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, February 2, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Daane 1/
Mr. Hickman
Mr. Mills
Mr. Mitchell
Mr. Robertson
Mr. Shepardson
Mr. Shuford
Mr. Swan
Mr. Wayne

Messrs. Ellis, Bryan, and Scanlon, 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. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Brill, Garvy, Jones, Koch, Mann, and Ratchford, 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
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

1/ Entered the meeting at the point indicated.

Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss Roberts, Secretary, Office of the Secretary, Board of Governors

Mr. Strothman, First Vice President of the Federal Reserve Bank of Minneapolis
Messrs. Eastburn, Baughman, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Philadelphia, Chicago, Kansas City, and Dallas, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Brandt, Assistant Vice President, Federal Reserve Bank of Atlanta
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on January 12, 1965, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market operations and on Open Market Account and Treasury operations in foreign currencies for the period January 12 through 27, 1965, and a supplemental report for January 28 through February 1, 1965. Copies of these reports have been placed in the files of the Committee.

Supplementing the written reports, Mr. Coombs stated that the gold stock would be reduced by $100 million this week in order to replenish the Stabilization Fund. He estimated that gold sales during the month of February would come to at least $85 million without taking account of the U.S. debt of $25 million to the Gold Pool. Unless the Russians came into the market with heavy sales, therefore, the U.S. probably would have to show another sizable reduction in the gold stock towards the end of this month or early March. On the London gold market speculative buying pressure had continued although in somewhat more moderate volume during the last week or so. The Gold Pool was now in deficit to the extent of $50 million despite the fact that the flow of gold from South Africa had been running well above normal levels. Mr. Coombs thought continuing pressure on the gold market could be expected until there was a decisive improvement in both the British and the U.S. balance of payments.

On the exchange markets, Mr. Coombs continued, sterling had held fairly steady with a minimum of intervention during the past three weeks. The report on January 18 of a much improved U.K. trade position in December had contributed to a better atmosphere and he assumed that the January trade figures, at least so far as imports were concerned, would look even better. Many of the market analysts who had been predicting a sterling devaluation now were beginning to take a more optimistic line and, in the absence of some new misadventure, the worst of the sterling crisis might have been seen. During the past two days the spot rate for sterling had moved up fairly strongly and if this performance could be maintained for another week or so the beginning of a return flow of funds might be seen. This morning sterling was up to $2.7954 and the Bank of England had taken in $70 million, making this their best day in some time. However, Britain still owed $3.5 billion, and the situation remained highly fragile.

The three-month credit facilities provided to the Bank of England by various foreign central banks last November 25 would reach the end of their term on February 25, Mr. Coombs said, and some of the Common Market Central banks might be inclined to do some bargaining over the terms and conditions of another three-month renewal. This would be a prime subject of discussion at the Basle meeting this coming weekend, but Mr. Coombs was hopeful that it would prove possible to maintain the $3 billion package intact for another three months. As of the end of January, the Bank of England had drawn a total of $200 million on the $750 million swap line with the System and nearly $600 million on the credit facilities made available by the other central banks involved, for a total of $800 million. They had engaged in forward operations in a volume roughly twice this amount and in addition they owed $1 billion to the International Monetary Fund. It was obvious that they still had a long way to go in restoring their position.

So far as System drawings were concerned, Mr. Coombs said, the most troublesome problem was in connection with the Dutch guilder, where the System had drawn the full $100 million equivalent under the swap line, and had joined forces with the U.S. Treasury in executing a combined total of $50 million in sterling-guilder swaps and $190 million in guilder forward contracts. He noted that at the last meeting he had requested approval of renewals of swap drawings of $20 million and $10 million falling due on February 4 and February 10, respectively. Since the Dutch meanwhile had expressed some concern that a turn-around in their surplus position might be delayed for a good many months to come, he had arranged with the U.S. Treasury to pay off one-half of the $20 million drawing maturing on February 4 in gold and to pay off the remaining $10 million of this maturity by buying guilders with dollars from the Netherlands Bank. Unless the Dutch took in many more dollars during the next week or so, it might be possible to purchase enough guilders directly from the Netherlands Bank to pay off the $10 million drawing maturing on February 10. In view of the fact that there had not yet been a reversal of the inflows to the Netherlands it was desirable to chip away at these outstanding debts whenever there was an opportunity to do so, in his judgment.

More generally, Mr. Coombs said, there were widespread expectations in the market of selective measures to limit bank lending and direct investment abroad. New York banks were being deluged by inquiries from commercial and industrial customers as to whether they should leave their earnings in foreign countries, and whether they should move funds abroad before such measures were taken. The commercial banks had stepped up their foreign lending in an effort to get in under the wire. Such market reaction to the prospect of Governmental action in the lending and investment area pointed up the necessity for moving as quickly as possible to bring the situation under control.

In answer to a question by Mr. Mitchell, Mr. Coombs said the deficit in the Gold Pool was being financed temporarily by the Bank of England out of its gold reserves. The British felt--in his judgment correctly--that they might have to sell gold in any case; and they were hopeful that within a month or so there would be a turnaround in the market situation that would permit liquidation of the deficit. There also was an advantage in deferring collection from the members of the Pool. As he had noted, the deficit stood at $50 million now, and the total of the Pool's resources was less than $300 million. This was a delicate situation, and if some country wanted to throw a monkey wrench into the machinery a great deal of damage could be done.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period January 12 through February 1, 1965, were approved, ratified, and confirmed.

Mr. Coombs said he had no recommendations to make to the Committee at this time. He noted that on March 1 a $15 million swap of sterling against guilders would mature for the first time and he indicated that in his judgment a renewal of this swap for another three months would be appropriate unless a major turn in the guilder situation made it possible to reverse the transaction.

The possible renewal for another three months of the sterling swap against guilders 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 January 12 through 27, 1965, and a supplemental report for January 28 through February 1, 1965. 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 experienced two distinct phases since the last meeting of the Committee. On January 12 the Treasury announced the results of its advance refunding. The extraordinary success of that operation was taken by the market as confirmation of its generally optimistic view of the outlook for interest rates. After a day or two of caution during which dealers waited to see if any significant volume of speculative holdings would be offered into the market (they were not), prices began to move higher, and rose almost steadily for several days in the middle of the recent period. Prices also moved up in the corporate and municipal bond markets. On January 19, an Aaa-rated utility issue was reoffered at a yield of 4.37 per cent--lower than yields on such issues before the discount rate increase. And on January 26 an A-rated corporate issue was reoffered at 4.44 per cent--the lowest yield on such an issue since February of last year. The market had some awareness during that period of the deterioration of the balance of payments in the fourth quarter. But it was not fully aware of the extent of the deterioration, and it felt that any official action taken to deal with the payments problem might well be confined to selective measures.

Early last week this situation changed. The market began to focus on the fact that the 1964 payments deficit might be in the neighborhood of $3 billion. Putting that fact together with the news that the President was planning to submit a balance of payments message to Congress in early February, the market drew the conclusion that there would indeed be further official action to deal with the payments deficit and that such action was likely to include a moderate shift in monetary policy toward less ease. In consequence, dealers, who had made rather good progress in distributing their large holdings of the issues acquired in the advance refunding, became restive with their remaining holdings and undertook to pare their inventories further. They have been quite successful in this effort, although they have had to make price concessions of 6/32 or so to achieve that success. As of last Friday night, dealer holdings of over-20-year bonds in trading accounts were $373 million, compared with $440 million two days earlier and about $600 million at the time of the last meeting. Their holdings of 5-10 year bonds in trading accounts stood at $304 million as of Friday night, compared with $351 million two days earlier and $565 million on January 12.

Rates on Treasury bills moved lower in the wake of the advance refunding, but the decline was short-lived. Dealers were cautious about acquiring additional inventory at the 3.76-3.77 per cent level to which rates had fallen, particularly since they expected their financing costs for such bills to continue to range upward from 4 per cent. Rates quickly moved to about 3.83 per cent and stabilized around that level for several days. With the development last week of the feeling that monetary policy might shift, the rate moved further upward, and the average issuing rate in the auction yesterday was 3.89 per cent for the three-month bill (and 3.97 per cent for the six-month issue). One may thus conclude--as indeed the market has concluded--that in the bill market, as well as in the market for longer-term obligations, a slight shift in policy has been partly discounted already.

