

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington on Tuesday, July 9, 1963, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Halderston
Mr. Bopp
Mr. Glay
Mr. Irons
Mr. King
Mr. Mills
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Shepardson

Messrs. Hickman, Wayne, and Shuford, Alternate
Members of the Federal Open Market Committee

Messrs. Ellis, Bryar, and Deming, Presidents of
the Federal Reserve Banks of Boston, Atlanta,
and Minneapolis, respectively

Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Hexter, Assistant General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Eastburn, Furth, Garvy,
Green, Holland, Koch, and Tow, Associate
Economists
Mr. Stone, Manager, System Open Market
Account
Mr. Coombs, Special Manager, System Open
Market Account

Mr. Molony, Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and
Statistics, Board of Governors
Mr. Yager, Chief, Government Finance Section,
Division of Research and Statistics, Board
of Governors

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Mr. Hemmings, First Vice President, Federal Reserve Bank of San Francisco
Messrs. Mann, Black, Rawlings, Parsons, and Grove, Vice Presidents of the Federal Reserve Banks of Cleveland, Richmond, Atlanta, Minneapolis, and San Francisco, respectively
Mr. Willis, Economic Adviser, Federal Reserve Bank of Boston
Mr. Sternlight, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Bowsher, Assistant Vice President, Federal Reserve Bank of St. Louis

Before this meeting there had been distributed to 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 June 18 through July 3, 1963, together with a supplementary report covering the period July 5 through July 8, 1963. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs discussed current and prospective developments with respect to the U. S. gold stock and the situation in the London gold market. As to the exchanges, he noted that there was currently a brief breathing spell following the termination of midyear window-dressing operations by foreign banks. However, the dollar was generally weak across the board.

Mr. Coombs then described System operations in support of the dollar against the German mark, for the purpose of which the System had now drawn to the full extent of \$150 million under its swap arrangement

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with the German Federal Bank. He also noted prospective Treasury operations in this area. Turning to the guilder, Mr. Coombs noted a pending development that might provide more scope for purchases of guilders on the market by the Federal Reserve, possibly enabling some progress in repaying System drawings under the swap arrangement with the Netherlands Bank.

Mr. Coombs reported that the central bankers in attendance at the latest monthly meeting of the Bank for International Settlements seemed encouraged by the recent moderate rise in U. S. short-term rates. In all cases, they seemed to feel that a further rise would have beneficial effects from the standpoint of the exchange markets. Nearly all of the central banks represented at the meeting were strongly tempted to employ credit restraint to deal with inflationary trends at home, but were holding back out of deference to the U. S. balance of payments position. The exception was France, where tight money conditions seemed to be pulling in a great deal of short-term money, mainly through the Euro-dollar market.

More generally speaking, Mr. Coombs said, central bank resistance to financing of the U. S. balance of payments deficit seemed to be stiffening, and in this respect he reviewed the situation in several countries. If firm central bank resistance should materialize, U. S. gold losses no doubt would rise rapidly in the second half of this year. In concluding his comments, Mr. Coombs expressed the view that the dollar had become seriously vulnerable.

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Thereupon, upon motion duly made and seconded, and by unanimous vote, the System Open Market Account transactions in foreign currencies during the period June 18 through July 8, 1963, were approved, ratified, and confirmed.

Mr. Coombs noted that the \$50 million swap arrangement with Austrian National Bank would mature July 24, 1963, while the swap arrangements with the Bank of France and the German Federal Bank, in the amounts of \$100 million and \$150 million, respectively, would mature August 6, 1963. He recommended renewal in each instance for a further period of three months.

Renewal of the three swap arrangements, as recommended by Mr. Coombs, was approved unanimously.

Mr. Coombs also noted that a \$25 million equivalent drawing of marks under the swap arrangement with the German Federal Bank would mature August 6, 1963, and he recommended renewal for a period of three months unless the System was able to effect repayment in the meanwhile.

Renewal of the drawing, if necessary, was noted without objection.

This concluded the consideration of System foreign currency operations.

Before this meeting there had been distributed to the members of the Committee a report covering open market operations in U. S. Government securities and bankers' acceptances for the period June 18 through July 3, 1963, and a supplementary report covering the period

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July 5 through July 8, 1963. Copies of these reports have been placed in the files of the Committee.

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

The past three weeks have been particularly active ones. At the outset of the period it was clear that very substantial amounts of reserves would have to be provided in order to offset heavy seasonal drains of funds from the banking system. Our problem, as we then saw it, was how to put perhaps a billion dollars into the market without exerting significant downward pressure on short-term rates. Through June 28, a week ago Friday, we had supplied about \$750 million of reserves with very little impact on prices and rates. Treasury bill rates were virtually unchanged, while a few intermediate issues were up two or three thirty-seconds. Interest rate expectations were also little changed from those that emerged around mid-June, after the System's policy move of May had been digested by the market; that is, the market was anticipating that rate levels would tend gradually upward over the months ahead with an expected further improvement in business activity. The possibility of an increase in the discount rate was discussed and evaluated, but that possibility was regarded as rather remote, and there was no significant body of opinion that such a move might come soon.

On Monday, July 1, however, both of the market letters that came out that day asserted with some emphasis that an early increase in the rate, to 3-1/2 per cent, was by no means a remote possibility, and indeed one of the letters ventured the view that the rate would be raised before the end of this month. This was followed the next day by a press article to the same effect by the same author. The round of rate discussion set off by these articles gathered force against the background of the \$65 million gold loss of the preceding week and particularly against the background of the statements on monetary matters made by the President on his European trip--- statements that were apparently construed by many as hints that the Administration was planning to take more forceful measures to deal with the balance of payments.

Rates began to adjust, and by the close last Friday three-month bill rates had moved up to the neighborhood of 3.10 per cent. After the close that day, the market learned that

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the free reserve figure for last week had fallen to below \$100 million--although it was generally understood that the low level was associated with the large downward revision of the previous week's free reserves. Yesterday morning the market once again read market letters that, particularly in one case, pointed to an early increase in the discount rate. And throughout the day yesterday the market read ticker reports of Secretary Dillon's testimony before the Joint Economic Committee, in which he spoke of the possibility of a rise in short-term rates.

It was in this expectational setting that the market approached yesterday's bill auction. While there was not a great deal of selling by investors, there was very little buying interest since it was almost universally felt that more attractive rates would soon be available. Rates thus moved upward to close to 3.20 per cent in the auction itself, and immediately following the auction outstanding bills moved up to the neighborhood of 3.20 per cent also. In conversations with the market late yesterday, I was informed that dealers will very likely approach today's auction of one-year bills with a view to bidding a rate that will give them an equivalent bond yield of at least 3.50 per cent or higher, thus protecting themselves against what many consider the likelihood of a 3-1/2 per cent discount rate in the near future.

While bill rates were moving up, yields in the intermediate and longer sectors were rising also. In the intermediate market, the increases amounted to 10-15 basis points for most issues, while in the longer end the increases generally amounted to 4 or 5 basis points. Thus far, I should add, yields on corporate and municipal obligations have been little affected by the rise in yields on Treasury issues.

Turning briefly to future Treasury financing, about the only thing that is certain is the forthcoming refunding of the August 15 maturities, the terms of which are scheduled to be announced on July 24 or 25. The Treasury had tentatively planned to do some cash financing in late July, as well as to raise additional cash in today's one-year bill auction; but its cash position is unexpectedly large, and it may decide to defer any new cash financing until August, either as a part of the refinancing or in a separate operation later that month.

I should like to return briefly to the free reserve statistics published last week. Last Friday morning our calculations showed that the free reserve figure for the week ended Wednesday was \$177 million. Shortly after 11 o'clock

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on Friday we discovered that \$85 million of that figure had been cut away by a revision in country bank required reserves dating back to the week ended June 26. I should like to note that if we had available daily reserve data from country banks--or from a significant sample of such banks--we could quickly catch the kind of bad estimate that led to so large a revision in the figures last week. I would hope that the study now going forward on this matter could be accelerated.

I suggest that the leeway for changes in the Account be continued at \$1.5 billion for another three weeks to allow for the reversal of the seasonal factors that gave rise to the recent heavy purchases--which, as you know, exceeded \$1 billion.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period June 18 through July 8, 1963, were approved, ratified, and confirmed.

Chairman Martin then called for the usual staff economic and financial reports beginning with Mr. Koch, who presented the following statement on economic developments:

The economic information that has become available since the last meeting of the Committee seems to me to support the general view expressed then, namely, that economic expansion has slackened somewhat, whether it be due to the usual summer doldrums, the cutback in steel inventory buying, or some other reasons. Business continues good, but does not appear to be moving up very rapidly; and sentiment, which still is quite cheerful, is a little less buoyant than it was in the spring.

I reach this conclusion regarding the current economic situation even though new data on a number of key areas are encouraging. Construction activity, for example, increased further in June, sparked by another record high in residential building. Apparently the President's anti-segregation actions in the housing area have not yet dampened home construction. The rate of unemployment was down slightly in June. It continues, however, within the narrow, high range where it has been fluctuating now for a year and a half. Our industrial

production index for June is likely to be up a little, or at least unchanged, with the effects of a decline in steel output on the index being about offset by those of a temporary rise in auto assemblies.

Over-all accumulation of business inventories slackened in April and May despite the accelerated stockpiling of steel. With new orders for steel having receded sharply for well over a month now, however, appreciable reduction in the rate of steel inventory accumulation is in prospect, if it has not already begun. It is still uncertain how much steel inventory will be liquidated, how long the adjustment will last, and how it will affect the general economy. On balance, however, the liquidation is not likely to be a major disrupting force in the economy. Users have apparently not built up as large inventories as last year, and the consumption of steel has risen markedly. As a result, even with the recent build-up in stocks, inventory/sales ratios in steel fabricating industries are still rather low by historical standards, although in evaluating the adequacy of the current level of these inventory/sales ratios one must allow for their longer-run general downward drift.

Incidentally, the fact that the recent steel settlement involved smaller relative cost increases for the companies than settlements in earlier years increases the possibility of avoiding price pressures from the cost side in this, and possibly in other durable goods industries. The steel wage settlement removed one uncertainty in the labor area, but another important one remains with the continuing lack of progress in the important rail negotiations.

In contrast to those of steel producers, new orders of other durable goods manufacturers rose a little further in May. New orders as a whole continued well above sales, and as a result, unfilled order backlogs increased further. At the end of May, the durable order backlog was almost 10 per cent above the recent low reached last December.

New domestic auto sales also slackened a little in June and were at a seasonally adjusted annual rate of 6.9 million cars as compared with the 7.3 million rate that had been characteristic of the earlier months of the current model year that began last October. Total retail sales were disappointing again in June, and have changed little now for four months.

The latest consumer attitude surveys, those taken by the Survey Research Center at the University of Michigan in May, and by the Sindlinger Service more recently, are reasonably consistent with the lagging retail sales figures. They show some slackening in buying plans for durable goods from earlier

advanced levels, as well as reduced consumer confidence about economic prospects. The surveys suggest that consumer buying of durable goods may not soon resume its earlier brisk advance unless income expands more rapidly. Other evidence supporting this conclusion includes the recent above-average relationship between consumer spending and disposable income and the increased share of personal income needed in recent months to repay instalment debt.

Announcements of price rises, which had been fairly numerous in April and May, have been relatively few recently. The weekly index for industrial commodity prices was little changed in June, but its coverage of fabricated materials and finished goods is small.

As to the relevance of recent economic developments taken as a whole to the likely future course of the economy, most observers still expect further economic expansion later this year and on into 1964, but some of the bloom may be off the forecasts. In the first place, progress on the tax cut has been slow. Although some cut is still widely anticipated, its effective date is not expected before the beginning of 1964, and its magnitude is likely to be less rather than more than that proposed by the Administration.

Second, the recent slackened rise in consumer and Government spending means the greater likely dependence of further economic expansion on business expenditures for plant and equipment, an area of spending particularly difficult to predict. Business capital spending actually declined in the first quarter, but most observers still look for increases throughout the rest of this year and into 1964, in part as a result of the lagged effects of the new depreciation guidelines and the investment tax credit. New capital appropriations of large manufacturing companies in the first quarter of the year, the latest data of this kind available, were down sharply from the fourth quarter of last year, but that quarter was unusually high. Appropriations generally precede spending by from six to nine months. Thus, evidence to date, taken as a whole, suggests that the further rise in business capital expenditures is likely to be moderate and gradual.

