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, December 1, 1964, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Daane
Mr. Hickman
Mr. Mitchell
Mr. Robertson
Mr. Shepardson
Mr. Shuford
Mr. Swan
Mr. Wayne

Messrs. Ellis, Bryan, Scanlon, and Deming, Alternate Members of the Federal Open Market Committee

Messrs. Bopp, Clay, and Irons, Presidents of the Federal Reserve Banks of Philadelphia, Kansas City, and Dallas, respectively

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Messrs. Brill, Garvy, Holland, Jones, and Mann, Associate Economists
Mr. Stone, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

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

Messrs. Willis, Eastburn, Taylor, Baughman, Parsons, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Atlanta, Chicago, Minneapolis, Kansas City, and Dallas, respectively
Mr. Parthemos, Assistant Vice President of the Federal Reserve Bank of Richmond
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 10, 1964, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market operations and on Open Market Account and Treasury operations in foreign currencies for the period November 10 through November 25, 1964, and a supplemental report for the period November 26 through 30, 1964. Copies of these reports have been placed in the files of the Committee.

Supplementing the written reports, Mr. Coombs said that the gold stock would remain unchanged this week and the Treasury was hopeful of avoiding any further reduction through the year end. The Stabilization Fund now had on hand $180 million in gold with prospective sales of $75 million through December. The outlook for 1965, unfortunately, was fairly ominous. If the French continued to buy their usual $34 million a month, this would mean sales of roughly $400 million for the entire year to France alone. In addition, the Spaniards had

indicated they would like to buy about $200 million. The Austrians might also be in.

As a rough guess, Mr. Coombs commented, in the absence of a major improvement in the U.S. balance of payments, total gold sales in 1965 might well exceed $1 billion. As an offset, a few countries might be selling relatively small amounts of gold to the United States, and if the Russians re-entered the London gold market the U.S. might have a certain supply from the London gold pool. On the basis of the present outlook, however, he suspected that the U.S. was unlikely to acquire much more than $250 million next year from Russian and other sources, which suggested a net reduction in the gold stock of $750 million or more. In the present very shaky state of confidence in the gold and foreign exchange markets, a resumption of gold losses on so sizable a scale might have rather serious consequences.

On the exchange markets, Mr. Coombs continued, the flight from sterling had been checked since the announcement of the $3 billion credit package, but as yet there had not been any swing back. He remarked that once confidence in a currency was lost, it was not an easy task to rebuild it and much would depend not only on what the British Government did during the coming weeks but also on what it said.

Perhaps the most serious aspect of the sterling crisis, Mr. Coombs said, was the risk that a sterling devaluation might have

unleashed a heavy speculative attack on the United States dollar. In 1949, when the British devalued by 30.5 per cent and brought down 33 other currencies with them, the dollar was able to ride through the storm without difficulty. Today the story would be quite different and, in his view, that further underlined the necessity for moving as fast as possible to eliminate the U.S. balance of payments deficit and restore the strength of the dollar.

In response to a question by Mr. Daane, Mr. Coombs said the figures he had given on possible changes in the U.S. gold stock did not take into account the effects of increases in IMF quotas, which might result in additional losses of about $1/2 billion. These losses, of course, could be explained as not reflecting any concern about the dollar. They would, however, raise the total figure.

Mr. Mitchell observed that from a long-range standpoint the fact that the U.S. had achieved a strong current account position was highly reassuring. He agreed with a statement he had heard that the condition of the current account was remarkable, given the present domestic situation in the U.S.

Mr. Hayes commented that despite the situation on current account there still was a serious problem in connection with the over-all balance of payments because of the size of capital outflows. Mr. Mitchell responded that in his judgment it was important for Committee members to keep in mind that the balance of payments

problem was one of capital flows, and not of the competitiveness of U.S. goods in world markets. Mr. Coombs had given a disturbing report on the prospects for the dollar and the U.S. gold stock. It was appropriate for him to bring these prospects to the Committee's attention, and he (Mr. Mitchell) agreed that the situation was serious. However, he thought the Committee should be cautious in deciding how to deal with the situation; in his judgment the remedy lay not in general monetary policy but in measures addressed specifically to the problem of capital outflows.

Mr. Hayes said that in the reasoned judgment of many people here and abroad there were grounds for concern not only about sterling but also about the whole international financial structure.

Mr. Daane asked whether there were any technical reasons for the failure of a reflow to Britain to develop after the events of the past week Mr. Coombs replied that the basic explanation lay in the factor of confidence. Many people on the continent were maintaining large short positions in sterling and were borrowing pounds to mee their immediate needs on a day-to-day basis. It was impossible to say how long they would continue to act in this way; perhaps until it became apparent that the actions on Bank rate and import surcharges were beginning to take effect. Britain was moving into a period of seasonal strength in their balance of payments, and this would be in their favor. If they could get through the year-end without any

further break in confidence, a reflow might develop. Recent developments relating to leads and lags in payments, hedging by foreign traders, outflows of funds because of lack of confidence in sterling, and so forth, all could be reversed quickly under favorable circumstances.

Mr. Coombs replied affirmatively to Mr. Balderston's question as to whether the recent flow of funds from London to the continent involved the dollar. Mr. Balderston then asked about the extent to which the use of dollars in transmitting these funds caused European central bank claims against the U.S. to increase. Mr. Coombs replied that the funds initially went into the Euro-dollar market and then, after a brief lag, to European central banks. These banks had taken in a substantial amount of dollars--several hundred million. This had put pressure on the dollar and had created a serious problem. There was no doubt that the U.S. had a large stake in the package of credits to Britain.

Mr. Coombs added that Britain planned to repay $500 million of the $675 million now outstanding in drawings on its swap with the System after they made their $1 billion drawing tomorrow on the International Monetary Fund. Meanwhile they were drawing on the credits advanced by continental European countries. Since only $200 million of their IMF drawing would be in dollars, the net effect would be to mop up dollars that had been flowing to the continent.

In response to a question by Mr. Shuford, Mr. Coombs said that the Treasury gold stock had been reduced by $75 million last week because of a transfer to the Stabilization Fund in anticipation of orders for gold. If the transfer had not been made the Fund's holdings would have been $105 million rather than $180 million.

Mr. Bryan noted that the "free" gold stock of the U.S. at present was at the low level of $2.3 billion. He recalled earlier discussions in which it had been suggested that legislation be recommended at a time when the dollar was not in danger to remove the requirement of gold cover against Federal Reserve notes. He wondered now whether the U.S. would not have its hand forced in this connection. When the level of free gold was so low it became obvious in financial markets that the dollar was highly vulnerable.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period November 10 through November 30, 1964, were approved, ratified, and confirmed.

Mr. Coombs recommended renewal for another three months of the $100 million standby swap arrangement with the Netherlands Bank, which matured December 15, 1964. He noted that this swap arrangement, and the one with the Bank of France, were the only ones remaining on a three-month basis. However, he did not recommend proposing an extension of term to the Netherlands Bank at this time.

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

Mr. Coombs then noted that drawings on the swap line with the Netherlands Bank in the amounts of $30 million and $5 million would fall due on December 16 and December 21, respectively. He recommended their renewal for another three months; in both cases these would be first renewals.

Renewal of the two drawings on the swap arrangement with the Netherlands Bank was noted without objection.

Mr. Coombs then noted that the original $50 million swap arrangement with the National Bank of Belgium would reach the end of its six-month term on December 22. As the Committee members would recall, he said, when the increase in the Belgian swap line from $50 to $100 million was negotiated on October 22, it was agreed that both the first $50 million and the second $50 million would be consolidated on December 22 into a single twelve-month swap arrangement for $100 million, with $50 million of this amount to be fully drawn at all times on a six-month maturity basis.

In reply to Mr. Shepardson's question concerning the fully drawn $50 million, Mr. Coombs said that unlike all other swap arrangements the original arrangement with the Belgians had been fully drawn on both sides from its initiation, at their request. He

personally would have preferred the more usual type of arrangement. In this special case the "temporary" factor came into play in connection with disbursements, which were repaid within three months. The drawing was not recorded as such except insofar as funds actually were disbursed.

> Consolidation of the two swap arrangements with the Bank of Belgium, as recommended by Mr. Coombs, was approved.

Mr. Coombs reported that a $13 million swap with the Bank for International Settlements against Swiss francs would mature once more on December 10. By that time this swap arrangement would have been on the books for a total of 18 months, and he thought the time had come to liquidate it.

> Liquidation of the $13 million swap with the B.I.S., as recommended by Mr. Coombs, was noted without objection.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period November 10 through November 25, 1964, and a supplemental report for the period November 26 through November 30, 1964. Copies of these reports have been placed in the files of the Committee.

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

The market has once again demonstrated its extraordinary capacity to make orderly adaptations to sharp and sudden changes in the environment in which it operates. Market participants were aware, during the few days before Britain's November 23 Bank rate change, that sterling was under pressure. The feeling that the Bank rate would not go up--a feeling that had nourished the early November rally in the bond market--was already being questioned by some in the market, and a move to 6 per cent on Thursday, November 26, would not, I think, have come as a complete surprise. The move to 7 per cent on Monday, however, did come as a complete surprise. The market immediately underwent an adjustment that ranged to 1/2 point in prices of Treasury bonds and 10-15 basis points in Treasury bills. Market attention was then focussed on the discount rate. The market felt that a move to 4 per cent would come before the end of the year, and the only question was precisely when. After Monday afternoon's announcement of the rate increase at five Reserve Banks, the market underwent a further, although smaller, adjustment on Tuesday. The market was particularly soft on Wednesday in response to the news that sterling had come under strong attack despite the Bank rate move, although it recovered when the news of the $3 billion aid package was announced. During the past two days prices have continued to move lower and yields higher. Three- and six-month Treasury bills were auctioned yesterday at average rates of 3.87 per cent and 4.03 per cent, respectively, up 11 and 9 basis points from last week's averages, and up 30 and 29 basis points from the averages set in the auction held the day before the last meeting of the Committee. Yields on bonds, on the other hand, have moved up only moderately. Intermediate-term issues are some 10-15 basis points above the levels at which they were trading before the rate changes, and longer-term issues are up about 4-7 basis points. These adjustments seem to me very moderate under the circumstances, and the market's move to the new rate levels had been orderly and without any trace of panic.