It was in the course of the market's adjustment that the Treasury sold yesterday its 21-month, 4 per cent note for cash. When the operation was announced last week, the market reception was highly favorable, and expectations were that allotments would be about 10 per cent. But with the erosion of prices during recent days the initial enthusiasm has dimmed, and by the close yesterday expectations of allotments had risen to the neighborhood of 15 per cent. We probably won't know until late today or tomorrow how the financing actually came out.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period January 12 through February 1, 1965, were approved, ratified, and confirmed.

The staff economic and financial review at this meeting was in the form of a visual-auditory presentation on balance of payments developments, for which Messrs. Hersey, Katz, and Dahl joined the meeting. Copies of the text of the presentation and of the accompanying charts have been placed in the files of the Committee.

The introductory portion of the review, presented by Mr. Hersey, was as follows:

The U.S. payments deficit--however measured--was smaller last year than in any year since 1957. But for the seventh successive year, the deficit was still substantial--$3 billion on the "regular transactions" basis and $1-1/2 billion on the "official settlements" basis. Adjustment toward equilibrium has been disappointingly slow. In view of the sterling crisis, abnormal activity in gold markets, and sharp worsening of the U.S. deficit in the fourth quarter, it seems urgent that a substantial reduction in the deficit be attained this year and next.

A much larger part of this year's deficit will have to be covered by gold sales. Last year, as shown in the upper panel of the chart, commercial banks abroad increased their balances in this country by an unusually large amount--about $1-1/2 billion, or 25 per cent. There was also a sizable increase, shown in the second panel, in U.S. liabilities to foreign official holders (including Roosa bonds). The gold stock declined by only $125 million. For this year, things look very different. Commercial banks abroad are most unlikely to add another $1-1/2 billion to their assets here. And European central banks are resisting further increases in their claims on this country.

The U.S. gold stock has declined by $7-1/2 billion, or one-third, in the past 7 years. To make clear that the remaining $15 billion is available as needed to maintain the present gold value of the dollar the Administration has proposed eliminating the statutory gold reserve requirement against the deposit liabilities of Reserve Banks, thus increasing the so-called "free" gold by nearly $5 billion. But this will in no way lessen the importance of coming to grips with the payments problem.

Large U.S. payments deficits have had their counterpart in payments surpluses of other countries. The combined "official settlements" surpluses of the Group-of-Ten countries other than the U.S. and U.K. (shown in the top line) declined by half between '60 and '62. But this downward trend was halted in '63 and '64. The rest of the world (the bottom line in the chart) developed increasing surpluses in 1962-63, but began last year to reduce them again. Reduction in the U.S. "official settlements" deficit in '64 was materially aided by increased exports to this last group, as well as by the inflow of foreign commercial bank funds mentioned earlier.

The dramatic new payments development last year was the deterioration in the U.K. position. If both the U.S.

and the U.K. positions are to be substantially improved this year, there will have to be a reduction in the combined surpluses of other members of the Group of Ten, and of some large reserve gainers among the nonindustrial countries.

France has had the largest and most persistent payments surplus in the past 5 years, adding more than $4 billion to its reserves, including $2-1/2 billion in gold. This year France is expected to take all its gains in gold, and to hold its dollar balances near the level of approximately $1.1 billion to which they were reduced by last month's gold purchase. Germany has taken more than half of its reserve gains in gold since 1959, but, since early last year, Germany has not been in over-all surplus. Spain continues to run a large surplus, and is currently buying $210 million of gold in 7 monthly instalments. Other continental European countries, and Canada and Australia, also added to reserves last year.

We turn now to the British situation which has recently been the focus of international financial attention. Consideration of its elements makes an appropriate beginning for today's review of the U.S. payments problem.

Mr. Daane entered the meeting during the course of Mr. Hersey's remarks.

The concluding portion of the review, presented by Mr. Young, was as follows:

The problem of bringing U.S. payments into balance has become one of major international import. In contrast with other international problems, it is one for which the United States alone has primary responsibility. After seven years of large disequilibrium, averaging on regular transactions some $3-1/2 billion, it is surely vital to reduce this deficit substantially this year, with a target of attaining tolerable balance next year.

How can this be done? It will indeed be hard to improve the current account surplus much in '65. An indispensable condition for further satisfactory growth of exports is assuredly continued U.S. cost and price stability.

On Government account, large reduction in spending abroad presents difficult military and political decision. Spending in the European area is for military and security ends, rather than for aid. Our economic aid is mainly to less developed areas. Though largely tied to U.S. exports, this aid does make it easier for such areas to use their own export earnings to purchase European products.

On private capital flow, there are powerful economic incentives in a wide range of credit markets to encourage foreign residents to borrow dollars and U.S. institutions to seek foreign business. The capacity and variety of U.S. credit markets, the ample availability of our credit, and the lower level of U.S. interest rates--all these factors contribute to sustaining the various types of private capital outflow.

U.S. bank rates charged prime domestic borrowers are lower than rates charged by European banks to their prime domestic customers. The rates quoted on the chart are, of course, only crude measures, since they do not allow for the cost to borrowers of the minimum balance requirements of U.S. banks or for various commissions or fees usually charged by European banks. Also, the rates U.S banks typically charge foreign borrowers are above the prime rate. In considering these loan rate differentials, it is well to have in mind that, as European and Japanese businesses extend their international operations, they are becoming better credit risks. U.S. bankers are fully aware of this, which is another reason for the recent extention of U.S. banking operations internationally.

Some narrowing of the gap between U.S. and European interest levels could be achieved by a lowering of interest rates abroad. But persistent inflationary pressures in Europe, combined with strong financing demands pressing on less-than-adequate supplies of savings and inadequate capital market facilities, make it difficult to foresee much easing of interest levels there.

So persistent, indeed, has been the creeping inflation problem in Europe that European financial authorities increasingly argue the duty of a deficit country, such as the U.S., to raise its interest level not only to solve its payments problem, but also to help contain their own inflationary pressures. While the European authorities pride themselves in using fiscal policy to foster economic growth, they seem less persuaded of their ability to use it in support of monetary policy to combat current inflationary tendencies.

From the United States point of view, any judgment made now about a less stimulative monetary policy and higher interest levels domestically must weigh such help as this would give the balance of payments against the consequences it might have for domestic expansion. In the past four years we have had a well-balanced economic expansion that has raised real GNP by 20 per cent and has reduced unemployment to 5 per cent. With the continuing strength of consumer demand, with demand pressures on capacity strong enough to encourage widespread plant expansion with the present buoyancy of profit expectations and also of the prices of equities as well as of many goods, further stimulus to business and consumer investment through ready availability of bank credit and low long-term interest rates is no longer so desirable, in my personal judgment, as it was at an earlier stage.

Whatever evaluation of domestic economic factors may be arrived at individually, consideration needs also to be given to what may happen if, to avoid any brake on the current cyclical expansion, no monetary action is taken and the U.S. payments deficit continues large. In that case, if and when economic downturn later sets in, monetary policy may find itself unable to give much help; in short, it may have surrendered, at least for the short-run, much of its countercyclical flexibility.

In his Economic Message, the President has emphasized the urgency of full correction of the U.S. payments deficit and has indicated that a special message setting forth a program to this end will be forthcoming soon. Presumably, selective fiscal and moral suasion actions directed at reducing the capital account deficit will be primary elements in this program. Presumably, too, monetary policy will be asked to participate both in a selective and in a generally reinforcing role. Experience with the IET points not only to temporary effectiveness but also to erosion of that effectiveness through leakages as borrowers search out new ways of getting the funds they need. The bolstering of one selective measure by another tends to suggest to the market a step-by-step retreat toward more and more Governmental restriction on financial transactions. The less effective the chosen selective measures prove to be, the stronger and more generalized any subsequent actions, including those of monetary policy, may have to be.

