A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington on Tuesday, August 2, 1955, at 10:45 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Sproul, Vice Chairman
Mr. Balderston
Mr. Earhart
Mr. Erickson, Alternate for Mr. Leach
Mr. Fulton
Mr. Irons
Mr. Mills
Mr. Robertson
Mr. Shepardson
Mr. Szymczak

Messrs. Johns, Treiber, and C. S. Young, Alternate Members of the Federal Open Market Committee

Messrs. Williams, Bryan, and Leedy, Presidents of the Federal Reserve Banks of Philadelphia, Atlanta, and Kansas City, respectively

Mr. Riefler, Secretary
Mr. Thurston, Assistant Secretary
Mr. Vest, General Counsel
Mr. Solomon, Assistant General Counsel
Messrs. Daane, Hostetler, Rice, Roelse, Wheeler, and Young, Associate Economists
Mr. Rouse, Manager, System Open Market Account
Mr. Carpenter, Secretary, Board of Governors
Mr. D. C. Miller, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mr. Marsh, Manager, Securities Department, Federal Reserve Bank of New York

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 12, 1955, were approved.

Before this meeting there had been sent to the members of the Committee a report of open market operations prepared at the Federal Reserve Bank of New York covering the period July 12 to 27, 1955, inclusive, and at this meeting there were distributed copies of a supplementary report prepared at the Bank covering operations during the period July 28 through August 1, 1955. Copies of these reports have been placed in the files of the Federal Open Market Committee.

Mr. Rouse commented briefly with regard to the effect on the money and securities markets of a statement with respect to a possible increase in the discount rate of 1/2 per cent contained in a Government securities market weekly news letter which was received by subscribers on Monday morning. He said that a similar statement was circulated to Government securities dealers on Friday in a telephone service which the writer of the news letter provides and that it had had quite a disturbing effect.

> Upon motion duly made and seconded, and by unanimous vote, the open market transactions during the period July 12 to August 1, 1955, inclusive, were approved, ratified, and confirmed.

At the meeting of the Committee on July 12, 1955, the Secretary was requested to look into and report on the question whether the authorization for repurchase agreements covering Government securities should run to all Federal Reserve Banks or only to the Federal Reserve Bank of

New York. A memorandum prepared by Mr. Riefler in accordance with this request under date of August 2, 1955, which had been sent to the members of the Committee, expressed the view that in practice there was little likelihood that the authority would be used by the Federal Reserve Banks other than New York. Therefore, he recommended that hereafter the Committee's authorization be only to the New York Bank and that the authorization be in the form attached to the memorandum.

Mr. Riefler outlined briefly the reasons for his recommendation pointing out that it was understood, on the basis of the discussion at the meeting on July 12, 1955, that hereafter the Committee would consider at each meeting the extent to which repurchase agreements were to be authorized and the rate at which such agreements would be entered into.

At the conclusion of a brief discussion, upon motion duly made and seconded, and by unanimous vote the authorization was approved as follows with the understanding agreed upon at the meeting on July 12, 1955, and suggested by Mr. Earhart at this meeting, that the authority would be used sparingly in entering into agreements at rates below the discount rate:

CONDITIONS FOR REPURCHASE AGREEMENTS
PRESCRIBED BY THE FEDERAL OPEN MARKET COMMITTEE

As Amended, August 2, 1955

The Federal Reserve Bank of New York is hereby authorized to enter into repurchase agreements with nonbank dealers in United States Government securities subject to the following conditions:

1. Such agreements

    (a) In no event shall be at a rate below whichever is the lower of (1) the discount rate of the Federal Reserve Bank on eligible commercial paper, or (2) the average issuing rate on the most recent issue of three-month Treasury bills;

    (b) Shall be for periods of not to exceed 15 calendar days;

    (c) Shall cover only Government securities maturing within 15 months; and

    (d) Shall be used as a means of providing the money market with sufficient Federal Reserve funds to avoid undue strain on a day-to-day basis.

2. Reports of such transactions shall be included in the weekly report of open market operations which is sent to the members of the Federal Open Market Committee.

3. In the event Government securities covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, the securities thus acquired by the Federal Reserve Bank of New York shall be sold in the market or transferred to the System Open Market Account.

Governor Robertson stated that notwithstanding his doubts about the use of repurchase agreements--which are well known by other members of the Committee--he would not oppose the above action if, in addition to the understanding referred to above, it was understood that the repurchase authorization would be used only in necessitous cases.

Chairman Martin called on Mr. Ralph Young who made substantially the following statement which was based largely on a staff memorandum sent to the members of the Committee under date of July 29, 1955:

Expectations earlier were that some deceleration of advance in activity might become evident over the summer in conformity with average business cycle patterns. The first big item of today's report is that advance continues with no clear evidence of deceleration in the economy as a whole. The index of industrial production for July, seasonally adjusted, is tentatively placed at better than 140, but not clearly at 141. Advances are indicated to be fairly general in durable and nondurable goods lines, as well as in minerals. A number of industries--including metals, building materials, rubber, and chemicals--now appear to be producing at near capacity. With business demands in excess of output, backlog orders have continued to rise, with steel a noteworthy area of further rise.

The second big item of today's report is that a secondary upsurge of consumer buying seems to be developing. Consumer buying of autos in July remained at record rates. Buying of appliances and other goods at department stores showed remarkable gains from last month and a year ago. While this buying wave reflects the rapid rise of personal income over recent months as well as recent wage advances in major industries, it doubtless also reflects pervasive consumer confidence, some taking of capital gains on stock investment, an increased willingness to draw on widely held liquid asset accumulations, and some consumer expectations of higher prices later.

Consumer instalment credit expansion has been of key importance in recent buying levels and probably in the recent upsurge. The seasonally adjusted increase in June was about 600 million dollars. The expansion of over 2.5 billion for the six months ending with June was a new record. Maintenance of auto sales in July foretells another large rise in outstandings for this month. Competitive liberalization of terms as yet shows no alleviation, although recent supervisory steps in the banking sector and some industry-generated efforts in the sales finance sector may work to temper further terms relaxation in the months ahead.

Business inventory accumulation, which attracted much attention in May, slackened off in June. With the pick-up in consumer buying in July, further inventory rise has probably been moderate in recent weeks. By the end of June, the total value of business inventories had risen only 2 per cent from last autumn.

Activity in construction and real estate markets has been maintained at close to record levels. With residential construction showing signs of slackening, non-residential construction awards have been up a third over a year ago in June and the first half of July.

Mortgage lending on non-farm real estate has continued in record volume, although mortgage commitments on residential properties have been harder to get and mortgage yields have risen somewhat. To finance their active participation in this lending, savings and loan associations owed the Federal Home Loan Banks over a billion dollars on July 21, up 300 million for the year. Thus, the insurance companies have not been alone in lending in excess of available funds. Over the week-end, the Federal housing authorities took action to discontinue 30-year maturity and no downpayment mortgages on Federal underwritings from yesterday on. Maximum maturities become 25 years, with FHA required downpayments raised along the line by 2 percentage points and with VA introducing a minimum downpayment of 2 per cent.

Prices of industrial materials have continued upward in recent weeks and prices of finished goods show more frequent rises, but over-all these recent increases have been offset by declines, partly seasonal, of some farm and food products. The uptrend of industrial prices is now more general than at any time during the present upswing in general business. Further information on the steel price advance shows a bigger advance than at first indicated. This increase has not yet been fully reflected in prices of finished metal products. Crop prospects continue to point to a sagging level of farm prices through the harvest and marketing season.

The labor market still features strength, with non-farm employment showing further increases and unemployment showing little change or possibly a modest down drift. The number of industrial areas showing labor surpluses fell to 31 in July compared with 53 a year ago, and present surplus communities include few major centers. Over-all productivity gains, which were sharp last year, have virtually disappeared in recent months. The present phase is thus one in which a given percentage gain in output is associated with about an equal percentage gain in man hours. This is the third big news item in this report. With wage and salary payments up 6 per cent from a year ago, recent wage settlements and negotiations now in process are expected to give important impulse to still further rise.

United States imports have continued to rise while exports have held close to their earlier advanced levels. Abroad, further production advances characterize most important industrial areas, and reflecting this condition as well as U. S. prosperity, primary materials prices on world markets have firmed up further. The boom atmosphere in Britain has obliged the Government again to strengthen its measures to stem inflationary trends.

In domestic financial markets, the Treasury's financing needs have now been provided for until early October.

Private and local government financing demands in the capital markets, while seasonally light, are substantial enough, with forward negotiations in process, to indicate continued high levels of market financing in the months ahead. Stock prices, on the basis of very favorable second quarter earnings reports for most reporting companies, rose to new highs late in July. Yesterday, a fairly orderly technical reaction occurred. Stock market credit to customers and brokers would appear to have shown little change on balance over July.