Mr. Holland presented the following statement on financial developments:

It is obvious that market events of recent days have created a special problem for the Committee in its deliberations today. A sizable proportion of financial market

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participants are probably now operating under the assumption that Federal Reserve policy is in the process of becoming more restrictive. A variety of reasons have contributed to this construction, as Mr. Stone has outlined in some detail. This was undoubtedly one of those times when the whole was greater than the sum of its parts; that is, the seemingly corroborative nature of several separate occurrences produced a combined impact on market attitudes a good deal sharper than they would have generated in isolation. Events culminated yesterday in the sharpest rise in 3-month bill yields in three years. The frequency of daily rate changes of this size in the years before 1961, however, is a reminder of the money market's innate ability to generate such fluctuations--and to weather them. Long-term rates, meanwhile, have moved up relatively little. The result has been to create a quite artificial current yield curve--one so flat as to be of doubtful viability, in the absence of strong official action to prop up this short rate level, and perhaps also to hold down long rates.

The consequences of these recent developments are already spreading beyond the money market proper. As midyear approached, we began to hear of apparently sizable bank sales of Government securities--including bills--to raise cash to meet reserve requirements. In New York and Chicago city banks alone, such sales totaled \$316 million in the week ending July 3. In the face of the sharp bill market drops on Friday and Monday, however, we have since heard that some of these selling programs may have been temporarily shelved.

In a sense, some bank divestment of Government securities should be regarded as appropriate at this stage, although the abruptness of the latest developments in this respect can give one pause. Up until the last few days, the banking system had shown remarkably little response to the modest lessening of ease introduced by the System after mid-May. Indeed, total bank credit, seasonally adjusted, jumped \$4.6 billion in June, up from its more moderate pace of expansion earlier in the spring. Little of this pick-up occurred in the types of loans most directly associated with production and consumption; the combined total of business loans, real estate loans, farm loans, and consumer loans continued to grow more or less at the same rate as before. The June bulge rather reflected a big addition to Government securities holdings, partly associated with subscriptions to the 4 per cent bonds of 1970, and substantial acquisitions of municipals. Along with these operations in the market came a sizable but presumably partly temporary demand for securities loans, which banks also accommodated. Banks sustained this asset

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increase and accompanying deposit expansion for a time by paring their excess reserves and by borrowing somewhat more from the Reserve Banks. The public, for its part, also held bank deposits high, partly by acting to replenish demand balances drawn upon to make net payments to the Treasury. Consequently, as our staff memorandum shows, required reserves against private deposits held close to the guideline throughout the past month. On average during June, both money supply and time deposits rose moderately further, capping a second quarter advance that amounted to annual rates of growth of 2.4 per cent and 10.6 per cent, respectively.

The big bank deposit accruals during June, of course, centered in Treasury accounts. They were fed chiefly by a combination of smaller than expected budgetary expenditures and bigger than expected proceeds from the sales of the 4 per cent bonds. The \$11 billion cash balance with which the Treasury finished 1963 is so large, and its advance refunding of late 1963 maturities has already proceeded so far, that the debt managers face one of the lightest dollar totals of July-December financing needs in recent years. Two implications for monetary policy should be pointed out. The Treasury will be putting less upward pressure on interest rates and providing less expansive impetus to the banking system in the months ahead--considerably less than was thought likely even a few short weeks ago. As a corollary, the Treasury will also be in a position to adapt its policies to provide somewhat more room for monetary policy maneuver than we are ordinarily accustomed to in the second half of the year. As a concrete example, after the one-year bill roll-over today the Treasury has no need, from a cash point of view, for approaching the market until its end-of-July arrangements for the usual August refinancing. If in fact the Treasury sells another bill strip in the interim, it will be for its interest rate effect; and such a sale can more easily be adjusted to make room for a Federal Reserve policy change.

Whatever course of action the Treasury chooses, it is likely to run down its cash balance considerably more than seasonally during July. This should have the effect of bolstering private deposits. Such a result may well turn out to be a fortunate one, because it can provide some offset to the contractive effect on private deposits and liquidity that may well result from recent and prospective bank sales of assets for adjustment purposes.

A part of this indicated bank asset disposition is in reaction to the higher level of borrowings that materialized in the past six weeks. Reports indicate the higher average level of Federal Reserve advances has involved a substantially larger number of banks, and some for larger amounts than before. There are thus far no more than the beginnings of signs of repetitive borrowing by banks, of the type that might in time call for a rise in the discount rate to reinforce the discipline of administrative standards.

The key question that arises out of all these domestic financial developments is whether or not policy should permit a market move back to something like the status quo ante, or whether it should now be made an additional notch less easy, taking advantage of current developments in order to render more permanent the greater tension that has inadvertently come into the money market and the banking system in recent days. This latter tactic, you will recall, was used with considerable success in the policy change last December. On that occasion, however, the tightening influence grew essentially out of a natural market tendency toward accelerated credit expansion. The present situation, in contrast, has developed in important part from market expectations of a marked change in policy. With rate relationships in the debt markets more vulnerable, and the banking system appearing already to be in the throes of some adjustment of its asset alignment, the immediate concern would seem to be to guard against a cumulative reaction developing in either area.

Even if the situation in the banking system itself were not calling for lessened monetary ease, one might find developments in the nonbank financial structure of a type that could constructively be offset by greater pressure on the banking system proper. But the latest round of statistical reports on other financial sectors do not suggest this. The latest adjustments of credit conditions in these sectors seem to be taking more the form of lower money costs, or more widespread customer accommodation at conventional ceiling maturities and other terms, rather than much further liberalization of maturity and loan-to-value ceilings.

There is a still wider horizon of considerations, of course, that must affect the ultimate choice of a current monetary policy. But I think it is fair to say that the situation within the domestic financial sphere would benefit from a steady central bank hand on the tiller at this juncture.

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Mr. Furth presented the following statement with respect to the balance of payments:

On the basis of the fragmentary weekly data, the payments deficit for June is tentatively estimated at less than \$200 million. This would be about 40 per cent lower than the April-May average; but the decline was partly seasonal, and it still leaves the second quarter total in the neighborhood of an annual rate of \$3-1/2 billion, about the same as the seasonally adjusted first quarter rate and as the total for 1962. Net gold sales still remained unusually small; even if Friday's gold sale to France were put into the second quarter figure (where it belongs for purposes of economic analysis), total sales for that quarter would barely exceed \$200 million. But in assessing this figure it should be remembered that the net short foreign-exchange position under System swaps was enlarged in that quarter by \$100 million, and that the Treasury borrowed another \$100 million in foreign currencies; in the absence of these System and Treasury operations, a significant portion of those amounts would presumably have been financed by larger gold sales.

On a seasonally unadjusted basis, the payments deficit apparently rose about \$100 million between the first and the second quarters. Our trade surplus (for which only figures through May are available) increased by perhaps \$500 million, and the outflow on long-term security transactions was reduced by \$150 million; thus, there must have been a deterioration on all other accounts of about \$750 million. Net government expenditures abroad, which were relatively modest in the first quarter, probably rose somewhat, but this rise at most accounted for a small fraction of the difference. There is no reason to assume a significant reduction in our surplus on service transactions or a significant rise in our outflow on direct investments; the bulk of the difference must, therefore, be found in bank lending to foreigners, other outflows of short-term capital, and "errors and omissions."

Actually, bank-reported claims on foreigners rose in April and May by a quarterly rate in excess of \$500 million, in contrast to a reduction of nearly \$100 million in the first quarter. This would leave a balance of \$100-\$200 million attributable to other short-term flows, including unreported movements reflected in the "errors and omissions" item of the balance of payments.

Part of the change from the first quarter reflected the cessation of inflows rather than an increase in outflows. The

U. S. payments position no longer profited from the reversal of year-end window-dressing, the repayment of a large Japanese bank loan, the interruption of flows to Canada because of political instability, and the inflow from Britain due to uncertainties created by the failure of the Common Market negotiations. Nevertheless, in the second quarter short-term capital movements seem to have accounted for a larger part of the deficit than in the earlier period.

At first glance, this development seems reassuring. First, since our deficit basically represents an exchange of liquid reserves for illiquid foreign assets, and since short-term claims on foreigners are less illiquid than other foreign assets, the U. S. net liquidity position deteriorated qualitatively less grievously than if the deficit had been caused by a reduction in our current surplus or by an increase in government expenditures or in private direct investments abroad. Second, and more important, since short-term capital movements are probably more directly influenced than any other payments item by changes in monetary policies, it would seem that it should be easier for the System to minimize these outflows than either to raise the current account surplus or to reduce private long-term investments.

Unfortunately, the problem is not quite as simple as we might wish. For the increase in the outflow of short-term funds occurred in a period in which monetary ease was slightly lessened and U. S. short-term rates were slightly raised, both absolutely and in relation to rates in important foreign financial centers.

In order to explain this paradox, we must try, in spite of the paucity of data available at this time, to present a tentative assessment of the composition of the short-term capital outflow (including bank term loans). This outflow was probably concentrated in five groups:

- (1) A rise in medium-term bank loans to foreigners;
- (2) A rise in bankers' acceptances for foreign account;
- (3) The flow of U. S. corporate funds into the Euro-dollar market;
- (4) An increase in money-market investments denominated in foreign currencies; and
- (5) An increase in "leads and lags" in commercial payments.

(I) Most of the medium-term bank loans to foreigners appear to have gone to countries such as Japan and Germany where interest rates are very much higher than in the United States; the difference is nearly 3 per cent for Japan and probably 1 to 2 per cent for Germany. Nothing short of a

substantial rise in U. S. rates or a substantial lessening of monetary ease could be expected to make such loans significantly less attractive to both lenders and borrowers.

(2) The increase in acceptance credits in part probably reflected the rise in U. S. foreign trade; in addition, there was a more than proportionate increase in acceptances for account of Japanese banks, which may be explained not only by the rate differentials between Japan and the United States but also by the restrictions on third-country financing in other centers, especially in London.

(3) The flows to the Euro-dollar market presumably respond to rate differentials in Euro-dollar and domestic dollar markets. But while the exact relationship between these markets is uncertain, there is some reason to believe that Euro-dollar rates tend, in the longer run, to move parallel with U. S. rates so that the differential need not significantly vary in response to small changes in U. S. rates.

(4) The flows to foreign money markets respond primarily to covered rather than uncovered rate differentials. But while uncovered differentials significantly narrowed between the U. S. dollar and the Canadian dollar and changed little between the dollar and the pound sterling, covered differentials moved against the U. S. dollar in both instances as the Canadian dollar rose from a forward discount to a forward premium and the forward discount on the pound sterling was cut in half.

(5) Finally, the movement of leads and lags probably reflected continuing if not increasing uncertainty about the future value of dollar, which induces foreign exporters to hedge against a possible further weakening of the dollar rate, quite apart from any outright speculation on dollar devaluation.

In cases (4) and (5), the movements of funds might well prove to be more easily influenced by a change in the psychological climate than by the strictly financial consequences of small variations in U. S. interest rates. Thus, the possible confidence effect rather than the arithmetic of rates and rate differentials might have to be given primary consideration in assessing the impact of U. S. monetary policies on short-term capital flows.

Chairman Martin noted at this point that Messrs. Robertson and Ellis had recently returned from European trips during which each attended

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the annual meeting of the Bank for International Settlements and also visited a number of the European central banks.

At the invitation of the Chairman, Mr. Robertson presented substantially the following comments:

First, let me say it was a most stimulating and enjoyable trip. We (Mr. Holland and I) were graciously received everywhere. In general, I was pleasantly surprised by the moderateness of the views expressed on the U. S. position, and the constructive nature of the comments received.

We visited London, Amsterdam, Copenhagen, and Stockholm, then the BIS annual meeting at Basle, and afterwards Vienna, Paris, and Frankfurt. We talked mostly to central bankers, but also to various officials of the Ministries of Finance, academic economists, officers of foreign commercial banks, and officers of American bank branches abroad.

Literally everyone we talked with emphasized the long-range strength of the U. S. economy--its competitive ability, its comparatively fine record of cost and price stability. This meant to them that our balance of payments problem was a relatively short-run, transitional thing that could be dealt with accordingly. Some put less emphasis on our unemployment problem than others, but it also was recognized.

Almost everyone recognized that the best policy approach to both our domestic and balance of payments problems was the stimulation of demand at home, with the aim of producing rising business activity and higher interest rates as a natural consequence. A good deal of optimism was expressed about the U. S. situation because of our good performance on the cost front, signs of improving business activity, and indications that a tax cut stimulus is coming closer to reality.

