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 19, 1958, at 10:00 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Balderston
Mr. Fulton
Mr. Irons
Mr. Leach
Mr. Mangels
Mr. Shepardson
Mr. Vardaman
Mr. Treiber, Alternate for Mr. Hayes

Messrs. Erickson, Allen, Johns, and Deming, Alternate Members of the Federal Open Market Committee

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

Mr. Riefler, Secretary
Mr. Thurston, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Solomon, Assistant General Counsel
Messrs. Daane, Hostetler, Marget, Roelse, and Young, Associate Economists
Mr. Kenyon, Assistant Secretary, Board of Governors
Mr. Koch, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Keir, Acting Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mr. Stone, Manager, Securities Department, Federal Reserve Bank of New York

Mr. Swan, First Vice President, Federal Reserve Bank of San Francisco; Messrs. Jones and Tow, Vice Presidents of the Federal Reserve Banks of St. Louis and Kansas City, respectively; Messrs. Larkin and Baughman, Assistant Vice Presidents of the Federal Reserve Banks of New York and Chicago, respectively; Messrs. Willis, Anderson, and Atkinson, Economic Advisers of the Federal Reserve Banks of Boston, Philadelphia, and Atlanta, respectively; Mr. Coldwell, Director of Research, Federal Reserve Bank of Dallas; and Mr. Hellweg, Economist, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the telephone conference meetings of the Federal Open Market Committee held on July 15, July 18 (two meetings), July 21, 22, 23, 24, 25, 30, 31, and August 1 and 4, 1958, were approved.

Before this meeting there had been distributed to the members of the Committee a report prepared at the Federal Reserve Bank of New York covering open market operations during the period July 29 through August 13, 1958, and a supplemental report covering commitments executed August 14 through August 18, 1958. Copies of both reports have been placed in the files of the Federal Open Market Committee.

Reporting on open market operations, Mr. Larkin stated that developments since the last meeting had been covered in detail in the written reports and that he would merely emphasize a few points. The redundancy of reserves, which was the principal concern of the Committee at the last meeting, had been eliminated during the period through sizable net sales or redemptions of Treasury bills. Although free reserves moved over a wide range on a day-to-day basis, they averaged less than $500 million during the past three weeks, more than $100 million lower than the average of the previous three weeks. The money market has been generally less easy than in recent months, with the Federal funds rate frequently close to the discount rate. Conditions in the securities markets, Mr. Larkin said, speak for themselves. Short, intermediate, and long-term rates have risen. In the past two days there have appeared some signs of relative stability in the long-term area, but there has been no significant revival of activity. Short-term rates continue to rise, most recently under the impetus of the San Francisco Bank's action in increasing its discount rate. The average issuing rate in the Treasury bill auction yesterday was 1.90 per cent.

Mr. Larkin called the Committee's attention to the fact that the Supplementary Report, which had been distributed prior to the meeting, contained a page (Exhibit B-4) setting forth the assumptions underlying the reserve projections of the New York Bank.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions during the period July 29 through August 18, 1958, were approved, ratified, and confirmed.

In supplementation of the staff memorandum distributed under date of August 15, 1958, Mr. Young presented the following statement on the economic and financial outlook:

We no longer need be tentative about the fact of domestic economic recovery. The unfolding data are abundantly clear. They show vigorous revival--one of the more robust on record following one of history's shorter and milder contraction periods.

In industrial countries abroad, the evidence indicates that final demand has continued to be fairly well sustained. In Canada, as here, revival appears to be under way. In Europe, production trends have been mixed, with contractions, where occurring, apparently associated with inventory adjustment. Reflecting cumulative relaxation of inflationary tensions, further declines in European interest rate levels have occurred in July and August.

Recent domestic economic developments

The turnaround in GNP from the first to the second quarter now appears to amount to just short of one per cent, and a jump from the second to the third quarter of at least two per cent appears likely. Personal income in July was above its August 1957 level, though the June-July rise was partly influenced by one nonrecurring item--back pay of Federal employees.

The Board's index of industrial production through July has risen at least 7 points, or 6 per cent, from April, and the odds are large that late data will raise the amount of advance by two index points. The recovery in industrial output has been diffused through durable and nondurable industries as well as through mineral lines. The rise in durables output since April has been 10 index points, in nondurables 5 points, and in minerals 5 points.

Construction activity has risen for two months, mainly reflecting increases in residential building. Contract awards in July continued close to the high levels of May and June. Private housing starts in July, rising further for the fifth successive month, attained a seasonally adjusted rate close to 1.2 million units. Financing and selling conditions in residential markets remain on the stimulative side.

Total business sales in June increased for the third month, recovering over three months about one-third of the previous decline. Inventory liquidation also continued in June for the ninth month, making a total inventory decline since early autumn of last year of about $5 billion. The rate of inventory decline in June, however, was more moderate than for any single month since December. At manufacturers, both in June and in May, there was a large liquidation of finished goods inventory. At retail stores in June, stocks over-all rose. New orders received by durable manufacturers have now risen for three consecutive months, though they still run below shipments.

While unemployment holds at a rate moderately in excess of 7 per cent, the labor market has shown additional strengthening through a further increase in nonfarm employment (seasonally adjusted), a continued decline in the number of employees on short workweeks, and an additional rise in average hours worked per week in manufacturing. Recent wage advances in major manufacturing industries are being reflected in a slight advance in average hourly earnings, and weekly earnings, reflecting both wage rate advances and more hours worked, are rising slowly. In assessing the continuing high unemployment rate in the face of recovery, it needs to be remembered that such a pattern is not unusual for the early stages of recovery and that a similar pattern was followed in the recoveries from the 1948-49 and 1953-54 recessions. The pattern results because employers wait until average hours of work have increased before engaging in extensive new hiring and also because productivity gains in the early recovery phase are typically very sharp.

Farm income, already considerably improved in the first half year, promises, on the basis of crop and marketing prospects, to be further raised in the months ahead. The August 1 crop report points to a total harvest some 13 per cent above the 1948-49 average and 7 per cent ahead of the large harvests of the past two years.

In consumer markets, sales continued in July at the level of May and June--about 3 per cent above the March low and 3 per cent under last summer's high. Gains in sales continued to be marked at apparel and general merchandise stores, but at durable goods stores they remained sluggish. Department store sales in July were 140 per cent of the 1947-49 average, compared with 133 per cent in June and the record 144 for August of last year. In early August, department store sales have maintained the July level.

Automobile sales in July declined less than seasonally and yet more improvement is indicated by sales in the first 10 days of August. With new car stocks in hands of dealers at about 660,000 and with model change-over curtailments in process, the industry now expects a substantial liquidation of dealer inventory holdings by the end of September. In view of this prospect, industry production schedules for the fourth quarter contemplate a rate of output at least equal to that of the fourth quarter of 1957.

Preliminary data indicate that outstanding instalment credit declined again in July after allowance for seasonal factors. Since January of this year the decline has totaled about three-quarters of a billion dollars. This is the largest decline and longest period of decline in the postwar period.

Total exports in May and June were at a seasonally adjusted annual rate of $16-1/2 billion, up slightly from March and April. There was a marked pickup in agricultural exports between these two periods, some of which apparently reflected a catching up in Government-financed shipments. This increase was largely offset by further declines in exports of metals, machinery, textile manufactures, and coal. For many of these items, however, the rate of decrease was smaller than before. In general, the best judgment of the experts in export markets is that contraction of demand for U. S. exports has largely run its course. While total import data beyond May is still lacking, from such partial information as is available it would appear that total imports in June and July have remained close to an annual rate of $12-1/2 billion, the average rate in the first five months of the year.

While the average of wholesale prices has been about stable over the past two months, the average of industrial commodity prices has risen .7 per cent, mostly since the end of June, and the average of farm product and food prices has declined about 2 per cent. Since April, the average of raw industrial material prices has risen 8 per cent, or about the same percentage as from March to June in 1954; in both periods, advance in the price of steel scrap was a main factor in the price rise. Consumer prices, which rose slightly further in mid-June, are expected to show either no change or slight decline at mid-July. With food prices seasonally lower and a slowing of advance in prices of consumer services, the August index may show modest decline.

Recent domestic financial developments

Financial markets have been influenced by three lines of news: (1) the stream of economic data and corporation reports indicating that vigorous recovery was under way; (2) indications and rumors that Federal Reserve policy might be shifting its posture away from ease; and (3) a flow of banking, monetary, and Treasury deficit data pointing to a record-breaking six-month increase in the cash balance position of the economy, suggesting both monetary validation of post-1955 price increases and a financial stage set for an extension of creeping inflation.

In these circumstances, further upward yield adjustments have occurred for Treasury bonds, corporate bonds, and municipals. The additional rise in Treasury yields has been accentuated, of course, by further liquidation of speculative holdings. At the close of last week, the yield on long-term Treasury bonds averaged 3-5/8 per cent and in the intermediate range the yield was about 3 per cent. Triple A corporate bond yields had reached about 3-7/8 per cent, and on high-grade municipals the yield had somewhat exceeded 3 per cent. Partly reflecting summer underwriting letup and partly reflecting upward adjustment of market yields, the corporate and municipal new issue volume has lightened significantly.