In essence, our payments problem is a matter of bringing our total outpayments on Government and private capital accounts within the limits set by our earnings from exports and investment income, bearing in mind that these earnings are partly generated by Government and private capital flows. The Administration and the Congress have some hard thinking to do to determine how far action should be taken to cut back Government spending abroad and how far in policies constraining private transactions. Meanwhile, the Federal Reserve is responsible for finding the monetary and credit policies for coming months that will best serve the two vital and interrelated objectives of maintaining well-balanced economic growth and of sustaining world confidence in the dollar.

Either action or inaction involves risks, but risks of different kind. A failure to take effective measures, including effective monetary action, to strengthen the U.S. payments position at this time would clearly involve serious future risks for the U.S. economy. Recent developments across the Atlantic warn us against allowing an international currency to drift into a position where really drastic and burdensome actions on the monetary and on other fronts may be forced upon an unwilling nation.

Mr. Hayes remarked he thought the presentation had been an excellent one He had a footnote to add to a comment by Mr. Katz about the vital need for the British to free resources for production of export goods. One aspect of the situation that was worrying many people was Britain's program of public spending, and it seemed to him that this was an area in which they might well exercise great restraint.

Mr. Mitchell noted that one chart, relating to various countries' shares of world export markets, had indicated that in recent years France and Germany had gained substantially and the United States and Britain had not gained. In the period covered by the chart the Common Market had become effective and tariffs among the member countries had been reduced. He asked whether the impression given regarding trends in the U.S. share of exports would not have been quite different if the figures portrayed in the chart had excluded exports of one Common Market country to another.

Mr. Katz replied there was indeed some statistical bias in the figures charted because of the inclusion of trade among Common Market countries. However, it was worth noting that the tariff reductions within the European Economic Community affected not only the exports of member countries to one another but also to the rest of the world. The typical French or German business concern now could compete more effectively in world markets because its costs had been lowered through the greater competition within the Common Market following the reduction in internal tariffs. At the same time, these concerns had a strong incentive to maximize efficiency because of their knowledge that Italian firms, say, would displace them if they did not.

Mr. Mitchell said he thought it was important to recognize that the U.S. and Britain had been placed at a competitive disadvantage by the development of the Common Market.

Prior to this meeting the staff had prepared and distributed certain questions and responses for consideration by the Committee. These materials were as follows:

(1) Business activity and prices--In view of the strength in new orders for durable goods, the recent sharp step-up in inventory investment, and the marked acceleration of production of business equipment over the past year, what are the prospects for sustaining economic expansion with continued broad stability of commodity prices?

Production for inventory, partly to replenish stocks depleted in last fall's auto strikes and partly in anticipation of a steel strike this spring, has been contributing support for recent advanced levels of industrial activity and for continued strength in new orders for durable goods. There are indications that current rates of output in some industries exceed sustainable levels While record auto sales to consumers have limited the rise in dealer stocks of new cars, output of other consumer durable goods has continued to advance at a rapid rate even though retail sales of these products leveled off some time ago. Inventory accumulation also is evident in some nondurable goods areas, notably textiles, where mill production has risen about one-tenth since mid-1964, much more rapidly than consumption of textile products.

Over all, it is estimated that about 4 per cent of total industrial production is now going into inventories in contrast to a more usual volume of 1 per cent. There is no evidence that inventory stocking will slacken before steel wage negotiations are terminated. Preliminary and partial data suggest little further advance in industrial production in January, but this appears to reflect mainly capacity considerations in autos and steel rather than achievement of desired inventory levels.

Barring an unlikely early settlement in steel, inventory demands and strong consumer takings of new autos probably will sustain a high level of production activity for the near term. Whether final demands will be adequate to sustain the pace of aggregate activity after inventory demands subside in the late spring is less certain. Business spending for plant and equipment, which exceeded expectations last year, is now anticipated to rise at a somewhat slower rate in the second quarter, and Federal spending is scheduled to remain at recent levels. Much will hinge on consumers' willingness and ability to increase their spending to historically high rates relative to available incomes, on continued expansion of State and local government demands, and on the maintenance of housing activity at levels no lower than the reduced pace of recent months.

One heartening aspect of recent developments is the continued general stability of industrial prices, despite peak strains on production resources. Upward pressures have been evident in some commodity lines--most recently, petroleum and textiles--but improvement in supplies has reduced pressure in the nonferrous metals markets, where the largest price advances occurred last year. Unit labor costs in manufacturing declined in December to their lowest level for this expansion period. The current and prospective increases in materials supplies and production capacity, and the continued public pressure on both labor and industry to keep wage settlements within productivity bounds, should help to maintain general price stability.

(2) Balance of payments.

A. What are the basic elements in Britain's longer run payments difficulties, and are the measures so far taken adequate to close their payments gap?

B. What are the prospects for, and limitations on, achieving a reduction in U.S. capital outflows from recent record rates?

(Staff responses were given in course of chart presentation.)

(3) Bank credit and money--What do recent developments in bank credit, money, and time deposits suggest with respect to both demands for credit and changing liquidity needs? How may banks be expected to adjust the structure of their assets and/or liabilities if recent credit trends persist?

In January, there was a marked strengthening in business loans at commercial banks, a sharp rise in the inflow of time and savings deposits, and continued substantial growth in the money supply. These developments, along with the moderate volume of capital market financing, suggest (a) that the current pace and structure of industrial activity--particularly the strength of inventory buying--are focusing credit demands on the commercial banking system, and (b) that commercial banks are competing successfully for savings flows under the new higher Regulation Q ceilings.

The rise in business loan demands has been general, with smaller than usual declines in loans to most seasonal industries and increased borrowing by others. While inventory accumulation undoubtedly has been a contributing factor, the industry distribution suggests that strength of loan demands is more broadly based. Part of the rise in loans may be attributable to increased foreign lending, possibly related to expectations that the I.E.T. may be extended to banks.

The January acceleration in savings deposit inflows to banks probably represented in large measure a diversion of funds from other financial institutions. There has also been a surge recently in the inflow of other time deposits at commercial banks, about two-thirds of it in CDs. Reserve pressures at some large city banks early in January and anticipation of large CD maturities later in the month may have figured in bank solicitation of these funds. That this inflow has been much larger than in the comparable period of any other recent year suggests that funds available for liquidity reserves, at least in some sectors of the economy, are sizable.

Following a relatively small increase in December, money supply growth was substantial in the first half of January, reflecting in part a more-than-seasonal decline in U.S. Government deposits. Some decline is projected for the second half of January, and growth for the month as a whole is likely to be about in line with the pace since last July.

Banks are not expected to encounter significant difficulty in satisfying continued strong loan demand in the near term, in view of the likelihood of continued large savings inflows and of seasonal repayments in some lines of business loans. While banks ordinarily allocate a large share of their savings inflows to such assets as mortgages and municipals, they might not do so if strong loan demands materialize, particularly in view of the recent high rates of acquisition of municipals. Banks might also make some further inroads in their liquidity positions. This could involve run-offs of Treasury bills and sales of other short-term Governments, and for some of the large banks, reduction in loans to dealers and brokers.

Finally, banks still have some leeway to increase the attractiveness of CDs. Most recently, offering rates on CDs at New York City banks have receded a bit to a range of 4 to 4-1/8 per cent. Even so, the cost of these funds is relatively high, and some large banks have cut back on their issuance of CDs. Most banks, however, would willingly resort to this source of funds to meet the credit demands of their regular customers.

In summary, banks appear to be well situated to meet a strong loan demand in view of their large savings inflows and their ability to compete more aggressively for CD money, to reduce acquisitions of municipals, and to reduce their liquidity positions somewhat further. Such adjustments, however, would have rate implications for both short- and long-term financial markets.

(4) Money and credit markets.

A. In light of recent and prospective demand and supply developments in long-term credit markets, does the current level of long-term yield appear generally sustainable?

B. Taking into account the Treasury's recent advance refunding and the mid-February refunding, what market constraints, if any, will there be on the conduct of monetary policy for the next few weeks?

A. Under current conditions of reserve availability and savings flows, prospective demands for long-term credit are likely to be met at about prevailing levels of long-term interest rates. The large public exchange in the Treasury's recent advance refunding and the subsequent strong performance of bond markets suggest that the dominant expectation of market participants was for stable or perhaps declining yields. Most recently, however, as is indicated under 4B below, some hesitancy has developed as concern has increased over balance of payments implications for the future course of monetary policy.