When it came to policy prescriptions, views differed as to (a) whether anything more needed to be done on the policy front to fill in during the transition period, and (b) if so, what should be done. The majority seemed satisfied that the best course was to push for improving business activity by maintaining monetary ease and making efforts to get the supplemental stimulus of a tax cut as soon as practicable. These included chiefly the British and Scandinavian officials, but also all of the academic economists we talked to in the various countries. Most of these also said pointedly that some observers, including perhaps the U. S. itself, put too

much weight on the balance of payments deficit and, especially, the ability of monetary policy to curtail it. They expressed the view that there was a fundamental distinction between a deficit on current account and a deficit on capital account--the former being bad, the latter being more in the nature of an investment in the future. Several, for example, volunteered the comment that they would rather be in the U. S. position than the Swiss position.

Some pointed out that monetary tightening in the U. S. would have several disadvantages. Not only might it slow down U. S. domestic activity, but any interest rate increases might also compel others to raise their rates. Several spokesmen maintained that if the U. S., U. K., and Canada together held their short rates in line--or even reduced them--the capacity of the Continent to receive funds was not large enough relative to the resources of these three countries to be a serious threat in the short run. To be sure, such movements could be of sufficient size compared to the size of the receiving country to partly offset any tightening of rates for domestic reasons to curb inflationary development. In this sense, higher interest rates in the U. S. could make it easier for France, Germany, and the Netherlands to raise rates to deal with their domestic problems; but it would make it harder for us to deal with our domestic slack, and would have little or no over-all benefit in reducing the capital outflow.

A second group felt that, even though the prospect over the longer run was favorable, something more needed to be done now to reduce the deficit in the near future. But this group fell into two camps. The restrictionists felt moderately higher interest rates might not do a great deal to slow us domestically, but neither would they reduce the capital outflow. They would not mind higher rates, but for real effectiveness they favored direct controls--usually at least on new capital issues in the U. S. market, but sometimes also on foreign lending by U. S. banks. Actually, they seemed to be bothered mostly by direct investments by U. S. corporations abroad (a number of striking examples were cited to us); still, no one (with one possible exception) seemed prepared to recommend any direct controls over direct investments at this time. In so far as controls over loans and capital issues are concerned, these people suggested they were feasible in the environment of Europe and would be accepted there, not as a sign of weakness but as a sign of determination on our part.

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But these restrictionists were in the distinct minority. Each had at least one colleague who felt differently--favoring some action to dampen flows, but by general action rather than direct controls because of the inequities, leakages, and general inappropriateness of such controls for a key currency. Two who were outspoken on this point felt their own experiences with direct controls had demonstrated the unworkability of such controls over the long run. When we pressed them concerning the dampening domestic effects of tightening U. S. money policy prior to the achievement of better business, I was impressed with their inclination to choose to wait out the improvement in J. S. business, with whatever policy mix we thought we could manage, rather than jumping to direct controls in the interim.

The often-expressed view was that all that was needed was the start of a declining trend in our balance of payments deficit; with that, a change in market attitudes could be expected that would accelerate the reflow of dollars. Some even said that before many years we might be faced again with a dollar gap.

Clearly there exists some restiveness over increasing holdings of dollars at this juncture. Discussions tended to indicate a desire for more multilateral understandings; for example, on U. S. Treasury issues denominated in foreign currencies, on the desirability for the U. S. to make an IMF drawing, and on the need to harmonize gold reserve ratios. The "push" behind these ideas stems partly, I think, from the feeling that we (the U. S.) can manage to borrow more bilaterally than we can multilaterally (and I think that is right).

There also seems to be an increasing worry about the Continent and its inflation. But this worry has resulted in diverting some attention from the previous preoccupation with the U. S. balance of payments deficit. The concern with European inflation, however, did not extend to fear that it was getting out of hand. International competition and the application of governmental policies were generally expected to hold future price trends within not too unreasonable bounds. "Wage drift" and "creeping inflation" were the typical phrases applied to the current and prospective situation.

Every country other than France and Holland spoke out strongly on the need to move ahead with more economic coordination, for a whole variety of reasons. Most recognize that this means a tendency toward more uniform monetary policies in Europe, and some need to open up capital markets, at least to undertake net capital exports more freely. Most

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also recognize that this would eventually leave fiscal policy as the only governmental policy which could still be used very differently in different countries to deal with differing national situations. Therefore, most speak of the need to develop more flexible and responsible fiscal policy machinery. In this connection, Sweden has made real progress with its investment reserve program. In the interim, however, most European countries are now having to orient monetary policy more toward their own internal problems, and this seems to be making for a somewhat more sympathetic view of our own situation as well.

In conclusion, I can say that I found not one single bit of evidence among the officials with whom I spoke of lack of confidence in the basic soundness of the dollar, despite my efforts to draw them out in this respect. Some even suggested that much of the talk about the underlying strength or weakness of the dollar emanated from within the U. S. itself. While some countries may be holding more dollars than they would like to hold, no one expressed fears with respect thereto. One or two of the more candid of the dollar holders said they had no worry about dollar devaluation, for if we should ever devalue they would have to devalue, too, thereby avoiding any loss on their dollar holdings, but more importantly, thereby also negating any gain to the U. S. balance of payments position. Because they think the responsible officials in both the U. S. and elsewhere are wise enough to foresee these futile consequences of a U. S. devaluation, they feel sure it will not happen.

Of course, everyone recognizes that the U. S. cannot go on forever with a continuing deficit in our balance of payments, but there seems to exist an underlying confidence in the strength and competitive ability of the American economy which in the long run will carry us back to a suitable balance of payments position.

There followed a general discussion based on the impressions reported by Mr. Robertson, in the course of which Mr. Hayes--referring back to Mr. Robertson's statement that interest rate increases in the U. S. might compel other countries to raise their rates--said that in the case of one major country that Mr. Robertson presumably had in mind,

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Mr. Hayes had received a distinct impression from a high official that that country's rates would not necessarily follow ours upward.

Chairman Martin then turned to Mr. Ellis, who said that he concurred in many respects with Mr. Robertson's summarization as just presented, although there were naturally some differences in emphasis in their views. As an illustration, he would start with the observation that in the ten countries he had visited the primary concern quite logically was not with the U. S. balance of payments problem but with their domestic situations. The people with whom he had visited were concerned principally about the relationship of their respective countries to the United States insofar as the latter's problems affected their own economies adversely. The Scandinavians, for example, were anxious to continue to receive dollars to offset their current account deficits; they would regard seriously any interference with access to the U. S. capital market. On the other hand, the French and the Germans disliked the pressure on their internal markets occasioned by the inflow of capital and felt that the U. S. should take action to stem the outflow of capital.

Of the impressions that had remained with him longest, Mr. Ellis said, the attitudes toward gold were dominant. The French were concerned that their gold ratio was not as high as the ratio in some other countries. The possibility was suggested of a kind of gentlemen's agreement among central banks to the effect that they would

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not hold gold above a certain percentage of total reserves. In Holland, on the other hand, it was said that the holding of gold was a central bank duty and that there should be an agreement for a minimum holding of gold by each central bank. The Danes and others in Scandinavia had low gold ratios but liked them because they could invest dollars and earn on their reserves.

The concern expressed on an intellectual level throughout Europe, Mr. Ellis continued, was that the U. S. seemed to be warding off what was referred to by some as the discipline of the gold standard. There were some suggestions about the possibility of the U. S. going to the International Monetary Fund.

Mr. Ellis said that the principal difference he might have with Mr. Robertson's summary had to do with the matter of timing. It was true that the Europeans urged expansion in the U. S. that would help to resolve the balance of payments problem, but the technique they suggested seemed to envisage higher interest rates created by strengthening demands. They differed on how soon they would expect interest rates to rise in the U. S., but some seemed to expect that a rise should occur rather quickly.

Mr. Ellis indicated that he had detected a general lack of confidence that higher interest rates alone were going to resolve the balance of payments problem. Nevertheless, it was suggested that they would have some effect on short-term outflows. They would also have a

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psychological effect, by showing a willingness on the part of the U. S. to use monetary policy for balance of payments purposes. Likewise, it was suggested that a discount rate increase would strengthen the position of the U. S. Treasury when it attempted to negotiate further on financing the balance of payments deficit.

After expressing appreciation to Messrs. Robertson and Ellis for their presentations, Chairman Martin said that at this point-- prior to the usual go-around of views on monetary policy--he would like to make certain comments, not with a view to influencing anyone's position but with the thought of providing everyone as much information as possible. By way of introduction, he noted that some time ago, at a meeting of the Open Market Committee, there was a suggestion to the effect that it would be desirable to work toward a package deal, in which the Federal Reserve would participate, for coping with the balance of payments situation. At that time, the Chairman recalled, he had pointed out hazards that he felt might be involved from the standpoint of the position of the Federal Reserve System. Yet it must be recognized that there are two sides to every issue.

Since then, Chairman Martin continued, he had participated at the cabinet level in discussions of the balance of payments. One such meeting, held in late April, included participants from the Treasury, Defense, and State Departments, the Council of Economic Advisers, and the Bureau of the Budget. While there were no specific decisions, he

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thought everyone came away from the meeting with a conviction that the problem should not be allowed to linger indefinitely, that it would have a damaging effect on the business picture if it lingered indefinitely, and that it would have to be attacked on a broad front. He was careful at that time, the Chairman said, as in all discussions, to express only a personal point of view and to make it clear that he was expressing only his own personal views. He also made it clear that the Federal Reserve System retained the right of willingness or unwillingness to participate in any general program that might be evolved.

On June 10 there was another meeting with the President, toward the end of which he (Chairman Martin) mentioned that there were two schools of thought within the Federal Reserve System on the use of monetary policy in relation to the balance of payments problem. Personally, he told the group, he was convinced that monetary policy alone would not solve the problem. He also pointed out--and he continued to believe--that there was some similarity between the current situation and the days prior to the Treasury-Federal Reserve accord when arguments were heard that flexible interest rates would accomplish little or nothing, and that their use would be disastrous to the economy, and that even modest rate changes would have a dramatic impact. In his opinion the extreme positions, in either direction, were not sound. Today it was heard frequently that interest rates would be of little avail in

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dealing with the outflow of funds, yet in the past few years the treasurers of large corporations had become international operators. They were no longer going to sit by in the same way as 10 or 15 years ago, and the development of the Euro-dollar market to its present magnitude had been a reflection of these activities. He had told the meeting on June 10 that he questioned very much whether one could any longer be an isolationist with respect to interest rates any more than politically. In his opinion this was one of the factors in the over-all situation. Everything possible ought to be done on the military front, in the foreign aid field, and in other directions before any move was made toward direct controls or before sustaining a substantial loss of gold, and he would hope that monetary policy would make some contribution, at least to demonstrate whether it could have any significant influence.

As a result of the June 10 meeting, Chairman Martin continued, it was agreed to set up a working party to make an evaluation at the staff level without committing any of the principals, and with full understanding of the Federal Reserve's status. He had requested Mr. Noyes to represent him on this staff working party, which also included representatives of the Treasury, the Council of Economic Advisers, and the Budget Bureau. Copies of a paper prepared by that group under date of July 5, 1963, had been distributed to the members of the Open Market Committee on a confidential basis at the beginning of this meeting. This paper presented staff estimates of the effects

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on the balance of payments, on the domestic economy, and on the budget of a program that would include a rise in the Federal Reserve discount rate to 3-1/2 per cent; a target Treasury bill rate of 3-1/4 to 3-3/8 per cent; a Federal Reserve policy that would supply normal seasonal needs for reserves, plus normal reserve growth, through purchases of intermediate and longer term securities to the maximum extent possible; a debt management policy that would to the greatest feasible extent rely upon bill financing rather than issuance of intermediate- and long-term securities for meeting the Treasury's cash and refunding needs (the latter two points were designed to minimize adverse domestic impacts of the program); a rise in interest rate ceilings on time deposits sufficient to permit banks to continue to compete for such deposits in the face of rising bill rates; intervention, if necessary, in the foreign exchange markets to maintain as far as possible existing spreads between spot and forward rates; attempts to obtain the cooperation of other countries in pursuing interest rate policies that would be consistent with the objectives of this program and, to the extent possible, in persuading their banks to reduce their borrowing in the Euro-dollar market; and announcement of the program in a way that would make clear its limited objectives and avoid damaging effects on the interest rate expectations of asset holders.

Chairman Martin pointed out that he had not subscribed to the paper as yet. It was a staff paper, and it might not be approved by

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the principals. However, it represented an effort to bring together divergent points of view.

