning on the original draft. He proposed that, while this work was in process, the Committee move into executive session to discuss a memorandum dated today that

had been distributed to Committee members and other Reserve Bank Presidents, entitled "Contingency Planning for the Government Securities Market."

Thereupon, all members of the staff left the meeting except Messrs. Young, Holmes, and Sanford. Mr. Balderston summarized the contents of the memorandum that had been distributed, following which there was general discussion of the actions that might be appropriate under various possible contingencies.

Chairman Martin then suggested that the Committee members be prepared for the possible necessity for holding a meeting, either by telephone conference or with all participants in Washington, in the interim before the meeting tentatively scheduled for September 28, 1965. There were many uncertainties existing at present, he noted, and the interval between today's date and September 28 was relatively long.

Following the executive session the regular meeting resumed and Mr. Young read two new alternative drafts of the directive that had been prepared by the staff. After further discussion, a consensus emerged in favor of the shorter of the two alternatives.

> Thereupon, upon motion duly made and seconded, and with Mr. Treiber 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:

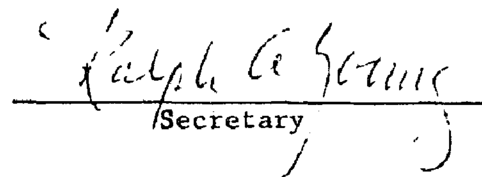
The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, but with markets characterized by uncertainties as to possible developments in steel, sterling, and Vietnam. Our international payments have reverted to deficit in August, and gold outflows have continued, although at a more moderate rate. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account unsettled conditions in securities and foreign exchange markets.

In explaining his dissenting vote, Mr. Treiber said that he agreed that caution was necessary in view of the existing uncertainties in the bond and foreign exchange markets. He continued to feel, however, that it was desirable for the Committee to make a further slight move toward a somewhat lessened degree of credit availability at present, recognizing that in the prevailing conditions any such move must be made with caution. In his judgment such a policy decision would not have an undesirable effect on the position of sterling.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 28, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

August 30, 1965.

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on August 31, 1965

Alternative A (no change)

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, our international payments have reverted to deficit in August, gold outflows have continued, and uncertainties persist in securities and foreign exchange markets. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next four weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks, while taking into account the unsettled conditions in securities and foreign exchange markets.

Alternative B (firming)

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further, business sentiment has become buoyant, some prices have been under upward pressure, bank credit expansion has been vigorous thus far this year, and Federal expenditures are expected to increase in the months ahead as a result of the hostilities in Vietnam. Our international payments have reverted to deficit in August, gold outflows have continued, and uncertainties persist in securities and foreign exchange markets. In this situation, it is the Federal Open Market Committee's current policy to move further to strengthen the international position of the dollar, and to counter the emergence of inflationary pressures, by moderating somewhat the pace of growth in the reserve base, bank credit, and the money supply.

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 unsettled conditions in securities and foreign exchange markets.