Looking first at demands for long-term credit, at this point in time any increase in the aggregate appears likely to be moderate and to come mainly from the business area. External financing needs of corporations were tending upward in the latter part of 1964 as profits leveled off, inventory spending accelerated, and funds needed for plant and equipment outlays and accounts receivable financing continued to grow. Although corporate profits are expected to rise in early 1965, partly reflecting the second instalment of the tax cut, cash flows required to meet the speed-up in current-year tax collections will more than offset this gain. However, much of the increase in external financing is likely to be met by commercial banks, partly through term loans, which should reduce upward pressure on corporate bond yields.

Other capital market demands are not expected to increase significantly. Construction of 1-4 family housing is projected to do little more than hold its own, and funds needed for new multi-family and commercial properties may actually decline. Heightened competition among lenders may encourage more refinancing of existing properties, but such an increase is not likely to be large.

No additional supply of long-term Treasury bonds is in prospect for the near term because the cash surplus in the first half of this year is expected to be somewhat larger than usual and because the recent Treasury advance refunding has already accomplished substantial debt lengthening. State and local government financing has been heavy in recent months, and municipal demands for funds could mark time for a period. Offerings thus far scheduled for February seem on the light side, which should help municipal dealers to distribute the sizable inventories accumulated in recent weeks.

Long-term savings have continued large and there has been some recent acceleration in flows to commercial banks, perhaps in large part at the expense of other depository institutions. Net inflows to institutions receiving savings under contractual arrangements, such as life insurance companies and pension funds, are apparently continuing to grow at a steady rate.

These savings flows, in conjunction with the prospective credit demands outlined above, should result in fairly balanced supply/demand conditions in capital markets and relatively stable long-term interest rates. But a significant change in commercial bank capacity to acquire long-term investments resulting from reduced reserve availability and increased loan demands would upset this balance.

B. There are no hard and fast rules for determining how far into the period of market "digestion" of Treasury issues the System's responsibility for even keel should extend. This FOMC meeting takes place about three weeks after the subscription books closed for the January advance refunding and one day after the books were opened for the small February refunding.

As noted in the Green Book, dealers have made somewhat better progress in secondary distribution of the recent advance refunding than they did over a comparable period in July. As of January 26, they had a little over $900 million of securities maturing in over 5 years in portfolio, including over $500 million in the over 20-year area. In the past few days dealers have become more concerned over the balance of payments and have undertaken to reduce their positions further. As of January 28, their portfolio of securities maturing in over 5 years was $719 million, including $390 million in the over 20-year category. This further reduction in their inventories involved price declines running to 4/32 - 6/32 in the long-term area.

Constraints on monetary policy arising from the February refinancing, payment date for which is February 15, are clearly of a lesser order than those stemming from the January refunding. This offering of a 21-month note for cash to refinance $1.7 billion of publicly-held issues should prove routine, except that dealer allotments in the financing will represent a net addition to their total holdings of coupon issues.

In a similar situation last August, when public holdings of the maturing issues were $2.2 billion, dealers took into position about $430 million of a new 18-month note. These takings, together with the remaining large holdings from the July advance refundings, began to be pressed actively on the market later in August, and interest rates on notes and bonds moved somewhat higher until mid-September.

Given the combined overhang of the two Treasury financings and the still bullish state of investor expectations, any change in policy at this time could put some upward pressure on intermediate- and long-term rates for both public and private issues. Even a minor change in policy could produce at least a short-lived reaction in bond yields, but if it were put into effect gradually (as in mid-August last year) the extent and duration of such a reaction would be moderated.

(5) Monetary and fiscal policy--What does the Federal Budget message imply for the impact of fiscal policy on the economy in the first half and the second half of calendar 1965?

The proposals contained in the January 1965 Budget message (outlined in the Green Book 1/) are likely to result in a more stimulative fiscal policy during the second half of 1965 than in the first half. For the current January-June period, the surplus in the cash budget now is estimated at $6.6 billion, somewhat more than in other recent years. Expenditures are expected to remain steady and tax receipts to rise more than seasonally. Thus, the impact of fiscal policy will be less stimulative in the first half of this year.

The first-half surplus will probably be followed by a much larger than seasonal swing to deficit in the second half of 1965--perhaps to a deficit of around $13 billion, one-fifth more than in July-December last year. Because of the timing patterns of receipts and expenditures implicit in the proposed Budget, the second-half deficit is likely to be followed by another sharp swing to surplus in the first half of calendar 1966. Similar swings in the degree of fiscal stimulation are shown when the projected Federal activity is calculated on the national income account and the full employment surplus bases.

The additional fiscal stimulus expected in the second half of this year stems mainly from increased expenditures, and to some extent from proposed excise tax cuts. Reduction in excise taxes is planned for the beginning of the third quarter, but additional taxes to pay for increased social security benefits and medicare are not scheduled to come into effect until January 1, 1966. Practically none of the increase in expenditures represents direct Federal purchases of goods and services. Rather, greater outlays are projected for transfer payments (primarily increased social security benefits) and grants to State and local governments (for increased educational programs and public assistance). The largest increase in expenditures is anticipated in the third

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

quarter, when the additional social security benefits are scheduled to begin and when a lump sum payment to cover retroactive benefits is expected to be made. But expenditures still remain well above first-half levels thereafter.

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

1. Business Activity and Prices. Economic activity advanced strongly in December, as evidenced by data on industrial production, retail sales, and new orders for durable goods. January seems likely to have brought further gains--new car sales especially appear to have been extremely strong. The prospects for sustained economic expansion in the coming months are very bright. Indeed, barring a steel strike and taking into account the stimulus that the Federal budget may exert in the second half of the year, sustained expansion through 1965 seems likely--although perhaps at a somewhat slower pace than in 1964. In this environment of business expansion, there is a risk, still latent, that inflationary pressures may develop.

2. Balance of Payments. The sharp deterioration in the U.S. balance of payments in the fourth quarter is less significant for its own sake than as a sobering reminder that our chronic payments problem of the past seven years is still far from solved. It appears that much of the sizable December deficit was due to capital outflows which were reversed after the end of the year--so that neither the December nor the January figures are especially meaningful by themselves. But after full allowance for special factors it is still clear that capital outflows have played a large and growing part in producing the deficit in the past year, and bank credit to foreigners has been especially important, including substantial term lending to Europe. Canadian issues were very heavy in the fourth quarter but much more moderate in the year 1964 if the four quarters' figures are spread equally over the entire year.

While I have reluctantly concluded that some form of selective restraint to stem capital outflows is now warranted as part of a many-pronged attack on our payments problem, they are likely to prove ineffective unless we reduce the availability of reserves. A move toward reduced monetary ease would reinforce the impact of selective measures, for it would improve our chances of containing the pressures that make funds seek higher returns abroad, whether through bank loans, through investments in foreign money markets, or through direct investments.

The relative calm in the exchange markets in the past couple of weeks should not obsecure the fundamentally dangerous situations confronting both the pound and the dollar, and the vital need both here and in Britain to take strong remedial and mutually supporting measures.

3. Bank Credit and Money. As for domestic credit developments, business loans rose more rapidly in 1964 than in the preceding years, and partial data for January suggest continuing strength. Moderate increases in interest rates have been no hindrance to monetary expansion in an optimistic economic climate. While loan-deposit ratios are high, and the banks do not have as much of a Government securities cushion as they did a couple of years ago, they do not seem to view the historic measures of their liquidity positions as calling for as much restraint on lending as such ratios once implied--one reason being the change in the mix of demand and time deposits. Business and the public are still in quite a liquid position; and while velocity has been moving sideways for at least half a year, it would not be wise to count on such leveling out as much of a restraint while the business outlook is as good as it is.

4. Money and Credit Markets. There would appear to be a pretty general consensus that the current level of long-term rates is sustainable. Were it not for some expectation of a possible change toward a less easy monetary policy, the weight of opinion would probably be on the side of some net downward pressure on long rates. With the yield curve as flat as it is, however, it would seem probable that a moderate lessening of monetary ease might find some reflection in higher long-term rates, but only slightly higher. Indeed, it is likely that the market has already gone some distance toward discounting a modest policy move.