The Chairman then turned to Mr. Noyes, who commented that the working party had endeavored to look into the basis for varying estimates of the possible impact on the domestic economy and on the balance of payments of a change in the discount rate from 3 to 3-1/2 per cent. It was apparent that at least in part this difference was due to differing assumptions as to the ancillary conditions. After these assumptions were clarified, the working party devoted itself to a refinement and more formal restatement of them, and to an appraisal of the impact of a discount rate change under these special conditions. Basically, the group's paper concluded that, if successfully maneuvered, an increase of 1/2 per cent in the discount rate, and of about 3/8 per cent in the bill rate, without a reduction of credit availability and any increase in long-term rates would produce some not inconsiderable benefits for the balance of payments with only very moderate restrictive implications for the domestic economy.

In further discussion, Chairman Martin referred to testimony given yesterday by Secretary of the Treasury before the Joint Economic Committee in connection with a special study of the balance of payments, adding that copies of the Secretary's statement would be available after this meeting for any of the members of the Committee who might want to have them. The Chairman pointed out that the Secretary had consistently

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made it clear that any final decision on a matter such as a discount rate change was within the province of the Federal Reserve System. The Secretary, of course, could not conscientiously refrain from expressing his own best judgment. It was impossible to live in a vacuum, the Chairman said, but he thought it could not be alleged that pressure had been brought to bear on the Federal Reserve.

The Chairman noted that he had also caused to be distributed to the Committee copies of a memorandum marked "administratively confidential" from the Chairman of the Council of Economic Advisers to the President and Cabinet dated July 3, 1963, on the economy in 1963. He (Chairman Martin) emphasized that the distribution of this memorandum and of the staff working party paper was not intended in any way to urge anyone to change his position. They were distributed simply to supply as much information as possible.

As he saw it, the Chairman added, the problem was one of maintaining for the Federal Reserve System a proper degree of independence, while at the same time allowing it to have a role in the general policy-making process. He also commented that it was understood that the President might make a speech on the balance of payments later this month, in which reference presumably would be made to all of the various measures that would have been undertaken to deal with the problem. The President, he added, was without doubt as sincerely concerned about the balance of payments as anyone around the table at this meeting.

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

The fundamental conditions on which monetary policy must be based do not seem to have changed materially since our last meeting. The domestic economy has continued to move up and further expansion is likely, although there are some uncertainties in the outlook and the pace of the advance may slacken in the next few months. On the other hand, further heavy balance of payments deficits continue to undermine the international strength of the dollar, and the need for concerted and effective action to defend the dollar becomes ever more apparent.

On the domestic side there may have been some slight deterioration of business sentiment, partly reflecting uncertainty over the effects and timing of inventory readjustments in the wake of the steel settlement--also reflecting the usual summer letdown, some doubt about the strength of consumer demand, and concern lest the civil rights struggle have both direct adverse effects on business activity and indirect adverse effects by delaying a tax cut. While retail buying has been relatively sluggish on a high plateau, too much has been made, in my judgment, of the slippage of consumer sentiment indicated by the University of Michigan survey, since this and other surveys generally show buying intentions at a high level. Moreover, in contrast to the doubts about the consumer picture, the outlook for plant and equipment spending appears to be on firmer ground. For the first time, plans to increase outlays on plant and equipment are beginning to show up in the monthly series of new orders and contract awards. The housing picture continues to show greater strength.

Bank credit apparently expanded vigorously in June, and for the first half of the year as a whole credit growth has proceeded at the same brisk rate as in 1962. The money supply advanced in June, in spite of the exceptionally large build-up of Treasury deposits. There is some slight indication that New York banks' eagerness to seek new loans is being affected by concern over the extent to which they can hold on to certificates of deposit if the rates thereon, as limited by Regulation Q, begin to fall behind the rates on competing market instruments. Indeed, the outstanding volume of certificates of

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deposit of New York City and Chicago banks has already declined from the peak reached at the end of May.

Although very preliminary balance of payments statistics indicate some decline in the deficit from May to June, the second quarter report will probably be at least as unsatisfactory as that for the first quarter. From a longer perspective the fact stands out that, contrary to the experience during earlier cyclical upswings when offsetting changes occurred in the trade and capital accounts, in the current business expansion our balance of payments has been exposed simultaneously to larger imports and increasing capital outflows.

While there is no way of knowing just when the situation will become critical, the dollar has clearly reached a vulnerable stage. The forthcoming gold losses caused by French purchases will tend to unsettle the exchange markets, and there are increasingly ominous signs of apprehension and impatience among central bankers in Europe. It behooves us to demonstrate that progress is being made on the balance of payments front before this apprehension reaches crisis proportions. My associates and I have made a number of careful appraisals of recent short-term capital outflows and of the probability that a moderate increase in the discount rate and short-term market rates might materially affect these flows. I am impressed by the fact that the April-May aggregate of capital outflows in only three specific categories--acceptance financing of foreign borrowers, placement of time deposits in Canadian banks, and term loans by American banks to foreign borrowers--came to about \$550 million. For years there has been a heavy short-term drain, taking many forms, and it seems wholly reasonable to believe that an appreciable firming of short-term rates in this country would check the flow and might even bring a reversal. In addition, it could have very important psychological effects by signaling to our friends abroad, as well as to our own citizens, the determination of the System to maintain a strong dollar.

Accordingly, I would hope that the System would be prepared to take positive action as soon as possible in the form of a 1/2 per cent increase in the discount rate. I have no doubt that our directors will be prepared to do their part, as they have felt for some time that we should be giving greater emphasis to our international responsibilities. My present intention is to recommend action to our directors this Thursday.

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Against the background of the demand-supply situation existing in financial markets, and in view of the widespread expectation in these markets that a discount rate rise is a clear prospect, it is my belief that a prompt discount rate increase would have minimum undesirable domestic effects.

The rise in market rates over the past few days is such that a 1/2 per cent increase in our rate has been largely discounted, as indicated particularly by the market's expectation that the one-year bill today may be auctioned at a rate in the neighborhood of 3-1/2 per cent. This raises the question whether the customary even-keel considerations apply in these circumstances. Many, perhaps most, market participants anticipate that the change will be made this week, both because one-year bill auctions have come to be regarded as largely routine and because, as I just noted, today's auction has so substantially discounted a 3-1/2 per cent discount rate.

Indeed, if the rate should not be raised this week, there is some danger that investors would be enticed into committing funds being held off the market, with a consequent rate decline that in turn would be abruptly reversed if the rate should be raised on the 18th of July. It seems needless to subject the market to this kind of whipsaw and to the demoralizing effects of an additional week of great uncertainty.

Moreover, the rate increase of recent days has generated momentum that it would be unfortunate to lose. The positive impact abroad of the recent rise in our market rates would be strengthened and confirmed by early discount rate action. A week of delay could cause us to lose that momentum and could create abroad an impression of indecision. Finally, I should note that the testimony yesterday by the Secretary of the Treasury has helped set the stage for action this week.

As for open market policy, I should think any change in policy should be deferred until the discount rate is increased. It is hard at this juncture to gauge the degree of pressure required to make the discount rate move reasonably effective in its influence on the level of short-term market rates. In order to get a desirable degree of benefit in this respect from the discount rate rise, it would probably be well to try to achieve and then maintain a three-month bill rate of around 3-3/8 per cent to 3-1/2 per cent, and this might call for free reserves averaging less than they have and perhaps ranging from \$100 million down to zero. On

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the other hand, it is conceivable that the rate objective could be achieved with hardly any further reduction in free reserves--and certainly the Committee's aim should be to keep them as high as proves to be consistent with this rate objective.

Thus open market policy might well be used, following the discount rate increase, to offer reassurance to those who might fear a general tightening of credit all along the line. Expectational effects on long-term rates might be minimized by this means, as well as by use of swaps to whatever extent they may be practicable. Furthermore, it might be well to accompany the rate action with a statement that it is being taken solely for balance of payments reasons.

The directive might well be modified to indicate the Committee's willingness to lend open market support to the extent required to any discount rate action, if and when it may be taken by the System.

I should like to urge again that the Board of Governors consider increasing the interest rate ceilings on 3-month and 6-month time deposits under Regulation Q to 3-1/2 per cent and 3-3/4 per cent, respectively, leaving some substantial leeway above current market rates, and that this be done without reference to possible discount rate action--although, if such action is taken, a move with respect to Regulation Q would lend appropriate support to the major policy move.

Of course, monetary policy cannot be expected to solve the balance of payments problem alone; and I have strong hopes that the Administration will contribute other important elements in the near future to a concerted program, besides lending moral support to the System with respect to the discount rate action itself. From the important standpoint of maintaining the maximum practicable degree of independence of the System within the Government, I think it would be greatly preferable for the System to act in advance of, rather than after, any Administration announcement of a systematic attack on the balance of payments problem. Let me add that it is not necessary that we see clearly at this time the means of eliminating the deficit entirely. The dollar's position will be immeasurably strengthened if the country can demonstrate, abroad and at home, that it is embarking on a program that promises substantial progress along this path.

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Mr. Shuford said that after studying the various elements of the situation last week in preparation for this meeting, he had concluded that he would prefer no change in monetary policy at this time, with no change in the discount rate. This conclusion reflected mainly two factors. In the first place, he had some feeling that there had not been time fully to evaluate the effects of the recent policy shift toward a lesser degree of ease. Second, it seemed that there were considerable elements of uncertainty in the economy, including the steel situation and the railroad labor dispute.

In the past, Mr. Shuford continued, he had expressed the view that monetary policy had a role to play in connection with the balance of payments problem, that it had, in fact, played an appropriate role, and that it could continue to have some, although perhaps a short run, effect. On occasions he had questioned suggestions for changes toward lesser monetary ease, mainly because of the domestic economy but also because he had felt that any benefit from the balance of payments standpoint might be more or less temporary. Also, he had believed that there were other areas in relation to the balance of payments that were more fundamental and more important, and therefore deserved forceful attention. There was also the question of timing in considering changes in monetary policy in relationship to steps being taken in other areas. It now appeared, however, that those other areas were receiving active attention and that more forceful steps were being planned and would be

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taken. Accordingly, even though he was still concerned about the domestic economy, with its unutilized resources, and while he still felt that action in areas other than monetary policy was fundamental to correction of the balance of payments problem, he would subscribe to the general outlines of a policy such as set forth by Mr. Hayes. As he understood it, this would envisage an increase of 1/2 per cent in the discount rate and no substantial change in the thrust of open market operations until after the discount rate move had been made and the results could be appraised.

Mr. Bryan reported that the latest available statistics for the Sixth District were rather mixed. Employment was up, but manufacturing payrolls were down. Unemployment was up slightly, while retail sales continued sluggish at a high level. Personal income was up, along with bank loans and investments. In agriculture there had been some relief from drought. In general, it was his impression that the District figures did not show up as well as the national figures, but he was not certain that the difference was too significant. Similar variations between the District and national figures had been seen before, and they had ironed themselves out in due course.

From the national standpoint, it seemed to Mr. Bryan that the current figures exhibited strength, even though there was certainly no evidence of boom conditions. The inventory situation seemed to

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contain an element of strength; while inventories had been tending to increase, the ratio of inventories to final domestic takings had gone down. Meantime, the narrowly defined money supply was up about 3 per cent on a year-to-year basis. The total money supply, including time and savings deposits, was up 7.7 per cent, and liquid assets were up 7.8 per cent. Looking at the total picture, he had considerable optimism regarding the domestic business situation.

As far as monetary policy was concerned, Mr. Bryan expressed the view that the System was in a difficult situation. It was a matter of trying to reconcile elements that seemed almost irreconcilable. As to the balance of payments, he concurred in the view that the problem was indeed serious, perhaps almost of crisis proportions. The System was being called upon to consider attempting to remedy this problem in some degree through monetary policy, but he thought it was easily demonstrable that the problem had not been caused by the rate of monetary expansion in this country vis-a-vis the world. As to the domestic situation, the unemployment problem was properly a matter of concern. However, there seemed to have been a complete divorcement of value theory from employment theory, and unskilled manpower had been priced out of the market. Also, there seemed to be a tendency to bemoan the growth rate and overlook the fact that economic growth was being inhibited by factors such as longer vacations, shorter work hours, and the pouring of savings into a lot of things that would not stand the test of the market.