During July at city banks, bank credit showed a large increase, reflecting especially acquisitions of U. S. securities and some further rise in loans. All banking reports confirm a continuing strong demand for bank credit. While the money supply showed little growth in May and June, there was again an increase in July. Turnover of demand deposits in leading centers outside New York in May and June was the highest in recent years. Thus, recent Federal Reserve policy has restrained the rise of quantity, but use of money has responded to general business psychology and activity.

Continuing pressures of demand for credit and smaller growth of supply were reflected in July in resumed advance in the general level of market yields, particularly for Governments and municipals but also for private short-term market paper and to a less marked extent for long-term corporates, especially new issues. Yesterday, reflecting a tight credit and bank reserve situation as well as market expectations of early Federal Reserve discount action, this upward movement of yields was further extended.

Mr. Miller, commenting on the member bank reserve situation, stated that recent and projected reserve changes, as shown on a sheet distributed during this meeting, present a pattern of increasing tightness for the coming two weeks, with free reserves for the week ending August 10 expected to average around a negative $100 million. He also stated that the situation had tightened up during the last few days largely because of an increase in Treasury balances to more than $600 million, with the result that the Treasury was considering cancelling one of its calls. He noted that, after the next two weeks, a somewhat easier pattern was expected because of the mid-month increase in float so that during that period there may be a small positive reserve position, but that thereafter a pattern of increasing tightness was expected resulting from an outflow of currency over Labor Day followed by some easing as currency flows back and float expands during mid-September. At the end of the month free reserves were expected to drop to a negative $230 million. These projections, he said, were similar to those of the Federal Reserve Bank of New York as shown in the supplementary report referred to above except that after the next two weeks the New York projection showed a much tighter position. The difference between the estimates grew out of the different estimates on the movement of float and the fact that the Board's estimates showed larger declines in required reserves.

Chairman Martin initiated the discussion of credit policy with a statement substantially as follows:

I want to say that differences of opinion in the System are a good thing as long as we resolve those differences in a friendly spirit and handle them properly. That is a sign of a strong and vigorous System and is nothing to be alarmed about. My experience with differences is that when they are put on the table and people assume responsibility for the decisions made, the differences are not as large as they seem when they first arise.

Since the meeting of the Committee on July 12 a number of things have happened which I want to report to the members of the Committee. First, I want to read from the excellent statement by Mr. Sproul at the last meeting of the Committee. I think the meetings of the Federal Open Market Committee are the place where we should discuss all aspects of System monetary and credit policy and we are very much indebted to Mr. Sproul for the manner in which he prepares for these meetings and the fine way in which he brings his thinking to bear on our problems. We have some very important decisions to make. The times when critical decisions have to be made are relatively few and, while I may exaggerate, I am inclined to think that the decisions we have to make today are critical ones. The comment in Mr. Sproul's statement which I want to read is as follows:

> "I see nothing in the immediate situation which demands that we embarrass the Treasury in its management of the public debt by further restrictive credit moves during its July-August financings. We are not at a point where the dangers of inflationary developments clearly outweigh all other considerations. The danger signals of inventory accumulation outrunning sales expansion, upward price movements, production, material and employment bottlenecks, and excessive increases in bank credit and the money supply have not yet flashed red."

This statement opens up a number of points. Now in my opinion it would have been better if the discount rate at the Federal Reserve Banks had been increased prior to the recent Treasury financing operations rather than afterward. However, financing presents a difficult problem for the Treasury as well as for us. What I have just said is hindsight. I don't want anyone to think I am criticizing small points. At the same time, there have been unfortunate developments in the market. I want to put the whole sequence of developments out on the table. A lot of comments have been made and a lot of gossip has gone around. Whether the market is upset or credit is tight is all part of the same picture:

(1) On July 20, Paul Heffernan had a story in the New York Times about credit policy. I received inquiries during the subsequent week whether the story was authoritative and where it came from. I refused comment.

(2) On July 21 we had a difficult market situation to deal with because the Treasury financing was still under way and the market was jittery. Mr. Riefler came to me that morning with an indication that our projections might be going awry and that we would have another period of a tightening market during a period of Treasury financing. Not wanting to "butt in" on the management of the System account, I called Mr. Sproul at the New York Bank. Mr. Tiebout, General Counsel of the Federal Reserve Bank of New York, was taking Mr. Sproul's calls and I talked with him about keeping the reserve position on an even keel while the financing was in progress. After consulting with Mr. Rouse who was in Buffalo with Mr. Sproul, and with the desk, Mr. Tiebout called me back and reported that the Bank could get bills, that purchases were being made, and that he thought it would be wise to handle the problem in this way. It was handled well and the situation worked out satisfactorily.

(3) Friday morning I addressed 100 representatives of stock exchange firms in New York and was very careful to avoid any reference to Federal Reserve policy. At the end of the meeting an individual arose and said: "I don't know why you are so coy because I understand that the New York Bank has said that the discount rate would be increased and that restraint would only be mild." I refused to comment on this.

(4) On Saturday the Sylvia Porter letter came out and quoted a series of seven points as important forecasts of Federal Reserve policy. I did not know whether the statement was or was not a misquotation and, while it did not trouble me, nevertheless it is an important episode in recent developments and I am putting it out on the table because it concerns all of us.

(5) On Monday of last week Mr. Fulton called to say that his directors had been considering the discount rate, that they were disposed to make an increase and would like some guidance. I replied that now the Treasury financing was out of the way I would discuss the matter and give him what guidance I could.

(6) On Tuesday the Board had a discussion of the problem and decided that it would be wise for me to solicit the views of the Treasury. I went to the Treasury and met with Secretary Humphrey and Mr. Burgess. At my suggestion Mr. Burns, Chairman of the Council of Economic Advisers, was also present. I laid before them the facts of the situation indicating a need for an increase in the discount rate and also the fact that the market might suffer a serious decline if the discount rate were advanced, that the Treasury might be embarrassed and that the System might be accused of waiting until the financing was out of the way and then letting the market drop. I said the Board of Governors had been discussing whether it would be better to increase the discount rate in two steps or to go to 2-1/4 per cent on one step. While the Board was inclined to believe that a one-step action was better, it wanted the judgment of the Treasury. I was given the unequivocal decision that the Treasury would prefer that the increase be in one step to 2-1/4 per cent. I think that at the meeting at the Treasury we covered all of the dangers inherent in such action, although presumably there was some question subsequently as to that.

(7) After meeting with the Treasury representatives the Board discussed the matter further and I called Mr. Sproul and told him what had occurred. I then called Mr. Fulton and, as he will testify, I did not attempt to put any pressure on him. I simply told him what the thinking was here and said the Board was disposed to move to 2-1/4 per cent in one step. Subsequently, on July 27, the directors of the Cleveland Bank came in with a rate of 2-1/4 per cent and I understand the action was unanimous. Having received that advice from the Cleveland Bank, I felt obliged to telephone the other Presidents and I talked with every President I could reach. I made no effort to put pressure on them but informed them as to the thinking here and as to the course that was being pursued. Thereafter, Mr. Young telephoned to say that the directors of the Federal Reserve Bank of Chicago had agreed on a rate of 2 per cent and on Monday of this week the Boston Bank advised of action by their directors to fix a rate of 2 per cent.

(8) On last Thursday Mr. Burgess called me to say that he had had a long talk with Mr. Sproul and that there was some concern whether, if the increase in the discount rate were in one step, it would be very disruptive to the market. He wanted to know whether I had weakened in my position that a one-step increase was desirable. I replied that I knew the action would be disruptive to the market but that I had not weakened in my position. Mr. Burgess said he had talked with Secretary Humphrey again and assured me that they thought 2-1/4 per cent was the correct rate. At that point I went to New York with Mr. Burns to address the Consumer Credit Conference. The next evening I received a telephone call from Mr. Riefler which I will ask him to relate to you.

(9) Mr. Riefler stated that about 3:50 p.m. on last Friday afternoon Mr. Sproul called to say that he had tried to reach Chairman Martin and Vice Chairman Balderston but had been unable to do so, that a dealer had just reported that the writer of a leading Government securities market news letter had said that a responsible Federal Reserve official had made the statement that classically the discount rate went down by 1/4 per cent and up by 1/2 per cent, and that action could be expected in the near future. The dealer thought that the statement had had a very disruptive effect on the market Friday afternoon. Mr. Riefler said he responded that the observation was not one he had heard before and it did not sound like an inadvertent leak. He added that about one hour later on the same Friday Mr. Burgess called to say that he had tried to reach Chairman Martin and Vice Chairman Balderston but had been unable to do so. He said that he was with Messrs. Humphrey, Blyth, and Overby of the Treasury, that they had been considering whether the rate increase should be in one step or two, and that they had changed their minds and now felt that two increases of 1/4 per cent each were probably better than a single increase of 1/2 per cent, that they realized that this was a change in position, but that they had in mind that many institutions which had subscribed for the 3 per cent bonds recently might regard it as a breach of faith if the rate were increased to 2-1/4 per cent so soon afterward. Mr. Burgess asked Mr. Riefler to get in touch with Chairman Martin and ask him to get in touch with Secretary Humphrey early on Monday morning.