I usually avoid indulging in guesswork in these statements as to what might happen under this or that set of conditions in ensuing weeks. On this occasion, however, I thought it might be helpful to the Committee if I were to do a little guessing about the way in which

> rates might behave over the next few weeks if the Committee should decide to leave its posture with respect to reserves about unchanged. Bearing in mind that we are approaching the peak of seasonal pressures on bill rates with the dividend date on the 10th and the tax date on the 15th of the month, I would anticipate that three-month bills would move in the 3.90-4.0 per cent range. After the passage of those seasonal pressures, and particularly when we move into the New Year, the rate would probably move back down into the 3.80's, perhaps centering around 3.85 per cent. I have difficulty seeing how it could be much lower, since dealer financing costs would probably average in the neighborhood of 4.10 per cent. Indeed, if it were desired to keep the bill rate around 3.80 per cent, I think free reserves in the neighborhood of $200 million would be required in December, and perhaps $100 million or thereabouts in January.
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> With bill rates in the 3.90-4.0 per cent range during December, I would anticipate some slight further upward pressure on intermediate and long rates, although if the bills were to move back into the 3.80's in January, something around the present level of long rates might well be sustained. This, I repeat, is only guesswork. The market situation is still very fluid and can change quickly in response to any number of events, including any further developments in sterling or in our military position in Viet Nam. But I thought it might be helpful to cite for the Committee a few concrete numbers that represent what seem to me to be the rate levels most likely to flow from an unchanged reserve posture if that should be the decision of the Committee.

Mr. Stone added that the reserve outlook now was highly uncertain from day to day in view of the large flows connected with foreign operations. For example, people at the Desk came in last Friday morning not knowing whether free reserves had gone up $250 million overnight as the British drew on the newly enlarged swap or whether reserves would have to be supplied. Again, there might be a reserve withdrawal tomorrow of anywhere from $1/4 to $1/2 billion as

the British drew on the IMF and repaid part or all of their drawing on the System. Under these circumstances the Desk had to play by ear from day to day, making the best adjustments to developments that it could.

Mr. Swan asked what figures Mr. Stone had in mind when he referred to the possibility of keeping the reserve posture unchanged. Mr. Stone said he had been thinking in terms of a free reserve level of about $50 million, although under present circumstances the figure might be expected to fluctuate rather widely. He suspected that if free reserves were kept to $50 million or less during the next two weeks the bill rate would move up close to 4 per cent. To keep the bill rate in the 3.90-3.95 range probably would require free reserves on the high side of $50 million during the next few weeks of peak seasonal pressures and the occurrence of tax and dividend payment dates. In January, however, a lower free reserve figure probably would be consistent with a bill rate in that range.

Mr. Mitchell asked whether Mr. Stone was saying in effect that in order to limit the decline in Treasury bond prices to 1/2 point the free reserve target would have to be raised. Continuing, Mr. Mitchell observed that the Chairman had noted in his press conference on Monday that the discount rate action was not directed at reducing the availability of funds. In his opinion, for the higher discount rates to have a minimum impact on credit availability it would be necessary to raise the free reserve target.

Mr. Stone replied that he intended only to indicate what rate levels would be likely to develop _if_ the Committee wanted to make no change in reserve posture.

Mr. Mitchell then asked what level of aggregate member bank borrowing the Committee might reasonably expect to attain.

Mr. Stone said that a strong saw-toothed pattern in borrowings seemed to be emerging. In the first week of the two-week country bank settlement period, country banks tended to withhold their excess reserves from the central money market and borrowings by city banks tended to be heavy. In the second week country banks would sell Federal funds and borrowings by city banks would decline. Thus, it was necessary to look at borrowings on a two-week average basis. It would be his guess that with an unchanged reserve posture member bank borrowings probably would average around $400 million during the coming period of peak seasonal need, and would decline after seasonal pressures had abated. Within the two-week period they would be higher in the first week and lower in the second.

Mr. Daane said he had been present at a recent meeting involving a number of senior representatives of securities houses. He gathered that they would expect a marked impact on rates in the intermediate-maturity area and considerable impact on long-term rates if bill rates moved into the 3.90-4.0 per cent range. They were watching the market situation closely.

Mr. Stone agreed that if bill rates moved up to that range there probably would be effects on longer-term yields. He cited instances of transactions yesterday in which some banks had shortened their portfolios by selling securities in the 1968-1970 area and buying one-year bills, in the process gaining about 1/8 point in yield when the returns on bills were figured on an investment-yield basis.

Mr. Mitchell inquired whether the Desk had bought any coupon issues recently and Mr. Stone replied in the negative. At the time of the Bank rate action last Monday, he said, the technical position of the bond market had been good. However, dealers had held a relatively large amount of Treasury bills--about $2 billion--in their trading positions and they had had additional amounts out under long-term repurchase agreements. Treasury bill auctions were scheduled for both Monday and Tuesday. It seemed clear that if the bill market adjusted in an orderly fashion to the events that occurred, the odds were better than even that the adjustment in the coupon market also would be orderly. It seemed equally clear that if the bill market adjustment was not orderly, neither would be that in the bond market. Accordingly, the Desk had addressed its attention to the bill market. It also seemed desirable to stay out of the bond market for a time to avoid giving the impression that the Desk had aborted an adjustment that otherwise would have occurred. That adjustment now had been about completed. Therefore, it was now appropriate to begin acquiring some coupon issues in meeting indicated reserve needs, and he planned to do so.

Mr. Mitchell then asked whether Mr. Stone thought a free reserve target of $250 million would be consistent with a relatively modest adjustment of short-term rates from their levels prior to the discount rate action--perhaps of 15 basis points.

Mr. Stone responded that to keep the bill rate in the neighborhood of the implied level of 3.75 per cent probably would require free reserves in the $200-$300 million range over the next few weeks. In January, it might require a range of $100-$200 million. Continuing, Mr. Stone observed that the bill rate would tend to gravitate toward the discount rate unless the free reserve target was raised. At present levels of free reserves and country bank excess reserves, city banks would be borrowing in volume at the discount window, and the Federal funds rate would stay close to the discount rate. This would exert an upward pull on the bill rate. Also, dealer lending rates would then average a few basis points above the discount rate. But dealers would not hold bills yielding 3.75 per cent if the carrying cost was [illegible] per cent or more. The key to the situation lay in the level of borrowings; if they were high the Federal funds rate would be at the discount rate most of the time and the bill rate would move up.

Mr. Daane commented that he could see the logic of the free reserve-bill rate relationship Mr. Stone had suggested would hold in the December period of seasonal pressures, but he was skeptical about the proposition that in January free reserves of $100-$200 million would necessarily be consistent with a bill rate in the neighborhood of 3.75 per cent.

Mr. Hickman asked whether the present free reserve target could be retained if the Committee was willing to allow the bill rate to move up to a level just below the discount rate. Mr. Stone replied that he thought a free reserve target of $50 million plus or minus $100 million over the next few weeks would lead to a bill rate in the 3.90-4.0 per cent range. In the past few days, he noted, dealer lending rates at New York banks had been at 4-1/8 - 4-1/4 per cent on new loans, with one bank posting a rate of 4-3/8 per cent. At these lending rates dealers would not carry bills yielding much below the discount rate.

Mr. Hickman then asked whether a free reserve target of $200 million would not lead to a large run-up in the money supply, and Mr. Stone replied that that would depend on the strength of credit demands.

Mr. Ellis said he also was disturbed about the possible consequences of free reserves in the $200-$300 million range. He noted that what the Committee was dealing with was a progression, in which successively higher free reserve levels would be associated with successively lower ranges for bill rates. He did not think it was necessary to let free reserves rise to the level that would keep the bill rate at 3.75 per cent; there was some intermediate level of free reserves--perhaps centering on $100 million--that would be consistent with bill rates in the range 3.85-3.90 per cent.

Mr. Deming commented that in his opinion it was futile under present circumstances to attempt to guess the precise level of free reserves that would be required to produce a particular bill rate. The real concern of the Committee, he thought, was to establish a target for the next two weeks in terms of the bill rate. Accordingly, he proposed that the Committee direct its attention to the appropriate bill rate target.

Mr. Stone agreed that it was not possible to make accurate forecasts of the underlying relations. If the Committee set a target for bill rates, some level of free reserves would emerge as a residual.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period November 10 through November 30, 1964, were approved, ratified, and confirmed.

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

Mr. Brill presented the following statement on economic conditions:

> It is far too soon to expect any observable impact on the domestic economy from last week's international financial crisis. The most that can be said is that no sense of panic has been evident in the financial and commodity markets that tend to mirror current psychology of domestic business

leaders and investors. Security markets have responded in a generally mild and orderly fashion, both to the crisis and to the official rate actions, and adjustments in markets for internationally-traded commodities have been moderate.

Since a run on one bank tends to bring into question the solvency of the rest of the financial community, it is natural at this juncture to inquire into the vulnerability of the United States to a global loss of confidence of the sort experienced by the British. Of course, the basic international positions of the two countries are quite different, as Mr. Reynolds will explain in a moment, and fortunately our election results have been conducive to confidence in the stability of public policy, in contrast to the British experience.

Nevertheless, there are emerging problems that could well bring into question the fundamental strength of the U.S. economy. It is the near unanimous view of the staff, as indicated in the "green book"1/ and in the various draft directives submitted to you, that our current economic situation is one of "underlying strength, obscured by the effects of strikes." Partly because I enjoy the role of "devil's advocate" but also with some underlying strength to my own convictions, let me express certain reservations about this appraisal.

My first reservation relates to prospects for continued price stability. We are now getting some pass-through of earlier price increases in basic nonferrous metals to the finished goods level, without significant offsets in other industrial commodities. The 0.4 per cent increase in the industrial materials price index in October has not been followed by much further rise, but neither has it been offset by a decline. Stability in the over-all index of wholesale prices has been maintained only by a decline in some agricultural prices. Obviously, one month's experience is not enough to warrant the cry of "inflation," but it isn't an encouraging development, particularly since the nonferrous area continues under upward pressure.

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

Moreover, the true test of whether wage pressures will upset price stability is still to come, in settlements for industries where productivity gains have been much smaller than in automobiles. The heavy overhang of unemployment among teenagers and younger men generally, and the loss of production-line jobs in manufacturing industries, have diverted union demands toward job security and pensions rather than money wage increases, and as far as one can observe productivity has continued to rise generally and unit labor costs to remain stable. It's a fragile stability, however, with much of it resting on the Administration's efforts to contain the steel settlement to reasonable dimensions.

But along with increasing threats to price stability, we have increasing indications of declining strength in some key final demands. Business investment in fixed capital has been a major factor in contributing to rising productivity as well as to rising aggregate demands. The outlook for future investment is much less optimistic, however, as indicated first by the McGraw-Hill survey and as now confirmed by a more recent Government survey. Recognizing that businessmen generally underestimate future capital spending during upswings, the McGraw-Hill staff made extensive efforts to determine what sort of correction factor would be appropriate to apply to their latest survey findings. On the basis of their inquiries they reached the conclusion that any upward adjustments this time should be minimal, since many respondents reported that in overshooting this year they had substantially completed their capacity expansion programs. This conclusion is not inconsistent with the course of new orders for nonelectrical machinery, which have not risen since last spring. And results of the latest Government survey, as yet still preliminary and confidential until released next week, suggest that the McGraw-Hill estimate is close to the mark; i.e., that spending for fixed capital will be showing much less thrust in 1965 than it has this year.