The Treasury's February refunding is so small and so routine in nature that it does not call for the customary "even keel" restraint on the part of the System. Of somewhat greater concern is the fact that dealer holdings arising out of the January advance refunding have not yet been worked down to satisfactory levels, although the dealers have made particularly good progress in reducing their holdings of bonds over the last few days. But while this suggests the need for a gradual approach in any policy move on our part, it does not preclude some cautious change of policy at this time.

5. Fiscal Policy. As I have already indicated, fiscal policy is likely to provide a quite substantial stimulus to the economy in the second half of 1965, whereas in the first half the stimulus should be very small. Our analysis suggests that the expenditures side of the budget provides a moderate positive and rising stimulus during the year. On the other hand, the tax side will probably provide a powerful stimulus in the second half as contrasted with a small drag on the economy in the first half. The second-half stimulus could of course be increased further, should this later appear desirable, by enlarging the size of the proposed excise tax cuts.

6. Monetary Policy. In the light of our serious international problem, combined with the strong domestic outlook, I believe monetary policy should move toward a lessening of ease. A reduction in reserve availability is desirable both to push the bill rate gradually up to the discount rate and to slow down the growth of bank credit. Such a decline would tend to reduce the pace of bank lending abroad and would not, in my judgment, harm the domestic economy. On the contrary, it might even prolong the life of the business advance by providing some protection against excesses.

This is clearly an appropriate moment for the System to make some move toward less ease, especially as the President's balance of payments message, due in a few days will alert the public to the seriousness of the whole balance of payments problem. It will be well understood that the System should have some part to play in an effective solution, and it would be desirable for the record to show that we have been alert to our responsibilities.

Open market operations should be conducted with a view to permitting free reserves to decline gradually in the coming four weeks to about the zero level, with fluctuations perhaps on both sides. Since Friday, February 12, is a holiday, the announcement of lower free reserve figures for the coming week ended February 10 could not affect the market before Monday, February 15, when the new securities will be delivered. Hence a start could safely be made right away.

The directive should be amended to indicate that priority is now being given to strengthing the dollar's international position. Also, the specific reference to Treasury financing is no longer needed, though the Committee might wish to substitute a clause indicating some desire on our part to moderate any impact of our operations on the longer-term market. The staff's alternative B seems to me eminently satisfactory. 1/

Mr. Shuford remarked that business activity had continued to rise in recent months, and average prices had changed only slightly and continued to be reasonably stable. In any business upswing, he noted, some sectors of the economy rose more rapidly than others. Since early 1961, the over-all economy had expanded fairly smoothly although there had been some spurts and some reversals of production and sales in individual lines.

There had been some precautionary buying of steel, Mr. Shuford continued, and recent data indicated a step-up in total inventory investment and a rise in new orders for durable goods. Those developments, along with future wage and price developments, had to be watched closely, and it might become necessary for monetary action to become more restrictive. But it seemed to him that it was premature to say that the economy now was confronted with a general price rise.

1/ The two alternative draft directives prepared by the staff are appended to these minutes as Attachment A.

Turning to international developments, Mr. Shuford said the rise of industrial production in Great Britain during October and November and the favorable December trade figures suggested that a turning point in the U.K. trade balance might be developing, although this was not clear. British imports might be expected to decline over the next few months, reflecting the impact of the surcharge and a decline of inventory accumulation. Over the longer run, however, their basic problem was to raise exports, and whether they could do so would depend in large part on whether there was sufficient flexibility in the U.K. economy to permit the shift of resources from production for home markets to production for foreign markets.

Capital outflows from the U.S. had been large, Mr. Shuford observed, and considered in conjunction with the net balance on other U.S. transactions, they were of serious proportions for the U.S. international liquidity position. In his judgment monetary actions had played a significant role in limiting capital outflows and additional steps might still be needed. However, it was doubtful that any general monetary actions which the Federal Reserve, standing alone, might take could substantially reduce the capital outflows. Although he disliked the interference in individual market decisions that followed from attempts at moral suasion or from selective controls, under existing international payments mechanisms these actions might be necessary if more fundamental actions to improve the balance of payments were not taken soon.

Total member bank reserves and the money supply had continued to rise since the increases in the discount rate and short-term market rates last November, Mr. Shuford noted. The higher short-term yields had been desirable in view of the international situation, but he also was pleased that the money supply, considered over a period of time, had continued to expand at a moderate rate.

Long-term interest rates seemed to Mr. Shuford to have been appropriate for domestic activity in recent months. He believed, however. that interest rates should remain flexible to adjust as changes in the supply and demand for funds developed. In the short-term market there currently was a seasonal contraction in credit demands, and maintenance of the present level of short-term rates might be possible only by restraining the growth in bank reserves, bank credit, and money. He was not certain what position should be taken with respect to the Treasury's recent advance refunding and the mid-February financing, but it seemed that stability in the money market would be desirable for a period unless a strong case was made to the contrary at this time.

According to the standard measures, Mr. Shuford said, fiscal policy currently was operating in a contractionary way on the economy. It appeared that a significant deficit would develop later in the year if the Administration's programs were enacted. However, it did not now appear that within the next few months the budget would move significantly toward greater stimulation to the economy so that monetary actions could be more restrictive, permitting continued economic expansion with higher interest rates.

It seemed to Mr. Shuford the Committee again had come to one of those periods in which the issue was one of timing. There was no question but that the balance of payments problem and the international financial situation were serious. As he had indicated, there might be a need for a more restrictive monetary policy at this time. On balance, however, he would favor no change in policy now, partly in view of the Treasury financings--which, he observed, the Committee customarily took into consideration--even though the February financing was of minor proportions. He noted that distribution of the securities issued in the advance refunding was still in process. He would favor keeping money market conditions at about current levels, with short-term interest rates ranging between 3.75 and 3.95 per cent or even pressing up to the discount rate. He suspected that these conditions would be consistent with continued moderate expansion in the money supply and bank reserves, but probably at reduced rates; at least, he would hope so. For the directive, he preferred alternative A of the staff's drafts.

Mr. Bryan said he had reluctantly concluded that the Committee should move at least slightly in the direction of less ease. Accordingly, if he might abstract from the Treasury financing, he favored moving toward a lesser availability of reserves. He came to that conclusion partly because of the international situation which, while not disastrous, was alarming; he was deeply concerned about possible eventual developments in that area. His judgment also was influenced by the belief that the recent growth rates in the various reserve measures--since last August, for example--were higher than the rates consistent in the long run with a sound development of the economy and lack of inflationary pressures. Accordingly, he would favor free reserves averaging about zero and fluctuating in the range of plus and minus $50 million. For the longer run he thought the Committee should reduce its sights for the growth rate in total reserves to a maximum of 2 per cent or perhaps even lower.

Mr. Bryan thought the questions and answers prepared by the staff for this meeting were extremely good on the whole. However, he would take exception to the staff responses on one point--he was not as confident about the eventual stability of the average price level as the staff was. He also thought his views differed a little from those of the staff on the balance of payments. Along with others at the table, he felt that some selective credit controls would be needed to deal with the balance of payments problem. This was a painful conclusion for him because he did not believe in selective controls in principle, and he doubted that any member of the Committee did. He was afraid that they would mushroom into a full-fledged panoply of controls. Nevertheless, he thought that selective measures would be necessary because monetary policy, in his judgment, could not be tightened sufficiently to deal with the problem without doing great damage to the economy--although, as he had indicated, he regarded some firming as appropriate.

Mr. Bopp said he would limit his remarks this morning principally to the question of bank liquidity rather than comment on each of the questions prepared by the staff. A survey recently undertaken by the Philadelphia Bank indicated that some rather fundamental shifts were taking place in country bank participation in the Federal funds market in the Third District. Those shifts had interesting implications for bank liquidity and for monetary policy.