(10) (Chairman Martin continuing.) I called Secretary Humphrey yesterday morning and went over the situation with him again. He agreed that he had given us the "go ahead" on a 2-1/4 per cent rate. I told him I had seen several dealers coming up from the street on Friday (including Mr. Craft) and that they said the discussion in the market was all on the point whether the increase would be 2 per cent or 2-1/4 per cent. I told Secretary Humphrey that I had not changed my mind at all and still favored an increase of 1/2 per cent. He was worried about whether we had thought through fully the Treasury's responsibility to the people who had bought long-term bonds. I said I thought it was a little late to bring that point up, that while I would go back and discuss the matter with the Board, I thought the Board was disposed to go to 2-1/4 per cent for the one Bank that had acted to fix that rate. After discussing the matter with the Board, I talked to Messrs. Humphrey and Burns again. As of the moment, Mr. Humphrey is not happy about the picture but is relying on our judgment. He has some question whether we should go first to 2 per cent and then to 2-1/4 per cent but he thinks that we should get to 2-1/4 because he believes we are in an inflationary situation. However, he is not altogether happy with the prospect of a single increase to 2-1/4 per cent.

That is a background statement for the discussion at this meeting. If I have made any errors in what I have said I hope someone will correct me. We have a difficult situation before us. We will always have differences of opinion on these matters. I would like to point out that my views would be the same if we had not had the discussions with the Treasury.

I would like to go back now to Mr. Sproul's statement which I read earlier. I think personally that all the danger signals he mentions are now flashing red. Inflation is a thief in the night and if we don't act promptly and decisively we will always be behind. All of us know that it sometimes takes a long time for seeds to germinate, but when they flower, they do so with explosive force. A move such as we had in General Motors of fifteen points in one day would be disastrous if it developed over the whole price level, and once such action has occurred, neither monetary policy nor anything else could effectively restore the purchasing power of the dollar without creating such distress as to preclude its usefulness.

It is true we may have a difficult situation in the Government securities market. At the same time, banks are no different from consumer credit lenders who always want "the other fellow" to restrict credit. With the heaviest demand for credit that we have had for a long time the cost of credit must go up or the groundwork will be laid for burgeoning difficulties.

We are faced with a wage cost push at a time of virtually full employment, consumer and mortgage credit are "running out of our ears," and while the housing authorities have stiffened their terms slightly it would have been better if they had never gotten into the position of overstimulating the housing market. The new requirement of a $200 down payment on a $10,000 house is not my idea of a drastic credit move.

Inventory accumulation is already under way. I don't believe in intuitive judgments, but we can not always wait for statistics. A recent revision of earlier statistics tells us that in the first quarter gross national product was up $5 billion more than we had thought earlier and I think it is now at an annual rate of $383 billion. That is quite a jump and it is utterly incomprehensible that in that situation orders to expand inventories are not increasing. People with whom I have talked tell me that the reason inventories have not increased is because sales have been so high. Easy credit has pushed up sales when easy credit was not necessary. Plant and equipment expenditures are definitely on the increase. I doubt that this trend will change because of a drop in the Government securities market. At the same time, I doubt that the increase in the discount rate will cause either panic or catastrophe. We are having panic and catastrophe "thrown at us" but we are faced with a situation in which we have to act. It seems to me money and credit have become a stimulating force at a time when it is not required in the economy. There are always offsetting factors. Farm prices are declining, but I don't want the industrial sector of the economy to go "haywire" on its prices and get completely out of adjustment. Farm prices may well be higher before the end of the year, and if farm prices were up in addition to what we now have, general prices would be "sky high".

With reference to the directive to be issued to the Federal Reserve Bank of New York, I would suggest that we change clause (b) in paragraph (1) to read: "to restraining inflationary developments in the interest of sustainable economic growth."

Chairman Martin then called on the Presidents of the three Federal Reserve Banks whose directors had acted to increase the discount rate.

Mr. Fulton's comments were substantially as follows:

My directors met on July 14 at which time they discussed the discount rate. In view of all of the facts that had been given by Mr. Young in his economic review at the meeting on July 12 and which were existent in the fourth Federal Reserve District, the directors were in favor of an increase in the discount rate. However, because of the Treasury's financing operation which was still in progress I counseled against any action at that time. As the minutes will show, at the meeting of the Federal Open Market Committee on July 12 I expressed the view that inflation was already present in a degree that was not readily discernible except from the "feel of the situation." Our directors discussed whether the increase in the discount rate should be in one or two steps but they were all of the opinion that an increase of 1/2 per cent was desirable in the circumstances.

The directors held a special meeting last Wednesday primarily to discuss our Pittsburgh building but they discussed the discount rate problem also. They still felt that the rate should be increased. Several of the directors had talked with bankers and industrialists throughout the district and one banker had expressed the view that if the Federal Reserve increased the rate by less than 1/2 per cent it would be temporizing with the situation and would ultimately regret the action. Our directors were unanimous in their decision that an increase of 1/2 per cent was desirable from the standpoint of the over-all economy, including the fact that the demand for credit was so strong that it seemed to be without limit. Last Tuesday Mr. Blyth, of the Treasury, was in Cleveland and I had a long talk with him without divulging what we were thinking. He said that the Treasury probably would have to come into the picture for additional cash financing in September rather than in October because of the need for funds for farm price support operations and

> other purposes and that this would preclude increasing the discount rate in two steps. It was his view that whatever action was taken should be in one step so that the market could adjust to it. That all served to fortify the feeling of our directors that an increase in the discount rate of 1/2 per cent is the appropriate action to take at this time.

Mr. Young stated that at the meeting of his directors last Thursday at which seven directors were present (he had previously talked to the two absent directors and obtained their views) the national economic situation and conditions in the Seventh Federal Reserve District were reviewed and that everything pointed in the direction of strong expansion. He had talked with two or three large automobile dealers and felt that the credit extended on new automobiles, because of the very easy terms, was second grade in quality when compared with credit extended on used cars. He felt that the resulting situation was a dangerous one and that immediate action to restrict credit should be taken. He added that the directors considered whether action should be an increase of 1/4 per cent or 1/2 per cent and that they discussed an increase of 1/2 per cent first. Some of the directors had prepared statements which they read at the directors' meeting, Mr. Young said, and while they agreed that inflation was here and that something should be done, no one wanted to increase the rate by 1/2 per cent. They then talked about an increase of 1/4 per cent and voted to approve that. Mr. Young went on to say that he asked his directors for authority to call a meeting of the executive committee to consider a further increase in the rate on the basis that if other Federal Reserve Banks should increase their rate to 2-1/4 per cent he felt the Chicago Bank should make the same change. He also said that following the meeting two of the directors called to question whether their action should have been an increase of 1/2 per cent and that he had received a wire from one of the directors to the effect that if, after attending this meeting, he (Mr. Young) felt the rate should be 2-1/4 per cent, the director would vote for such an increase.

Mr. Erickson stated that at the meeting of his directors on March 28 he recommended an increase of 1/4 per cent in the discount rate which the directors approved provided some other Federal Reserve Bank made a similar increase. The reason for this action was that the directors did not think that the economy of New England was as buoyant as in other districts and they wanted some other Reserve Bank to act first. In April as soon as the Federal Reserve Bank of Kansas City increased its rate the Boston directors voted an increase of 1/4 per cent. In May, Mr. Erickson said, the directors brought up the question of the unsoundness of consumer credit development and approved a letter to all banks in the First Federal Reserve District cautioning them about unsound consumer credit terms. He went on to say that the directors recently had been anxious to increase the discount rate but had not done so because of Treasury financing, but that at the meeting yesterday after reviewing the situation again and discussing whether the increase should be 1/4 or 1/2 per cent they felt that, in view of what might happen in the Government securities market if the increase of 1/2 per cent were made in one step, they would prefer to take the action in two steps and consequently voted an increase of 1/4 per cent. Their thought, Mr. Erickson said, was that after the market had adjusted to that change the rate could move up to 2-1/4 per cent if it then seemed desirable. He added that the directors also expressed the hope that through open market operations the market would be further tightened.