Consumer investment in housing is also a relatively weak area of economic activity. While housing starts bounced up in October, if allowance is made for the volatility of this series the best one can say is that the downdrift from last year's peak may have been arrested but no significant rise has occurred or is in prospect.

Neither is there much impetus to be expected from fiscal policy. Federal expenditures for goods and services haven't risen much this year, on balance, and there appears to be a dedication to keeping future spending close to the present level. Given a rapid recovery in revenues despite reduced tax rates, it won't be long before we are concerned again with "fiscal drag." The vehicle now in favor for preventing it, namely, a reduction in excise taxes, seems to me to be the most difficult type of tax reduction to achieve politically and the least sure in terms of economic impact.

If this less than sanguine appraisal is near correct, what we are left with to sustain rising activity is consumer and State and local spending and business inventory accumulation. Consumer spending for durable goods has been held back in recent weeks by the auto strikes, and spending for nondurables by unseasonable weather. With the advent of some snow, Christmas, and new GM cars in the salesrooms, retail sales should resume and maintain their strong upward course for some time. The latest buying plans survey is strong and any concern over consumers' contribution of sustained expansion must relate to later in 1965, not to the near-term future.

Business spending for inventories is another matter, however. It is an important component of the current production picture, but this is about as undersirable a source of aggregate demand as one can get, since a rapid acceleration in the rate of inventory accumulation resulting from strikes and strike threats, such as we are experiencing now, is conducive to price increases and has a built-in backlash once the occasion for it has passed.

In summary, I find almost as many signs of underlying weakness as of strength, and among the weaknesses, the not unfamiliar paradox of emerging price pressures at a time of emerging slowup in aggregate demand. Either development could limit the possibility of improving our balance of payments, for while price increases would have their impact on our trade balance, a reduced rate of economic growth here would decrease incentives for long-term capital inflows and for retention of domestic investment capital. In other words, we can't afford, internationally, either inflation <u>or</u> a slackening in expansion.

> In light of this appraisal, it would seem to me that the appropriate stance for policy would be one of maintaining domestic investment incentives through relatively stable long-term interest rates, while keeping the availability of banking funds to the minimum consistent with this. Certainly, there is no need for additional encouragement to the financing of speculative inventories, nor does there appear to be any need for encouraging a more rapid rise in consumer credit. But neither would it be appropriate to put financial roadblocks in the path of business fixed capital outlays or of local government capital outlays that contribute to the efficiency of our productive system. Effecting such allocation of credit flows through a general policy tool is difficult, but "Operation Twist" seems to have worked; now we apparently need "Operation Supertwist."

Mr. Hickman noted that in a chart presentation to the Committee at a recent meeting the staff had projected a substantial availability of long-term funds and moderate demands for them, implying some downward pressure on long-term rates over the coming period. He asked whether this was still the prospect; if so, it would assist in the "Operation Supertwist" to which Mr. Brill had referred.

Mr. Brill said that, if anything, such a development appeared more likely now than it had at the time of the presentation. This was because the staff's projection for capital expenditures had been larger than it would now make in light of the more recent surveys of capital spending plans.

Mr. Hickman then asked whether there would not be a fairly comfortable availability of long-term capital if the bill rate did not move much above its present level. Mr. Brill replied that he

thought that would be the case unless investors were induced by arbitrage opportunities to move out of the long-term area.

Mr. Balderston asked whether Mr. Brill would comment regarding the probable impact of the recent change in Regulation Q on bank purchases of municipal securities and mortgages. He noted that after the Regulation Q change in January 1962 the rate of growth in time deposits at commercial banks rose from 12 to 18 per cent. However, in November of this year time deposits were growing at an annual rate of 18-1/2 per cent. In 1962 banks had bought four-fifths of all municipal issues and one-sixth of the supply of mortgages. Did Mr. Brill foresee banks continuing to be active in these two areas? If so, was there some chance that mortgage rates would remain low?

Mr. Brill replied that "Operation Twist" undoubtedly would be aided by the Regulation Q action; at the minimum, that action might prevent some diversions of bank funds away from municipals and mortgages. However, there was some question as to whether banks might already have invested so heavily in these areas that there was not much room for increasing further the rate of such investment, particularly in light of the rates of return they could expect and the rates they would be paying on time deposits. He did not think the cushion had been completely exhausted, but it undoubtedly was smaller than it had been at the time of earlier increases in Regulation Q ceilings.

Mr. Holland made the following statement concerning financial developments:

Mr. Stone has already outlined the yield changes that occurred in various categories of market securities in initial response to last week's official rate actions. Insofar as commercial bank rates were concerned, only two banks have thus far raised the prime loan rate, without confirming action as yet by other of the nation's large institutions. Savings deposits rate increases centered in New York City, where banks have been hard pressed by mutual savings bank competition this past year. Time CD rates were increased promptly by a number of banks around the country, but by no means generally, and most announced increases seemed defensive in nature, bespeaking no aggressive intentions to capture large additional amounts of deposits, given the current flat yield curve.

Contributing to these comparatively orderly reactions were a general awareness of the continued large flow of savings, the modest current supply of new capital offerings apart from Treasury and Government-sponsored issues, last week's relatively easy money market, and assurances that the step was not intended to have as its counterpart a reduction in the availability of credit.

Now that the first market adjustments are behind us, the more important financial questions concern the responses that such rate changes might engender in broad credit and capital flows, both domestically and internationally. Comments on international flows I leave to my colleague, Mr. Reynolds. In the domestic arena, financial flows prior to the discount rate change can be characterized as somewhere between moderate and vigorous. Business and financial loans at city banks picked up in November, with loan demand significantly strong from borrowers in the metals and petroleum industries. Banks acquired Treasury securities from time to time during the month, reflecting a larger than usual amount of Treasury financing to be paid for in November, but parts of such holdings were in the nature of underwriting positions that were gradually being worked back down.

The combination of these influences seemed to be pushing average bank credit and deposits up at over a 9 per cent annual rate during the month. The bulk of such deposits, however, were being sequestered in time deposits and in a substantial nonseasonal rise in Government deposits with private demand deposits down slightly on average and total money supply up only at between a 1 per cent and 2 per cent annual rate, on first estimates. This extreme pattern of deposit distribution does not seem likely to hold. Likely rundowns of Government deposits in late November and December could easily serve both to lower total bank deposit and credit expansion and raise the portion representing the money supply. Perhaps, therefore, it is not misleading to think of the performance of the banking system prior to the discount rate increase as being represented by the average annual rates of growth of total bank deposits and money supply for the year to date, namely, about 7-1/2 per cent and 4 per cent, respectively. Through the first three quarters of 1964, bank credit was accounting for a somewhat smaller share of total credit extended than earlier in the expansion, and the money supply was rising a bit slower than the revised 5 per cent rate of growth in real GNP.

How much will such monetary and credit expansion be affected by the higher discount and time deposit rates now in effect? The plain fact is that the current situation is sufficiently unique so that past experience gives no dependable guide. A precise answer can only be given by events. But the direction of influence of such rate increases can be fairly well foreseen, and open market operations in coming weeks need to be shaped with that in mind.

If member bank borrowings were to be kept around their fall average of $350 million, mostly by city banks, bank reserve adjustment actions would be likely to keep crowding the constellation of money market rates up close around the 4 per cent level. This is because major banks, before paying the Reserve Banks 4 per cent for very much money, are likely to drain any short-run alternative sources of funds available at cheaper prices. Such rate consequences of continued sizable member bank borrowing are doubly likely between now and the cresting of seasonal rate pressures around the third week in

December, for in this period nonbank needs for funds are large and the money market becomes particularly dependent upon banks as residual lenders.

The hazards of such a short-run rate development are twofold: first, the possible triggering of a second round of sympathetic and expectational increases in longer term yields; and, second, the attraction of funds away from longer term uses, either directly or through arbitrage or swapping operations, in response to the centripetal pull of high yields available in the central money markets. The latter is an especially treacherous development, for it can create a comfortable sense of availability in the money market at the very time when longer-term credit availability throughout the economy is being dampened. This happened to a degree last March, you will recall, as banks particularly dumped longer-term securities and bought bills in the wake of the previous British Bank rate increase.

Presumably yield pressures will relax a bit after the turn of the year, as the supply of nonbank funds swells seasonally, but any resulting ease in money markets could still restrain bank credit and deposit growth, if it encouraged banks to sell assets rather than CDs in an endeavor to pare down their 4 per cent debt at the Reserve Banks.

As you can see, in my model the cutting edge of open market policy at this juncture is the level of borrowing imposed upon larger member banks. (I do not cite free or excess reserves, because I think excess reserve movements in the next two months are going to be under such conflicting pressures as to make them particularly hard to predict--being pushed upward by usual seasonal pressures, but pulled down by the tug of higher money market rates.) To keep the half-point higher borrowing cost from cutting into credit availability, a lower borrowing total than the average for this fall would seem to be called for currently, even though the usual seasonal tendency is for somewhat higher borrowing in December. How much lower cannot be said precisely, but the answer will have to depend on signals of ample availability of funds not just in the money market, but, even more importantly, in the broader markets for credit and capital. And the signals being watched will have to include the quantities of money and credit flows, both bank and nonbank, as well as

interest rates, if we are to guard against the possibility of a creeping contraction akin to what developed in early 1960.

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

While the timing and size of the System's interest rate actions last week were dictated by the rise in Britain's Bank rate, our own balance of payments indicators had independently been suggesting for some months that a move towards firmer credit conditions here might be appropriate. The over-all deficit on "regular transactions" had not been increasing, but it had gotten stuck at an annual rate of about $2-1/2 billion. Furthermore there was little basis for expecting much improvement soon. A few weeks ago, for example, a group of balance of payments analysts within the Government tentatively projected a deficit of nearly $2 billion for 1965.

Complete data for October, together with weekly indicators through November 25, suggest that the seasonally adjusted deficit will be somewhat higher in the fourth quarter than it was in the third. This would not be surprising, in view of the huge bulge this quarter in new foreign security issues in this country, and it probably would not represent any fundamental deterioration. But one more quarter without improvement would intensify the widespread feeling--both here and abroad--that the deficit has continued too large for too long.

Furthermore, our payments position may to some extent have benefited temporarily in recent months and weeks from Britain's difficulties. Large increases in the official reserves of foreign countries, and exchange market reports, both suggest that recent outflows from Britain have gone mainly to Continental Western Europe, rather than to the United States. But we know that U.S. commercial firms joined in selling sterling short last week, and they may have done so in less obvious ways earlier--for example, by changing leads and lags in commercial payments. Also, some of the unusually large rise in liquid U.S. liabilities to private foreigners since mid-year may have resulted from foreign shifting out of sterling into dollars. Such movements do not reduce the over-all U.S. deficit calculated for "regular

transactions"; but they do reduce foreign official claims on this country, and hence reduce the pressure on our gold reserves.