With almost 90 per cent of District country banks responding to the survey, 121 banks, or more than one-third of the total, were now found to be active in the Federal funds market. This was a very significant increase in participation in a very few years; before 1961, only 18 per cent of the banks now participating were in the market. Moreover, of the 121 banks now in the market, 37 per cent first became active in 1964 and 32 per cent first became active in 1963. Thus, the majority of country banks had never had experience in the market during a period of tight money.

Another interesting finding to emerge from the study, Mr. Bopp noted, was that 80 per cent of the banks now in the market only on the selling side indicated a willingness to buy funds if the need arose. Moreover, a sizable proportion of banks which had never been in the market on either the buying or selling sides indicated a willingness to buy funds if needed.

This large increase in country bank participation in the Federal funds market, and the declining cushion of excess reserves held by country banks, meant that a move toward greater restraint would tend to result in a quicker and more pervasive tightening, Mr. Bopp said. Adjustment conditions might be strained for individual country banks with limited experience in the Federal funds market, especially for those expecting to purchase Federal funds when such funds in fact were not available. Larger correspondents might also be affected, both as the availability of funds from country banks diminished and as the larger banks were called upon to supply funds. This could create problems in the administration of the discount window.

Turning to policy for the next four weeks, Mr. Bopp observed that that the climate of business continued to be affected significantly by the effort to build inventories. Still, however, there appeared to be no general over-heating of the economy. Prices remained unusually stable, as did unit costs; and, although capacity might be strained in certain areas, this condition did not pervade the entire economy. On the financial front, credit demand had been strong and growth of the money supply recently had been rapid. Though the behavior of money and credit warranted close attention, he would not take restrictive action unless the rate of increase continued unduly high for a longer period.

On the balance of payments front, Mr. Bopp said, it was discouraging to see the marked increase in the deficit during the fourth quarter, especially after the apparent progress earlier in the year. Without minimizing the problem, it was important to note the temporary factors that were at work--a spurt in Canadian borrowing, withholding of the British payment on the 1947 sterling debt, and some outflow of short-term funds to meet year-end pressures in the Euro-dollar market. Yet, beyond those temporary factors the fact remained that the U.S. payments deficit was large and continuing, and many observers viewed the deficit, if not with apprehension, then certainly with concern. Under those conditions, a significant reduction in the deficit during 1965 would appear the advisable course of action.

In Mr. Bopp's opinion, however, a general tightening of monetary policy to reduce capital outflows would be ill-advised. To assure a significant reduction in capital flows would require a significant shift toward less ease, and the risks to the domestic economy seemed to him too great. Thus, even though he also disliked the notion of selective controls, he thought it was important to explore other avenues to reduce the deficit.

On balance, weighing both domestic and balance of payments considerations, Mr. Bopp would make no change in the general posture of monetary policy, even in the absence of need for an even keel. He preferred alternative A for the directive. In a concluding remark Mr. Bopp observed that after the discussion this morning he was less positive about this position than he had been for some time.

Mr. Hickman commented that business continued to expand, paced by unsustainable levels of output in autos and steel. Perhaps the most important recent news had been the emergence of large-scale inventory building, a phenomenon that frequently occurred in the late stages of business expansions. The inventory expansion appeared to some degree to have been associated with some upward pressure on prices. The increase in the industrial component of the wholesale price index during the fourth quarter of 1964, of about seven-tenths of a point, was the largest for any three-month period since late 1958.

A preliminary analysis of the Budget Message and Economic Report left Mr. Hickman with the feeling that more vigorous steps would be needed than had been thus far proposed to avert a serious slowdown in growth in 1965. He personally welcomed the effort towards countercyclical fiscal policy, but under the circumstances would prefer greater stimulus for the second half of the year. On the basis of the full employment surplus figures provided by the Board's staff, he estimated that the Federal sector in the second half of 1965 would provide only about half as much stimulus as needed to achieve desired growth. To him this suggested rising unemployment, lower industrial production, and perhaps a larger budget deficit after all, unless steps were taken to promote additional growth.

In respect to the near-term outlook, Mr. Hickman continued, the auto and steel sub-cycles that he had referred to at the previous meeting appeared to be approaching their peaks. Auto sales had about made up the losses due to last fall's strikes. Thus, total car sales (including imports) over the four months October through January, when expressed on an annual-rate basis, worked out to 8.1 million cars, which was the same as actual total sales for 1964. Even assuming that car sales in 1965 would surpass 1964, it seemed clear that the recent spurt had not much further to go.

Fourth District business activity had roughly paralleled the national pattern thus far in 1965, Mr. Hickman said. Steel production was still rising in the District and retail sales were still very strong. He had just learned of another huge electric power project on the order of a quarter of a billion dollars that soon would be started in the eastern part of the District. On the other hand, slightly adverse changes in unemployment and electric power output were common in the District in January and were reflected in the national totals.

With reference to international developments, Mr. Hickman said that the British balance of payments problem seemed roughly divided between current account and capital account. The trade balance had improved in December, and presumably there would be some further improvement as a result of steps already taken. However, the Labor Government's egalitarian proposals might not remedy the fundamental difficulty of under-investment in the United Kingdom. It was difficult to see why or how the Labor Government's program for nationalizing steel and adjusting taxes would attract foreign capital.

Insofar as the U.S. was concerned, Mr. Hickman was pleased to note that the Administration was coming to grips with the fact that this country had a serious balance of payments problem and he awaited the proposed remedy with interest. One broad approach would be the application of selective controls over many sectors of the balance of payments. Another approach would be the classical one of monetary restraint coupled with, in this case, reduced military and economic aid, and perhaps some use of moral suasion to reduce bank lending overseas. He leaned towards the latter approach, but without much hope that it would be chosen.

On the domestic financial front, Mr. Hickman commented, the apparent preference of the public to hold large amounts of time and savings deposits rather than money had induced banks to purchase longer-term, higher-yielding assets. In the Fourth District and in the nation, banks had continued to add municipal securities, mortgages, and longer-term assets to portfolios, and had reduced shorter-term liquid assets. Some light was shed on this matter by the Cleveland Bank's most recent semi-annual survey of municipal holdings of reporting banks in the District. Preliminary figures revealed that during the second half of 1964 banks continued to acquire municipals in large amounts, with almost all the net change occurring in the group with maturities of over five years.

So long as the public continued to shift from demand balances to time and savings deposits, Mr. Hickman said, and so long as monetary policy remained easy, banks would compete with other long-term investors for the limited supply of long-term investments. Under those conditions, bond yields probably would remain steady or move lower. However, if the System were to tighten to the extent that short yields moved above the ceilings under Regulation Q, time and savings deposits would decline, banks would withdraw from the long-term market, and long-term yields would rise.

As for policy over the next four weeks, Mr. Hickman thought that the small magnitude of the Treasury's February cash refinancing provided no serious constraint on System operations. The money supply in December and January seemed to have increased at a rate of 3.5 per cent or so, which was in accord with guidelines that he had suggested earlier. Bank credit, on the other hand, had shown considerable vigor, and over the two-month period had expanded at a rate higher than he thought desirable over the long pull. For that reason, and also because of his concern over the balance of payments situation, as described so clearly by the staff this morning, he would prefer slightly lower free reserves than had obtained recently (say, $50 million plus or minus $50 million) and a 91-day bill rate slightly above its current level but below the discount rate. The type of change he had in mind would be so small as to be virtually imperceptible. If the Committee made any change in policy before the next meeting, he would prefer not to temporize by purchasing more than token amounts of intermediate- and long-term bonds, and would therefore choose alternative A of the staff's policy directive drafts rather than alternative B. Of course, a great deal depended on the Administration's program for coming to grips with the balance of payments problem. If that program called for more drastic steps on the Committee's part, Mr. Hickman would be prepared to support them. However, he did not think it would be appropriate for the System to lead the way at the moment.

Mr. Daane remarked that, as the Committee knew, he had been clearly among those who had resisted any move toward less ease, even the "almost imperceptible" move of last August that had become quite perceptible later. Now he felt strongly that despite Treasury financing--and he would include not only the routine February financing in process but also the continued large size of dealer holdings of securities issued in the January advance refunding--that the time had come for the System to move. He agreed heartily with those who had observed that monetary policy alone could not solve the problems of the balance of payments and the position of the dollar. He felt, however, that the Committee had to do its part in dealing with what to his mind was largely a problem of confidence in the dollar and was becoming increasingly so. In his judgment the Committee should move in the direction of less credit availability as rapidly as possible against the background of Treasury financing.