Chairman Martin then called on Mr. Sproul who, before reading a prepared statement, made substantially the following comment:

> In view of the reference that has been made to getting everything "out on the table" I don't want to leave any implication that I have anything "under the table." I would like to refer first to the New York Times story mentioned by the Chairman, which followed a press conference I had with financial reporters of the New York daily newspapers. The conference was an ordinary press conference such as has been held at the Federal Reserve Bank of New York ever since I have been there to provide financial reporters with whatever background information we feel we can give them so that they will be better able to write about financial and credit matters.
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> The second-hand report in the market news letter of what went on was based on a general discussion without explicit or implicit statements concerning certain matters. It was put in the form of definite statements as to what happened. With reference to the statement on mild restraint, the reporters had asked how the present policy could be characterized and I said I did not believe in trying to characterize a policy in one or two words but that it had been characterized at times as one of mild restraint. Any questions about the discount rate were answered that I could not and would not say anything about it.
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> So far as the telephone conversations are concerned, Chairman Martin called and told me of his views and the views

of the Treasury and Mr. Burns. Subsequently, he called to tell me about the action of the Federal Reserve Bank of Cleveland. Mr. Rouse was away and I had fairly frequent conversations with Mr. Burgess for whom we were carrying out operations and with whom we were discussing the situation in the market. He referred to the discussions with Chairman Martin and to the fact that there was concern about the credit situation and the view that had been expressed that the rate be increased by 1/2 per cent. I asked him if adequate consideration had been given to what that might do to the capital and Government securities markets. He said that it had been considered. I expressed the opinion that the capital market was under strain and was undergoing an adjustment and I thought that an increase in discount rates of 1/2 per cent might have a more serious effect than might be expected.

He called back the next day and told me that he had talked with Secretary Humphrey and Chairman Martin and that they were still of the same opinion but thought that the matter should be thoroughly discussed at the meeting of the Federal Open Market Committee and Mr. Burgess said he hoped I would express any views that I had. I said that I certainly would. He called again on Friday to say that Mr. Blyth of the Treasury had returned to the Treasury, that there had been further discussions with the Secretary, and that it was thought that it might be better to move in two steps rather than one and that the Secretary was going to try to get in touch with Chairman Martin on Monday morning. He said he had called me so that I would know that they at the Treasury had not set their faces definitely and irrevocably against action in two steps instead of one. That was the end of my conversation with Mr. Burgess.

Mr. Sproul's prepared statement was as follows:

1. There is no need to debate whether or not we have entered an economic area in which increased monetary restraint on credit expansion is indicated. We have had a substantial and contra-seasonal rise in bank loans during the first half of the year and we face heavy demands for bank credit during the second half of the year. We have the possibility that, with

increased costs pushing upward on industrial prices, the general price level may break out on the upside. We have the possibility that, in these circumstances, speculative increases in inventories will take place. We have the fact that consumer spending (bolstered by expanding consumer credit and mortgage credit on relaxed terms) has become high and saving has become low in relation to current income. We know that prospective capital expenditures by business are slated to rise from earlier high levels.

2. The principal questions of judgment which remain are
   (a) Whether the weight of evidence is now indicative of desirable growth but with speculative and credit excesses in some sectors, or whether it is indicative of inflationary forces which have or are about to get out of hand?
   (b) Whether continued steady and probably increasing pressure, as the season advances, is the best contribution which monetary policy can make to the maintenance of growth and the containment of excessive use of credit and of speculation, or whether it is time to take action which will signal a more serious economic situation and more drastic measures to deal with it?
3. There are also subsidiary questions
   (a) As to whether the Treasury's financing needs during the remainder of the calendar year are likely to hamper us in the later use of credit measures, and particularly of the discount rate, so that it might be better to act now in anticipation of possible later need.
   (b) As to whether a policy of continued and probably increasing pressure will interfere more seriously with Treasury financing than would anticipatory action now followed by a period of stability, at least so far as the discount rate is concerned.

4. Taking up the subsidiary questions first, the Treasury's financing difficulties are fundamentally due to its need to come to the market for refundings, and more particularly for cash, in a period of rising interest rates. Nothing we can do, short of abandoning whatever restrictive credit policy is required by economic conditions can change this situation, or can keep Treasury issues at par for very long after they begin to be traded in the

market. But having said that, we have before us the recent example of the Treasury's ability successfully to raise cash and conduct an exchange offering in the face of an already tightened reserve situation and of widespread expectation of a rise in interest rates, including the discount rate. I see no need to try to anticipate now what may be the situation in late September, in order to be out of the way of the Treasury's September-October financing, which in any case will presumably take the form of a tax anticipation certificate not requiring much if any assistance from us. And, certainly, we can give no assurance to the Treasury, nor anyone else, that whatever action we take now will foreclose the possibility of further action later if the economic situation seems to require it.

5. Taking up the main question, I recognize the strength and the risks of the present situation, but I do not know whether it is getting out of hand. I do not know whether we have reached the limits of our productive capacity in terms of men, materials and equipment. On these matters we have opinions rather than conclusive evidence. In such circumstances, I would deal with the situation with firmness in the light of what we can see now and immediately ahead, but I would not try to project myself too far into the future. What we can see here and now suggests

(a) An open market policy which will develop conditions tight enough to bring about a further increase in member bank borrowing and in interest rates. Insofar as free reserves are still used as a guide, they would ordinarily be on the minus side of zero, but they would be less a guide than fluctuations in member bank borrowing and in interest rates.

(b) An immediate increase in the discount rate from 1-3/4 to 2 per cent.

(c) Retention of the power to use repurchase agreements, within the authorized range of rates.

6. What are the risks of an increase in the discount rate to 2-1/4 per cent instead of 2 per cent, if we want to increase the pressure of credit restraint in any case? It is only a 1/4 of 1 per cent difference. Well, as I see it they are

(a) The risk of giving expression to a judgment about a future economic situation which we do not yet have to make. I also see here, again, an attempt to place on credit policy too much of the burden of fears about future economic developments - with the shadows they may cast on 1956. If the situation is as critical as some suggest, credit policy can't do the whole job, and shouldn't try to do it. It may be, for example, that fiscal policy will have to be called in, and housing policy will have to be overhauled further. Because these things won't or can't be done, doesn't mean that credit policy should try to do more than it is capable of doing effectively.

(b) The risk of bringing about an erosion instead of an adjustment in the capital markets. The capital markets have been adjusting to what we have already done, and will adjust gradually further, to advantage, as the pressure of demand for credit meets a reluctant supply. Too sharp an adjustment, however, can arouse fears and create strains which would go beyond what we need or desire. We cannot dismiss altogether what happened in 1953, even though conditions then and now are quite different in many ways. An increase in the discount rate by 1/2 of 1 per cent, after a long period of 1/4 per cent changes, and coming when capital markets are already uncertain and beginning to show strain, would be a risky move. I know that it is argued that the most likely outcome of a substantial increase in the discount rate now would be to relieve further uncertainty and to put a floor under the market, and that even if the initial reaction proved too severe we could offset it by open market operations to correct a disorderly market. For my part, I doubt if any one knows what an increase of 1/2 of 1 per cent would do to the capital market. I think it is an unnecessary risk to take. Nor can we "get it over with", and put a floor under the market because this may well be more than a one-shot problem - we may have to raise the rate again, whatever is done now. And finally, to raise the rate by 1/2 of 1 per cent now with the assumption that we would offset the effect of the increase in rate by open market operations would suggest that we did not know what we were doing or did not mean what we said when we raised the rate in the first place.

(c) That is the third risk, the risk of getting the discount rate and open market operations out of tandem.

With the smaller increase in the discount rate we shall have open market operations and the discount rate running together in harness, and the discount rate keeping more or less continuously in touch with open market rates. With the larger increase, we run greater risk of having to take counter action through open market operations, if the business and credit situation does not perform according to our projections, or if the immediate results of our action are more drastic than we intended.

7. To sum up, these things I have mentioned might not happen, but we don't need to run the risk of their happening in order to have monetary policy do its share in trying to prevent inflationary developments. I think it is a time for steady pressure, not for jumpy moves. We haven't the same domestic situation and we have no balance of payments problem forcing us into immediate and dramatic action, such as has been taken by the United Kingdom and other countries where substantial increases in discount rates have been made, and where monetary policy was probably asked to bear too great a share of the burden of economic stability. We can afford the better course, at this stage, of gradual moves fitted to the economic situation as it emerges.

Chairman Martin then called on Mr. Bryan who read the following statement:

The problem of judging appropriate monetary policy is difficult because of the unusually complex economic situation, complex, of course, not from the statistical but from the standpoint of cyclical analysis. Monetary policy is also especially difficult at this time because we have denied to ourselves a current knowledge of the economic effects of previous monetary action, and, as if that were not enough, the difficulties are compounded by the prospective presence in the market of the Treasury, a large and necessitous borrower.

1. We can all agree that the economic situation is ebullient and presses on the comfortable capacity of the economy. It can thus be concluded that the apparent present trends in the economy simply extend themselves to over-reach comfortable capacity and that, accordingly, an inflation is inevitable in the absence of additional immediate, and substantial monetary restraint.

I would agree that sophisticated economic arguments can be advanced to support the opinion that an extension of recent trends is likely and that, in the absence of substantial monetary restraint, a price-level inflation, with its accompanying distortions of the economy, is also likely. So, with regard to the economic situation, I content myself with two caveats, one in the field of business cycle relationships and one in the field of American economic history.