Long-term lending to foreigners by U.S. banks continued large in October for the fourth successive month, at $110 million. This is an area in which I continue to suspect that reduced credit availability might have useful effects, although former commercial bankers in this room tell me that most foreign lending is much too profitable, or too closely related to other profitable business, to be significantly affected by general monetary measures.

During the current period of international financial tension, it is helpful to bear in mind some similarities and differences between Britain's payments problem and ours. Unlike Britain, we have been improving our cost-price position relative to other industrial nations. Unlike Britain, we have had a large and growing export surplus on goods and services, and have been acquiring at a rapid rate investments abroad which will continue to fortify our receipts in years to come. Unlike Britain, we have gold reserves that are as large, even now, as the total of all foreign official claims upon this country. On all these counts, our situation is more comfortable than Britain's.

On the other hand, the United States has had a large balance of payments deficit, however you measure it, in each of seven successive years, and Britain has not. On an "official settlement" basis, Britain actually had a small cumulative surplus from the end of 1957 through mid-1964, whereas the United States had a large cumulative deficit amounting to about $17 billion if debt prepayments are counted as settlement items, and $14 billion if they are not. This year, our deficit on an official settlements basis has been running at an annual rate of only about $1 billion, which is considerably better than before; but it is still a deficit, and it produces a corresponding further deterioration in our international reserve position.

While Britain's reserve position was precarious at the end of 1957, and is precarious now, it has not worsened on balance since then, whereas the U.S. reserve position has worsened considerably, even though it

is still much more comfortable than Britain's. What has been chronic about the British payments problem is the lack of elbow room, which makes cyclical swings into deficit touch off speculative runs on the currency. These runs have had to be stopped by drastic policy actions, and the resulting "stop-go" policies have frustrated private initiative to some extent and have tended to reduce the long-run rate of economic growth. What has been chronic about the U.S. payments problem is the deficit itself, which needs to be eliminated in the next few years if we are not to drift into a much more uncomfortable reserve position of the British type.

Britain has now bought time, as in earlier crises, by obtaining international credits, by throttling back a little at home, and--this time--by making imports more expensive. The speculative flight from sterling has been much more acute this time than it was in 1961, mainly because of clumsiness on the part of the new Government coupled with doubts about its intentions, but also because the current account deficit has opened somewhat wider than it did in 1960. Also, both things happened at the same time this year, whereas in 1960-61 they came a year apart. Therefore the prospects for a short-run cure are more uncertain this time, although on balance it seems reasonable to hope for a partial reversal of the speculative flows and an improvement in the current account balance on roughly the 1961-62 pattern, accelerated by the import surcharge.

The United States also has been buying time--in more sustained and less dramatic doses--by using its large reserves and the credit standing they confer, and by arguing plausibly that a balance of payments adjustment by the world's largest industrial and financial giant must be gradual if it is not to be disruptive. We have to make sure that the gradual adjustment continues. For this, we need above all to continue to avoid inflation. We probably also have to allow conditions in our credit and capital markets to move a little bit closer to those in leading surplus countries abroad. For both these purposes, the recent actions seem helpful.

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

Since our last regular meeting we have been face to face with a major world financial crisis of a kind that we have contemplated as a possible threat for many years. The speedy arrangement of the $3 billion credit for the Bank of England was an impressive demonstration that all the leading industrial countries regard stability of the key currencies as a common interest of great importance. While the pound sterling was the immediate focus of the crisis, it seems probable that failure to stem the heavy speculative attack on sterling could easily have led to a series of events culminating in serious danger to the dollar. As long as the United States and the United Kingdom remain in a fundamentally weak balance of payments position, the stability of our whole financial system, based on the dollar and--to a lesser extent--sterling as key currencies, will remain undersirably vulnerable. Hopefully the immediate crisis is past, and if this is confirmed in the next few days and weeks we can afford to play a relatively passive role for a while and observe what kinds of financial and economic adjustments will be made in response to the recent discount rate changes on both sides of the Atlantic.

The domestic economic situation appears to be about unchanged from three weeks ago. While current business indicators have been sharply depressed by the General Motors strike, the outlook for continued expansion into 1965 remains bright. Prospects for capital spending are still relatively strong, as are consumer buying intentions, and even housing starts have shown some improvement after several months' deterioration. Corporate profits, while vulnerable to a squeeze in the event of a spread of overgenerous wage settlements, have been at the highest level in relation to GNP since the Korean war boom and will be helped by the second phase of corporate profits tax cut in 1965. As for prices, announcements of increases continue to predominate, and the industrial wholesale price index appears to be under somewhat more upward pressure. However, it is too early to say whether a pervasive spread of upward price pressures is in the making; and it is somewhat reassuring that business pricing expectations for 1965 seem to give little indication of any developing inflationary psychology.

Our balance of payments position remains a cause for considerable concern. The 1964 deficit may well be around $2 to $2.5 billion, probably in the upper part of this range. While much of this has been financed through larger private foreign holdings of dollars, the outlook is for growing pressure on our gold stock in the months ahead. The beneficial effects on our balance of payments stemming from large export surpluses continue to be swamped by unusually heavy capital outflows, including both capital issues and bank loans.

The general performance in the bank credit area remains about unchanged. Although bank credit declined in October (probably in part because of the pattern of Treasury financing) the annual rate of growth of 7 per cent so far this year is about the same as a year earlier; and a sizable increase occurred at weekly reporting banks in the first two weeks of November. Money supply has grown so far this year at a slightly slower rate than a year ago. A broader measure of liquidity, total nonbank liquid assets, has shown virtually no change in relation to GNP since the third quarter of 1963.

Our policy determination for the next two weeks should reflect the fact that the rise in U.S. discount rates was essentially a precautionary move in response to the British Bank rate action. The rise was undertaken to avoid a possible shift of speculative pressures from the pound to the dollar, and the joint move, together with the changes in Regulation Q, should help improve the balance of payments of both the United States and the United Kingdom vis-a-vis the continent. While the domestic business and credit situation did not call for a curtailment of domestic demand, or for any major change in availability of credit, the domestic outlook is nonetheless strong enough to absorb the rise in short-term rates that has occurred or may occur in response to the discount rate action.

The balance of payments would doubtless be helped further by a reduction of credit availability. Nevertheless I think we should consciously refrain from encouraging such a reduction for the time being. With adjustments to recent changes still under way and with continued uncertainties as to how things will work out (including the effect of the increased Regulation Q

maximum on capital flows) we can well afford to set a goal for the next two weeks of generally unchanged availability of credit, as reflected by the tone of the market. This may require on occasion a rise in free reserves so as to cushion any tendency of the three-month bill rate to push close to the 4 per cent level. An objective expressed in these rather general terms would, I believe, be preferable to either a specific bill rate range or a specific range for free reserves or borrowing. At the same time it implies granting the Manager somewhat greater leeway than usual in carrying out the Committee's wishes in response to actual market developments as they unfold.

It seems to me that the second paragraph of the directive should be revised to give effect to such a policy, and the first paragraph should include a reference to the recent sterling crisis as well as the discount rate advances in Britain and the United States. The draft prepared by the staff meets my views in regard to the first paragraph, except that I would take out the word "apparent" preceding the words "underlying strength of the domestic economy."1/ I find the second paragraph of the staff's draft a little hard to interpret, and I suggest, as a simpler alternative, the following: "To implement this policy during the current period of adjustment, System open market operations shall be conducted with a view to maintaining about the same conditions of reserve and credit availability as have prevailed in recent months."

Mr. Ellis said that perhaps the most obvious recent economic development in New England had been a surge in consumer buying. General Motors automobiles were now flowing into and out of the dealers' showrooms. Department store sales, seasonally adjusted, showed a rather sharp rise in October and then went on to register an 8 per

1/ The draft directive prepared by the staff is appended to these minutes as Attachment A.

cent year-to-year gain for the four weeks ending November 21. The two days following Thanksgiving had launched a Christmas shopping period in which sales were expected to set an all-time record.

However, Mr. Ellis continued, recent financial developments were equally noteworthy. Business loans at weekly reporting member banks in the First District, having increased 15 per cent in a year, were still expanding at that annual rate according to data for the most recent weeks. While private demand deposits had spurted recently, their year-to-year growth at a 3.4 per cent rate had brought loan-deposit ratios in the District to record levels. For Boston banks the fourth-quarter ratio would approximate 75 per cent and for all District banks it was running at 71 per cent. These figures compared with the national average ratio of 68 per cent.

Mr. Ellis commented that it was still too early to see how widely District banks were going to use the new leeway under Regulation Q to raise rates on time and savings deposits. It was clear, however, that they were faced with loan demands strong enough to support an increase in the prime rate. One banker was quick to label press reports of Chairman Martin's press conference as "the steel treatment," and to say that he was being told his costs would rise but he was not expected to raise his prices. Another regretted what he described as "political pressure" being brought on the New York banks not to raise prime rates.

Mr. Ellis said that the assessment of the outlook by regional economists at a recent conference held at the Boston Reserve Bank did not agree with Mr. Brill's. The balance of events since the last meeting of the Committee seemed to him to confirm a strong upward thrust of the economy. There had been a rapid recovery in auto production following settlement of the auto strike; an expansion in steel ordering, and a sharp one-month recovery in private housing starts. Credit continued to play an expansionary role, judging from the expansion of bank reserves, bank loans and investments, and the money supply in the past few months. In each of these series the seasonally adjusted rate of growth since August had exceeded the average rate for the preceding twelve months. When coupled with a 5 per cent increase in velocity, the recent increase of over 4 per cent in the money supply seemed clearly excessive when matched against the expansion rate of real GNP.

In Mr. Ellis' judgment the discount rate actions of last week had had a salutory effect on expectations both internationally and domestically. He had come to this meeting prepared to suggest some validating action in connection with reserve availability, but he was willing to join in the search for no change, whatever "no change" might mean in the changing world. With an unchanged free reserve position, bill rates evidently would move toward 4 per cent. The Committee had to choose between no change in free reserves on the one

hand and altering its targets to emphasize a ceiling level on bill rates on the other hand. Mr. Ellis' own preference was to accept the market's pressure to move the bill rate up to 3.90 per cent and above, and to instruct the Manager to accept rates in the 3.90-3.95 per cent range. He would accept Mr. Holland's suggestion that member bank borrowings should not move too much above recent levels. He pointed out that while borrowings recently had been high, it was customary for them to rise in December. Accordingly, borrowings at about $450 million would not be out of line with expectations. Given these targets, he would expect free reserves to be around $100 million plus or minus $100 million, rather than be pushed up into the $200-$300 million range.