As to possible domestic repercussions of such a move, Mr. Daane thought there sometimes was a tendency to exaggerate the consequences of relatively marginal changes in reserve availability as exemplified in the free reserve figures. In particular, he did not think a shift in free reserves from plus $50 million to minus $50 million would have any drastic, or even perceptible, repercussions on the domestic economy, which in his judgment was exceedingly strong at present. He believed that such a change could be accomplished with no great effects on the availability of credit for continued worthwhile expansion of the economy. Moreover, he sensed some speculative overtones in the economy at present. This admittedly was hard to document, but he thought there was evidence of it in the stock market; and more generally, there seemed to be a growing feeling of ebullience. In sum, he was inclined to discount the possibility of injurious effects of a policy change on the domestic economy and he agreed with the observation that the Committee might in fact promote the sustainability of the expansion by reducing credit availability at this point. But he favored a policy change mainly on the grounds of confidence in the dollar and in the belief that the Committee should participate in what clearly would have to be a national effort.

Operationally, Mr. Daane agreed in general with the objectives Mr. Hayes had described, but would perhaps go a bit further. He would like to see the Committee make a perceptible move, with free reserves fluctuating on the negative side of zero. He would then expect the short-term bill rate to be at the discount rate, and, from time to time, a few basis points above it.

On the directive, Mr. Daane leaned toward the spirit of alternative B of the staff's drafts but was not happy with the language. He thought the directive should make it clear that the Committee was moving in the direction of lessened availability of credit in the interest of a strong dollar internationally and in light of the definite strength of the domestic economy. Also, he thought it would be unwise to delete altogether the reference to Treasury financing, as in alternative B. The Committee was concerned with both the February financing and the continuing effects of the advance refunding, and if it decided to change policy today it should do so in such a way as to take account of the financings. In his judgment the directive should reflect that fact.

Mr. Mitchell observed that the urge to do something to relieve the balance of payments constraint or to remove the anxiety of a continuing deficit seemed to mount at successive meetings of the Committee. It had been a bad time for both fears and hopes, so often proved unfounded and unrealized. Over the years since the "constraint" became an overt factor in its deliberations the Committee had nudged and ratcheted--through two 1/2 per cent increases in the discount rate--Treasury bill rates from less than 2.5 per cent to nearly 4 per cent. And under "operation twist" long-term Treasury rates had held to a paltry 1/4 of 1 per cent rise, while rates on tax exempts, mortgages, and corporates had been unchanged or had declined. Now there was an unnatural relationship between long and short yield, with both borrowers and lenders susceptible to official action. Borrowing short as U.S. banks were doing and lending long or longer might be precarious business if a significant change occurred in the short-long rate relationship. The Committee was in a position to affect this relationship dramatically by a careless or advertent boat rocking.

Would an increase of 25 to 50 basis points bring long and short Government yields together or would short rates rise above long rates? Or, Mr. Mitchell continued, had "operation twist" exhausted its twistability? If the Committee moved now should it expect a full reflection of its action in long rates? What public advantage was gained from maneuvers of this size?

On the side of the real economy, Mr. Mitchell said, recent consumer buying rates and business inventory accumulations were explainable as the effects of strikes and anticipation of shortages. If there was more to them than that, it would only be that consumer expenditures stimulated by the tax cut were showing a larger reaction than had appeared likely, but not a larger reaction than sought when it was hoped that the tax cut might achieve a lower rate of unemployment than 5 per cent. If such a stimulus appeared to be evident in the current figures, it should not be tranquilized by monetary restraint in the face of the contractive effects of a steel strike or settlement, a working-off of automobile demand, and a less expansive Federal budget in the coming months (cash or income accounts). He did not expect recession to begin in May of this year but it was not an unreasonable possibility, and he certainly would not like to see it heralded or triggered by a contractive maneuver by the Federal Open Market Committee.

The balance of payments deficit was something the Committee could not remove without abuse of its powers, Mr. Mitchell said, but he doubted that any member would want to withhold aid to accomplishing that devoutly desired goal if the Committee could see how it might help. Developments over the past three years had convinced him that the U.S. trading position was good and was continuing to improve as Europe's prosperity inflated. The figures looked better than they were because of tied aid and compensatory purchases, and in some degree they benefited from the direct and indirect financing of exports. As long as the boom in Europe continued, he would expect the U.S. trading position not only to hold its own but to grow stronger. He could not judge how much additional contribution to reducing the net outflow might take place as a result of changing the Government's aid program, but he assumed it would be small.

In Mr. Mitchell's view the balance of payments problem today was not one of making the U.S. more competitive in the sale of goods and services, welcome as that might be. Rather, it was one of dealing with a capital outflow induced by interest rate differentials arising from differences in the marginal productivity of capital in capital-short countries with rudimentary capital markets. Those interest differentials were not a temporary phenomena to be met by temporary expedients. One could not hope to match in the domestic interest rate structure the earning opportunities offered in Western Europe or in the less-developed countries.

It was possible, Mr. Mitchell said, for the problem to be solved fortuitously by outbreaks of political unrest in Western Europe, Communist expropriation, or other events which would arouse fears for the safety of foreign investment. It was to be hoped that the problem would not be solved in this way. It could be solved by some dramatic change in U.S. saving propensities or investment opportunities, which was possible but unlikely.

Mr. Mitchell expressed the view that if the United States was determined to solve the problem with policy instead of chance it really had only two broad alternatives. The first was to raise domestic interest rates drastically, with a sharp rise in the discount rate, an immediate contraction in the money supply, and a consequent fall in the price of outstanding debt. The ultimate goal would be to make the contraction sufficiently drastic to reduce funds available for business, housing, State and local governments, and individuals, so that the rates that would have to be paid would be competitive with those in Western Europe and less-developed countries. He doubted that this action would be effective for long in maintaining high interest rates and he was sure that it would drastically deflate the economy.

The other alternative, Mr. Mitchell said, was to adopt a measure or measures that either insulated the U.S. interest rate structure or made it competitive with those in other countries. Moral suasion was an effort to insulate U.S. from foreign interest rate levels by restricting or barring foreign investments to U.S. nationals, corporations, and banks. For a short-run remedy it had much to recommend it, he thought.

But the problem was likely to persist for a longer period, Mr. Mitchell observed. It was better to be armed with a device that was more durable. His preference was for something akin to the interest equalization tax imposed on loans, direct investment, and deposits of all U.S. citizens, corporations, and financial institutions. The rate should be administratively flexible. The only exemption should be for the financing of U.S. exports and the burden of proof should be on the taxpayers to show that that was the case. With such a device the capital outflow could be regulated according to the nation's capacity to support it by earnings on current account and by the willingness of foreigners to hold dollars.

The balance of payments deficit doubtless would remain a constraint on Committee actions for some time, Mr. Mitchell concluded, but he hoped the Committee shortly could look to measures to solve it, not to keeping it alive. On these philosophical grounds he would favor no change in policy now.

After observing that the staff presentation today had been excellent, Mr. Shepardson said that the domestic economy at present seemed to him to be in a vigorous, continuing expansion. Admittedly, both anticipations of a possible steel strike and efforts to make up the output lost in the automobile strike were having temporary effects on activity, and there might be some let down in the not-too-distant future when these effects ended. On the other hand, the Administration's fiscal program seemed to him definitely expansive for the rest of the year and the period beyond. In general, he did not see a prospect of an immediate or near-term slackening.

In fact, Mr. Shepardson continued, present levels of activity caused him to question the staff's optimism on the subject of price stability, as Mr. Bryan had. The pressure on wages continued and the prospect that wage increases would not exceed the Administration's guidelines did not seem promising. Upward pressure on prices would persist unless wage increases in goods-producing industries were kept in better alignment with productivity gains and there were some resulting price reductions in those areas to offset the inevitable price crawl in service industries. In his judgment the Committee would have to continue to be concerned about price developments.