After holding persistently below 1 per cent during June and July, the Treasury bill rate moved up from early August to 1.895 per cent yesterday, with the rise reflecting both a change in the credit outlook and a larger supply of short-term securities in the market. Rates on bankers' acceptances, finance company paper, and commercial paper have all been marked up sympathetically with the bill rate movement.

Since the new highs in stock prices and trading activity that were reached following the hike in margin requirements late in July, stock prices and trading have edged off somewhat. Equity investors, however, still cling to inflationary expectations. The average yield on common stocks late last week was 3.79 per cent, or slightly below the average yield on Aaa corporate bonds and slightly above the yield on the longest Treasury bonds--the 3-1/2 per cent bonds of 1990.

In the first seven months of the year, total commercial bank credit has expanded by $7 billion compared with a decline of almost $.5 billion in the same period of 1957. This is by far the largest increase for the same months of any preceding postwar year. It is also a much larger increase than occurred in the comparable late contraction phase and early recovery phase of the two preceding postwar cycles.

This large expansion in bank credit has been associated with the largest increase in cash balance holdings of the public for any comparable postwar interval, whether reckoned according to calendar period or according to business cycle period. Over the past six months the annual rate of increase in the total money supply--time deposits plus demand deposits and currency, seasonally adjusted--has been nearly 12 per cent. The privately-held active money supply--demand deposits and currency--has increased at an annual rate in excess of 8 per cent, while the annual rate of increase for time deposits alone has attained a peacetime record of 20 per cent. Some part of the large increase in time deposits must represent consumer, financial, and business balances that will likely be withdrawn for spending or investing in the period ahead, and so will be transferred to the category of active money and swell further the active money supply.

<u>The current policy problem</u>

System policy at this juncture is faced with three pervasive facts: (1) a significant and broadly-spread revival in productive activity and in incomes; (2) a pace of, and momentum in, expansion in privately-held cash balances that is by any historical standard abnormally high; and (3) an inflationary psychology in financial markets that could easily spill over into commodity and real estate markets.

These facts raise a basic question about the kind of instability problem that System policy has been called upon to grapple with since last mid-autumn. In short, just what sort of cyclical malady has the economy been suffering and what dosage of monetary medicine has been needed to help restore economic health?

This is a most perplexing question, but some perspective on it can be gained by brief comparison with other periods of significant cyclical contraction since World War I. The Board's index of industrial production, which is generally recognized by analysts of economic cycles as a reliable coincident indicator, can be taken as an effective reference measure for this historical diagnosis.

Of the eight business cycle contractions occurring over this span of nearly four decades, the recent contraction was one of four lasting nine months or less. It was also one of four contractions in which a decline in industrial output of less than 15 per cent occurred. It was one of two contractions taking as few as nine months until significant upturn began. And it was one of two contractions followed by rebound that recovered a substantial fraction of preceding decline by the end of eleven months. Whatever mechanical historical criteria are used for comparison with past economic contractions, it seems certain from these data that the 1957-58 recession will go down in the annals of economic cycles as one of the milder recession experiences.

This important diagnostic inference as to the nature of the economy's recent instability problem, together with the key facts about the current situation mentioned above, point to only one course for Federal Reserve action under prospective conditions over the short-term. That course of action is one that will temper the rate of expansion in the money supply. The first step in accomplishing this objective should be to reduce to zero as rapidly as possible the net free reserve position of member banks. On the basis of current projections of reserve changes by the Board's staff, seasonal factors will be working in this direction through the Labor Day week end, but they will need some help from sales by the Open Market Account to meet a time schedule consistent with the urgency of the situation.

A larger problem of Federal Reserve decision looms for the future. It relates to the rate of monetary expansion that should be the System target for the autumn and winter period. Having an eye to the high rates of monetary expansion of the recent past, it can be argued justifiably that the economy's cash balance position is already redundant and that no further increase in cash balances, other than of reasonable seasonal dimensions, will be consistent with sustainable economic development and tolerable stability for the value of the dollar. Under this line of reasoning, appropriate policy would call for allowing more active use of existing money balances to carry the main load of financing the increased spending and investing associated with rising activity and incomes.

On the other hand, it can be argued that the annual rate of increase in the money supply, seasonally adjusted, over the balance of the year ought not to fall below 2 to 3 per cent. This second position is premised on the proposition that a shift from an 8 per cent rate of increase to a zero rate might risk curbing recovery and even induce recurrence of contractive tendencies.

This central problem needs clarification through study by the Committee's staff and further discussion by the Committee itself. When a conclusion has been reached on the problem, then a secondary problem will arise as to the required reserve changes and the reserve need projections that will be consistent with the monetary expansion target adopted.

In the meantime, the course of prudence in day-to-day operating procedures calls for staff reserve need projections, both at the Board and at the New York Bank, to be on the basis of seasonal patterns only and to exclude any allowance for monetary growth. At least, after the extent of monetary expansion over the past six months, it would seem imprudent to premise projections of prospective reserve needs on a further increase in the money supply at a rate anywhere close to that recently experienced.

Finally, a word in regard to Treasury financing prospects. Available Treasury cash balances plus September tax receipts should make it possible to defer further Treasury cash financing until the third week in October. At that time, the Treasury will need to borrow as much as $4-1/2 billion in cash. Another $4 billion will possibly be needed over the turn of the year, with say $2 billion borrowed in December and $2 billion in January. These estimates are necessarily tentative. At this stage, it is most uncertain how fast Federal cash spending will actually rise over the months ahead; also, September and December corporate tax receipts may run higher than now thought likely.

In response to questions by Mr. Vardaman, Mr. Young said he thought there were clear signals already of a vigorous recovery "across the board." During a period in which there had been a relatively mild contraction of business activity, followed by business recovery, there had also been a very rapid expansion of the money supply. He did not know of any cycle recorded in history in which the sort of thing occurred that had been experienced in the past six months. Asked by Mr. Vardaman whether he thought that the vigor of the recovery was such as to warrant a mild contraction of the money supply, beginning almost immediately, Mr. Young said that possibly this would be desirable. In his statement he had tried to avoid taking any position and had merely outlined two points of view. Another possible line of reasoning would be to the effect that there should be a contraction of the money supply from this point forward. In his judgment, however, it would be difficult enough just to get the rate of expansion slowed down.

Chairman Martin then stated that at this point in the meeting he would like to make certain observations about the operations of the Committee. First, he felt sure that none of the Committee members liked particularly the succession of telephone meetings that had been held recently, and it was his hope that there would not be many periods when it would be necessary to follow that procedure. Because of technical problems of communications, it was necessary to restrict participation in the recent series of meetings to those currently serving on the Open Market Committee, and even so telephone meetings are not conducive to full interchange of opinion.

The Chairman went on to say that this had been a difficult period, with events such as the crisis in Iraq that no one could have foreseen. Such a situation served to emphasize the confidential nature of the meetings of the Open Market Committee, where there is discussion of all aspects of System policy along lines which he hoped would at some point be recognized by statutory provisions. In such circumstances, when there are rumors they are sometimes attributed to the relatively large number of persons participating in the Open Market meetings, with the result that there is continued discussion about the size of the meetings. Personally, he did not think that attendance should be cut down, for in his opinion the advantages outweigh the disadvantages.

Referring to the San Francisco discount rate action, Chairman Martin expressed the view that as a general principle there should be an effort to defer important System decisions until after the meetings of the Open Market Committee, which afford an opportunity for full review and discussion of the current situation. However, in this instance he felt that the Board of Governors was correct in giving its approval to the rate increase promptly because rumors appeared almost immediately after the action was taken in San Francisco. If it had not been for those rumors--and Mr. Mangels had expressed the view that they could not have come from the West Coast--the Board of Governors might have held up its action until after this meeting so as to have had the benefit of the discussion, regardless of its position in the final analysis.

The Chairman also noted that when margin requirements were discussed at the Committee meeting on July 29, there were rumors within two or three days of possible action in that respect. While he did not think that those rumors had a Committee source, nevertheless the mere fact that a Committee meeting is held gives rise to a certain amount of conjecture and makes it necessary to exercise unusual caution. He was not unduly concerned, but he considered it his duty to bring the matter again to the Committee's attention, for unless matters can be kept within the System family it becomes difficult to take any actions and the integrity of the System is called into question. Therefore, it is very important for the System to keep as clear as possible. In his opinion it was wise, when the Committee reached its unanimous decision on July 18, to put an announcement on the ticker immediately. On the other hand, the System has no commitment to make all of its actions available to the public as soon as they are taken.

With regard to the discount rate action, the Chairman recognized that the difficulty of timing was compounded by the vacation season and its effects on the schedule of directors' meetings of the respective Banks. That is one of the problems encountered in operating a far-flung system and is something to be kept in mind. Later in the meeting, he said, Mr. Mangels would explain the thinking of the San Francisco directors and present his own views, and he (Chairman Martin) simply wanted to say in advance that there was no effort to drum up the support of the San Francisco directors with respect to a rate increase or to oppose such an increase.

Putting the problem in broad perspective, Chairman Martin commented, it is up to each person to do everything in his power to make the Federal Reserve System work as a system, and the integrity of the System is something that each person should guard zealously at all times. Again, he felt that the Board of Governors took the right action in approving the San Francisco rate increase immediately, but if there had not been rumors the Board's thinking might have been to postpone action until after this meeting.