Turning to the directive drafted by the staff, Mr. Ellis said that he would omit the phrase that had been added in the first paragraph to help explain the recent increase in the industrial price index, which read "partly reflecting the carry-through of earlier advances in nonferrous metals prices." The increase partly reflected other things also, and this language sounded like an invitation to disregard it. He would replace the next clause of the same sentence, which began "and the recent moderation in monetary expansion" with the words "and the continued expansion of bank credit and money supply." The language he proposed had the advantage of focusing on the record since the Committee's last change in policy in August rather than on the

possibility that growth in the money supply may have slackened for one month. Finally, he would not inject the word "continued" before "moderate expansion in aggregate bank reserves" in the second paragraph. This word implied a judgment that the 5.4 per cent growth rate in total reserves over the past three months constituted "moderate" growth, a judgment he would question.

Mr. Irons observed that the economic situation in the Eleventh District was little different from three weeks ago. There were elements of strength, and some mixed trends. Activity in the oil industry continued at a level a little lower than earlier, and the industrial production index reflected a decline, perhaps partly because of the auto strike. Employment continued to move up and the unemployment figures continued favorable relative to those for the nation.

On the financial side, Mr. Irons said, the bank loan situation in the District was sluggish, with smaller increases in commercial and industrial loans than a year ago. It was hard to make an over-all assessment of bank liquidity positions; some banks were a bit more liquid than earlier but it appeared that others were not. Borrowings at the Reserve Bank had not been particularly high on most recent days. The larger banks had been moving back and forth between the Federal funds market and the discount window, buying funds when they were available and borrowing from the Reserve Bank when they were not.

So far there had been no particularly startling reactions in the District to the events of last week, Mr. Irons observed. No District banks had raised the prime rate as yet. Interest was centered mainly in the changes in Regulation Q, with some country banks who did not want to raise rates on their savings deposits reacting unfavorably. It was their feeling that the Regulation Q action would help New York banks but generally would hurt country banks.

With respect to general monetary policy, Mr. Irons thought that recent developments in the market had been rather satisfactory in view of the nature of the actions that had been taken last week. He was not sure that the market's adjustments had been completed; further adjustments might be in the offing. He was inclined to think that this was an occasion on which the Account Manager should be given a considerable amount of leeway and should not be bound by precise figures, because one could not be sure how the relationships between availability and cost would work out.

Mr. Irons thought that at present the Committee should give primary consideration to interest rates. He noted that bill rates would be under upward seasonal pressure from now until the end of the year and that they also would be subject to the uncertain effects of the discount rate action. He would be satisfied if during the next two weeks the bill rate was at a fairly neutral level against the

British bill rate on a covered basis, as had been the case recently. He hoped this could be accomplished in the next two weeks with a U.S. bill rate in the 3.80-3.85 area, and if the job could be done with the bill rate in that neighborhood he would not want to see the rate forced up to 3.90 or 4.00 per cent. He proposed that the target range of 3.80-3.85 be used as a guide to operations for the next two weeks, and that reserve availability be allowed to come out where it might.

Continuing, Mr. Irons observed that recent official actions had been substantial and significant. He thought it would be well to allow time for adjustments to work themselves out before deciding to take any definite position on policy. The Committee would meet again in two weeks, and he favored an attitude of watchful waiting in this interval. He would expect member bank borrowing to be in the $350-$450 million area if only on seasonal grounds, and as long as borrowings did not go very far above that level he would not be concerned.

Mr. Swan reported that total employment in the Pacific Coast States was down slightly from September to October but nonagricultural employment was up fractionally. The unemployment rate was unchanged in October at 6.1 per cent. Retail sales continued strong and expectations were for excellent sales in the Christmas season.

The recent changes in Regulation Q had been of particular interest in the Twelfth District, Mr. Swan said, because of the high proportion of total deposits at District banks that were in the form of time and savings deposits. As the Committee knew, some larger California banks had announced increases in rates on time CDs issued to public bodies and corporations. These banks did not go all the way to the new ceilings, increasing rates on CDs with maturities of a year or more to 4-1/4 per cent. At the same time they announced that for the time being there would be no change in the rates paid on savings accounts, which would remain at 3-1/2 per cent. However, the actions of these banks were followed by increases to the limits permitted in rates on both savings and time deposits by several small banks in the Los Angeles and San Francisco areas. Also, a number of banks in Phoenix, including two major banks, raised rates on savings deposits to 4 per cent, an event which might in turn have some impact on California banks. One bank in Los Angeles had announced an increase in the prime rate yesterday.

It was possible, Mr. Swan said, that there would be further increases in rates on time and savings deposits at District banks. At the same time, there was considerable concern about the effects of such rate increases on costs and profits, particularly in view of the feeling that the supply of mortgage funds would continue to be quite ample. There was little or no expectation of significant increases in

interest rates on mortgages. If banks did increase the rates paid on deposits it seemed quite improbable that savings and loan accociations would feel that they could make similar increases in order to maintain the pre-existing differentials against commercial bank rates. Before the Regulation Q action there had been growing discussion of a possible reduction in the rates paid by savings and loan associations from 4.85 or 4.90 per cent to, perhaps, 4-1/2 per cent. One could not say whether reductions would have been made, but in any event such discussion had stopped since the change in Regulation Q and there was little likelihood now of their occurring. The situation was still fluid, but his guess was that increases in time and savings deposit rates would be announced by a significantly larger number of banks in the District.

Mr. Swan observed that he had found helpful the discussion by Mr. Stone and others of possible relations between levels of free reserves and bills rates over the coming period but he was impressed by the various uncertainties existing at the moment. While Committee members probably all agreed they would like to see the adjustments to recent actions occur with a minimum impact on availability, he thought this would be rather difficult to accomplish.

It seemed to Mr. Swan that for the next two weeks the bill rate was the most significant variable and the one that should be used as the immediate guide to policy. The expected seasonal pressures on

bill rates complicated the situation. He would not favor rolling these pressures back, but at the same time he would be concerned by a further increase in the bill rate to the neighborhood of 4 per cent and by any attempt to explain such a rate level in terms of seasonal pressures. He would favor bill rates in the 3.80-3.90 per cent range for the next two weeks, and would hope that they would not exceed 3.90 per cent if at all possible. Member bank borrowings might be relatively high, but as had been suggested this could be expected as a result of seasonal pressures. He agreed that free reserves should be treated as a residual, and he would not be at all concerned if they came out in the $100-$200 million range.

As to the directive, Mr. Swan said, he had considerable difficulty with the clause in the second paragraph of the staff draft that read "while permitting such further adjustments of money market conditions to recent official rate actions both here and abroad as are consistent with minimum impact on over-all credit and availability." He though the reference to "further adjustments" implied an expectation of further increases in interest rates which, in his opinion, should be avoided. He also had some question about the phrase Mr. Hayes had suggested, calling for "maintaining about the same conditions of reserve and credit availability as have prevailed in recent months." If reserve availability was intended to refer to free reserves, the language would involve a contradiction; a continuation of the recent level of free reserves would imply reduced

credit availability. He would prefer language calling for money market conditions that were consistent with minimum impact on overall credit availability, and including a quantitative reference to a bill rate target in the range from 3.80 to 3.90 per cent.

Mr. Deming reported that economic conditions in the Ninth District has shown little change recently. The military base phase-out was affecting some small towns in the District but it would have little effect on the District as a whole. There had been no particularly significant developments in banking during the past three weeks, except for the fact that Minnesota banks were concerned about a State law limiting interest rates on time and savings deposits to 4 per cent and were readying promissory notes as a substitute for time certificates of deposit.

Mr. Deming remarked that while the actions taken by the Federal Reserve System last week were directed primarily to the balance of payments situation they were not incompatible in his judgment with the domestic economic situation. In the absence of international grounds for those actions, reasonably persuasive arguments could have been made in terms of domestic considerations for some reduction in credit availability. It was not possible to say as yet what cost-availability relations would follow the actions taken, and the Committee was faced with the alternatives that Mr. Ellis had described. On the basis of the earlier discussion today it seemed to Mr. Deming that if one

interpreted no change in availability as meaning no change in free reserves the bill rate would approach 4 per cent and there would be some spillover into the longer-term market. He was not prepared at this time to accept the risks entailed in such rate developments. He agreed that the bill rate should be used for target purposes in the next two weeks, and he favored rates reasonably close to the 3.80-3.90 per cent range. In his opinion the Committee should be as careful as possible to let the dust settle during the period until its next meeting.

Mr. Deming thought the staff's draft directive needed modification. For one thing, he would strike the last phrase of the second paragraph, which read "as are consistent with minimum impact on overall credit availability," on the ground that it was not clear. He would delete the word "such" in the phrase "while permitting such further adjustments." With respect to the first paragraph, he questioned the phrase, "in the wake of the recent sterling crisis" because he was not convinced that the crisis had been passed. And, like Mr. Ellis, he was disturbed by the phrase "recent moderation in monetary expansion" and by the language of the clause concerning wholesale price developments.

Mr. Scanlon reported that the level of economic activity in the Seventh District appeared to be rising again following settlement of strikes in the auto industry. Production of steel had risen

further and order backlogs of major producers of machinery and business equipment continued to increase. Increases in initial claims for unemployment compensation in Michigan, Indiana, and Illinois in October were believed to result from the strike in the auto industry. Analysts in the steel industry reported that delays were being experienced now in delivering virtually all kinds of steel. Efforts to build inventories apparently were widespread and the easing of demand in some lines caused by the auto strike was past.

Mr. Scanlon commented that some improvement in farm income was expected in 1965, following the decline this year. Cattle feeding was expected to be more profitable than the very unfavorable results this year, primarily because of lower prices of feeder replacements. Profits prospects also were improved for hogs. Prices of feed grains were expected to average above the 1964 level and soybean prices were expected to remain close to the relatively high level of this year, but production of these crops in 1964 (to be marketed largely in 1965) was below the high levels of last year.

Mr. Scanlon said that November data indicated that loans at weekly reporting member banks in the District rose relative to the comparable period a year ago. The largest increases were in business and real estate loans; consumer loans increased only slightly, most likely reflecting the decline in sales of new cars. The largest

increase in loans to business firms was to durable goods manufacturers, probably to finance additions to steel inventory.

The net deficit position of large Chicago banks increased in November, Mr. Scanlon said, but was smaller than in the same period last year. Compared with a month earlier, these banks had large increases in loans and Treasury bills and sold large amounts of CDs. The large Chicago banks were following a policy of watchful waiting on changes in prime rates. Mr. Scanlon believed there had been a tendency in recent weeks for the banks to move some borrowers above the prime rate, but it was probable these borrowers were actually never entitled to prime rates to begin with.