We should not forget, I think, that a boom extending toward the upper reaches of comfortable capacity automatically produces powerful countervailing forces. These forces have to do with the declining profitability of marginal employment and the declining profitability of new real investment in the face of a stable or relatively stable level of prices for finished products. It would be pointless to pursue such considerations in detail, but it would also be unwise, I believe, to forget that such forces exist and that they exert a powerful braking action on an unlimited and continuous extension of an economic boom.

We should also at least remind ourselves of American economic history. At this time, when we are fearing inflation, we can take some comfort from the fact that the American economy in its now long history has not shown a general important price-level inflation except in war and as the direct aftermath and consequence of war. Our experience has been that the productive capacity of the American economy, its competitive nature, and the countervailing forces already alluded to, have made the American economic system exceptionally difficult to inflate in peacetime.

In making these brief comments, I do so merely in order to indicate that our inflationary problems may not be as great or as intractable as we may be inclined to fear.

2. It seems to me that we can take comfort from another factor. The monetary situation is such that general inflation is hardly going to get off the ground unless we, by decision subsequent to this time, deliberately decide that we will supply the funds necessary for an inflationary price-level movement in the economy. There exist, by and large, no free reserves in the banking system. The money supply as against last year represents a modest increase. The increase of banking reserves as against last year is likewise quite modest. Even if these factors should be countervailed by an excited increase in the turnover of the money supply, we have the power to dampen down the result with no untoward delay.

All this is to me quite comforting because it has a definite meaning. If the economic system endeavors to overrun its comfortable capacity it will not be supplied by large, existing, and idle reserve funds. It will automatically run against an extremely limited reserve situation, and we will be quite able to make decisions from time to time regarding the degree and extent to which we supply additional reserve funds or subtract from them. That is, we can make such decisions provided we preserve a monetary climate in which we can act of our own volition and do not create a climate in which we must act involuntarily.

3. Let me now turn to what I consider the major awkwardness in our consideration of further immediate monetary restraint. In so doing, it is necessary to recite some recent monetary history, not for the sake of history but particularly to illustrate what I regard as the grave danger of getting ourselves into precisely the same box in the future in which we now find ourselves uncomfortably confined.

It will be recalled that some months ago we raised our discount rate to 1.75 per cent. We thus adopted a stated short-term rate of 1.75 per cent, which I believe could only indicate our belief that the economic system required the restraint of an increased cost for the borrowing and using of money and an increased reward for money savings. That was a correct decision, but at the time of the May financing we apparently became a little tremulous and fearful of the effects consequent to the course we had adopted, and entered into token purchases in the open market. Thereafter, flushed with a heavy corporate and other demand for bills, the open market rate drifted down into the 1.50ies, the 1.40ies, the 1.30ies, and actually reached a point more than 40 basis points below the discount rate. During nearly the whole period after the increase in the discount rate, the corresponding open market rate was permitted by us to be substantially lower than the discount rate. The net effect of this situation was to prevent the arbitrage of yields that would have made the cost of borrowing and using money more expensive. The net effect, in short, was largely to prevent the economic restraint that we had presumably thought desirable.

Only in the last few weeks, with the Treasury increasing bill offerings and with a variety of factors causing corporate and other bill purchasers to need funds, has the bill rate gotten into touch with the System's discount rate. Only in the last few weeks, therefore, have the arbitrage effects of the previous increase in the System's discount rate begun to occur. Only in the past few weeks have we been able to see what the money market and yield curve effects of our previous action are in kind and degree; but we still do not know the degree of economic restraint that we have accomplished. We do not know that vitally important fact because of the lag in transferring money rate causes to real economic effects.

We thus, it seems to me, have gotten ourselves into an embarrassing position. Our embarrassment arises from the necessity of considering further restraint at a time when we might have been currently pretty well informed regarding the restraint involved in our preceding action but are actually uninformed in major aspects because we did not quite mean what we said when we previously raised the discount rate.

As I say, I do not recite all this for the sake of history but as a caution. We should caution ourselves, I believe, about getting into the same box again, and we should caution ourselves against an over-zealous action at a time when we are not, to be sure, flying entirely blind but when the visibility is not good.

4. In the past few weeks, when the arbitrage of a preceding action has been allowed to come into being, we have been able to see something of the direction and extent of the money effects (not yet the consequent real economic effects) that we have produced. However, we can at least know the direction of the economic effects that our actions have created.

The money markets have been trying to tell us a story. That story seems to me not to have been a story read in fine print and whispered to us by innuendo. Instead, it seems to me to have been a story written in headline letters and cried out to us in a loud voice. I will not attempt to state in detail what the voice has been saying, but two major items are newsworthy.

a. The government market in nearly every sector of its maturity schedule has been exceedingly weak, and there has been a major adjustment of yields and capital values. We should not overlook the magnitude of the yield changes that have occured, I believe, and should not be at all sanguine about the theory that this merely represents an anticipatory discount of further monetary restraint. An examination of yield curves over the past few months does not settle the question, but it does not seem to me to support such a view.

The existing adjustment of yields is more likely, in my opinion, to represent a normal adjustment as the short open market rate has conformed itself more nearly to the System's discount rate, and further increases in short rates are likely, I judge, to involve further upward arbitrage of yields and downward arbitrage of capital values throughout the whole range of maturity and quality schedules.

b. The municipal market has been dreadfully sick. Unless we pump funds into the banking system in tremendous quantity, which I think we will not do voluntarily at near term, it would seem reasonable to suppose that that market is going to be ill for a good long time and have a slow recuperation. There are going to be many offerings; undigested inventories of municipal securities are great; and most important of all, the banking system, which has for years provided a major market for the short end of the municipal maturity strip, is now loaded.

These developments tell us a story. They tell us that the banks of the country, almost without exception, have substantial losses in their investment portfolios, not alone in governments, but in municipals and corporates. They have a substantial erosion of their capital accounts. That fact in turn tells us another story. Whereas, a few weeks ago, the banks of the country could peddle securities with, for the most part, minor losses, and thus accommodate even marginal borrowings, we know that now their net security sales will generally be accompanied by losses that are not so minor and in many instances are major. Whereas, a few weeks ago, the banks were really not restrained in accommodating marginal borrowings, now the restraint has been increased.

I cannot pretend to say how great the restraining effect on the banks will be in quantity, but I think it can safely be asserted that the effects of the past few weeks have established a new and restraining influence that was not present theretofore, and I would personally judge that that restraining influence is far more powerful than we may be inclined to imagine. Unfortunately, it will hardly show up in our statistics or in any contraction of loans for some little time in the future.

The markets for both municipals and government securities have also been trying to tell us that there will be a slower but nonetheless considerable revulsion in the mortgage markets as commitments expire. For many classes of mortgage lenders, in consideration of taxes, administrative costs, and the risk aspects of some mortgage loans, the municipal markets give a higher net yield at shorter term, with equal or greater safety, than the mortgage market. Indeed, for some mortgage lenders the government market is also attractive. We thus know that the restraint already begun in the mortgage lending field is going to be powerfully increased and augmented by investment opportunity relationships now clearly evident, and, in a few months, as mortgage lenders run out of existing commitments, these money market and investment shifts will begin to show up in real economic effects.

Other things of the sort I have noted can be cited. I will not even allude to what I diagnose as the metastasized cancers eating at the equity markets, markets still in the apparent flush of good health. What I have said, though, is enough to indicate the awkwardness of our position if we adopt large further restraint without a fairly good knowledge, which we do not have, of the economic effects we have already, though very recently, set in motion.

5. Now, if we raise the discount rate we shall be confronted with the problem that has tripped us so badly in the past. That is, if we adopt a new and higher System rate, we will be saying, in effect, that the cost and use of money should be more expensive, and that the reward for money saving should be increased. We will then be confronted with the problem of whether we mean what we say or whether we are merely making a polite observation. If we mean what we say, then we will have to permit the short open market rate to conform itself to the System discount rate, or force it to do so, and thus effect an arbitrage of interest costs along the whole maturity and quality schedule.

Before we take any long step in that direction, we ought to have in mind, I think, not merely the hazard of acting in the absence of knowledge of the economic effects that we have thus far set in process, but we should also, lest we be startled by developments, have in mind the magnitude of the price changes that can occur as a result of certain upward shifts of yields at this time, for if we become surprised and startled, we may respond erratically.

Let us then consider the possibilities of 25 more basis points in the short rate, bring the short rate in the neighborhood of 2 per cent. No one would, of course, contend that a quarter of a per cent increase in the short market would make an exactly corresponding increase in yields in the long market. If it did, then, the new forty-year 3's would sell in the neighborhood of 90. Still, a man would be considered reasonably conservative if he judged that a 25 basis point upward change in the short rate could easily produce a change in the longest rate in the range of 8 to 12 basis points. That puts the new forty-year 3's in the neighborhood of 95. The basis point adjustment to the short rate will be greater naturally, as we go down the maturity curve. A corresponding adjustment in the 2-1/2's of 67-72 could put them in the neighborhood of 90. Neither figure allows much, if anything, for the overrun typical of free markets. There would be further repercussions in the municipal and corporate markets.