The Chairman then turned to Mr. Treiber, who presented the following statement of his views on the business outlook and credit policy:

1. Since the last meeting of the Committee here in Washington there has been some turbulence in the U. S. Government securities market. This week, however, the market has shown more stability, with little evidence of liquidation by speculators. We may be in, however, for a further downward adjustment in prices and an upward adjustment in yields in the short-term area.

2. In the economic area there has been a fairly widespread improvement in production, accompanied by a somewhat less general improvement in the employment situation. There is growing optimism as to the speed and the extent of the recovery; and there is some concern over the revival of inflationary tendencies. Nevertheless, there remains the possibility of serious interruptions to the recovery.

3. Important factors that are likely to have a moderating influence on inflationary tendencies in the coming months include:

(a) Lower food prices;
(b) Excess capacity, particularly in important areas of primary production;
(c) Larger productivity increase;
(d) Continued substantial unemployment;
(e) More moderate wage demands; and
(f) Foreign competition.

4. The Government deficit will be an important stimulus to the economy, but at the same time it is giving rise to expressions of concern as to its inflationary implications.

5. We are also hearing expressions of concern as to whether the Federal Reserve may have created too much liquidity.

6. Since October 1957 the System's policy of ease has resulted in a net release of over $3 billion of

reserves to member banks through open market operations and cuts in reserve requirements. During the remainder of 1958 the System faces the prospect of supplying further substantial amounts of reserves to cover

(a) the normal seasonal credit demands of business and currency requirements,
(b) the demands arising out of a cyclical upturn in business,
(c) the demands arising out of heavy Treasury financing, and
(d) quite possibly some further outflow of gold.

7. Our easy money policy has promoted a substantial growth in the money supply, and the heavy demands during the remainder of the year will increase it further. Yet, how great is nonbank liquidity? Although various measures of nonbank liquidity show an improvement in liquidity since last fall, they still indicate that liquidity is considerably less than it was in 1954.

8. Bank liquidity has improved since last fall but it is not as great as it was in 1954. As for bank investments, between October 1957 and June 1958, commercial banks increased their total holdings of U. S. Government securities by almost $7 billion, from $50 billion to $57 billion. Securities maturing in 5-10 years rose by $8 billion, from $8-1/2 billion to $16-1/2 billion. Securities in the 1-5 year category declined $2 billion to $24 billion, and securities maturing in less than one year increased only slightly. As regards Mr. Young's statement concerning the possible withdrawal of time deposit balances for investment purposes, the drawing down of some of such balances might be reflected in a decline in bank investments rather than an increase in the money supply.

9. The demand for long-term capital has been high in 1958. Public offerings of corporate and municipal securities in the first nine months of 1958 are estimated to be about $1/2 billion more than in the corresponding period of 1957. This increase, however, is likely to be more than offset by a reduction in private placements.

10. We are concerned over the recent rapid rise in long-term yields, especially in view of the current amount of unemployment. Eighty-two per cent of the decline in yields that occurred since last November has been wiped out.

11. The current unsettlement in the long-term Government securities market has put a brake on public offerings of corporate securities and there have been some postponements. Postponements for an indefinite time due to unavailability of funds or too high rates would be an obstacle to the further progress of the recovery which is still in its early stages. We hope that the present indications of more stability in the long-term Government securities market will clear away the hesitation regarding corporate offerings.

12. We believe that the developments in the economy call for the System to move away gradually from the position of ease that appeared appropriate while activity was declining. On the other hand, the situation in the securities markets calls for a high degree of caution.

13. We would favor a gradual movement toward reducing the availability of reserves. We would want to avoid creating a severe tightening in the "feel" of the money market and to avoid perpetuating or intensifying the current weakness in the longer-term securities market. In view of the touchy situation in the Government securities market it would seem well to avoid a specific target of free reserves.

14. We believe that the directive should be changed to reflect the interest of the Federal Reserve in promoting the recovery. We suggest that clause (b) of the directive be amended so as to call for operations with a view "to promoting sustainable economic recovery."

15. We had carefully considered the discount rate of the Federal Reserve Bank of New York and had concluded that it should not be changed. We felt that a gradual movement away from the former degree of ease could and should be made within the framework of our present discount rate of 1-3/4 per cent. We looked forward to the opportunity of having a general discussion of the discount rate at this meeting of the Federal Open Market Committee before any action would be taken on the rate.

16. At our directors' meetings in the last two weeks we have had full discussions of the discount rate. At last Thursday's meeting, we encouraged a discussion of the factors that might be important in our consideration of the discount rate not only last week but also over the next month or so. Our directors were clear in their opinion that there should be no change in the rate at this time. On the basis of present facts they saw no reason for considering an increase in the rate in the next month or so, preferring to await developments and to pass judgment upon them when they occur.

Mr. Vardaman inquired of Mr. Treiber whether he correctly inferred that the latter would favor keeping the reserve position and the Government securities market in a posture which would encourage private offerings.

Mr. Treiber replied in the affirmative. He said that he would favor moving toward less ease, but not moving so fast that there would be repercussions in the long-term market. He hoped that the long-term market would stabilize and that the corporate market would then encourage stability in the Government securities market. He would want to avoid action on the part of the System that would press for further adjustments in the long-term market; in other words, avoid action that would disturb any further that sector of the market.

Mr. Erickson said that in the First District most of the statistics continued to show improvement. The revised New England manufacturing index for June reflected a 3-point increase over May, while construction contracts had a big month in June and for the first six months of this year were only .4 per cent behind last year. In residential construction contracts, the increase reflected strength in multiple-unit dwellings. However, nonagricultural employment in June was down 4.3 per cent from last year. Up to the most recent report only two areas in the district were considered areas of substantial unemployment, but in July three additional areas were added to the list. Department store sales had spurted since the fourth of July and the ensuing weeks reflected a 9 per cent increase; for the year to date department store sales were 2 per cent behind last year. The latest consumer credit survey, which includes 16 large banks that originate a large percentage of the consumer credit in the district, showed that the percentage of long-term automobile contracts was down for the first time since January, from 42 to 40 per cent. The Reserve Bank's discount window had been used relatively little until the last three days of last week, when there were borrowings by seven fairly large banks, most of them in the larger cities of the district.

Turning to monetary policy, Mr. Erickson said he was happy that the System had been able to eliminate redundant reserves as rapidly and as easily as it had. He agreed with Mr. Young that the System should get free reserves down to zero as quickly as possible without creating too much tightness in the market. His own feeling would be to bring free reserves down and to increase the discount rate sometime after Labor Day. The Reserve Bank's Board of Directors was to meet next Monday and he did not know what the directors would decide. He noted, however, that in the First District there has not been as much business improvement as in the San Francisco District. The policy directive should be changed and he would suggest "with a view to fostering stable economic growth and maintaining conditions in the money market to encourage recovery and prevent unsustainable expansion."

Mr. Irons said that in the Eleventh District there had not been any very significant changes in the last three weeks. Economic activity was moving along at about the same high level as he had reported previously. In July, department store sales were above June; sales for the month ran only a little below the record July of the previous year and August was showing further improvement, with sales about 3 per cent above the same period a year ago. The employment picture had not shown much change in terms of the number of employed or unemployed, but there had been an increase in hours worked in manufacturing and also an increase in wages paid. The construction picture was very good, and he believed that July was a record month for the period in which the series on value of construction contracts awarded has been maintained. The agricultural picture also was good. There had been warm weather and not too much rain, but it was still a favorable picture. Cotton output in Texas was expected to be well over 4 million bales, which led him to observe that the changes that have taken place in yield, acreage, and production are rather amazing. For example, comparing this year with last year, acreage would be down roughly 14 per cent and production up roughly 10 per cent. Comparison with a ten-year average showed acreage down 50 per cent and larger total production. The situation with respect to other agricultural crops also was favorable.

Mr. Irons said that the banking picture in the district showed little change, with the demand for loans apparently fairly strong. As against a year ago, there had been a 30 per cent increase in time deposits and an increase of about 9 per cent in demand deposits. Like Mr. Young, he felt that a good part of the time deposit money must represent funds waiting to be spent and that it did not just represent genuine savings in time accounts. Mr. Irons went on to say that the position of the banks in the district seemed to be adequately liquid. There had not been much borrowing at the Reserve Bank, although in the last two or three days a couple of the larger banks had come to the discount window. It appeared that they might be moving out of Federal funds and borrowing at the Reserve Bank.

After stating that the general picture in the district was one of high level strength, much as it had been for the past several months, Mr. Irons turned to the oil industry and said that the authorities had increased allowables to 11 days in July. The indications were that the allowables, when next set, probably would move up another day, and that possibly they would continue to move up. He was not sure that the oil industry was out of the woods, for he had always felt that the import situation was the key factor and that problem had not yet been solved. In any event, however, there was a movement toward higher allowables.

With reference to policy, Mr. Irons said he felt that the System should continue to move away from the degree of ease that had prevailed. He would like to see free reserves eliminated, although without any shock treatment since one could not overlook at any time the uncertain situation in the Government securities market. It was a market that, in his opinion, should not be subjected to shock one way or the other. He had rather thought in terms of a steady reduction of ease to the point of getting out of free reserves and bringing the banks in to the discount window for needed reserves. This would contemplate holding additions to reserves down to those necessary to meet purely seasonal needs.