As to policy, Mr. Scanlon found it extremely difficult to arrive at language for the directive. In the light of Mr. Stone's comments it seemed to him that for the next two-week period the Committee should make the bill rate its prime target and, as Mr. Stone had stated it, let the free reserve figure emerge as residual. Like Mr. Irons, Mr. Scanlon believed the Manager should be given sufficient latitude to meet any undue market pressures during this adjustment period. He would hope this could be done with a short-term bill rate in the 3.80 to 3.90 per cent range.

Like others, Mr. Scanlon had difficulty with the second paragraph of the staff's draft directive. He would prefer to make the changes in this paragraph that had been suggested by Mr. Deming.

Mr. Clay said it appeared reasonable to assume that financial markets were in a state of flux at present and that time would be needed for adjustments to work themselves out following the dramatic monetary policy actions a week ago. Accordingly, the immediate Committee decisions probably needed to be made on a short-run basis today, although it was important to bear underlying long-run considerations in mind.

In recent days, Mr. Clay observed, the international phase of System monetary policy decision-making had taken priority. It was essential, however, that the System not push money market rates any higher than necessary for international payments purposes and that reserve availability be maintained as fully as possible within that money market range. Just what that appropriate level of rates for international purposes should be was not readily apparent. Moreover, that determination could not be made apart from the requirements of monetary policy for the domestic economy. Accordingly, it seemed reasonable to him to suggest that an effort be made to maintain Treasury bill rates in approximately their present position for the period immediately ahead, as represented by a 90-day Treasury bill rate of 3.75 to 3.90 per cent, and to supply member bank reserves freely within that range of bill rates. This approach to policy would provide time to assess the situation more fully and to permit further re-adjustments to financial markets to take place in alignment with the

present level of Treasury bill rates. In the interim, further information, and possibly clarification, would become available on financial developments, on the domestic economy, and on the international situation.

It was questionable whether the actions taken last week could be carried out without reducing credit availability, Mr. Clay said, even though that might not be true during the early period of uncertainty and readjustment in the financial markets. After the period when short-term interest rates were under upward pressure beyond what appeared to be an appropriate level, operations should be conducted in longer maturities in order to maintain reserve availability. The success of such operations with the present configuration of the yield curve was by no means clear. The market response would be highly dependent upon the predominant expectations in the financial markets as to the future course of longer-term interest rates.

The staff draft of the economic policy directive was satisfactory to Mr. Clay except for the vagueness of the language added at the end of the second paragraph. It appeared appropriate to him to add a phrase indicating the approximate range of fluctuation for the 90-day Treasury bill rate that the Committee had in mind. Mr. Clay suggested that the range be considered as 3.75 to 3.90 per cent.

Mr. Wayne reported that four items relating to the Fifth District seemed to have some general significance. In October, activity

in the textile and furniture industries, measured by man-hours, rose considerably from a high level. Coal production continued strong, with some mines operating six days per week and some employers reporting difficulty in finding workers. In a special survey of 40 manufacturers on prices paid for raw materials and equipment, a little less than half reported prices up slightly in the past few weeks and a little more than half expected prices to be up slightly in the next few weeks. For the District as a whole, employment and man-hours were up significantly in October compared with small decreases in the whole country.

Nationally, perhaps the most significant recent development had been the ending of several large strikes--at the Ford Motor Company, the Allis-Chalmers Company, and in the paper industry on the West Coast. Over the past month these strikes had curtailed business activity and, by reducing personal income and the demand for raw materials, had probably restrained price increases. As these firms resumed full activity, and in the absence of further strikes, upward pressure on prices might be increased. The industrial component of both the monthly and weekly indexes of wholesale prices had risen 0.5 per cent in the past two months. The daily price index declined slightly for almost a month following October 21, but regained all of the loss in one week and went on to new high levels. There had been a few price reductions recently, but there had also been important price increases, led by aluminum. It was possible that most of the slack

in the price structure, in the form of unlisted discounts, had been eliminated, so that the price indexes might reflect more fully the upward pressures from now on. In this respect, the moderate firming of credit in the past two weeks was appropriate.

Policy developments in the past three weeks had, of course, been dominated by the sharp increase in the British Bank rate and its repercussions, Mr. Wayne observed. Initial market reaction to the whole series of developments could be described only as surprisingly mild. In fact, except for the rise in yields on Treasury bills, it was hardly detectable. The rise in the discount rate was made to provide insurance against a large outflow of funds. Apparently there had been no such outflow thus far and so the insurance had not been used.

For the present, Mr. Wayne said, he would like to see Treasury bill rates stay about where they were for two reasons. First, higher rates were not likely to have much effect vis-a-vis the British at the moment and if conditions stabilized they might increase the difficulties with which the British had to contend. Second, by not pushing rates higher now some room would be left for maneuver without again raising the discount rate if an outflow of funds should develop. So, to carry through on the insurance operation Mr. Wayne suggested that for the next two weeks, as an interim measure, the Committee place primary emphasis on the bill rate and aim to keep it, roughly, between 3.75

and 3.90 per cent, with the level of free reserves being considered as a residual. He favored a directive which would implement such a policy. Clearly, he said, there should be no further change in the discount rate at this time.

Mr. Robertson then made the following statement:

> We have lived through some very eventful days since the Committee last met. The latest sterling crisis has led to a number of dramatic official actions, and the full implications of such actions, both for the international monetary mechanism and for the domestic economy, are yet to be seen.
>
> One consequence is very much in the hands of this Committee, and demands that we be particularly careful at this meeting. Otherwise, we can fall into a trap of our own making; and, in fact, tighten monetary policy while proclaiming to the world that we are not.
>
> I am of the opinion that we should not tighten credit conditions at this juncture. In this respect I find myself in agreement with the sense of the Chairman's remarks to the press last week. I stated my basic reasons for this conviction at our last meeting, and our staff reports this morning serve to reinforce those views.
>
> What is the appropriate open market policy to achieve relatively unchanged over-all credit availability in the wake of recent events?
>
> This is one time when we cannot wait for the dust to settle and markets to adjust by their own devices, for that very adjustment is proceeding under greater pressure as a result of our actions last week. By raising discount rates we have raised the cost of the last few hundred million dollars of reserves that banks are compelled to borrow from the Reserve Bank, under our present open market posture, in order to support the existing level of bank deposits. If price means anything--and I am enough of a believer in the market process to think it does--then banks are being squeezed harder and credit availability cannot help but be affected adversely.
>
> If we want to keep over-all credit availability about unchanged, what we have to do today is to inject some offsetting ease, through open market operations, that will

> correspondingly reduce bank dependence on the discount window. Precisely how much higher free reserves, or lower bank borrowing, it would take to roughly counteract the higher cost of what borrowing remains, I do not pretend to know. From what the staff has said this morning, however, it seems clear that it will take a significantly easier reserve position to accomplish that than has been our aim this fall, and perhaps a still easier one after the December seasonal pressures than before. I urge, therefore, that the Manager be instructed to try to provide sufficient reserves so that member bank borrowings will not average over $250 million between now and the next meeting, and to be prepared to make reserves still more ample if any signs appear that banks are contracting credit counterseasonally in the process of adjusting to the changed money market climate.
>
> With this view as to policy, I would have the Manager resolve uncertainties on the side of ease during the next two weeks of peak seasonal pressures.

Mr. Robertson added that he could accept the draft directive submitted by the staff.

Mr. Shepardson remarked that on balance over-all economic conditions appeared to be still moving forward at a satisfactory rate. Granting that some indicators were not favorable, most were rising. As already had been noted, financial markets were in a period of adjustment at present and it was difficult to predict developments. In his judgment, however, recent rates of expansion in bank credit and the money supply were a little higher than desirable, and were it not for the uncertainties in the present situation he would not want to see reserve availability increased. Given the present uncertainties, however, and the possibility that interest rate increases might be greater than desirable if the Committee employed a free reserve target,

he would agree with those who had advocated using a bill rate target for the next two weeks. His preference would be for a bill rate in the range of 3.80-3.90 per cent. He concurred in Mr. Deming's proposals for modifying the directive drafted by the staff.

Mr. Mitchell commented that the System had been forced by events and by its own convictions to grasp the scepter of leadership and in his judgment it should not now relinquish leadership to the market because of difficulties in deciding on an appropriate course of action. He favored no reduction in credit availability and no significant change in the pattern of long-term interest rates. In order to achieve those ends he thought it would be necessary to have a significantly higher level of free reserves, and Mr. Stone's earlier remarks were consistent with that view. Since it was customary for the Committee to express its targets in terms of free reserves he thought it should do so now, although in some respects a target expressed in terms of borrowings might be preferable. Mr. Mitchell favored a free reserve target for the next two weeks in the range of $250 to $300 million. He would expect the bill rate to be in the range 3.65-3.85 per cent, and was inclined to favor a level of bill rates somewhat lower than others had indicated. Under such conditions he thought the bond market would become more tranquil.

Mr. Mitchell said he found the first paragraph of the directive acceptable either as drafted by the staff or with the modifications

that had been proposed, but he could not say the same for the second paragraph. In his judgment the language of element 4 of the "trial" directive that had been distributed before this meeting would make an appropriate second paragraph for the regular directive if certain changes were made in the quantitative statements regarding free reserves and bill rates. Each Committee member had his own preferences with respect to these quantities, but with one possible set the paragraph would read as follows:

> To implement this policy, and recognizing that a larger than usual degree of flexibility in operations will be needed in this period when financial markets, while under strong seasonal pressures, are still adjusting to official rate actions here and abroad, System open market operations over the next two weeks shall be conducted with a view to permitting a higher level of free reserves than has prevailed recently, perhaps in the order of $250 to $300 million. Such reserves shall be permitted to move outside this range in order to moderate any tendency for the 3-month Treasury bill rate to move below 3.60 or above 3.85 per cent, or to prevent any serious constriction or excess in the availability of Federal funds or dealer financing.

Mr. Daane said it seemed obvious to him that the general posture of policy should be kept unchanged. Within that context he found himself in agreement with a number of those who already had spoken; in particular, he shared the concern that had been expressed about any further increases in bill rates, because of their possible effects on financial markets generally. In his judgment the Committee should defend against upward pressures during the next two weeks and let the reserve

figures fall where they might. He would not try to narrow down the bill rate target any further than this, and he did not think it was feasible to forecast the relations between bill rates and free reserves during the coming period with sufficient accuracy to use a reserve target.

Mr. Daane said he would amend the second paragraph of the directive to read: "To implement this policy. System open market operations shall be conducted with a view to accommodating moderate expansion in aggregate bank reserves and to moderating further adjustments of money market conditions to recent developments here and abroad." He preferred this language because it represented a positive stance instead of the permissive posture of the staff's draft language.