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Mr. Bryan went on to say that he had found appealing the reference at a recent meeting to "neutral" monetary policy. If monetary policy could assume a posture of neutrality in the present struggle of varying elements, that would have an attraction to him, but unfortunately he did not know that a definition of neutrality had quite been reached. Perhaps it would be signified by free reserve figures around the zero point, with some excursions into the free reserve category and at other times a dip into net borrowed reserves.

As to the discount rate, Mr. Bryan found himself uncertain as to the proper posture of the System at this time. A discount rate move probably would have considerable announcement effect and lead to charges that the System was preoccupied with the balance of payments problem in the formulation of monetary policy. Also, such an announcement might cause the market to anticipate further monetary actions. If a discount rate increase to 3-1/2 per cent had already been discounted by the latest spectacular developments in the short-term market, the System might be under some compulsion to make the new discount rate the effective market rate, and he was not sure how much in the way of open market operations would be required toward that end. On balance, Mr. Bryan said, his preference would be to let the System's operations in the supplying of reserves speak for themselves and then to follow with action on the discount rate.

Mr. Bopp said that there was little new to report from the Third District. The economy continued sluggish, and the difficulties

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that had been reported on previous occasions persisted. Over a long period the District had shown less growth than the national economy. It suffered more in periods of recession and gained less in periods of expansion.

Mr. Bopp went on to say that since the previous Committee meeting he had studied further the memorandum from Mr. Coombs on the position of the dollar and also had read the statement on liquidity and monetary policy presented by Mr. Young at the meeting of Working Party 3 of the Organization for Economic Cooperation and Development held in Paris on June 19, 1963. Because of their cogency, he would like to quote certain excerpts from Mr. Young's paper, one of which was as follows:

If bank credit had been less available and interest rates higher, capital spending would doubtless have been even less expansionary than it was. Considering the delicate and uncertain balance of expansionary forces and U. S. margins of unused capacity and manpower, the result might well have been a full-scale and deflationary recession in the U. S. rather than a slow expansion.

This was still possible, Mr. Bopp suggested, although Mr. Young's comments related to the situation in the past couple of years. Referring further to Mr. Young's paper, Mr. Bopp quoted as follows:

Unless demands are vigorous, rates can be raised only by reducing the supply of bank credit—possibly to the point of deflationary contraction in the volume of cash balances Firm action to reduce the internal supply of loanable funds in order to make foreign lending less attractive in the past year or two could have had an adverse effect on domestic spending, and if undertaken through a crash program

would have had serious repercussions on the domestic economy and in turn on the international economy. Surely a better way to reduce foreign lending is to foster domestic expansion so that the attraction of U. S. funds for external placement would be significantly reduced.... Recently, economic developments in the U. S. have been encouraging. If resurgence of expansive tendencies really carries through, impelled in part by tax reduction, gradual reduction in U. S. credit availability would be possible. In their duty to resist possible future speculative tendencies and keep U. S. industry competitive internationally, the U. S. monetary authorities may be expected to pursue policies less conducive to credit ease than in the last year. Some adaptation in policy toward less ease occurred near the close of last year, and further adaptation has taken place recently. Whether and when still further steps will be taken is at this point in time uncertain. Given our balance of payments problem, there would be no hesitancy in taking additional steps, if domestic activity was showing strong upward momentum, but we are too wary of economic forecasting to predict such strength now.... In my personal judgment, the monetary policy rein in the U. S. is probably more taut now than at the comparable stage of any earlier postwar cyclical expansion. There has recently been another pull on these reins by the Federal Reserve, reflected in a further decline in free reserves and some further reduction in money market ease. The Federal Reserve feeling is that it is operating in close contact with the market and that it need go through no special effort to make the market responsive to any change in its policy.

Mr. Bopp commented that he wished the recent shift toward lesser ease had not occurred, and he would not favor going further in that direction at this time. He would recommend a somewhat greater availability of reserves, with no change in the policy directive, recognizing that recently the market had been tighter than intended by the directive issued at the June 18 meeting. Neither would he recommend a change in the discount rate at this time.

Mr. Hickman commented that the flow of domestic business news continued to support the view that the economy was in an expansionary

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phase. New developments had been both on the favorable and unfavorable sides, but with the favorable definitely predominant. Reduction in steel activity was proceeding about as expected, with no reason to change the view, which he had previously expressed, that the economy was in a position to absorb the impact without serious disturbance.

By far the most significant development on the domestic scene since the previous Committee meeting, Mr. Hickman suggested, was the accumulation of strongly favorable news about construction activity and prospects. Both the housing starts series and Dodge construction contracts were at new highs. Starts in May were up 5 per cent from April and 9 per cent from a year ago, while construction contracts were up 21 per cent from a year ago. Recent gains had been impressive enough to dominate the large random element in these series. The construction sector of the economy, which had previously been regarded as giving little support to general business activity, now gave clear signs of becoming a strong plus factor. The manufacturing component of the construction contract series was particularly impressive, confirming the widely-held view that plant and equipment spending was in an upward phase.

Consumer spending remained strong, Mr. Hickman continued. Department store sales increased substantially in June. Auto sales declined, but remained at a very high level. The decline in June auto sales may have reflected some stiffening in dealer terms in anticipation of inventory tightness during the impending model changeover.

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The performance of the Fourth District economy in June was satisfactory. The drop-off in steel output had been orderly and moderate thus far. Auto sales had eased somewhat, but other indicators showed substantial improvement. Department store sales had continued to increase, and the unemployment situation to improve, even in the steel centers. In late June, the rate of insured unemployment was at its lowest level in nearly four years, and remained well below that of the nation. Electric power production in the District had continued to expand at a more rapid rate than nationally.

Loan volume and other assets of Fourth District reporting banks expanded sharply in June, with the gain in bank credit the largest in recent years. The bulk of the June gain occurred in bank loans, with all categories contributing. Deterioration in bank liquidity continued. The character and continuity of borrowing from the Cleveland Reserve Bank were causing some concern, and were beginning to create difficulties in the policing of the discount window at present rate levels.

As had already been reported, the most recent information on the balance of payments indicated that the second quarter record was at least as unfavorable as that of the first quarter. In addition to being disturbed by the over-all payments situation, Mr. Hickman was uneasy over reports of large outflows of long-term capital in excess of last year, and of increasing outflows of short-term capital. In his opinion, long- and short-term capital outflows were highly sensitive to interest rate

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differentials and excessive liquidity in the U. S. economy. The dollar had not been strong vis-a-vis foreign currencies, and official intervention in the foreign exchange markets was increasing. He was concerned over the possibility that tampering devices of the Federal Reserve and Treasury had misled the Open Market Committee by obscuring the seriousness of the deterioration in the country's international position. The seriousness of this situation stemmed primarily from large capital outflows, which were responsive to the policy of the Committee, and about which the Committee has done very little.

Insofar as policy over the next three weeks was concerned, Mr. Rickman believed that a shift was not only appropriate but long overdue. The domestic economy continued to move ahead and the balance of international payments to deteriorate. He would recommend moving immediately toward a higher term structure of interest rates. Further, he would favor an increase in the discount rate from 3 per cent to 3-1/2 per cent, effective as soon as feasible, and he was prepared to make such a recommendation at the July 11 meeting of the Board of Directors of the Cleveland Bank.

Mr. Mitchell expressed the view that this was a juncture when a major mistake could be made in the formulation of monetary policy. He would not in any sense impugn the tenor of the earlier remarks by Chairman Martin, which he thought had been properly stated. However, in view of public statements that had been made recently, it appeared

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that the Federal Reserve was placed in an awkward position. More than that, he was concerned about the System making a policy move and then finding itself charged with having plunged the country into recession. This would be damaging to the prestige and the independence of the System.

Mr. Mitchell said he continued of the view that the domestic economy was not as robust as its recent performance might indicate. There was ahead a period of two or three months in which the economy would have to absorb a shock from the change in inventory accumulation policy, particularly in steel. Also, consumer spending had failed to respond satisfactorily to rising levels of disposable income. For corroboration of his assessment of the economy, he referred to the staff economic memorandum distributed prior to this meeting, and to some of the matters discussed therein. For example, he interpreted the data on manufacturers' capital appropriations as discouraging, and the level of retail sales had remained substantially unchanged for several months. In summary, the domestic situation seemed to present a problem of timing from the standpoint of monetary policy. If a move were made at the moment, it might be found that such action had been taken right at the peak of activity. If so, it would be charged that the System's action was the straw that broke the back of the economic expansion. The only silver lining would be if it accelerated a tax reduction.

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Turning to the balance of payments situation, Mr. Mitchell noted that monetary policy admittedly had some part to play in relation to this problem. As he saw it, the proper role for monetary policy was in the area of trying to hold the line. It might stop some short-run outflow of funds, or encourage some short-run inflow. He did not suppose that many would subscribe to the use of monetary policy in a manner that would plunge the economy into recession in order to push down the price level. Mainly, it seemed to be a matter of buying time, while fundamental changes that had to be made to redress the balance of payments situation were accomplished. One of the things needed was a change in relative price levels, and the best hope here was inflation abroad, not contraction in the United States. A second thing needed was the containment of foreign aid and military spending overseas, and monetary policy could have no impact in those areas. A third thing needed was a change in the differentials in long-term rates. Here, the best hope was that the System would not have to move into this area. Actions such as suggested in the distributed staff working party paper would worsen the situation as far as long-term rates were concerned. While that paper might talk of a package deal, it appeared to him that the only organization making a real contribution to the package would be the Federal Reserve, and that actions suggested therein would involve only a postponement of the day of reckoning. It seemed to him that in a sense the issue was one between European socialism and free financial

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markets in the United States. In Europe, between cartelization and socialism, there were controlled market rates, and something of that sort apparently was being urged in the United States. For his part, he would like to insure the greatest possible latitude for the operation of free enterprise. For months efforts had been made to maintain the short-term rate and now the working party paper memorandum suggested pegging the long-term rate in a very complicated way. In his opinion such an operation was not realistic. He was willing to try to cooperate in any reasonable way. However, cooperation did not mean that the Federal Reserve ought to surrender its integrity and independence to further some proposition that seemed of doubtful workability.

Mr. King said he interpreted that what the System had been trying to do for some time was to help hold the line until more fundamental things could be done in respect to the balance of payments. Some steps had been taken, but the balance of payments was still in a bad position. In his view, monetary policy probably had made about as much of a contribution toward holding the line as it could without at the same time nipping whatever vigor had been shown in the domestic economy, which in his opinion was not robust. Mention had been made of subscribing to further monetary policy actions out of deference to the balance of payments problem, in view of what others were going to do. But in the distributed staff paper he could find evidence of nothing

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other than action in the area of debt management through limiting Treasury financing substantially to bills. In summary, he felt that the Federal Reserve had done quite a good job with the tools at its disposal, and considering its position within the Government. He doubted whether the System could do much more.

Mr. King indicated that as of today he would not be inclined to favor an increase in the discount rate, for he did not feel prepared to back up such a move with all of the measures that might then be required. He did not think that there had been nearly as much accomplished by other parts of the Government to deal with the balance of payments problem as could be done. For example, he was inclined to believe that fiscal policy might have more to do with causing funds to move abroad than any rate differential. Certainly rates had something to do with day-to-day movements, but he doubted whether higher interest rates at this point would provide any significant and lasting contribution to the over-all problem. While he would favor a tax cut, he considered it necessary that such action be accompanied by some reduction in governmental expenditures.

Mr. Shepardson agreed with the view that there were many factors other than monetary policy involved in the total problem, which included both the balance of payments and the domestic economy. So far as the domestic economy was concerned, however, it seemed to him that while expansion might not be proceeding as fast as some would like, activity

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was at rather high levels in nearly every sector.. As to unemployment, the problem was a serious one but it was going to take a different approach to deal with it adequately and the necessary measures lay outside the purview of monetary policy.. From the standpoint of the domestic economy, he was not concerned about the effect of some further lessening of monetary ease, for he did not believe that this was going to plunge the economy into a downturn in light of the existing liquidity.

As to the balance of payments, Mr. Shepardson said he was not sure how much could be done through monetary policy but he thought it could make some contribution at this time.. Market developments recently had been such that the System should take advantage of the situation and validate those developments through an increase in the discount rate. He was inclined to agree with the view that an operation such as outlined in the distributed staff paper lacked merit and he would expect some increase in interest rates across the maturity spectrum. He would be surprised if anything could be done to forestall some rate rise in the long-term sector and he was not sure, in view of the signs of deterioration in quality of credit in some areas, it would be advantageous if this could be done.