Mr. Irons said that prior to the San Francisco action he had been thinking of a discount rate change as the next policy move, probably in September. At the Dallas Bank there is no regularly scheduled meeting of the Board of Directors in August, and it is not the practice of the Bank to change the discount rate at a meeting of the executive committee, so there was no opportunity to act last week. If there had been a directors' meeting the vote might have been close, even assuming that the directors would not have known what happened at San Francisco. In view of the San Francisco action, he would personally be inclined to move in the same direction quite soon, which would, of course, necessitate a special meeting of the Board of Directors. While he did not know that the directors would do, he was inclined to think that it would be desirable under the circumstances for the directors to have a discussion quite promptly. The alternative would be to wait until the next regular directors' meeting in September and in view of his appraisal of the economic situation he would lean toward more prompt action.

Continuing, Mr. Irons said that he did not have any figure in mind with respect to reserves but that, consistent with conditions in the Government securities market, he would like to get away from free reserves to a neutral position or a position of bringing member banks in to the Federal Reserve Banks for borrowing. As to clause (b) of the policy directive, he would like to suggest "to fostering conditions in the money market conducive to balanced economic recovery and growth." In his view, it should now be the objective of the Committee to foster sustainable growth by a balanced economic recovery.

Mr. Mangels reported that conditions in the Twelfth District indicated continued improvement. He had mentioned in the past, perhaps too often, the plight of the lumber industry, but today the lumber people seemed to have their problems behind them and there was a better feeling. This resulted from an increase in construction and a reduction in the inventories of distributors, as a result of which orders were greatly in excess of production and prices had increased recently at the rate of about $2 a week. The price of fir lumber was now $70 per thousand compared with $60 in April and a high of $80 some time back. There was some feeling that perhaps prices had gone up too much in too short a period of time, but possibly there would be another $5 increase before the end of September. The lumber producers were in a position to accept, if they wished, more orders than they could fill 90 days ahead, but they were refusing them. There were some rumors to the effect that the unions might call a strike unless their demands were met.

Turning to other areas, Mr. Mangels said that July and early August figures indicated that recovery had proceeded further in the district, with agriculture and construction the two strongest factors in the economy. In the first five months of 1958 farmer income was up 11 per cent over last year and in three States it was up over 20 per cent. Only in Utah did farmer income show a decline. In general, agricultural conditions throughout the district were good except in the northwest which was beginning to feel the need of rain.

Continuing his review of the Twelfth District, Mr. Mangels said that the weekly average of heavy construction awards in July was 146 per cent higher than in July 1957; public awards were up sharply and private awards were up about 300 per cent. In the residential field, requests in July for VA appraisals were up

75 per cent and the FHA figure was up 100 per cent from a year ago. The FHA figure would have been higher except for budget limitations which prevented the organization from staffing up to process the increased number of requests for appraisals. One potential problem on the West Coast is the large increase in the percentage of residential construction in the form of multiple housing units where a number of vacancies are beginning to be noticed.

Mr. Mangels said that steel production for the month of July as a whole declined, but toward the end of that month and in early August improvement was shown. The demand for aluminum had increased substantially and Kaiser expected to expand its operations considerably. The copper industry also was improving, with one closed mine having been reopened and another large producer having increased the work week from four to five days. Petroleum operations were at 75 to 80 per cent of capacity, about 5 points less than the national average. Defense spending was increasing and ordnance plant employment in the area was at the highest level at which it had ever been. Aircraft employment was stabilizing; Boeing had received large jet orders from American Airlines and had something better than two years' orders ahead. Over all, employment was increasing, having been up .6 per cent in June. This figure, incidentally, was equal to the average monthly increase in the boom year 1955. The improved employment situation was beginning to be reflected in the operations of the Reserve Bank, with turnover increasing and more difficulty being experienced in obtaining certain kinds of employees.

In the financial field, Mr. Mangels said, total bank loans declined during the past three weeks although increases again were shown in real estate and agricultural loans. In this period demand deposits in the Twelfth District increased about $105 million, which was about equal to the increase of all reporting banks nationally, and the time deposit increase in the three weeks was about three times as great as in the similar 1957 period. An analysis of bank debit figures showed for July an increase of 3 per cent over a year ago; for the first seven months of 1958, bank debits showed a 1.4 per cent increase over 1957. The Reserve Bank's check volume in July was at an all-time high point, while the percentage of return items to the total was somewhat less than a year ago. Reports from some banks indicated that they were continuing to go out aggressively for real estate mortgages and instalment credit loans, but they did not expect any great increase in outstanding loans at year end, probably not more than 5 per cent above the present level. The banks in the district were in a relatively easy position, with sales of Federal funds about double the volume of purchases, and borrowings from the Reserve Bank continued to be nominal except for one substantial one-day borrowing by a San Francisco bank.

Mr. Mangels said that although free reserves had been at high levels in the recent period, he sensed that they were not indicative of the degree of tightness that had existed in the market. In other words, the market had been somewhat tighter than the free reserve figure would indicate. After referring to the reserve projections for the next three weeks, as distributed at the beginning of this meeting, he said it was his feeling that the System should proceed somewhat gradually in reducing free reserves, perhaps shooting at between $200-$400 million in the ensuing period. He would not want to make too big a jump too quickly. With reference to bank liquidity, he said an analysis by the San Francisco Bank indicated that the loan-to-deposit ratios of the larger banks in the district were lower now than they had been for 1-1/2 years or longer, but higher than in periods prior to 1956. Since August 1957 the reporting banks had increased their holdings of securities by $1.2 billion but holdings of bills had actually declined between that date and the present so the banks would not have any large supply of funds available this year from the run-off of securities. If there should be a sharp rise in credit demand, he anticipated that it would not be long before the availability of bank credit was greatly diminished, resulting in higher loan rates.

With reference to clause (b) of the policy directive, Mr. Mangels suggested wording along the lines of that contained in the

San Francisco Bank's wire to the Board of Governors concerning the discount rate action, namely, "to contributing to the continuance of sound monetary conditions essential to a sustainable recovery."

At this point Mr. Mangels commented on the circumstances surrounding the action taken by the San Francisco Board of Directors on August 13 in establishing a discount rate of 2 per cent. He said that when he went into the meeting he had no idea that such action would be taken. Following the usual presentation of the economic and financial picture by an officer economist of the Bank, there was a question and answer period, after which he (Mr. Mangels) summarized developments in the money and securities markets in the past couple of weeks. In doing so, he outlined reasons for and against consideration of a discount rate change in a manner not greatly different from the normal procedure. His own feeling at the time was that, although there might be some reasons for a change, the action could just as well wait until September because there would be clear sailing through August and most of September from the standpoint of Treasury financing. However, the Chairman of the Board of Directors then called for discussion and it developed that every one of the seven directors present favored an increase in the discount rate. The question, therefore, resolved itself into two parts. First, what should the increase be, and second, when should it be effective? A motion was made and seconded that the discount rate be increased by 1/2 a percentage point and this generated some further discussion following which an amendment to the earlier motion was offered and it was unanimously agreed to establish a rate of 2 per cent, effective upon approval by the Board of Governors.

Mr. Mangels said that in the discussion a number of factors favoring a change in the rate were presented by the directors. First, there was the contemplated Federal budget deficit, estimated to be as much as $13 billion. Second, the average of stock prices had moved up from 441 in February to 510 at the time of the meeting, and this had occurred during a period when earnings reports of corporations were very poor. This may be an indication of the beginning of a flight from the dollar and the purchase of equities as a hedge against inflation. Third, the price level had increased about 3 per cent in the past 12-month period, which led the directors to ask what would happen to the price level in a period of improved conditions under an easy money policy. Fourth, it was noted that labor demands for more pay than might be considered justified were again beginning to develop on the West Coast. Fifth, while the directors recognized that unemployment was in excess of 5 million, they believed that the situation would become better when the automobile industry improved, that this improvement would be felt in related industries, and that there would be increased employment for the purpose of stepping up production to replenish reduced inventories. Most of all, the directors sensed a feeling on the part of consumers that inflation is here and would more likely increase rather than decline. They believed that if enough people fell into this state of mind it would have a major detrimental effect on the economy. The directors felt that the Federal Reserve System should indicate its willingness to combat inflationary forces; that it should let the public know that it was willing to do its part. In the directors' opinion, the System should "lean against the wind before the tornado blows." Mr. Mangels concluded his comments by saying that reactions to the discount rate change from the press, bankers, and the public had been quite favorable.

Mr. Deming said that the Ninth District as a whole was doing well, the only weak spot continuing to be the mining areas. Prospective record crop production was the brightest spot. The wheat crop was almost a record and was of very high quality, while barley and soy beans would be at new records and corn was very good. Livestock production would be close to last year's record, with relatively favorable prices. Altogether, total district farm income should approach the 1948 high, and if it did the stimulating effects would be felt throughout the district. There had been some further improvement in nonagricultural employment, hours worked, and weekly earnings.

Construction also continued to show strength, and in general it was an optimistic picture.