It seems to me, accordingly, that we should have in mind some price adjustment magnitudes in the approximate order of those I have indicated, because, once we get them in mind, we begin to understand, and only by having them in mind can we at all understand, the power and force of the financial and economic effects that we can set in train. For my part, I have little doubt that capital losses in the magnitude I suggest--losses that I deem entirely likely from even a 25 basis point increase in the short rate in the face of a large money demand--would, if they occurred suddenly and dramatically, set in motion an economic restraint of the first class.

6. The general direction of the argument that I am trying to make is now clear.

I am arguing that we are in an awkward position because the restraining capital losses in the financial markets are now considerable and can be expected to have a considerable real economic effect, but those losses have been created so recently that we are not in a position reliably to appraise their real economic effects. That situation has occurred because we have used the discount rate as an admonition, not until very recent weeks, as an effective rate in the market. We are thus flying through heavy clouds in considering further restraining measures.

The obvious danger is that we may, with further measures, find ourselves developing a cumulative economic restraint that overshoots the mark. The danger that I would here emphasize, however, is that we may adopt a new and higher discount rate, clearly indicating to the financial and economic worlds that an arbitrage of yields throughout the rate and maturity schedule should occur. Then, when the arbitraging process begins, we may easily find ourselves startled by the magnitude of the downward capital adjustments in the investment market and promptly come in with open market purchases in order to prevent the effective open market rate from conforming to our discount rate and thus deny that we meant what we said when we raised the discount rate. In short, I am afraid that what we will do is to say that we want an arbitrage of yields and capital values in order to provide economic restraint and then, when they begin, deny the arbitrage of yields and capital values by establishing an effective open market rate substantially below the discount rate.

Such a monetary maneuver in my judgment is nearly always inept and has had unfortunate consequences at certain periods of the System's history. It is particularly dangerous at the present time. To my mind it has two clear dangers that we should by no means underestimate.

a. One danger of importance is that, if we raise the discount rate in the face of a booming economic situation and then, in the open market, countermand the effects, we can find ourselves, say in October, in the same position we are in today. That is, we will be under the necessity of considering a further increase in the discount rate, as we are now, and considering such further action without knowledge of the effects of the previous discount rate if it had been an effective rate. We will thus again be operating without a knowledge of the lagged, real economic effects involved in past action, and our second case will be worse than our first. The ultimate consequence of such procedure seems to me clear. At some point we shoot well beyond the degree of restraint that we want.

b. The second and perhaps even more important danger of such a procedure at this time is that the market, taking us at our word with regard to the increase of discount rates, will logically assume that we intend with reasonable promptness to conform the short open market rate to that statement of policy. We then get substantial upward adjustments of yields and downward adjustments of capital values. Remembering the tendency of free markets to overrun their mark, we can easily get a situation of actual or incipient disorder.

At that point we are almost certain to be frightened and practically compelled to perform a rescue operation with sole regard to the investment markets, not the underlying economic situation. That rescue operation in the presence of a raised discount rate is almost certain to involve putting reserves into the market in magnitudes far greater than would have been required if we had not given our discount rate signal and far greater than the economic situation, either on a long-run or seasonal basis, would remotely justify. The danger, then, is precisely this: that we maneuver ourselves into a position, in a momentary excess of enthusiasm, in which we will have to feed the very inflation that we are intending to restrain.

7. Having emphasized the awkwardness of our position at the present time and the hazards of giving a discount rate signal, it is fair to ask how I would proceed. Well, one thing is clear, I would not at the moment increase the discount rate to 2-1/4%. If we do so increase the rate, I take it as a practical certainty that we do not intend at all promptly to conform the short rate to it. I would judge that so large a short rate increase would produce yield and capital value arbitrage effects so great that we, ourselves, would not find them tolerable as a policy result at this time and that would not, in any event, be a practical maneuver in the field, let us say, of political economy.

So I would assume that a 2-1/4% rate would automatically mean that we would promptly establish an open market rate substantially below the discount rate. We would thus, by putting the discount rate so far above the effective open market rate, deny to ourselves the safety valve feature of the discount rate in the event adverse market developments tended to create an undesired degree of financial stringency. We would thus also be likely to find ourselves, as I have repeatedly said, later on considering further action without the degree of knowledge that we should have. It is my judgment, then, that the maximum increase of the discount rate that we should consider is to 2%.

However, I would consider this a time in which further restraint could be approached with the least danger by doing four things. I would thus be inclined to:

a. Use as our chief present guide to policy, not free reserves, not total reserves, but money rates, relying upon our knowledge that increases in those rates, particularly as they are transmitted into the long markets, will have a pervasive and powerful, though lagged, effect in the real economy.

b. Preserve the present discount rate for its safety valve feature, relying on our knowledge that, as banks are pressed for reserves, they will have to come in and borrow and, in their present illiquid position, such borrowing will act as a further important restraining measure.

c. To experiment with further rate increases by letting the bill rate float above the discount rate, carefully observing the effects in the government and other fixed income investment markets and stopping out the rate increase whenever the downturn of capital values appears to have mounting disorder or the existence of two-way markets seems seriously impaired by the withholding of investment funds in anticipation of lower prices.

d. To stop out, in any event, the increase in short rates in sufficient time to provide the Treasury with stability for its financings.

It is my judgment that proceeding in this way we could effect further powerful restraint, remain consistent in the handling of our instruments, and minimize the hazards that, to my mind, appear so great. If the economic boom is as powerful as we think it is, representing an unsustainable rate of economic expansion, and if the financial markets are able to take the restraint without erratic disorder, which would represent an unwanted degree of financial stringency, then, by floating the effective short rate above the discount rate, we shall be able to raise the discount rate as the visibility improves and as such a move seems needed.

At the end of his written statement Mr. Bryan said that he realized that the program outlined in his statement might not be followed and that the Atlanta Bank would increase its rate promptly to either 2 or 2-1/4 per cent as determined following the discussion at this meeting.

Chairman Martin then asked for the comments of Mr. Balderston who was the first to suggest an increase in the rate to 2-1/4 per cent.

Mr. Balderston's statement was substantially as follows:

It seems to me that we have to face the fact that many bankers will not like a 2-1/4 per cent rate. Some stand to suffer substantial portfolio losses, perhaps significant in relation to capital. Contrary to the line of thinking that Mr. Bryan has presented, I find myself greatly disturbed by Dr. Goldenweiser's remarks about the failure of the Board to act soon enough in 1919 because of Treasury financing. Also, the drastic action of 1928 and 1929 failed to control a movement that had gotten out of hand. Mr. Young's report reinforces my concern that the inflationary forces now loose will be difficult for monetary policy alone to stem. It will take more than monetary action. It will take fiscal action, and prudent decisions by businessmen as to borrowing and by banks as to lending. Loans are on a high plateau. Industrial production is up 14 per cent over the year, with the nondurable component up 13 per cent, and the durable goods component up 16 per cent. Capacity levels have been reached in metals, building materials, rubber and chemicals. Then there is the impact of personal incomes, which are up 6 per cent over a year ago, on retail sales. Automobile sales are up two-fifths over a year ago and the sales of major appliances at department stores are up three-fifths. It is clear that retail sales have recently been increasing at an increasing rate. Not only the current peak figures but increases in the rate of improvement should be taken into account.

Plans of entrepreneurs to expand capacity, and the growth of consumer credit and its misuse to the point where dealers are selling terms instead of automobiles are evidences of ebullience. Increases in heavy construction, consumer credit, the upsurge in retail sales, and flurries in the stock market may indicate that general credit has been too easy. I feel that a greater degree of ease has existed throughout this year than the Committee contemplated. This leads me to believe that action should be taken at once, and that a 1/2 per cent increase in the discount rate is indicated, despite the fact that it may create disorderly conditions in the Government security market. Since the price of inaction for the economy as a whole seems greater than the price of disturbing the bond market and bank portfolios, we should act decisively and not temporize with the situation.