Accordingly, Mr. Shepardson concluded, he would support the proposition of an increase in the discount rate and validation of that increase in terms of the bill rate, leaving other interest rates to fall where they would.

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Mr. Robertson presented the following statement:

I returned from Europe reaffirmed in the basic convictions that I have held concerning U. S. monetary policy.

First, there is not any question but that we have a troublesome balance of payments problem, in the short run, at least--not a problem of crisis proportions, but still one that needs to be dealt with through the application of appropriate remedies rather than gimmicks designed to encourage people to forget it exists. We are incurring deficits at a rate that cannot go on indefinitely. Something should be done to reverse the trend.

Second, what is needed is a thoughtful but resolute adjustment of governmental and private policies, at a level (and in areas) which will permit effective dealing with the causes of the deficits. We must have an "agonizing reappraisal," if you will, of our foreign aid and military objectives, and the extent to which they have to involve what are essentially unrequited dollar transfers abroad. We must strive even harder to knock down the barriers to our exports that exist in so many countries, denying us the full fruits of the real competitive strength that we have already achieved. Export promotion efforts at home can help, too, in this respect. But even more importantly, we must try to increase business incentive, enriching profit opportunities, employing idle resources, accelerating our rate of growth--all changes that will enhance the basic attractiveness of the U. S. as a place to invest. These call, above all, for an early tax cut and generally stimulative monetary conditions.

The third set of convictions that I have had reinforced by European conversations involves the futility--even the danger--of attacking these problems with temporary palliatives. I do not mean to deny a place for arrangements among central banks to counter the kind of private-interest-motivated surges between money and exchange markets that can arise from time to time. We have done rather well, I think, on this score. But let us never be confused into thinking that the kind of symbols and shibboleths that have a passing influence on private attitudes can deal with our larger problem. Let me be explicit. Marking up the discount rate, but at the same time trying to keep reserve availability so ample as to offset any dampening effect domestically, will not fool many foreign central bankers. If there ever was a time when they were so gullible, that time has now passed. Similarly, utilizing the kind of approach outlined in the Coombs memorandum of several

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weeks ago, in hopes of triggering a reversal of commercial "leads and lags" relationships, becomes very soon a self-defeating device. It strikes me as having about the same proportion of sense and nonsense as trying to cure our unemployment problem by encouraging all businesses to produce for inventory accumulation.

I am persuaded that these kinds of short-sighted devices, oriented to market attitudes, are the despair of our wisest official friends abroad. When we resort to them, we fall into the trap of appearing to care more about "papering over" the market manifestations of our problem than challenging its basic causes.

But it is even worse than that. Unnatural efforts at twisting short rates up, or at stampeding "lead-lag" movements, can create domestic drags that delay fundamental market adjustments, divert the focus of official attention from the basic problem, and create a later backwash of reactions that can worsen our balance of payments statistics in future months. How foolish it is to make today's figures better at the expense of making tomorrow's figures worse; the effect is to conceal for as long as possible any beginning of the basic trend of improvement, which is all that our friends abroad ask for. I suspect, unhappily, that we have accomplished something of this very result already by a number of our official actions, including our inch-at-a-time movements to tighten monetary policy over this past year and a half.

If bold action is to be called for, let us be bold where it counts: with a formal statement throwing the weight of Federal Reserve prestige behind a prompt tax cut, and behind the kind of private wage and price decisions that will help us reap the full fruits of that tax reduction in expanded real output, without inflationary diversions. Here, I submit, is where we ought to stand. And that is why I shall vote today in favor of a monetary policy at least as stimulative as that which prevailed before the unfortunate tightening of the last two weeks, with the hope that the Committee will see its way clear to move gradually back to a still more stimulative atmosphere.

Mr. Mills said he had great sympathy with the background reasoning of Messrs. Bopp, Mitchell, and Robertson. He wished that their reasoning could be translated into policy actions, but unfortunately he did not feel that this could be done. Therefore, he would take his text:

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today from the farewell address of President Washington, who adjured his countrymen to avoid foreign entanglements. His policy recommendations, Mr. Mills said, were colored by failure to take President Washington's advice more seriously. Mr. Mills then presented the following statement:

Significant developments since the last meeting of this Committee are inexorably driving Federal Reserve System monetary policy toward inducing a higher level of interest rates:

(a) Loose talk in the press and in financial circles, predicting that the balance of payments problem will be combatted through the vehicle of higher interest rates, and not having been officially denied has encouraged belief in its accuracy. In result, prices of U. S. Government securities have fallen sharply.

(b) Secretary of the Treasury Dillon in his testimony yesterday before the Joint Economic Committee stated unequivocally that the Treasury Department would not consider the imposition of controls over foreign borrowing in the United States markets, which continues to be a major cause of the outward movement of gold and dollars from this country.

In view of the Treasury's attitude and irrespective of the undesirable economic consequences that can be anticipated, it is clear that the Federal Reserve System is obliged to take the brunt of the attack on the balance of payments problem by way of whatever defense can be put up against the outflow of dollars through higher interest rates. Moreover, as the financial markets have already anticipated a more restrictive monetary and credit policy, it would be impractical to reverse the present market momentum toward higher interest rates without causing utter confusion in financial circles. As matters have shaped up, the Federal Reserve System has been committed to fostering a higher level of interest rates by circumstances that have not been within its complete control. Whether a moderate increase in interest rates will suffice to check the outflow of funds from the United States will remain to be seen, as will also whether foreign countries, if confronted with a reverse flow of funds back into the United States, will be content to allow the level of their domestic rates of interest to be below those ruling in the United

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States. The dramatic actions that were taken by Great Britain and Canada in raising interest rates on the occasions of international runs on their currencies cannot be taken as examples which the United States should now follow, in that the deficit in our balance of payments is not due to lack of confidence in the dollar but to capital movements arising out of commercial transactions which are not susceptible to correction through the vehicle of higher interest rates, but which should be plugged mechanistically at their source. It is unlikely that a modest rise in interest rates can cure the deep-seated malady of our balance of payments deficit and it is more probable that this attempted cure can do more harm than good.

Mr. Wayne reported that the slightly upward course of Fifth District business had continued almost without change. Statistics now supported evidence of improvement provided by the Reserve Bank's surveys a month or so ago. Seasonally adjusted nonfarm employment and factory man-hours had advanced rather generally, insured unemployment rates had continued to decline, contract awards had risen at a distinctly better than seasonal clip, and department store sales had gained slowly but steadily. The current survey indicated a greater diversity of business expectations but no significant change in the general outlook, which remained moderately optimistic. Textile producers again reported increases in new orders, backlogs, and shipments, but other manufacturers on balance presented a somewhat more neutral picture this time. Farmers' cash receipts during the first four months were 5 per cent higher than in 1962, and agricultural prospects had continued to improve. Business loans at District weekly reporting banks had shown better than seasonal strength during the past three weeks.

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Perhaps the most significant factor in the national outlook, Mr. Wayne thought, was the increasing feeling that the steel slowdown might not take as heavy a toll as originally appeared likely. With construction outlays rising, automobile sales holding at a high level, and business plant and equipment expenditures apparently headed upward, it was beginning to look more and more as if the tug of war between steel and the factors of strength would be resolved on the upside. He still doubted, however, that the sort of expansion was under way that was going to cut appreciably into the relatively high rate of unemployment any time soon.

As to policy, Mr. Wayne said he had come to this meeting prepared to endorse, with some reluctance, a modest probing toward less ease in view of the persistent outflow of sizeable quantities of capital. But in the closing hours of yesterday--for whatever reason--the market seemed to have already moved further (in three hours) than he had been prepared to accept over a period of three weeks.

There were many questions, Mr. Wayne continued, that disturbed him greatly at such a juncture as this. To the extent that any significant improvement in this country's short-term capital position was achieved, through monetary policy, might this not at the same time contribute to a Canadian or British crisis toward which the Federal Reserve could not remain indifferent? Even if no crisis should arise, to what extent could one really expect that the basic problem could be

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altered with short-term money? Finally, was it not possible that a pattern of rates that would produce the desired effects upon foreign long-term portfolio investment might dampen the domestic business outlook enough to produce offsetting effects on international direct investment?

Nevertheless, any effort to reverse the market movements of recent days was likely, in Mr. Wayne's opinion, to be misunderstood and prove confusing. His preference would be to validate these developments through open market actions first, with an increase in the discount rate to follow. However, he was prepared to accept an increase in the discount rate now if it seemed appropriate.

Mr. Clay commented that there appeared to have been no basic change since the last meeting in the economic problems faced by the Committee, although interest rate developments had created a problem of policy implementation. The policy issues continued to revolve around the dual problems of the pace of domestic economic activity and the adverse international balance of payments, and the probable impact on domestic activity of a policy action marked enough to have a significant effect on the international flow of funds. On balance, it appeared to him that a marked advance in interest rates would involve a serious risk to domestic economic activity. An adverse effect on economic activity would be unfortunate not only in terms of the domestic situation but with reference to the international situation as well.

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The unfavorable balance of payments did not involve a domestic economy operating under forced draft that could benefit by restrictive action both domestically and internationally. Rather, it was an economy that needed to expand its output for both domestic and international markets.

The availability of credit and its terms of availability, both short-term and long-term, were of crucial importance in economic expansion, Mr. Clay noted. In a period of business expansion, for instance, the rise in consumer and business capital outlays typically outpaced the gain in total economic activity, and these were sectors of the economy whose expansion was greatly dependent upon the use of credit.

In the past two years, consumer and business investment expenditures had expanded and thus had provided a push for the economy. Even so, their proportion to total economic activity remained relatively low. This was true in terms of both the ratio of consumer durable goods and housing to disposable personal income and the ratio of business capital outlays to gross national product. The fact that the growth in these sectors had not been in line with what one would expect in a period of rapid economic growth was an important factor in the lag in aggregate demand for goods and in the employment of national resources. In the attainment of these levels of consumer and business investment, even though their ratios to total output remained low, there had been a very substantial reliance upon borrowed funds. Any significant

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lessening of credit availability and the stiffening of its terms would appear to be a matter of considerable importance.

Accordingly, it appeared appropriate to Mr. Clay to continue the monetary policy decided upon at the previous meeting of the Committee. That would not infer a continuation of the situation that existed during the latter part of the period since the last meeting, however, as developments had moved beyond what the Committee's directive called for. Developments stemming from comments on policy in the press and the bond letters had complicated the implementation of monetary policy in accordance with the Committee's directive. The sizeable miss in the country bank required reserves estimate added to the difficulties, and this situation was compounded when the data became public.

Pursuit of the monetary policy Mr. Clay suggested would call for no change in the Reserve Bank discount rate. Admittedly, money and capital market developments had complicated the pursuit of this policy, but it could be carried out. Just as market expectations became a powerful factor on the upside, they could become a powerful factor on the other side if it became apparent that the System had not changed its monetary policy.

Mr. Scanlon said that prospects for moderate further expansion in Seventh District business activity continued to be favorable. This view was given added support recently by the semiannual roundup of

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opinions of top Midwest business executives conducted by one of the large Chicago banks. Employment continued to edge up and unemployment had declined further in some District areas. In May only two of 23 major labor market areas were considered to have a substantial labor surplus, and in June Detroit was removed from the substantial labor surplus group for the first time since July 1957. Total retail sales in the District seemed to have changed little in June from the plateau of earlier months. In April and May, debits to demand deposits at Chicago banks, seasonally adjusted, averaged 2 per cent below the average for the first quarter. However, in 51 District areas, excluding Chicago, debits were up 1 per cent in this comparison.

New car sales in mid-June were off slightly but still excellent, especially when consideration was given to the fact that sales of popular General Motors models were not being aided by special promotions. Industry sources advised that changeovers would run smoothly, with only minor facelifts made to most models. Luxury and bigness were to be stressed in 1964, and more compacts would be stretched into the previously intermediate-size range. Only one maker planned significant restyling, in an effort to increase its diminishing share of the market. There would be model shortages in the close-out period, but dealers were expected to be relatively well supplied with the 1964 models when introduction began, which would be slightly earlier than last year.

Steel production had declined since the last week in May, as expected. However, steel people indicated that business confidence was

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considerably stronger than a year ago, and there was a general expectation that prices would remain firm in the second half of 1963, in contrast to the concessions obtained by purchasers in the second half of 1962.

Construction contracts in May were very strong in the District. For the five-month period, total contracts were up 8 per cent in the Midwest. By far the most vigorous category in the District had been manufacturing. The rise in construction contracts for manufacturing plants might be the forerunner of a further improvement. Trade sources reported that "advance planning" on industrial plants in the first half of 1963 was more than double the year-ago total. The higher level of prospective plant construction coincided with reports of further increases in orders for capital equipment.