Turning to the national scene, Mr. Deming said that Mr. Young's review, the staff economic review, and the Minneapolis Bank's own analysis all pointed to a sharper rebound from the recession than had been expected a short time ago. They pointed to at least incipient inflationary developments accompanied by continuation of a fairly high level of unemployment. For a period of time, however, increased efficiency and unemployment might act as some brake against making the incipient inflationary developments real.

Mr. Deming commented that a recent tabulation of profits reports of 21 fairly large Twin Cities firms yielded some interesting results. Leaving aside the railroads and an air line and public utilities, reports of the twelve industrial firms included in the tabulation showed that eight had far better profits in the first half of 1958 than the like period of 1957 even though three of them had substantially lower sales. One company ran about even with 1957; two showed second quarter profits which were far better than those of the first quarter and approached last year's levels; and the remaining company was a special case in that it had experienced a severe strike. One basic conclusion was that there had been a rather rapid increase in efficiency and productivity and if the level of sales should increase, this should further improve the profits situation. It certainly might act to inhibit price increases to some degree over the shorter run. In other words, the cost-price push would tend not to operate so intensively.

Mr. Deming said that he was not as convinced as some others appeared to be that the economy had gotten into an excessively liquid position. This comment was particularly true of the banks because of the increase in long-term security holdings and the rapid downward movement in the prices of those securities. One large bank had been borrowing at the discount window the past week and it was a bank that normally would be most reluctant to borrow. He felt, like Mr. Treiber, that the rapid upward movement of yields and the unsettled conditions in the market might tend to slow things down a little bit. While recovery had been swift and probably would continue, it might not continue at as fast a pace, and the pressure of price increases in the next few months might not be as strong. Therefore, the System might have a little more time to put on the brakes than would otherwise be the case. Mr. Deming agreed that free reserves should move toward zero, but he did not think that the System would have to move them to zero in the next three weeks. Looking at the reserve projections which had been distributed at this meeting, he felt that it would be reasonable to let reserves stay about where projected if this could be accomplished without severe System action in the next three weeks. As to the directive, he favored the suggestion of Mr. Irons.

Turning to the discount rate, Mr. Deming said that a meeting of the Minneapolis Board of Directors was held last Thursday and that after careful consideration of the whole picture the directors came to the conclusion that a rate change probably would be desirable some time in the future. Primarily because of the state of the securities market, however, they concluded that a rate change would not be desirable as of the date of the meeting. There would not be another regularly scheduled directors' meeting for two weeks. With the San Francisco action, the argument about shock to the Government securities market had obviously disappeared and the directors might now feel that it was appropriate to take discount rate action. However, he would not expect the directors to act until a week from Thursday at the earliest.

Mr. Allen said that in the Seventh District there was increasing confidence that the business decline ended in the second quarter. However, the strength of the recovery in the district was less evident than in the nation as a whole. For example, the district's employment situation deteriorated more than in the nation since the highs of last year and had recovered less. As of June, total nonagricultural employment was 4.1 per cent below last year for the nation and down 6.8 per cent for the five Seventh District States. In the five weeks ended August 3, new claims for unemployment compensation in all district States other than Iowa were substantially greater than the average for the United States as a whole; the increase over 1957 was from 55 to 75 per cent compared with 37 per cent for the nation. Also, department store sales nationally had been surpassing the excellent record of last year in recent weeks, and in the four weeks ending August 10 a 2 per cent increase was reported. In the Seventh District, however, department store sales were 3 per cent below 1957 during this period. All of the large district centers participated in this decline. Similarly, construction contract awards nationally were very strong in May and June. For the United States as a whole, June saw an 18 per cent increase in awards which brought the six-month total approximately equal to last year. In the Midwest, however, contract awards in June only equaled last year, and for the first six months of the year the Midwest was off 12 per cent. Loan demand continued to be weak, partly because of continued heavy sales of capital issues, and net liquidation of business loans continued at a faster pace in the Midwest than in the country as a whole. For both the district and the nation, the reduction in borrowing by metals manufacturers accounted for the largest portion of the total decline. With a sharper loan reduction, Seventh District banks had acquired relatively more Government securities than banks elsewhere in the nation. From mid-July through August 6, including the period of the August exchange and new 1-1/2 per cent tax anticipation certificates, Seventh District banks added $373 million, or almost 9 per cent, to their Government portfolios. This expansion, of course, occurred mostly in the first week in August when the Treasury issued $3.5 billion of tax anticipation certificates. In addition to these newly issued securities, Chicago banks had continued to add to their holdings of Treasury bills. Bill portfolios of Chicago reporting banks on August 6 were almost as high as just prior to the pre-tax assessment date peak late in March. New York banks added relatively much less to their bill holdings and banks outside these two cities had shown little change in their holdings of bills.

Mr. Allen commented that the Detroit area was worthy of mention because of its importance and because it was so hard hit. Unemployment there reached 285,000 in July, or 18.6 per cent, and would increase in August and September. The automobile manufacturers still expected to attain their October 1 target of a 400,000 new car inventory, as against 635,000 on August 10. Of the 400,000, 300,000 would be 1958 models. The outcome of the labor negotiations now in their fifth month was, of course, the subject of wide speculation. The Michigan newspapers left the impression that the unions were attempting to develop an atmosphere where more liberal supplemental unemployment benefits might serve as a principal basis for settlement.

Therefore, Mr. Allen said, although his concern about inflation was as persistent as ever the Seventh District situation vis-a-vis that of the nation made him less eager to move rapidly from a position of monetary ease than he would otherwise be. As for the discount rate, he believed that the Chicago Bank's Board of Directors would prefer to act coincidentally with, or after, several of the other Banks, again because of the district's relatively less favorable business situation. At the present time the matter of reserves seemed to him more important than the discount rate and in his judgment the situation country-wise warranted a further, but not drastic, reduction of the free reserve position. He would suggest a goal for the next three weeks of $100-$300 million of free reserves, with the exact level to be left to the discretion of the Desk. In this connection, he noted that the reserve projections distributed at this meeting would be in conformity with what he had suggested. As to the directive, Mr. Allen said that it might be possible to just leave out clause (b) completely. If it were felt, however, that clause (b) was needed, he would lean more to the language suggested by Mr. Irons than to any of the other suggestions.

Mr. Leedy stated that in the Tenth District there continued to be signs of vigorous recovery starting from a more favorable level than the rest of the country. It now appeared that in agriculture new records were going to be set this year in the district. The wheat crop, which is most important in the area, was estimated to be about twice as large as last year's crop. Also, the construction picture was particularly strong, with the figures indicating an increase of 11 per cent for the first six months of this year as compared with the similar period in 1957. Nonfarm employment continued to show some improvement, although the level was still below last year. As to department store sales, figures for the last four weeks reflected an increase of 5 per cent above a year ago; for the year to date sales were 1 per cent above last year.

Mr. Leedy said he had been greatly surprised at the progress that the Management of the System Open Market Account had been able to make in the elimination of redundant reserves. It seemed to him that a remarkable job had been done in this respect. The problem immediately ahead, he said, had been pointed out by Mr. Young, namely, the matter of the very large additions to the money supply. Personally, he would respond to seasonal needs but beyond that he would certainly not subscribe to any further additions to the money supply. He would expect the discount window to be used to a considerable extent to supply seasonal needs. Even with a new level of interest rates emerging, he assumed that it would be possible to make some progress toward further reduction of the level of free reserves, but he would not want the operations of the System to create further difficulties for the Treasury. He would make sure, or attempt to, that System operations would not present problems in the Government securities market or, for that matter, in the capital markets generally. Rather, the System should be feeling its way along and, to the extent possible, bring about a reduction in the level of free reserves. In saying this, he had no particular figure in mind as a target for free reserves.

As to the policy directive, Mr. Leedy said that the very simple statement for clause (b) suggested by Mr. Treiber was quite close to language that he had drafted himself. He would suggest "with a view to fostering sustainable economic recovery." This would recognize the fact that the country was still in a recovery stage and would permit the Committee later to make some change in clause (b) referring, perhaps, to economic growth.

Mr. Leach said that Fifth District economic developments in recent weeks had been decidedly favorable. Furniture manufacturers reported improved shipments in July, sales of lumber mills had increased and higher demand levels were expected, and construction contracts had shown a sharp pickup. Department store sales were near the record levels of last August, cotton textile prices had remained firm, and higher levels of activity had reduced unemployment. Crop conditions had improved further and farm income for 1958 would likely be much better than the low level of last year. Sentiment in the Fifth District as to business prospects was almost universally more favorable, with predictions of inflation widespread. So far, however, predictions with respect to price increases seemed to be reflected primarily in increased interest in common stock and decreased interest in fixed income obligations. There was little evidence that business and consumer buying had been materially affected.

Beginning his comments with respect to policy, Mr. Leach said he was surprised at the timing of the discount rate increase at San Francisco. While he had been advocating for some time less ease with a lower level of free reserves, and while he had expected a discount rate change before long, he told his directors last Thursday that he thought an increase in the rate would be premature. At that time, he was feeling rather pleased about the rapidity with which the System had recaptured redundant reserves and moved into a $400-$500 million range of free reserves, with $300-$400 million forecast for the week ending tomorrow. The position of the Richmond directors, he said, probably would not have been different if they had known about the change in the rate at San Francisco.