Mr. Hickman said that in his opinion recent monetary policy had been appropriate and should be maintained unless, or until, there were clear signals that it had become inappropriate. Notwithstanding last week's dramatic developments with respect to Bank rate and the discount rate, he felt the Committee should maintain its recent posture, providing the reserves needed for balanced and orderly growth.

Opinions, of course, differed as to the appropriate rate of expansion of the reserve base, Mr. Hickman continued. His own preference would be a 3 to 4 per cent increase in the money supply and a 5 to 6 per cent increase in bank credit, rates far below those experienced last summer. For the time being, he would prefer to see the 91-day

bill rate in the range of 3.85 to 3.95 per cent, with rates below 3.90 per cent most of the time. A higher level of short-term rates than this probably would cause the entire structure of interest rates to rise markedly.

In his judgment, Mr. Hickman said, an appropriate near-term policy objective could possibly be accomplished with free reserves of about $50 million, plus or minus $100 million. While he was prepared to defer on this matter to the judgments of others who were better informed, he was concerned that a level of free reserves in excess of $100 million would mean a greater degree of credit availability than in the recent past, and not the same degree. Accordingly, he would prefer a free reserve target of $50 million but would allow the Manager wide latitude in this connection. In any event, he attached less importance to the level of free reserves than to the goals to be achieved by monetary policy, namely, sustainable growth in money and credit and domestic money rates compatible with rates abroad.

Mr. Hickman said it might be desirable and, in fact, necessary, to move towards still less ease or to outright restraint if commodity prices continued to rise as in October and if the money supply continued to advance as in early November. He would prefer to wait a few more weeks to see if the Committee's policy resulted in lower growth rates in the money supply and bank credit. If not, he would prefer to move towards less ease.

Mr. Bopp reported that economic conditions in the Third District continued to improve. For the first time in years, save for an aberrant month in 1961, the unemployment rate in the Philadelphia area (seasonally adjusted) had dropped to the national level. Throughout the District, unemployment rates were fluctuating around a downtrend that began early in 1963. Business failures in the District had followed a similar pattern, and capital spending by manufacturers was expected to rise in the Philadelphia area in 1965 by about 16 per cent over 1964 totals.

The basic reserve position of reserve city banks in the District indicated an increase in reserve pressure, Mr. Bopp said. This pressure was reflected in increased borrowing at the discount window, which reached the highest level since the end of 1963 during the past three weeks. Loan activity at weekly reporting member banks continued to expand, while total deposits (adjusted) were up.

Mr. Bopp remarked that the important international events of the past two weeks had brought the System to a new phase of the experiment in which it had been engaged for the past four years. Up to this point the Committee had had some success in balancing the twin objectives of domestic expansion and external equilibrium. It had achieved this success by subtle use of techniques which had made the most of a difficult dilemma. The question now was whether this experiment could be equally successful in the next stage. As the Chairman had stated to the press,

there was no need at this time to reduce the over-all availability of funds. It remained to be seen whether the same degree of availability could be continued in the face of the new level of rates, or whether the two were so incompatible that one or the other would have to give way.

For the second paragraph of the directive Mr. Bopp favored use of the language of element 4 of the trial directive, as Mr. Mitchell had suggested. However, he would specify a range for three-month Treasury bill rates of 3.70-3.85 per cent, rather than the 3.75-3.90 per cent range given in the draft of this element.

Mr. Bryan said that no special comment was needed on the economic situation in the Sixth District at this time. Most measures continued to move up in a fashion similar to those for the country as a whole. The major exception appeared to be greater strength in the District than nationally in construction and lending activity.

As far as national policy was concerned, it seemed to Mr. Bryan to be something of a tragedy for the richest nation in the world to find itself in a situation in which it had to follow others rather than lead. But that was a fact, and it was necessary to recognize it. At the moment it would appear that there were a number of significant questions to which the Committee did not have the answers. The domestic economic outlook appeared to be good, but nevertheless there were serious questions about the effects of increasing interest costs,

particularly for longer-term funds, on many marginal ventures. Moreover, it was not clear to what extent the present interest rate adjustments reflected real underlying forces or merely expectational factors.

Mr. Bryan said he would remind the Committee that free reserves always were a residual; the significant point was that they were more of a residual at present than they usually were. He thought Mr. Stone and others had made the point well that, if an effort were made to maintain bill rates in the range the Committee apparently desired, it was not possible to say at this particular time where the free reserve figures would come out even within a moderately wide range. Accordingly, while he felt that under ordinary circumstances it was not desirable to specify objectives in terms of interest rates, he believed that a rate objective had to take precedence now, and that reserve availability should be permitted to fall where it would. He strongly suspected that free reserves would come out at a relatively high level, as Mr. Mitchell and others had surmised. For a variety of reasons, Mr. Bryan said, he would favor a range of 3.75-3.85 per cent for the bill rate in the next two weeks. He would not go as high as a 3.80-3.90 per cent range.

Mr. Shuford remarked that the strikes in the automobile industry, as reflected in the statistics for recent months, made it difficult to come up with any meaningful analysis of the current economic situation. Nevertheless, he continued to feel, as the staff had reported, that underlying economic activity was at a high level and rising further.

No serious imbalances had yet appeared in the upswing and average prices had been remarkably stable.

During the past year, Mr. Shuford said, there had been fluctuations in the growth rates of total member bank reserves and money but on the average the rates of expansion had seemed to be appropriate. Bank reserves and the money supply rose very rapidly last summer, but more recently their rates of expansion had moderated. The average 5 per cent annual rate of increase in the money supply since April probably was higher than would be consistent with the objective of longer-run growth without inflation. But the lack of any growth in reserves and money during the past eight weeks was a development that would be undersirable if continued for any great length of time.

Mr. Shuford agreed with those who thought it was too early to evaluate fully the implications of the recent increases in money market interest rates. It was his opinion that the Committee should not move to further tightness in the money market or to significantly higher short-term rates until there was time to study the domestic and international effects of the recent actions. Those actions probably would reduce the rates of expansion in bank reserves, bank credit, and money. In his judgment some reduction from the growth rates experienced last summer and early fall was desirable from a domestic standpoint, but if possible within the framework of international necessity these monetary variables should continue to increase moderately.

As had been noted, Mr. Shuford continued, the Committee was faced today with the problems of cost and availability. He shared the view that bill rates should be used as the guideline for the next two weeks and that borrowings and free reserves should be allowed to fall where they would. He favored bill rates in the 3.75-3.85 per cent range, and he would not want to have them so high as to cut back on reserve availability.

Mr. Balderston said it was fortunate that the interval between this meeting and the next was only two weeks. He agreed that it was desirable to let the dust settle and to give the markets time to settle down. The Committee might ask the Account Manager to hold bill rates in some reasonable range, but he would not favor specifying a quantitative target in the directive. As to the language of the staff draft, Mr. Balderston said that for years he had been impressed by the destabilizing impact of strikes and threats of strikes. Accordingly, in the phrase of the first paragraph which read "obscured partially by the effects of recent and threatened work stoppages," he would substitute the word "destabilized" for the word "obscured." He approved the suggestions that had been made for the second paragraph to strike both the word "such" and the final phrase, and he liked Mr. Daane's suggestion that "moderating further adjustments" be substituted for "permitting further adjustments."

Mr. Balderston then said that he was concerned about the reports at this meeting on the probable balance of payments deficit for the current year, which evidently was going to be quite large. It seemed to him that there was an underlying problem of liquidity that should give the Committee continuing concern, and that the members should not be lulled into complacency by an improvement in the figures for any one quarter. The only favorable aspect of the situation was that the 1964 deficit was likely to be smaller than that of the previous year; even if the current year's figure turned out to be as high as $2.5 billion there still would have been some improvement from the 1963 figure of $3.2 billion. But if he were a foreigner holding dollars, Mr. Balderston said, he would be concerned that a nation as powerful as the United States could not so manage its affairs as to bring about a solution to its balance of payments problem.

Chairman Martin commented that the Committee should never be complacent about anything and he thought that Mr. Balderston's concluding remarks were wise. Continuing, the Chairman observed that it would be good if it were possible to make a clean separation between the questions of cost and availability of money, but it was not; in his own thinking, at least, he had never succeeded in disentangling the two completely. He thought the matter of timing was extremely important in decisions on monetary policy but, unfortunately, it was not always possible to time actions well. Sometimes the timing of an action turned

out to be good because of developments that could not be foreseen, and sometimes it was bad for the same reason. It was his feeling that the Committee's decision not to change policy at its last meeting had proved to have been wise in view of the subsequent events. He thought the System had behaved well during the past three weeks. Mr. Coombs had performed yeoman service in connection with the British credit arrangements, as had other personnel of the New York Bank; and in his judgment the Committee had made an appropriate decision in the telephone conference meeting last Tuesday.

Chairman Martin said that he thought the interest rate adjustments currently being made in markets reflected primarily psychological and expectational factors rather than underlying market forces, and that this situation was likely to continue for some time. Mr. Stone had given the Committee some informed guesses on the probable relations of bill rates and free reserves, but no one could predict these relations with confidence in the present market atmosphere. Therefore, he did not think it was feasible to call for specific levels of free reserves at present. In his judgment the Committee should concern itself with the desired result for interest rates until market participants had gone through the process of assessing costs, prices, and the business outlook. There were apt to be as many forecasts as there were forecasters, but he would hazard the judgment that business conditions in the next few months would be considerably stronger than many pessimists thought.

The recent events had occurred at a fortunate time; and the Committee would have an opportunity to assess developments over the next few months.

It was possible, Chairman Martin said, that many banks would raise their prime rates; a few already had announced such actions. But he personally had no strong convictions as to the likely course of the market after all of the present psychological and expectational uncertainties were resolved. As he had indicated, he thought the Committee should concentrate on interest rates and let reserves take care of themselves. Any reserve additions would not necessarily be permanent, and thoughtful bankers would know that they could not count on them positively. It was his impression from conversations with lending officers of some banks that they were not of one mind about prospects--in fact, they were about as far apart in their thinking as they could be.

Chairman Martin said he agreed with the view that the Committee should let the dust settle in the next two weeks. He thought the Manager of the Account had handled operations extremely well recently; the System had played a residual role in markets and he believed that it should continue to do so now. Market rates should not be permitted to rise to a level at which banks would say they were forced to raise the prime rate to 5 per cent. Such a development would be unfortunate at present, in his opinion.

The Chairman said it was apparent that the Committee did not seek any basic change in policy today. He remarked that several useful suggestions had been made for amending the first paragraph of the directive. He concurred in Mr. Mitchell's view that the language of element 4 of the trial directive would be appropriate for the second paragraph, although he personally would prefer a 3.75-3.90 per cent range for the bill rate. He said this without a conviction that the Manager could achieve precisely any named bill rate target; the Committee had to allow him a considerable degree of latitude.