With respect to policy, Mr. Scanlon said he came out at about the same place as at the meeting three weeks previously. The current evidence on prospective construction activity and business capital outlays, together with the relatively low level of corporate liquidity, tended to indicate a fairly firm demand for credit. The risk to the domestic economy of a somewhat less easy monetary policy probably had diminished somewhat. However, if the Congress should fail to act on taxes, this could have some negative effect, particularly on private capital outlays.

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He concluded, Mr. Scanlon said, that no change in policy should be made at this time, by which he meant no change from the position adopted by the Committee three weeks earlier. Insofar as a change in the discount rate was concerned, he would prefer to wait. At the same time, he was certain that the directors of the Chicago Reserve Bank were ready to increase the rate immediately, and he would find it difficult to recommend against such action even though he had serious doubt as to what this would accomplish, by itself, in the current climate. His feelings on the discount rate were similar to those expressed by Mr. Wayne.

Mr. Deming said that on balance the Ninth District economy generally paralleled the national economy. If there was adequate rainfall, the District economy would move ahead vigorously, while in the event of drought it might fall behind. In June, both bank credit and bank deposits expanded far more than seasonally, thereby changing a normal second quarter performance into a much stronger than seasonal one. So far this year loans and investments had both risen more than usual and deposits were up very strongly, both absolutely and seasonally. However, June, second quarter, and first half performance had been much stronger at country banks than at city banks. Even with high loan-to-deposit ratios evident in the former and well below peak ratios evident at the latter, the recent lessening in reserve availability seemed to have hit harder at city banks than at country banks. With Federal funds

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somewhat restricted recently, there had been some significant city bank borrowing through the discount window for the first time in a long period. Country bank borrowing had remained nominal. This suggested that, at least in the Ninth District, current bank liquidity figures might overstate the actual easiness of the banks, and consequently the sensitivity of the banks to a moderation of easy monetary policy. This was not to argue against such moderation but merely to note what seemed to be a fact.

Mr. Deming went on to say that he had watched with interest the developments in the money markets during the past week, and particularly those of yesterday. There seemed to be little question but that the markets expected discount rate action and a further lessening of ease. Whether those expectations should be confirmed by discount rate action or not seemed to him to rest on three points: (1) whether developments had gone so far as to make a lack of confirmation dangerous in the sense that market nervousness would be intensified by failure to confirm; (2) the need for or desirability of direct rate action for balance of payments reasons; and (3) the question of availability.

His own conclusion, Mr. Deming said, was that it would be unwise to take direct rate action at this time (although that conclusion was a far from certain one; if other Banks moved on the discount rate now, he would recommend such action to the Board of Directors of the Minneapolis Bank). It seemed to him that some available evidence pointed to moving

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via lessened availability rather than via rates. This, of course, was a matter of emphasis as well as a matter of judgment; for the availability and rate blades of the credit policy scissors both cut and one could not cut very well without the other. Thus, while he believed that some short-term capital flows were interest-rate sensitive, he thought the evidence indicated that some of them, especially the bank credit flows, might be more liquidity or availability sensitive. Therefore, he would prefer to lessen the degree of availability by reducing the level of free reserves and letting rates fall where they would rather than to attempt to seek a rate level and let the availability follow from the need to maintain a given rate level. He thought this would fit better a situation such as the current situation, where there might be a more than adequate credit supply, which might have produced more speculative and foreign lending than desirable, and where it was necessary to be concerned about flows from and to Canada and Great Britain as well as the Continent.

Therefore, Mr. Deming continued, he would prefer not to move on the discount rate at this time but to pave the way for a future move by lessening the level of free reserves. The amount of rate response to this move would reflect the liquidity sensitivity of foreign lending. If it was quite sensitive, there might be little rate response and relatively little availability response insofar as the domestic economy was concerned. He was not much worried about the former, but he was

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concerned about the latter. If rate response was obtained without lessened domestic availability, he thought that would be just what was wanted. On the other hand, it seemed to him that emphasis on rates as the primary objective would run the danger of too much lessening of domestic availability, which might unduly contain the expansion. Consequently, he would lean toward a lower level of free reserves-- - trending toward zero--; somewhat more borrowing, and no discount rate action now.

Mr. Hemmings reported that information that had become available since the preceding Committee meeting indicated a general rise in business in the Twelfth District. However, certain sectors lacked vigor and some general indicators offered a mixed picture. The unemployment rate in the Pacific Coast States dropped slightly from 6.1 per cent in April to 5.9 per cent in May. Nevertheless, there was some cause for local concern since employment in defense-related industries declined for the fourth consecutive month. Apparently there had been a rather sharp drop in defense contracts in the second quarter. Construction activity was strong in May. Steel output fell more in the District in June than nationally, and the decline in orders--along with the usual summer lull--forecast a further decline in production in July. Zinc, lead, and lumber prices had strengthened, while farm income rose more than seasonally in April. Department store sales in June remained at approximately the May level; the increase over the previous year was less than for the rest of the country. New car registrations in

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California in June continued at the high May rate. The cumulative rate of gain of new car registrations exceeded the rate for the nation as a whole.

There had been an increase in bank credit, attributable to an increase in loans, and the position of reserve city banks continued rather tight. Although District banks continued to be net-sellers of Federal funds, there was a decline in average net sales by the ten largest banks. Borrowing activity from the Reserve Bank was substantial. Rate changes had been announced by savings and loan associations in the District in both directions, with the result that the situation was confused; three different rates were currently in effect in the Los Angeles and San Francisco areas.

Mr. Irons said that in most lines of economic activity in the Eleventh District the indicators showed moderate improvement. While resources were not being used fully, the indices showed further improvement in industrial production, construction, agriculture, and employment. The agricultural situation looked more promising at present than a month or so ago. New car registrations continued to rise. Bank assets were up, along with both demand and time deposits, and District banks did not exhibit too much need for funds. Borrowings from the Reserve Bank were averaging around \$10 million. Federal funds purchases increased in June, but this was accounted for by a few of the largest banks. In general, the District seemed to be doing quite well,

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statistically speaking, and attitudes were generally favorable.. There was no expectation of a strong upward surge of economic activity, but neither did it appear to be felt that the economic advance would not hold.

Mr. Irons said he detected in casual conversations with businessmen, bankers, and others a growing concern about the balance of payments situation, with a feeling that little was being done about the problem. The question was how long the situation could continue. This was not a general feeling, perhaps, and he would not want to over-emphasize the remarks he had heard, but more and more comments had been made to him along such lines in the past couple of months..

Turning to policy considerations, Mr. Irons said that a few days ago he had about come to the conclusion that over the next few weeks it might be desirable to probe in the direction of a little more firmness. He had been thinking in terms of free reserves around \$100 million, a bill rate around 3.10 - 3.15 per cent, and other parts of the structure in comparison. Since then, however, the market itself had taken things in hand, and the Committee was now faced with a different situation. In view of the developments that had taken place in the market and in view of other factors that had entered into today's discussion, it would seem to him unrealistic to try to roll back the changes that had taken place. On the other hand, not much further probing would be necessary to get to the point where market rates were a clear signal for a change in the

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discount rate. The whole matter seemed to come down to a question of timing. He would have preferred it if conditions had prevailed such as to permit the System to probe in the market toward further firmness, yet perhaps not reach a position where a discount rate change would seem to be inevitable. Market events, however, seemed to have brought this step closer than he had anticipated in the middle of last week.

Mr. Irons went on to say that he was not too much concerned about the possible effect of more firmness on the domestic situation. Admittedly, there was a risk, but some risk must be accepted within reasonable limits. Perhaps more funds could be made available through the discount window and less through open market operations. That might mean, for the time being, somewhat less rigid administration of the window, for the System would want funds to be available in sufficient quantities to meet basic requirements.

Mr. Irons repeated that he would not attempt to roll back what had already happened in the past few days. As to the possibility of probing in the direction of further firmness, the situation apparently already was close to the point where discount rate action was generally anticipated. If discount rate action was to be taken by Reserve Banks, it seemed of some importance that there be some clustering. Therefore, he would be inclined to recommend a rate change at the meeting of the Dallas Board of Directors on Thursday, although other things being equal he would have preferred to wait and try to see more clearly what was ahead.

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Mr. Ellis commented that economic expansion was continuing in New England, but in a slower and more limited way than nationally. The expansion was not even in rate, it was spotty in coverage, and it was not resolving the unemployment problem. Manufacturing output was up in May after two months of decline, but it was only up 1.3 percent for the year. Manufacturing employment declined slightly in May, and on a year-to-year basis a decline was recorded of about two per cent. However, man'ours and weekly earnings in manufacturing in Massachusetts rose in May. In banking, commercial and industrial loans had risen more than seasonally since March and since the first of the year. With demand deposits holding and time deposits still rising, weekly reporting banks had been expanding their municipal investments and had resumed their buying of short-term Governments. They remained net sellers of Federal funds.

As a preface to his comments on policy, Mr. Ellis referred to remarks made to him by a foreign central banker during his recent European trip with respect to the rate of increase of dollar holdings since the first of this year. Question was raised as to how long this could continue and what was planned to be done about it. Using this as background, Mr. Ellis observed that System policy had appropriately been stimulative all through this recovery period. It had not been expected, of course, that monetary policy would solve the unemployment problem. At present, with greater domestic strength, he felt that

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Higher interest rates should be permitted, especially in the short-term market. Further, given the present level of short-term rates, the discount rate was now in effect a drag on those rates. He was impressed that what was needed essentially was something to last through another two, perhaps three, years during which inflation in Europe might work as a longer run solution to the balance of payments problem while this country continued to hold its prices in check. In retrospect, Mr. Ellis felt that the System probably had overshot on liquidity, which spilled over and stimulated demand in European countries.

The fact that monetary policy action might be blamed if there should be a downturn of the domestic economy was a risk that deserved consideration. Also deserving a consideration, however, was the risk of being criticized for contributing to the current imbalance in international payments. Such a charge might not be too well reasoned. As long as higher interest rates were not tried, however, the System would have to bear the responsibility for failing to use this method as a basic part of any program to resolve the balance of payments difficulty. If this method was not going to have any significant effect on capital outflows, perhaps the best thing was to try to find out, so as to avoid postponing further action in other areas of responsibility.

Mr. Ellis said that the Board of Directors of the Boston Reserve Bank had met yesterday and was prepared to take action on the discount

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rate. It had not done so, but a meeting of the executive committee had been scheduled for tomorrow, with authority to consider whatever recommendation he (Mr. Ellis) might make. His present inclination was to recommend an increase in the discount rate to 3-1/2 percent, which would be in line with the policy prescription outlined initially by Mr. Hayes. This would call for consideration of confirming open market action later, after the Open Market Committee had appraised the availability of reserves. While it had not been in his thinking earlier, at the moment he thought he saw a significant advantage, under present conditions, in an announcement of discount rate action. He felt it would be inadvisable to try to roll back the rate changes that had occurred in the market in anticipation of discount rate action.

Mr. Balderston referred, as a matter of interest, to a letter written by the Acting Chairman of the Open Market Investment Committee under date of April 17, 1928, which presented the following summary of principal credit and business developments: gradual advance in money rates; continued outflow of gold; moderate recovery in industrial activity; unusual activity in stock prices advancing to new high levels; increase in brokers' loans to higher levels than ever before; substantial increase in the demand for Reserve Bank credit; and substantial increase in commercial loans of reporting banks. The letter observed that the index of prices of 228 stocks was 33 per cent higher than a year earlier, when prices were higher relative to either earnings or dividends than in

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a number of years. Apparently the advance had been based on the feeling that there was an immense amount of funds in the country not needed for business purposes. In 1927, bank credit had expanded at the rate of 8 per cent; and there was comment to the effect that the rate of increase had been more rapid than could be continued without leading to abnormalities of value.

Moving forward in time a third of a century to the current staff report on economic and financial developments, Mr. Balderston noted that over the first half of this year the annual rate of growth of total loans and investments at all commercial banks, seasonally adjusted, was 9 per cent. This was about the same as for 1962 as a whole.