Continuing, Mr. Leach said that the weeks immediately ahead seemed to provide a good opportunity to take further actions to contain inflationary pressures. The Treasury presumably would be out of the market until October and there was less need to worry about the possible adverse effects on the Government securities market of a lower level of free reserves, for the market was well aware that policy had shifted. The vigor of the current upturn lessened the danger of monetary actions checking further recovery. In his opinion, the System should continue to move toward less ease as rapidly as market conditions might permit. Under present conditions he hesitated to mention a benchmark for free reserves but he would expect them to move downward rather sharply. Obviously, the policy directive should be changed and there were a number of ways in which that could be done. He would like to recognize in the directive that complete recovery had not yet come about and, after giving thought to whether the directive should incorporate reference to inflationary pressures at this time, he had concluded to suggest "to accommodating further recovery and avoiding the development of inflationary pressures." Whether it was desirable to mention inflationary pressures at this time or to wait until later reflected a matter of judgment. He did not see the need to refer to fostering or promoting further recovery but only to accommodating it.

Mr. Leach concluded his remarks by saying that as of the moment he did not intend to initiate any special meeting of the Reserve Bank's directors, which meant that he did not intend to make any recommendation to the directors with respect to the discount rate until the regular meeting to be held a week from next Thursday.

Mr. Vardaman said that in terms of the next three weeks it seemed to him that the goal for free reserves should be zero to $300 million, if in fact a target could be fixed. This would contemplate always leaving to the Desk the widest discretion to act on the basis of the feel of the market. In his opinion, the discount rate action of the San Francisco directors was most timely and had had a good effect. He felt that it was fortunate that the entire System did not move at one time. As it was, the San Francisco situation set people to thinking a little bit.

Mr. Vardaman said he believed that the frame of mind of the buying public was ahead of the statistics. The accumulation of savings suggested to him that the buying public was rather in the posture of a race runner awaiting the starting gun; in fact, some had already started. Very possibly there would be an all-out run for goods and services beginning in the early fall and culminating in heavy Thanksgiving and Christmas business. As nearly as one could feel that way, he felt definitely that shock treatment was going to be advisable in the late fall, and in preparation therefor he hoped that the System would now begin the necessary tightening process. Certainly, there should be a retreat from anything like ease and a tendency toward tightness.

As to the directive, Mr. Vardaman thought that it would be possible to drop clause (b). In any event, he hoped that the language used would be such that it could be clearly interpreted as a desire to regulate the expansion of the money supply in proportion to bona fide movements in the economy.

Mr. Shepardson said the reports clearly indicated that there was under way a very healthy recovery which could be approaching the explosive stage. With that in mind, he considered it important for the System to make decisions now in the light of the situation that it was apt to face. Like others at the table, he had been surprised and pleased at the rapid recovery of redundant reserves, for at the last meeting of the Committee there was a good deal of question as to how much could be done in the ensuing three weeks. It was fortunate, he said, that it had been possible to handle the matter so expeditiously. However, the Committee was still confronted by redundant reserves to the extent of the excess money supply reported by Mr. Young. He would hope that the Account Management might be able to bring down free reserves to a much lower level at a faster rate than some persons seemed to contemplate. In making this comment, he was not unmindful of the references made to tightness in the money market, and this was a matter which must be considered carefully. At times, however, the System had gotten into some difficulty because of a little more sensitiveness to what was considered tightness in the market than perhaps was justified, and the System had continued putting reserves into the market in view of that seeming tightness. He felt that it would be necessary for the System to exert a little pressure and that it should not be too sensitive to some feeling of tightness. If the System was not careful, it might find that the "horse had gotten the bit in his teeth" when it came to exerting pressure, so it would be better to put on a little pressure at this time. Admittedly, no one would want to exert such pressure as to throw the recovery movement into a tailspin, but it seemed necessary to use more pressure than had been exerted to date. Personally, he would favor moving free reserves downward faster than the projections distributed at this meeting would indicate. He would like to get to zero within a three-week period.

Mr. Shepardson expressed the opinion that the discount rate action at San Francisco was fortunate and said he would hope that in the succeeding days there would be further actions in support of that position. Like Mr. Vardaman, he felt it was a good thing that the action was not "across the board," but he would hope that those boards of directors in the best position to justify similar action would move fairly soon.

As to the directive, Mr. Shepardson said he had somewhat the same views as Mr. Leach. He rather liked Mr. Leach's suggestion about the lack of need to promote or foster further recovery for it seemed that recovery was well on the way and need only be accommodated. He would favor language of that kind in the directive, with some reference to possible inflationary pressures.

Mr. Fulton reported that the Fourth District was beginning to see a little more light than previously. As attested by statistics which he mentioned, steel production was creeping upward. He added, however, that the rates mentioned were still not nearly what production would be in a really vigorous recovery. The imponderable in the situation was the automotive industry which had not been ordering steel to the extent expected; possibly this could be attributed to anticipation of a work stoppage due to a strike in the industry. Nevertheless, there had been some ordering due to over-reduction of inventories. Turning to the mining and ore industries, he noted that only 66 per cent of the ore boats were in commission this year so that the tonnage pulled down would be substantially below last year. In the machine tool industry, there had been a little upturn in orders but shipments were still exceeding orders, which meant that backlogs were being further drawn down. Bituminous coal tonnage was down 42 per cent from the same date last year. As to the employment picture, conditions had not changed very much recently. In the Fourth District there were twelve areas of major unemployment and 28 areas of substantial unemployment, which represented no change in the last couple of months. However, the month of June may have been the low point in regard to unemployment. There had been some lengthening of the work week and productivity undoubtedly had increased in the plants of the district.

Continuing, Mr. Fulton said that construction contracts had increased sharply in June and July and mortgage loans at banks were at an all-time high. To date this year, department store trade was still 4 per cent under last year, while sales of automobiles were about 30 per cent below last year. Over all, the Fourth District was participating rather slowly but definitely in the upturn in business. Hopes for the last quarter of the year were still good, with most industries looking forward to improvement both in sales and manufacturing levels.

Mr. Fulton expressed the view that free reserves should be reduced to zero as soon as possible commensurate with the tone of the market and without upsetting the market. The Desk, he felt, should be commended for having reduced free reserves to the extent that it had, particularly in view of the large amount of securities that the System had been forced to purchase. Turning to the discount rate, he said he believed it would be the feeling of the Cleveland directors that no change should be made until there was a little more evidence of greater activity in the district and evidence that some of the industries that had been at low points were working up to higher production. As long as there was such a large amount of unemployment in the district, the directors might feel that it would not be well for the rate to be increased. In fact, he considered it probable that nothing would be done on the rate in September unless there was a substantial improvement over existing conditions in the district, that is, a degree of improvement beyond that which now appeared to be in prospect.

Mr. Fulton expressed agreement with others who had suggested that clause (b) of the policy directive might be eliminated. In such event, however, the words "without inducing inflation" should be added to clause (a) so that that clause would read "to relating the supply of funds in the market to the needs of commerce and business without inducing inflation." That would seem to be exactly what the System was trying to do.

Mr. Bopp presented substantially the following statement:

Improvement in business activity in the Third District is proceeding at a slow pace.

There was a small contraseasonal rise in manufacturing employment in June, including both durables and nondurables industries. The total, however, was still 8 per cent below June of last year. Average hours worked and average weekly earnings were also somewhat higher in June. Preliminary data for ten of the district's 14 labor-market areas, however, indicate a seasonal decline in manufacturing employment in July. Employment was below June in seven of the areas, only three showing small increases.

Construction activity in the Third District has not held up as well as nationally. Contract awards in June were 2 per cent above a year ago, much below the 18 per cent nationally--and reflected entirely a rise in public works. For the first half of this year, district contract awards were 8 per cent below last year as compared to only 1 per cent nationally.

Incipient recovery, the prospect of a large Treasury deficit, and price increases have inspired widespread belief that we are entering another round of unabated inflation. General anticipation of inflation seems to be confirmed by recent behavior in the stock and bond markets. On the other hand, there are over 5 million unemployed, and the vigor and speed of the recovery which seems to have emerged are as yet unknown. These developments raise the question of how much emphasis we should give to the threat of inflation and how much to fostering recovery from the recession.

Although the inflation psychology which has mushroomed in recent weeks is cause for concern, I do not believe inflation is our primary problem in the immediate future. First, recent price markups do not necessarily presage a resurgence of inflation. In 1954, for example, wholesale prices of a number of products, such as metals, industrial materials, building materials, and rubber, began rising before midyear but the index for all commodities other than farm and foods was fairly stable until mid-1955. Second, prices of services and foods--important factors pushing up the consumer price index since early 1956--were unchanged in June, indicating that the upward trend in these prices may be leveling off. Third, unemployment and unused plant capacity should be a strong deterrent for some time to rising prices. Fourth, an upward surge of credit, such as accompanied the 1954-1955 recovery, has not as yet emerged. Finally, inflation psychology is based largely on anticipations. Sentiment as to business prospects is volatile and could again change quickly should incipient recovery prove to be illusory or proceed more slowly than presently anticipated.