Inasmuch as Mr. Williams had to leave the meeting early, Chairman Martin called on him next. He said that there had been a number of extended staff discussions of the discount rate and discussions at two meetings of the directors of the Philadelphia Bank in which the staff participated. He added that his board of directors took a cautious attitude in respect to change in the discount rate in the present circumstances as indicated by the fact that the Philadelphia Bank had earlier this spring lagged behind other Banks in changing the discount rate; the businessmen on the board of directors were questioning the present rate of expansion and felt that the economy was coming to a period in which it could easily level out. He commented on the experience of one of his directors which indicated that there were conditions in the automobile industry which raised a question whether the present rate of production would be maintained. He went on to say that some smaller manufacturing concerns which are noted for quality work have not been making profits because of the squeeze on costs. There were other things, he said, which indicated that the economy is not likely to continue to expand at its present rate. He related an experience at the Bank recently in which the department stores came to the Reserve Bank and sought its offices in bringing together the credit rating bureaus. Four groups were interested including the commercial banks, large department stores, discount houses, and small loan companies. A survey had been made which indicated that in a number of instances consumer credit had been granted beyond any relationship of the ability of the customer to repay in a reasonable time. The group was attempting to establish in Philadelphia and throughout the State regional credit rating bureaus. All of these experiences, Mr. Williams said, caused the directors to be concerned, and, while there was no question that they feel some restraining action is necessary, they are fearful of the effect of a rate increase of as much as 1/2 per cent. They believe that it might be too harsh and that an increase in two steps would be better. However, he thought that there was also no question in his directors' minds but that the action taken should be a System action and that, if the decision is to increase the rate by 1/2 per cent, his directors would feel that because of the fluidity of the money market the Philadelphia Bank should go along.

Mr. Earhart, who also had to leave the meeting early, stated that his directors would meet tomorrow morning, that he knew from early discussions that the directors would be prepared to increase the rate, and that the only question would be how much. The San Francisco directors felt, he said, that the System had not been asserting sufficient restraint in the earlier part of the year but they had withheld any action on the discount rate because of the timing of Treasury financing. Mr. Earhart said that, notwithstanding the fact that some of his directors might prefer an increase in the rate to 2-1/4 per cent, it was his own judgment that it would be preferable to increase the rate to 2 per cent for reasons which had been mentioned at this meeting. He believed it was important that open market operations conform closely to discount rate policy; that is that market rates should be closer to the discount rate than had been the case in the past. While he would like to have an increase in the discount rate when there was a substantial amount of borrowing so that the increase would have more than a psychological effect, the volume of discounts in the Twelfth District had been nominal up to the present time. He thought it was possible, if the market tightened as it had during the past week, that there might be more discounting. In the circumstances his preference was to go to the 2 per cent rate.

Mr. Irons had no question that there is great strength in the economy but he did not feel that the situation called for severe action. It was not a question in his mind of continuing growth but of avoiding speculative developments that would lead to unsustainable growth. He also felt that System policy should be pointing toward increasing restraint. The question of the discount rate, he said, was not one of inaction but rather whether the increase should be to 2 or 2-1/4 per cent. His appraisal of the economy and the situation in the capital markets called for a 2 per cent action now with the understanding that the short-term rate (i.e., the longest Treasury bill rate) would be allowed to move up, if desirable, through the 2 per cent rate and in any event closer to the discount rate. The Committee could observe the reaction to that situation and the banks could determine rather quickly whether a second increase in the rate was justified--perhaps within a month or six weeks. Before the end of the year, if inflationary pressures develop further and persist, possibly even a third increase might be necessary. It was his view that the situation was such that the System should maintain steady and, if necessary, increasing pressure on the market and on bank reserves but should not take action that would cause a shock or a sharp down turn. He stated that the matter had been discussed at the last two meetings of the Dallas directors and that if two or three Reserve Banks increased their rate to 2-1/4 per cent, because of the fluidity of the money market, he would recommend that his Bank go to that rate notwithstanding his preference for an increase to 2 per cent.

Mr. Leedy did not feel as complacent about the situation as Mr. Irons. He had not felt complacent about the economy since the System changed the direction of its policy last December. Since that time, he said, the System had undertaken to apply a little restraint, increasingly perhaps, but apparently without too much in the way of results. After reading Mr. Young's review of the economic situation and listening to the discussion at this meeting, Mr. Leedy felt that if the figures are to be believed, the country is in a very serious economic situation inflation-wise and so far as the credit picture is concerned. In his judgment the increase in the discount rate in April had not created a "ripple." An increase of 1/4 per cent at this time would not create a "ripple." It was his view that the market is already discounting such a change and, therefore, it would be necessary to increase the rate more than that. He thought the time had come that the System should give an indication of its concern about the credit situation and one way that could be done would be to increase the rate by 1/2 per cent. That could not be done without some risk as to its effects on the market, but in his opinion the System could never take action that would be effective without taking some risks. He referred to Mr. Sproul's view that some monetary action was required and expressed the opinion that if an increase in the discount rate was to be used for that purpose the increase would have to be more than the minimum increase that had been approved in the past. In view of the over-all economic situation and the very real threat of inflation as presented at this meeting, his view was that rather vigorous action was required at this time.

Mr. Johns commented that there was no disposition in the Eighth District to deny the strength that exists in the economy. However, there were sections and people in the Eighth District who would question the existence of any inflation, and he saw no likelihood of an increase in agricultural prices but rather a continuation of the downtrend through this year. Notwithstanding these reservations, his Bank was inclined to believe that the situation calls for continuously increasing pressure without any dramatic or theatrical move. The discount rate problem, he said, was discussed thoroughly at the meeting of his directors on July 14, particularly because of the custom of his board to eliminate its August meeting. It was understood, he said, that in all probability before another meeting was held an increase in the discount rate would be given serious consideration and the executive committee was authorized to take whatever action was necessary. On the basis of the information obtained from Chairman Martin over the telephone, Mr. Johns had requested a meeting of his executive committee on Friday morning of last week at which time the committee recognized the need for continuing pressure but was of the opinion that it would be a mistake at this time to increase the discount rate to 2-1/4 per cent in one step although it would be glad after this meeting of the Open Market Committee to vote for a 2 per cent rate. Mr. Johns agreed that the last increase in the discount rate had had little effect but he concurred in the view that had been expressed by others that the System is just now beginning to see the effects of that increase, and he felt that greater pressure was possible with the present rate. However, if the disposition of the other Banks was to go to 2-1/4 per cent his directors would fix that rate at the St. Louis Bank.

Turning to the System's fundamental responsibility for supplying and withdrawing reserves from the market and the volume of reserves necessary to sustain the economy without inflationary tendencies and how this may be related to an increase in the discount rate, Mr. Mills referred to the fact that the System was faced at the moment with a tight money market--a market that has been made tight by System actions--and a situation in which the System has indicated by a declared policy and by inference that additional reserves would be added during the approaching season in amounts, in the discretion of the System, which would sustain a high level economy. He also said that the System is now at a crossroads where there is a really tight market and an economy that needs tightening and a signal of danger in the form of an increase in the discount rate which was a psychological signal rather than an action that would produce a further tightening. It appeared to him that the Committee should determine at this meeting what the mechanism would be to complement an increase in the discount rate in a manner that would reaffirm the System's previously declared intention and at the same time indicate beyond any question that in the judgment of the System the economy should be restrained. He pointed out that within the last week $108 million had been put into the market in the form of repurchase agreements which was withdrawn when the agreements expired yesterday, that the forecast was that there would be deficiencies in reserves in the present week and in succeeding weeks, and that the Committee should look rather closely at the total supply of reserves, and the possibility that excess reserves at country banks have not become available to the central money market through the medium of Federal funds. The tenor of his thinking was that the Committee should give serious consideration, as a means of reaffirming its intention and at the same time relieving pressure on the money market, to at least replacing the reserves that had been withdrawn through the expiration this week of repurchase agreements. He felt that that would relieve the position of dealers and enable them to pick up their purchases of this week's offering of Treasury bills. At the same time, he said, it would allow the New York money market banks a little leeway to purchase bills and thereby take some pressure off the market but only that pressure that could be reaffirmed through natural factors over a short space of time if desirable to do so. He suggested that if simultaneously with an announcement of an increase of the discount rate, which in his judgment should be 2-1/4 per cent, the System could reaffirm its intention to provide additional reserves, it would be making a declaration of combined policy to the investment and financial community which would be unmistakable and would allay any fear of a steadily drifting downward of prices in the securities markets. His opinion was that the replacement of reserves that had been lost to the market by the maturity of the repurchase agreements should be the minimum amount of reserves that should be supplied and that, for the purpose of giving confidence, direct purchases of bills should be the means of supplying such additional reserves as judgment might dictate.

The meeting then recessed for luncheon and reconvened at 1:45 p.m. with the same attendance as at the morning session except that Messrs. Williams and Miller were not present.

Chairman Martin suggested that consideration be given to the suggestion which he had made at the morning session with respect to a change in the language of the Committee's directive to the Federal Reserve Bank of New York. After a brief discussion it was agreed that the changed language should be incorporated in the new directive to be issued at this meeting.