Mr. Hayes commented that in light of the fact that the Manager undoubtedly had obtained a clear idea of the Committee's general objectives from the discussion today and in light of the many uncertainties existing at present, he would prefer to use general language in the directive rather than to specify numerical targets such as were given in element 4. Moreover, in his judgment quantification would be a step down a dangerous path. He suggested the following language: "...operations shall be conducted with a view to cushioning the impact of recent official rate actions on money market conditions and to minimizing their impact on over-all credit availability." This wording, he thought, would have the same effect as the kind of quantified instruction that had been proposed.

Mr. Mitchell commented that in his judgment the language Mr. Hayes had proposed was good, but it was not a substitute for specifying the targets numerically.

Mr. Daane remarked that one problem with using the element 4 language for the regular directive was that it did not meet the Chairman's objective of not specifying a free reserve target; in fact, it put primary emphasis on free reserves. The bill rate reference occurred in the context of a free reserves target and said in part that free reserves "shall be permitted to move outside this range in order to moderate any tendency for the 3-month Treasury bill rate to move below 3.75 or above 3.90 per cent."

Mr. Swan said he felt strongly that the Committee should not retreat to vague language at this time. Virtually everyone had agreed today that a bill rate target was appropriate for the next two weeks, and in his opinion it was important that the directive reflect the Committee's decision with respect to its primary target. Moreover, relatively wide ranges had been suggested for target purposes, and the language of element 4 would instruct the Manager only to "moderate" any tendency for the rate to move outside the indicated range. If such language was used the Committee certainly would not be tying the Manager's hands.

Mr. Wayne said he thought it clearly was the consensus of the Committee that its objectives for the next two weeks should be formulated in terms of bill rates, and he did not disagree with the range of rates that had been suggested. He was disturbed, however, about the proposal to include quantitative targets in the directive without first having a

full discussion of the desirability of quantification as a general matter. He, for one, would be reluctant to have the Committee specify numerical targets in its directive. He had strong feelings on this subject that went back to the period years ago when the System had struggled to get a mandate from Congress with respect to the nature of its powers. The Committee could not spell out today the context in which it would have to operate tomorrow, and today's mandate for freedom could become tomorrow's shackles of slavery. He objected to quantified instructions because they placed the Desk in the position of being almost completely obligated to seek the numerical results specified. He was not impressed with the necessity for explaining the Committee's objectives _ex post facto_ to the academic community. The Committee had had a full discussion today, and the Manager clearly understood what he was to attempt to accomplish.

Mr. Stone remarked that he certainly understood the range the Committee had in view for bill rates over the next two weeks. He thought it would be most unfortunate to introduce numerical targets into the directive at this time for two reasons. First, apart from the international crisis, the next two weeks was a period in which market rates would be buffeted by seasonal forces and the effects of the crisis would be superimposed on fluctuations caused by these seasonal pressures. Secondly, one problem with the market during the past year or two had been the tendency for rate fluctuations to be small. This

tendency had resulted in part from the market's feeling that the Committee had a narrow range of rate targets in mind. The Account Management had done its best in discussions with market participants to convince them that the Committee understood the need for fluctuations in rates. The directive adopted today would be published in the Board's Annual Report early next year, and if market participants learned then that the Committee had set a narrow range for bill rates at this time it would be extremely difficult in the future to convince them that the Committee was not acting similarly.

Mr. Ellis remarked with respect to Mr. Stone's first point that the expectation that various forces would be buffeting the market in the next two weeks was exactly why the Committee thought it necessary to specify its objective in terms of a range of bill rates today. On the second point, he was surprised that Mr. Stone would consider a bill rate range of 3.75 to 3.90 per cent to be narrow; he would view it as quite wide relative to the kinds of ranges the Committee had discussed on earlier occasions. The crucial question, he thought, was whether the Committee was going to describe its objectives clearly and specifically in the directive, or whether it was going to use vague language.

Mr. Wayne commented that while a 3.75-3.90 per cent range, taken by itself, was broad, only the upper end--perhaps 3.86-3.90 per cent--was really at issue at the moment, and this was a narrow range.

Mr. Daane said that he agreed that this was not the time to begin using quantitative instructions in the directive. The Committee was concerned with the end result, and Mr. Stone had indicated that he understood the sense of today's discussion. To include numerical targets in the directive would not contribute anything to the operations of the Desk, and in his opinion it would be an unfortunate step.

Mr. Shuford said that he had serious doubts about the desirability of quantifying instructions in the directive as a general matter, for reasons that he would not take time to go into at the moment. On the other hand, today the Committee had decided to aim for bill rates in a specific range. It could be argued that incorporating these numerical targets in the directive for the next two weeks would not necessarily imply approval of quantifying instructions as a general principle. On balance, however, it seemed desirable to stay within the framework of the Committee's current pattern until a decision had been reached on the basic question of whether or not the Committee should quantify its instructions.

Chairman Martin said that in view of the strong feelings that members had on the subject of quantification it might be best today to follow the usual practice of writing the directive in non-quantative terms pending further general discussion of the whole subject.

Mr. Young commented that language at the beginning of element 4 might be used for the second paragraph of the directive, and the

following language, specifying quantitative targets, might be replaced with a non-quantitative statement, perhaps on the lines of Mr. Daane's suggestion.

Several members commented favorably on Mr. Young's suggestion. Following further discussion of the wording of the second paragraph, the Secretariat was requested to prepare for the Committee's further consideration new drafts of both paragraphs of the directive in light of the comments that had been made on the original drafts.

The meeting then recessed and reconvened at 2:00 p.m. with the same attendance except for Messrs. Daane, Coombs and Williams.

Mr. Young distributed a new draft of the directive. In the course of discussion certain revisions in this draft were agreed upon.

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

It is the Federal Open Market Committee's current policy to accommodate moderate growth in the reserve base, bank credit, and the money supply for the purpose of facilitating continued expansion of the economy, while fostering improvement in the capital account of U.S. international payments, and seeking to avoid the emergence of inflationary pressures. This policy takes into account the fact that financial markets are currently in a period of adjustment in the wake of the recent sterling crisis and the discount rate advances and other responses in Britain, Canada, and the United States. The policy also takes into account the underlying strength of the domestic economy,

obscured partially by the effects of recent and threatened work stoppages; the recent increase in average wholesale prices of industrial goods; and the continued expansion of bank credit and money. It also gives consideration to the persistence of a sizable deficit in the U.S. balance of payments.

To implement this policy, and recognizing that a larger than usual degree of flexibility in operations will be needed in this period when financial markets, while under strong seasonal pressures, are still adjusting to official rate actions here and abroad, System open market operations over the next two weeks shall be conducted with a view to accommodating moderate expansion in aggregate bank reserves, while moderating adjustments of money market conditions to recent official actions.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 15, 1964, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary's Note: Following adjournment, the members of the Committee discussed further the question of the format of the current economic policy directive and certain related matters, including the conduct of deliberations at meetings, reviews of District developments, and procedures with respect to the policy record entries.

It was understood that the Committee would continue to explore new forms for the directive on a trial basis, looking toward a decision on this subject by the time of its next organization meeting in March 1965. It also was understood that the Committee would undertake to experiment along the lines of certain proposals contained in a memorandum from Mr. Robertson dated November 19, 1964, entitled, "A Further Suggestion for Directive Writing." (A copy of this memorandum has been placed in the files of the Committee.) Specifically, it was understood that:

(1) The staff would no longer be asked to draft elements 1 and 2 of the "trial" directives, but would prepare on an experimental basis and distribute before each meeting a selected list of the major economic and financial topics that in its

judgment were of central importance in the determination of monetary policy at that time. A brief analysis would be given on each topic, marshalling the relevant information and giving the staff's interpretation of its significance for current policy formulation. Alternative interpretations might be presented if the staff was divided in its views.

(2) The Committee's usual go-around of comments and views on economic conditions and monetary policy would be organized, at least in part, around this list of major topics, with members noting their points of agreement and disagreement with the staff's interpretations. All speakers would be free to add or subtract topics from the staff's list and to comment on District developments in connection with these topics or independently of them to the extent they considered appropriate. This discussion, as reflected in the minute record for the meeting, would be used as a basis for drafting the policy record entry for that meeting.

(3) In addition to preparing drafts for the regular directive, the staff would continue to draft language corresponding more or less closely to elements 3 and 4 of the trial directives, to be used by the Committee as a basis for its further discussions of possible new forms for the directive. It was suggested that the staff might experiment with different versions, perhaps varying them from meeting to meeting or submitting alternatives for Committee consideration at one meeting; and that the staff might also prepare background statements on the probable "linkages" among the different variables cited in the drafts.

It was noted that Messrs. Brill, Sherman, and Young had submitted certain proposals to Chairman Martin in a memorandum dated November 16, 1964, entitled, "A Suggested Program for FOMC Meetings." (Copies of this memorandum were distributed to the Committee subsequent to this meeting, and a copy has been placed in the Committee's files.) Among other things, the memorandum proposed that a brief written review of recent developments in each Federal Reserve District might be prepared at the Reserve Banks prior to each meeting and distributed to the Committee through the Secretariat. Most members thought it would be preferable for any comments on District developments to be made orally at the meetings in the course of the go-around rather than in written statements.

There was further discussion of the proposal that the policy record entry for each meeting be submitted for the Committee's approval at the following meeting. The possibility was noted that there might be insufficient time prior to the next meeting for preparing and distributing a draft entry and revising it on the basis of comments received. In this connection it was suggested that establishing a firm cut-off date for comments on each draft entry might help to make the proposal feasible.

Ralph A. Young
Secretary

Attachment A

CONFIDENTIAL (FR) November 28, 1964.

Draft language for current economic policy directive for consideration by the Federal Open Market Committee at its meeting on December 1, 1964

It is the Federal Open Market Committee's current policy to accommodate moderate growth in the reserve base, bank credit, and the money supply for the purpose of facilitating continued expansion of the economy, while fostering improvement in the capital account of U.S. international payments, and seeking to avoid the emergence of inflationary pressures. This policy takes into account the fact that financial markets are currently in a period of adjustment in the wake of the recent sterling crisis and the discount rate advances and other responses in England and the United States. This policy also takes into account the apparent underlying strength of the domestic economy, obscured partially by the effects of recent and threatened work stoppages; the recent increase in average wholesale prices of industrial goods, partly reflecting the carry-through of earlier advances in nonferrous metals prices; and the recent moderation in monetary expansion from the high rates of summer. It also gives consideration to the persistence of a sizable deficit in the U.S. balance of payments.

To implement this policy, System open market operations shall be conducted with a view to accommodating continued moderate expansion in aggregate bank reserves, while permitting such further adjustments of money market conditions to recent official rate actions both here and abroad as are consistent with minimum impact on over-all credit availability.