On the other hand, too many unemployed and too much idle capacity are real, not anticipated, conditions. For the immediate future, further recovery is a more pressing problem than the threat of inflation.

Consequently, I believe our immediate objective should be to maintain credit and money-market conditions conducive to recovery. In doing so, however, we should be unusually careful not to create a degree of ease and liquidity that would aggravate the threat of inflation or contribute to inflationary tendencies. In the present state of the economy, I believe that the risk of contributing significantly to inflation by a policy intended to encourage recovery is less than the risk of impeding recovery through restrictive action to deal with anticipated inflation.

Long-term rates are already too high, particularly as capital expenditures are one of the soft spots in the economy. Yields on long-term Governments and AAA corporates are nearly 1 per cent higher than at the beginning of recovery in the latter part of 1954. I would not do anything to put additional pressure there, but I would favor some lesser ease in the short-term area--if that can be achieved.

I do not favor raising the discount rate at the present. I think the national level of unemployment and of other unused resources is too high to add further at this time to the pressures that have already developed in the money and capital markets. Although monetary policy cannot deal effectively with structural and geographic imbalances, unemployment is still fairly widespread in the Third District, as throughout the country. Of 13 major labor markets, only 3, with 12 per cent of our labor force, are classified as high as "C". Four are classified "F" as having substantial labor surplusses; in addition, 8 minor markets are classified as "F".

I would revise the directive to reflect more accurately the changes that have occurred since it was adopted. It is important, I believe, that the wording of the directive indicate that the System has two objectives: (a) to foster recovery, and (b) without encouraging inflationary developments. A suggested wording for clause (b) of the directive is "to maintaining conditions in the credit and money markets that will promote recovery without encouraging inflationary developments." I appreciate that this is easier to put into a directive than to carry out in operations.

Mr. Bryan said that in preparation for this meeting he had been trying to answer in his own mind a few questions. The first question was whether recovery was proceeding in the Sixth District, and on the basis of the statistics the answer must be in the affirmative. The second question was whether recovery was proceeding in the nation. Here he wished to associate himself with Mr. Young's statement that recovery was proceeding and also with Mr. Young's thesis that reserve supplies and the money supply are entirely ample to support the recovery. Regarding possible action on the discount rate, he had asked himself how the Sixth District had been faring in comparison with the nation as a whole from the standpoint of year-to-year and month-to-month statistics. Mr. Bryan then cited a number of statistical comparisons on both bases from which, he said, it seemed clear that if a case could be made for a change in the discount rate on the basis of either national or district policy, then a case could be made for such a change in the Sixth District.

With regard to general policy, Mr. Bryan said that he thought the System had performed well in the past three weeks. While he had strongly advocated the elimination of redundant reserves at the last meeting, he did not think at the time that this could be effected as expeditiously as the Desk had actually been able to do it. The effects of the increase in margin requirements and the increase in the discount rate at San Francisco were, in his opinion, all to the good. Those actions publicly announced the System's concern. With regard to reducing free reserves and increasing the discount rate, it seemed to him that the only question was one of timing. If it were felt desirable to reduce the supply of free reserves or to make changes in the discount rate, then the earlier the better so that whatever possible repercussions these changes had in the capital markets would have ample time to adjust themselves. Accordingly, it was his inclination to recommend at next week's meeting of the Reserve Bank's executive committee a 1/4 per cent increase in the discount rate. That might present a problem for other districts, but for the immediate future it seemed to him that there was a very genuine difference as between districts and that possibly no harm at all would be done by having different discount rates in the various districts.

Mr. Johns said that although many comments had been made this morning with which he found himself substantially in agreement, he thought that he would like to align himself more closely with the comments of Mr. Bopp than with any of the other statements. As elsewhere, he said, the accumulating evidence of recovery was being observed in the Eighth District, and with those developments he was gratified for this was precisely what the System had been seeking. However, he was not yet convinced of the inevitability of inflation in the immediate future. As a matter of fact, he was inclined to characterize what some had called inflationary psychology as an inflationary psychosis. There had been a significant rise in interest rates and there was some opinion to the effect that this rise had occurred too rapidly and too sharply. Without attempting to express an opinion on those points, nevertheless it was his view that it would be premature--and therefore not advisable--to add through Federal Reserve policy to the magnitude and the speed of this adjustment. He was quite aware of the necessity for monetary policy to be flexible and he was also aware of the fact that there had been some criticism, both from outside the System and from within, concerning the slowness of change of monetary policy at the end of the 1953-54 recession. His thought at this time would be to construe flexible monetary policy as not meaning premature change but as implying a firm resolve to be just as resolute as the circumstances require when the evidence is clear that there is a need for change in policy.

Mr. Johns said that he would favor a gradual tailing-off of the free reserve position. However, he said that he did not look with favor on a discount rate change at this time and that he so indicated to the St. Louis directors at their meeting last Thursday. Obviously, the discount rate would have to be considered again by the directors a week from next Thursday. His present inclination was toward requesting the Chairman of the Board of Directors to convene a special meeting of the directors at that time because at the St. Louis Bank the directors almost unanimously feel that a rate change should be considered by the full board of directors. However, he was not sure that he would recommend a change in the rate. On the basis of the discussion at the directors' meeting last week and in view of conversations with some of the directors since the action on the part of the San Francisco Bank, he was not at all sure whether, even if he recommended a change in the rate, the directors would go along with such a recommendation.

With regard to the directive, Mr. Johns said that he would favor a change in it and that a number of suggestions had been made with which he would be quite happy. Of them, he liked best the suggestion made by Mr. Irons.

Mr. Balderston recalled that it was just a year ago when the System took an action that has been debated ever since, namely, action to increase the discount rate to 3-1/2 per cent. Therefore, it seemed to him appropriate to secure a view of the present picture in relation to the picture a year ago when the System was fighting inflation with all of the restraint that it could impose. It also seemed appropriate because the period ahead had been left clear for monetary policy by the Treasury. A year ago, Mr. Balderston pointed out, unemployment was at a level of three million, or about 4.6 per cent, while today it stood at 5.3 million, or 7.3 per cent. Thus, the unemployment situation was considerably worse now, and that fact ought not to be forgotten. Possibly the country might have to live for some time with more unemployment than would be found desirable. Continuing with his comparison, Mr. Balderston recalled that a year ago the commercial bank prime rate was 4-1/2 per cent and the System was raising the discount rate to 3-1/2 per cent to narrow the differential. At that time Congressional discussion was reflecting the popular revulsion against Government spending, while this August the Congress was going home leaving a budget deficit behind of perhaps $12 billion. Spending was not only excessive but ill-timed in view of the recovery movement. Before the next Congress convened, half a year must elapse and that period might be fateful in terms of how the System handled its responsibilities.

Mr. Balderston said he would be the last one to urge on the Administration or the Congress the adoption of controls of a selective character. To him, they were inimical to everything the System held dear and should be used only in dire emergencies. However, the country appeared to need the educational value of a great debate concerning how to avoid unemployment without inflation or, more precisely, how to keep unemployment in check without inflation. Unless that educational process was complete, he did not believe that Congress would come back to Washington in a frame of mind that would make for prudent policy decisions. However, if this education could be given, perhaps the new Congress would convene in a mood to bring Governmental spending in rein.

In the meantime, Mr. Balderston said, this placed an abnormal burden upon monetary policy--probably more of a burden than it should be expected to bear and one that it could not be expected to discharge with the success that the country seemed to expect. Fortunately, the Treasury had arranged its affairs so as to leave a clear path for monetary policy for about two months. Fortunately, also, there would be a seasonal tightening of credit which, in the absence of offsetting System action, would absorb about one-half billion dollars of reserves. Thus, certain natural forces were working along with the System.

Mr. Balderston said he subscribed to a good deal of what Mr. Vardaman had said. In the face of a fiscal policy which was almost frightening and in the face of a mass psychology that was even more frightening, the Federal Reserve System must take action that the country could understand in reliance upon the common sense of the general public. He said that he was pleased about the action taken by the San Francisco Bank, and he expressed the view that the posture of a split discount rate was not unbecoming at the moment. He would favor the wiping out of free reserves as fast as that could be done smoothly. In the face of a situation such as he had attempted to describe in his comments, the System should be starting on a policy of restraint and it could not do that with free reserves in the picture. Therefore, free reserves should be brought down to zero at the earliest possible moment. He did not care particularly how the directive was worded as long as the System took the actions that he considered right.

Chairman Martin prefaced his comments by saying that it was a good thing to have differences of opinion expressed within the Committee because they tend to illuminate the pboblems with which the Committee is dealing. As to his own position, he said that he wanted to associate himself with the thinking of the Federal Reserve Bank of San Francisco on the discount rate. From the standpoint of timing, something might have been said for delaying the action until after the discussion at this meeting of the Open Market Committee, but he was not certain that this was a very important matter. The System was dealing with what Mr. Johns had aptly described as an inflationary psychosis as well as inflationary psychology, and the System could never hope to be popular in conducting monetary policy; whenever it was popular, the System probably was not doing its job properly. At the same time, one could not expect to do too much when budget decisions, debt management, and fiscal policy are all in the picture along with monetary and credit policy. The System, he said, did not create the recession that started a year ago. In his opinion the discount rate actually should have been raised much earlier in 1957 but, because the Treasury was in the market virtually every month, the System went along from month to month during a frustrating period of Treasury-Federal Reserve relationships until finally it raised the discount rate in a technical decision at a time when some of the harvest of inflation was being reaped. In his judgment, the reason that there were now more than five million unemployed was to be found in the extent that inflation dominated the economy in the course of the last few years. Monetary policy did its part to restrain but there were severe budget flip-flops, including a complete flip-flop in the defense budget.