In a discussion of the suggestion made by Mr. Mills before the luncheon recess, Mr. Szymczak commented that reserves put into the market affect bank lending and the price of credit and the extent of the effect depended on the amount of reserves supplied. When reserves are supplied in the New York money market there is no assurance that they will stay there or for what purpose they will be used. He interpreted Mr. Bryan's statement to mean that if the Federal Reserve should put reserves into the market at this point, in effect it would be putting the discount rate up and keeping the short-term market rate down. He said he realized that the System may be faced with a disorderly market in which case it might be forced to correct the disorderly condition by purchasing securities contrary to current credit policy. To make certain, however, that we do not go in both directions at the same time, an early decision on what is a disorderly market and on the manner in which we shall purchase the securities and the amount of purchases considered essential, is vital lest we undo what we shall have done by an increased discount rate. He also said that any such securities should be sold as promptly as possible. He questioned the desirability of a statement to the effect that the discount rate would be increased but that the System was going to supply reserves to the extent necessary and he felt that such a statement would be confusing and would possibly be misconstrued.

Chairman Martin asked Mr. Rouse for his views on Mr. Mills' suggestion and in response to Mr. Rouse's request Mr. Mills stated his proposal as follows:

> We are in a position in the central money markets where a case can be made that, under almost any consideration, we should immediately or very shortly supply additional reserves to the market. We believe that the economic situation suggests a higher discount rate as being in line with that situation and the changes in interest rates. We have a tacit commitment to the financial community to provide reserves in amounts sufficient in our judgment to sustain the economy. If we raise the discount rate sharply and at the same time ignore the fact that the money market is temporarily starved for funds, and, speaking solely in terms of the money market and its relationship to the structure of the market for Government securities, we may very well be giving the impression that we are engaged in a policy of severe credit restraint and are reenforcing emphasis on that restraint by not supplying reserves in accordance with what the financial community regards as being a commitment. In my mind, there is a great distinction between the discount rate and the supplying or withdrawal of reserves and I can't see that there would be any contradiction in policy if we supply reserves in at least the amount necessary to replace the funds removed this week by the expiration of the repurchase agreements.

Mr. Rouse expressed the opinion that the reserve situation over the next two or three weeks would not suggest any injection of reserves into the market and that the only reason for such action would be to make clear at the time the discount rate was raised that the System had not forgotten the market.

Mr. Mills raised the question whether there were sufficient reserves in the money market to carry it over this week in the light of the commitment that the dealers have to pick up this week's offering of bills. He also inquired whether there were not good grounds for giving a temporary assist to the market to give a minimum of reassurance and confidence until the reaction to the increase in the discount rate could be ascertained and until market prices of Government securities and the whole range of corporate and municipal bond prices could move in adjustment to the discount rate.

Mr. Rouse stated that when the increase in the discount rate is announced there will be a mark-down of security prices to levels which the dealers think appropriate. Should the Committee intervene and buy bills, the price at which these purchases were made would be taken as the rate that the Committee was establishing in the short-term money market. He added that, in the light of the discussions in recent weeks and at this meeting, it was his judgment that on the basis of the possible reserve position during the next two weeks there would not be occasion to put reserves into the market.

Mr. Mills asked if there had been a sufficient test in a period of investment unsettlement, and also what situation the Committee will meet when the weekly average of free reserves declines. In his opinion, that question was particularly important when measured against the total supply of excess reserves, the larger portion of which is in the country banks and does not find its way into the money market except over a period of time.

Mr. Rouse referred to the reserve projections contained in the supplementary report of open market operations prepared by the Federal Reserve Bank of New York which estimated average negative free reserves for the current week of $85 million and for the week ending August 10 of $150 million.

Following a discussion of the possible level of bill rates if the discount rate is increased to 2 per cent and if it is increased to 2-1/4 per cent, Mr. Earhart stated that he was strongly of the view that open market operations and discount policy should be consistent and that the policy relating to both should be the same underlying policy. That was part of the reason why he did not want to move the discount rate up too far too fast. He thought it would not be consistent for the System to use the discount rate for psychological purposes and then keep money rates down through open market policy. Such action, he said, would confuse the dealers and the general public.

Mr. Robertson stated that there was agreement on the part of everyone that action to tighten the market was called for and that he would suggest that the discount rate be laid aside for the moment and that open market policy to be followed during the next three weeks be determined. It would be his suggestion, he said, that no reserves be put into the market unless the bill rate exceeded something like 2 per cent (in the event the discount rate were raised to 2 per cent) which would mean that the Federal Reserve would not put funds into the market but leave it to the member banks to go to the discount window unless the need for reserves was so great as to drive the bill rate above 2 per cent. In the event of a disorderly market, he said, the Committee could always step in.

Mr. Sproul questioned whether the Committee should fix a rate on bills which would determine whether open market operations should be undertaken. He thought that with the existing demand for credit and a discount rate of 2 per cent, the bill rate might properly go above 2 per cent.

Mr. Robertson said he did not mean that the Committee would have to put reserves in the market if the rate went above 2 per cent but rather that it would be reluctant to supply reserves and that a guide would be whether the bill rate went up. An increase above 2 per cent would not necessarily mean that the System would supply reserves.

In a discussion of this point, Mr. Mills stated that the Committee did not know what unusual situation might arise that would find the market stripped of reserves. The impact of that situation would fall on the dealers who might find it difficult and certainly expensive to position themselves and carry through a market situation which the Committee would wish to foster through the dealers' efforts. If the Manager of the Account, he said, had a clear prohibition that he could not supply reserves, then the only course open would be to poll the members of the Committee to get a reversal of that prohibition with a possible loss of time in correcting a worsening situation in the market.

Mr. Robertson did not feel that the Committee should prohibit operations but should supply a guide. It was his view that if the situation were such as to require it, the manager would arrange for repurchase agreements or the outright purchase of bills, but the 2 per cent rate would be a guide indicative of the sense of this meeting.

Mr. Sproul stated that the action already taken by the Committee at this meeting gave the New York Bank authority to enter into repurchase agreements which might be the only authority it would need to meet a temporary situation in the market during the next three weeks. It would be necessary, he said, to look at the reserve situation, member bank borrowings, and the action of money rates, and that it was the desire of the Committee as he sensed it to have increasing pressure on the market but to observe the effects of that pressure on the available supply of reserves and act accordingly. With expectations based on the projections presented at this meeting possibly nothing would need to be done in the open market within the next two or three weeks.

Mr. Bryan stated that he understood that repurchase agreements might do the job and that Mr. Robertson's comments were to the effect that if the discount rate is raised it should be made an effective rate as soon as possible. Mr. Sproul added that the bill rate could go to the discount rate or where it would.

Mr. Bryan commented that this point bothered him, that the last time the System had a 2 per cent rate the market rate went up to 2.41, that he felt that if the discount rate is fixed at 2 per cent the market should be in some relation to that rate and it would not seem proper to allow the market rate to get out of touch with the discount rate. In other words, he felt the System should not increase the discount rate to 2 per cent and then allow the effective open market rate to get as far out of line as would be indicated, for illustration, by a rate of 2.41 or 1.70.

Chairman Martin then asked if any other change should be made in the general directive to be issued by the Committee to the Federal Reserve

Bank of New York. Mr. Rouse stated that he saw no need for any further change and that the amounts contained in the existing directive were appropriate.

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

(1) To make such purchases, sales, or exchanges (including replacement of maturing securities, and allowing maturities to run off without replacement) for the System Open Market Account in the open market or, in the case of maturing securities, by direct exchange with the Treasury, as may be necessary in the light of current and prospective economic conditions and the general credit situation of the country, with a view (a) to relating the supply of funds in the market to the needs of commerce and business, (b) to restraining inflationary developments in the interest of sustainable economic growth, and (c) to the practical administration of the account; provided that the aggregate amount of securities held in the System account (including commitments for the purchase or sale of securities for the account) at the close of this date, other than special short-term certificates of indebtedness purchased from time to time for the temporary accommodation of the Treasury, shall not be increased or decreased by more than $750 million;

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

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

Chairman Martin stated that he had received two letters from Congressman Patman, one inquiring about the role of short selling in the United States Government securities market and the other raising several questions about the Federal funds market. He also said that the reply to the latter inquiry was being sent to Mr. Patman today and that a draft of the reply to the other letter had been distributed by Mr. Riefler at this meeting. He also said that it would be appreciated if the Presidents would study the draft and advise Mr. Riefler of any suggested changes that they might have, so that the reply could be sent within the next day or two.

> It was understood that the suggested procedure would be followed and that copies of the two replies as transmitted to Mr. Patman would be sent to the Presidents of all the Federal Reserve Banks.

In response to an inquiry by Mr. Bryan, Chairman Martin stated that following a meeting this afternoon of himself and Messrs. Sproul and Balderston with representatives of the Treasury, the Board would consider the action which it would take with respect to an increase in the discount rate and would advise the Reserve Banks of the decision reached. Mr. Bryan stated that as soon as his executive committee learned of the Board's decision it would act on an increase in the rate at the Atlanta Bank.

It was agreed that the next meeting of the Federal Open Market Committee should be held on August 23, 1955.

Thereupon the meeting adjourned.

Winfield W. Riefler
Secretary