Turning to current policy considerations, Mr. Balderston spoke favorably of the idea of a package of governmental actions, such as he understood the President might announce later this month, to deal with the balance of payments problem. When such an idea was advanced within the Open Market Committee some time ago, it had impressed him as having merit. Monetary policy obviously could not do the job alone. On the other hand, monetary policy should play its part. Therefore, despite whatever risk might be involved in participation from the standpoint of the System's independence of action, he would welcome the announcement of a package of concrete steps to stem the accumulation of dollars by other countries. The Government's spending and lending abroad should be curbed sharply in present circumstances, recognizing that substantial

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reductions in the outflow of dollars would take some time. The spending and lending programs, added to the outflow of private capital, long as well as short, had created a situation contrary to basic equilibrium.

Mr. Balderston said he favored attempting to try to see what a general flexible policy could do to stop the loss of dollars and gold, in lieu of resorting to selective controls.. In this, he agreed with what the Chairman had said at the meeting three weeks previously. If the Government was evolving concrete steps to stop the loss of gold and dollars, he felt that the System should play whatever role it could as part of an integrated effort. He would assume that a rise of interest rates would have to be accompanied by some reduction of liquidity and that an operation such as discussed in the staff working party memorandum was probably not feasible.

Mr. Balderston went on to say that he would aim at a range of free reserves that would support the bill rate at current levels, and he would meet any temporary needs through the discount window. As interest rates rose, he supposed the volume of negotiable certificates of deposit outstanding would shrink. If the total outstanding was in the order of \$6 or \$8 billion at present, the loss of deposits could be embarrassing to many banks. He felt sure there would be pressure on the Board again to amend Regulation Q, but he would not favor such action except in respect to 90-day to one-year time deposits.

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Chairman Martin commented that he found himself encouraged by the discussion at this meeting. Most of the points raised involved problems that he had gone over in his mind in the course of the past ten days. They were problems to which he either felt that he had found answers or concluded that they were impossible of solution. This was a time, he agreed, when the System could make a major mistake, but a mistake could be made in either direction. It was hardly possible to be neutral and avoid coming to grips with the situation. The question was whether the System wanted to continue to pursue an easy money policy in the face of what he sensed to be growing opinion in the banking and business community that a firmer policy should at least be tried. If it were not, and if the Government came forth with a program and it was not successful, many people were going to say that the Federal Reserve had not carried its weight--or that if the Federal Reserve had done something drastic action might have been avoided. His views, the Chairman noted, reflected his assumption that the problems of the balance of payments and the domestic economy were inseparable. Some would not agree, but he happened to think that they could not be separated. This pertained also to the unemployment problem, which was part of the whole picture.

In matters of this kind, the Chairman continued, there were always arguments as to who was carrying the greatest burden. Personally, he was convinced that there had always been a tendency, through many

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years, for monetary policy to be asked to bear more than its proper share of the load. He felt that monetary policy had contributed significantly to the current domestic recovery; perhaps it had over contributed--so much so that the process of money creation, even if it had not had the end result of inflation, had contributed to speculation and deterioration in the quality of credit. Even if monetary policy was asked to bear a larger share of the load than was proper, however, the System ought not approach any national problems on the basis of doing anything less than it could, in however small a way, to aid in solving them.

It might have been preferable if the whole thing had developed differently, Chairman Martin added. However, this was a big Government, with many forces at play, and the Federal Reserve was only a part of it. These forces had all converged in one way or another, and the Federal Reserve must now face up to making a decision. The decision might, of course, be the wrong one. There was always this risk. But if the System tried to roll back what had happened in the market, it might get into an impossible situation; the reality of the current market must be recognized.

On the other hand, Chairman Martin questioned whether the System ought to change policy, so far as the availability of reserves was concerned, at this meeting. He would think that that matter could well take its course. Accordingly, he would be inclined to favor no change

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in policy, as reflected in reserves, at the moment with no pressing one way or the other. In his opinion, the System did not have to cross the bridge of determining whether or not to press down on reserve levels at this particular juncture.

He would be prepared to support an increase in the discount rate, the Chairman said, if such an increase was submitted for review and determination by Federal Reserve Banks, but he felt that the timing of an announcement ought to be related to the Administration's package. This would not be a particularly easy thing to work out, but it was necessary to face up to realities and recognize what was involved. It seemed important, if discount rate action was to be taken, to have as much support as possible because this would put the action in perspective and make it more effective. It would be recognized around the world that this was a part of a concerted attack on the balance of payments problem.

Chairman Martin also pointed out that if a discount rate increase was decided against, that step would simply be left out of the total package. The System was at liberty to decide its own position. He did not think, however, that in such event the System could escape responsibility if drastic steps on the part of the Government later became necessary. While he did not believe for a moment that discount rate action would solve the balance of payments problem, it might do more than one would imagine. At least it was something that he felt ought to be tried, and the time for decision was at hand. Personally,

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be thought somewhat higher interest rates would stimulate the domestic economy and not injure it. This was something he could not prove, of course; it was in the area of psychology. It was in the area of psychology, however, that markets were frequently made, not in the area of logic.

The Chairman pointed out that obviously it was not for the Open Market Committee to approve or disapprove a move on the discount rate. That was something the Board of Governors must decide if, as, and when a rate change was submitted by a Reserve Bank. The timing of any action by the Board of Governors must be left to the discretion of the Board, as it always had been. On the other hand, the Open Market Committee was faced today with a question of open market policy. He would propose that a vote be taken on no change in current policy.

Mr. Hayes observed that even though the Open Market Committee, of course, had no power to take action on the discount rate, expectations regarding the discount rate were playing a major part in the market. It seemed to him that if the Committee could include some phrase in the current policy directive indicating that its present policy was to encourage short-term rates in a range consistent with the discount rate, this would accomplish a consistency of policy if there should be a change in the discount rate, and it would not alter present policy in advance of such action.

Chairman Martin observed that no reference of that sort had heretofore been included by the Committee in its policy directives.

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In his opinion it would be difficult to do this effectively. This tied in with the question whether there could be a change in the discount rate without a change in availability. He had come to believe that there could be under certain conditions, but it was a difficult thing to think through and he was not quite sure. In any event, however, market expectations definitely had played a role relative to present System policy. The Account Manager had not tried to develop a policy different from the Committee's instruction. Under present conditions he (Chairman Martin) was inclined to believe that it was not unreasonable to feel that, given a change in the discount rate, interest rates might be a little higher without any reduction in the availability of reserves.

In further discussion of this point, Mr. Deming noted that the past few days had suggested that kind of situation. Mr. Balderston expressed the view that it would be better to take one step at a time, the first of which would be to approve a continuation of present open market policy.

A vote was suggested on that basis, but question was raised as to whether "no change of policy" should be understood to mean a continuation of market conditions as of today or no change in the policy contemplated at the June 18 meeting of the Committee.

Mr. Hayes spoke in favor of a continuation of the present degree of firmness in the money market, which he thought would be quite clear,

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and Mr. Balderston stated that a different interpretation would force him to vote against a directive calling for no change in policy.

Chairman Martin noted that this question had come up in various ways from time to time within the Committee. The question was essentially whether inadvertent changes that occurred between Committee meetings should be construed as having established a current policy.

There followed references by members of the Committee to the phrasing of both the first and the second paragraphs of the outstanding policy directive. It was observed that one interpretation of the phrase "continuing the degree of money market firmness that has prevailed recently" would force the Account Manager to roll back the short-term rate closer to the level of three weeks ago. On this point, Mr. Stone brought out that the term "money market firmness" comprehends both rate and availability. The present degree of money market firmness reflected a state of availability of credit that by and large had obtained for six or eight weeks, but presently at a higher level of rates. This differed from what the Committee had intended three weeks ago. The current rate situation had been precipitated within the past week, by factors such as he had mentioned in his earlier oral comments on open market operations. The basis lay in expectations. The tone of the money market yesterday was in fact easy while rates were undergoing their sharp rise.

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As the discussion proceeded, several possible variations of wording of the second paragraph of the directive were suggested with a view to clarifying the intent of the instruction that was desired to be issued to the Management of the Account. During this discussion, Chairman Martin commented that he would not envisage aiming at a roll-back of rates unless that came about from market processes; the present situation might represent a temporary aberration that could reverse itself. Mr. Mitchell inquired whether there was something to be said for using the free reserve levels that the Account Manager had been working with before and seeing how the market reacted. Mr. Stone commented in this connection that, given free reserve levels in the neighborhood of \$150 to \$220 million, which had prevailed from mid-May until recently, it was his view that market expectations would keep short-term rates at least temporarily at or around the levels they had reached. If there was a discount rate change, he would expect short-term rates to rise somewhat further. He would not expect the bill rate to rise much more than another 15 basis points, however. If the Committee's instruction was in terms of continuing the present degree of firmness, he would regard this as contemplating short-term rates in the present range, with reserve availability about as it had been. Asked whether he felt that negative free reserves might not result, Mr. Stone replied that he thought bill rates could be maintained in the area of 3.25 to 3.40 per cent with free reserves little changed.

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Mr. Hickman suggested that if no discount rate action was forthcoming, market expectations probably would change in due course. To maintain the present level of bill rates, it might then be necessary to move toward zero on free reserves. If there was a change in the discount rate, expectational factors would tend to keep the bill rate up.

Chairman Martin proposed that the next Committee meeting would be a more appropriate time for the Committee to make determinations concerning the level of reserves. It was not known at present whether anything was going to be done on the discount rate in the next three weeks.

Mr. Mills asked whether the question did not come down essentially to the tone and feel of the market. To maintain the present degree of market firmness might require enough withdrawal of reserves to reduce the level of free reserves, but this would not be known until market developments could be appraised. In a further comment, Mr. Mills noted that if the discount rate were to be raised to 3-1/2 per cent, it would not necessarily require an immediate contraction of reserves to make the rate effective. However, he thought that would follow shortly. Upon being apprised of a discount rate change, the market would expect the new rate to be made effective promptly.

Mr. Hayes commented that he had been thinking of the problem the Account Manager would face if he should have a 3-1/2 per cent

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discount rate to contend with, and he continued to have in mind the question whether some appropriate instruction related to this possible rate change should not be included in the policy directive.

Chairman Martin repeated that this had not been done heretofore. It seemed to him that it would be necessary to write the directive on the basis of what the Account Manager should do if there was a discount rate change and what he should do if there was not a discount rate change. Mr. Balderston suggested that the System should not seem to the public to be backing and filling at this point. He recalled that during the go-around today a number of Committee members had advanced the view that there should be as much consistency as possible in System policy. Mr. Mitchell again inquired whether the Committee might not instruct the Manager to maintain the same level of free reserves and see what the market did. Mr. Hayes commented, however, that the level of free reserves had never been a very good target. It had not been used as a single specific target. At times of float bulge, for example, it was a poor guide. Mr. Robertson noted that he sensed that the discussion revolved largely around the question of the bill rate continuing in the general area in which it stood at present. If so, he felt that a sufficient instruction could be conveyed by words that had been suggested for the directive somewhat earlier in the discussion, namely, that open market operations should be conducted with a view to

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continuing the present degree of firmness in the money market. Mr. Hayes indicated that he would be satisfied with such wording.

It was then suggested that a vote be taken on a directive the second paragraph of which would be phrased in such manner. The first paragraph would incorporate a technical change from the existing directive so as to refer to the high level of domestic business activity rather than an improved domestic business outlook.

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

It is the Committee's current policy to accommodate moderate growth in bank credit, while putting increased emphasis on money market conditions that would contribute to an improvement in the capital account of the U. S. balance of payments. This policy takes into consideration the continuing adverse balance of payments position and its cumulative effects and the high level of domestic business activity, as well as the increases in bank credit, money supply, and the reserve base in recent months. At the same time, however, it recognizes the continuing underutilization of resources.

To implement this policy, System open market operations shall be conducted with a view to continuing the present degree of firmness in the money market.

Votes for this action: Messrs. Martin, Hayes, Balderston, Bopp, Clay, Irons, King, Mills, Scanlon, and Shepardson. Votes against this action: Messrs. Mitchell and Robertson.

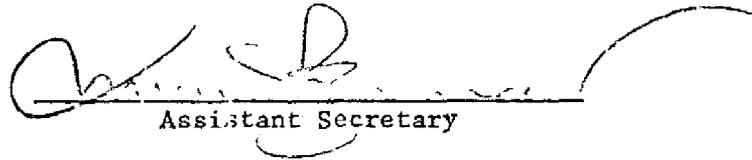
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It was agreed unanimously that no change should be made at this meeting in the continuing authority directive, which, in the form approved at the meeting on June 18, 1963, allowed a latitude of \$1.5 billion on changes in the Open Market Account in the period between meetings of the Open Market Committee.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, July 30, 1963.

The meeting then adjourned.



Assistant Secretary