The Chairman said that the System had to stand up and be counted in these things. It could not ignore an inflationary psychosis any more than inflationary psychology. Mr. Bryan had pointed the problem up very well in his comments at the last meeting of the Committee. At the present, there had been an increase in personal income, housing starts--financed in large part through FHA money--were increasing, and production had recouped one-third of its total decline in a period of three months. The System had to take note of those things, and the System had let the increase in the money supply run away from it. The commentators and the public, he noted, were prone to say that the System started a recession when it raised the discount rate to 3-1/2 per cent, and now they would say that the System was starting another recession when it raised the discount rate to 2 per cent.

Chairman Martin said that, as Mr. Young had pointed out in his comments, the expansion in the money supply had been proceeding at quite a strong rate. Some of this expansion had repercussions in the Government securities market at an unfortunate time and compounded the Treasury's problem at that point. Now the System did not have too much time because the Treasury would have to go to the market for new money in early October and under present conditions the System would probably have to supply some reserves for it could not let the Treasury financing fail. However, the present atmosphere required the adjustments that had taken place in the market, unfortunate as they were.

It must not be forgotten, Chairman Martin said, that in a way there is a distinct bias toward easy money, for it is much easier to go down than up. When the System moves down everyone applauds, and then little notice is given to the further actions taken so that the System tends to get enamoured of moving in that direction. Then, when the System has to move in the other direction, it is not so easy and the System runs into more resistance.

The Chairman expressed the view that the Secretary of the Treasury and Under Secretary Baird were acting in exemplary fashion. They were not happy about some of the things that had occurred, they were just as concerned as the System about the major current problems, and they wanted to do whatever possible to assist. At the same time, when the System was talking about further reductions in reserve requirements, there was no resistance from the Treasury.

Continuing, Chairman Martin said that at present there was a maelstrom of maladjustments. This situation was reflected in Congress, and it might be that the System was going to have a very hard time in the next session of the Congress. In saying this, he was not talking about monetary problems alone. Mr. Balderston, he said, had referred to the need for a great debate. It might be stated in other ways, but, however one put it, the principal problem in the area of political science was the role of the central bank in relation to the Treasury. This problem was world-wide and the Federal Reserve System was in the center of it, so the System must try to exert what leadership it could. It ought to move in the direction of mopping up the excess reserves that were not being used before the time came when there would be virtually no opportunity for the System to do anything. At present, there was some opportunity to move toward lower levels of free reserves. He again wished to express the opinion that the San Francisco Bank's action was justified and that the Board of Governors had been justified in approving the higher discount rate. It was his hope that other Reserve Banks would move ahead on the rate. It would be his view that those who did not move were wrong, although he could understand that conditions in each district must be considered.

In talking about recovery, Chairman Martin said, it is necessary to put the matter in longer-range perspective. If inflation should begin to develop again, it might be that the number of unemployed would be temporarily reduced to four million, or some figure in that range, but there would be a larger amount of unemployment for a long time to come. If inflation should really get a head of steam up, unemployment might rise to ten million or fifteen million and that would completely destroy all of the emphasis that had been placed on the role of private enterprise. He noted that in a recent resolution Senator Proxmire had stated that the Congress should order the Federal Reserve to study "other means of controlling inflation," and that suggested a prevalent attitude today. His own judgment, the Chairman said, might be incorrect as to the usefulness of monetary and credit policy. To the average person today monetary policy had again become discredited.

Chairman Martin said that he had recently been watching public reactions closely and that the general reaction of the average man was along the lines of: "You did the best you could in 1955 and 1956 but prices continued to go up. Therefore, why not just have easy money and avoid frustrations"? That was the major public relations problem confronting the System, and the System was not going to win any friends by failing to face up to what it could do. A great many people, including some foreign central bankers, had begun to worry about the expansion of the money supply in which the System was engaged, particularly when this was placed in the perspective of a budget deficit which might be in excess of $12 billion and no real tempering of expenditures. These circumstances contrived to produce a potentially dangerous situation. He was not sure that there was not an element of truth in one article which said in effect: "You have acted with courage, but this is the Federal Reserve System's last chance." It might be that the problem could not be explained to the public and that the central bank eventually would become subordinate to the Treasury. However, the System should not in any way jeopardize its position by failing to have courage to assume the risks that were involved. There was certainly a risk, for if there should be a decline in business this fall the System would be blamed for it.

Chairman Martin went on to say that he understood fully the apprehension that Mr. Bopp had expressed very well with respect to unemployment, idle capacity, and the capital markets. All of those factors should be of major concern to the Committee but they should not prevent the Committee from trying to mop up idle money or from trying to the best of its ability to highlight the nature of the outlook. Incidentally, he noted, there were some people who took heart when the San Francisco action was announced.

Chairman Martin said he did not think that the System had faced in recent years anything like the present problem, whether it be called an inflationary psychosis or inflationary psychology. He did not know how to deal with the specifics of the problem except by moving in the right direction within the System. When the Treasury was forced to go to the market in October, the System was not going to be able to move dramatically for it would have to take into account the Treasury's requirements and the Treasury probably would have a very difficult situation. Also, there was the wage-cost push which was not at all the central bank's problem.

Summarizing the discussion at this meeting, the Chairman said it appeared to indicate a desire on the part of the majority to move in the direction of lower free reserves and, it seemed fair to say, without seriously disrupting the Government securities market. This would not be easy to do, and it was a problem which the Account

Management must face. However, the reserve projections were moving materially in that direction, so without too much pressure the Management might be more or less able to meet the wishes of the majority by moving along with the projections. The Management should not be tied to any specific figure of free reserves because the Committee had found out how vulnerable it was when it set up a specific target. The fears often expressed by Mr. Irons in that respect had been vindicated.

Turning to the directive, Chairman Martin said that almost any of the suggestions that had been made would be acceptable as far as he was concerned. Mr. Young, he said, had suggested "to tempering the rate of expansion of the money supply." This wording would have the advantage of being directed specifically to what the Committee was doing.

During a discussion of Mr. Young's suggestion, Chairman Martin pointed out that it would be possible to add to that language "and fostering sustainable economic recovery" or any similar phrase that the Committee might favor. The merit in Mr. Young's suggestion was that it would meet the System's immediate problem.

Mr. Irons inquired whether it was the view of the Committee that over the next three weeks it wanted the money supply to expand. When several negative indications were heard, he commented that the wording proposed by Mr. Young would seem to suggest further expansion of the money supply. In response, Chairman Martin suggested that the proposed wording was designed to leave the Account Management some latitude in its operations.

Mr. Balderston said that the concept he would like to see embodied in any directive for the next three-week period would be something like "to adjusting the money supply to the constructive needs of the economy." At a time like the present he felt that this was especially important.

Mr. Shepardson noted that it had been suggested by some of those around the table that it might be possible to eliminate clause (b) of the directive and to add to clause (a) a few words such as "without inducing inflation."

In further discussion of alternate possibilities, Mr. Treiber commented that he was not sure how a directive such as "tempering the rate of expansion of the money supply" would work out in practice. He had thought of the directive more in terms of outlining the climate in which the Account Management was to operate.

At the request of the Committee, Mr. Irons then repeated his suggestion for clause (b) which was "to fostering conditions in the money market conducive to balanced economic recovery and growth." Subsequently, he indicated that upon consideration he was inclined to feel that it would be preferable to delete the words "and growth."

With reference to the comments that had been made about wanting to avoid any disruption of market conditions, Mr. Shepardson said he considered it important that this not be interpreted to mean that no pressure would be exerted, for he felt that the System must exert some pressure to obtain the desired results. On this point, Mr. Balderston remarked that he would be unhappy if the System did not get rid of free reserves by the time of the next Open Market meeting.

Chairman Martin pointed out that the Committee did not appear to be unanimous in that view. However, it was unanimous with regard to the trend. It was clear that the Committee wanted to be moving in the direction of the elimination of free reserves by the time of the next meeting.

Mr. Larkin said that conceivably a zero level of free reserves might be achievable in the next three-week period and, if so, that presumably would become the target. He inquired whether that was the sense of the Committee.

Chairman Martin replied that he did not think anyone would quarrel with reaching toward a zero level of free reserves if it was achievable.

Mr. Irons remarked that he did not think the objective was necessarily to get back to zero. He did not like pinpointing any fixed figure, whether it was zero or $500 million, because in his opinion the System only got into difficulty by trying to specify any particular figure, no matter what it was.

Mr. Larkin then stated that he thought he understood the sense of the meeting.

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 fostering conditions in the money market conducive to balanced economic recovery, 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 $1 billion;

(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.

It was agreed that the next regular meeting of the Committee would be held on Tuesday, September 9, 1958, at 10:00 a.m.

Thereupon the meeting adjourned.

Winfield W. Riefler
Secretary