Mr. Shepardson thought the balance of payments problem was acute and something had to be done about it. He agreed that it was not appropriate for the Committee to undertake monetary policy action extensive enough to bring about a solution; the use of other measures also was necessary. But monetary policy had a part to play, not as the principal instrument but as a supporting instrument. With business conditions as they were at present he thought the Committee could take some step without impairing the domestic economy.

Therefore, Mr. Shepardson said, it seemed appropriate for the Committee to make some move now toward a lesser availability of funds; it had waited about as long as it could. He did not favor a sharp change, but rather a small adjustment made gradually. He had in mind having the 90-day bill rate work up to around the discount rate and a free reserve level in the zero plus or minus $50 million range.

Mr. Shepardson favored the essence of alternative B for the directive. He doubted, however, that it was either necessary or appropriate to include the final clause, reading "while moderating the impact of these conditions in markets for intermediate- and long-term securities." The Committee might want operations along that line, but much would depend on the particular situation that developed. Also, he was not particularly happy with the wording of the first paragraph of alternative B and would prefer a somewhat different emphasis. Specifically, he suggested the following wording:

> In light of the economic and financial developments reviewed at this meeting including the generally strong and continuing expansion of the domestic economy and the continuing adverse position of our international balance of payments, it remains the Federal Open Market Committee's current policy to accommodate growth in the reserve base,

bank credit and the money supply but at a more moderate pace than in recent months as it seeks to avoid the emergence of inflationary pressures and to support other measures that may be taken to strengthen the international position of the dollar.

Mr. Robertson then made the following statement:

On the domestic scene there appear to be two principal new developments recently, both of which may be potentially disturbing. One is the clearer emergence of stepped-up inventory accumulations, not only from steel but from other output, and also an apparently unsustainable pace of automobile sales. Another is the expansionary Federal budget for fiscal 1966 presented to Congress, but with the fiscal stimulus pretty much concentrated in the second half of this calendar year.

These developments give me pause, but do not yet suggest the need for changing the course of policy. The automobile and steel situation is not being accompanied by any inflationary price developments--or even, it seems from staff reports, by any rise in labor costs. I doubt that basic demands are so fragile that possible temporary overexpansion in automobile and steel will be followed by a recession in activity. But even if so, it is not clear that the situation would be improved by a tightening of policy now.

As to the budget, while the persuasiveness of President Johnson should not be underestimated, the programs still have to be approved by Congress. In any event, they are six months away and to that degree conjectural, while we are still confronted with a larger than seasonal surplus in the first half of this year that has been generated out of the current budget. Finally, the expansionary effects of the new programs are difficult to assess, involving as they do excise tax cuts, transfer payments, and grants-in-aid rather than what had been more usual, income tax cuts and direct spending.

Our balance of payments news is less favorable than one would have wished. As the Committee knows, I am not among those who think we are doomed if we do not instantly bring the outflow and inflow of capital into balance. As a matter of fact, although I favor taking reasonable measures to deal with the problem, I am not inclined to panic at the current news. Nevertheless, I hope that the adverse character of the news serves to speed up the Administration's search for a policy adequate to deal with the problem. At the same time, I must say that I am not aware of any information that would suggest to me that we should risk a slowdown of domestic economic growth through a more restrictive monetary policy. I cannot go along with those who seem to feel we must buy voluntary banker efforts to diminish their loans abroad, by promising a tighter monetary policy with its accompanying higher bank loan rates. Any beneficial influence on our external payments that might stem from a restrictive policy change, within the realm of reason, would be too insignificant to warrant even a small risk to our domestic economy. A change in monetary policy adequate to reduce substantially the capital outflows--and hence have a beneficial effect on our balance of payments--would have to be so large as to unquestionably affect the domestic economy severely. Thus, it is my view that the remedy or remedies lie elsewhere.

Finally, the still sizable dealer holdings of long-term securities after the advance refunding, the recent market weakness, and the new mid-February financing all speak to keeping policy on a steady course in the four weeks ahead.

Mr. Robertson added that he would prefer alternative A for the directive.

Mr. Mills said that as he was counting on the adoption, at long last, of fiscal measures as the chief plan for attack on the balance of payments problem, his comments today would be directed to the domestic situation. He then made the following statement:

During thirteen years of service as a member of the Federal Open Market Committee, I have been party to the buildup of a mammoth credit inflation which in its present stage reveals a topheavy and creaking superstructure of credit carried on an all too narrow equity base. In order to prevent at some future point of time an unfortunate credit deflation, it is essential that a good-size proportion of outstanding credits be terminated through the normal service and performance of the obligors so that a broader and stronger equity base can be placed under the credit superstructure. Incidentally, a Federal Reserve System credit policy geared to attaining such an objective by virture of restraining the expansion of credit would at the same time conserve the underpinning given by our gold reserves to the entire credit structure, and would thereby relieve the current concern that has been expressed regarding the future credit expansive limitations of our gold reserves.

I continue to believe that a policy shift toward moderate credit restraint is overdue and, therefore, would approve Alternate B of the proposed current economic policy directive. Leaving aside the long-range factors bearing on adoption of an appropriate monetary and credit policy, near-run factors also argue for credit restraint; namely, actions to exert a cautionary influence at a time of latent inflationary pressures, overconfidence in business prospects, and definite indications that the commercial banks are becoming overloaned and illiquid.

Mr. Wayne noted that business activity was definitely high and rising in December and the evidence seemed to indicate that the trend had continued in January. While steel and automobiles were responsible for much of the strength, gains were widespread throughout nearly all of the economy A check of 11 major indicators for which December data were available showed that ten moved favorably, several of them by substantial amounts, while only unemployment moved in an unfavorable direction This record was equaled or exceeded in only two months of the past three years, during which the economy was generally moving upward at a fair rate. Additional strength was reflected by the large backlog of manufacturers' unfilled orders and the very sharp rise in construction contract awards in the last four months of 1964, which would seem to provide some assurance of high levels of activity in manufacturing and construction in the months immediately ahead. Several other major industries were operating at or near practical capacity. On the other hand, it seemed fairly clear that production rates in steel and automobileswere not sustainable and must decline before long. The recent high rates of business activity had been accompanied by only moderate price pressure and most price indicators had probably been more stable in the past month than they were in the closing months of last year.

Other domestic indicators seemed to be consistent with the behavior of business activity and prices, Mr. Wayne said. Bank credit and the money supply apparently made significant gains in January after fairly large average gains in the latter part of last year. Both long-term and short-term interest rates had been generally stable with nothing in sight to cause any significant change. The Federal budget was designed to contribute a substantial stimulus to the economy in the second half of the year when some weaknesses might be expected to develop in the automobile and steel sectors. As a whole, then, the domestic picture was one of strength and high activity with a few sectors of the economy verging on overheating. The domestic economy could stand some moderate restraint if it did not actually require it. The deciding factor would seem to be the international situation.

The basic long-run elements in Britain's payments problem, Mr. Wayne continued, were the large trade deficit and the capital outflow, as the staff had pointed out. The measures taken thus far to correct them were largely short-run and of a stop-gap nature. They might provide some respite but they did not offer a solution. On the basic and longer-run problems there had been plans and talks but little specific action. British exports had not grown as rapidly as imports in recent years, and the share of Britain's exports in total world trade had fallen substantially. Part of this could be attributed to the formation of the Common Market (which had also hurt Britain's long-term capital position), but the failure of British exporters to hold their own in world competition was also an important factor. A solution to the latter problem would require more fundamental changes in the British economy. At the moment, prospects for such changes did not appear good.

As for the U.S. position, Mr. Wayne said, the sharp deterioration in the U.S. capital accounts was a matter of serious concern. More action than had been taken thus far was required but he was not sure just what form that action should take. Some reduction in reserve availability might exert some influence toward curtailing bank lending abroad and, if the interest rate effects of such action were allowed to be transmitted to the long end of the market, some nonbank outflows might be reduced as well. He was aware of the hazard involved in disturbing the long end of the rate structure, but in view of the persistence of the balance of payments problem and the magnitude of the recent deterioration, he felt that this course of action had to be given serious consideration.

Like Mr. Hayes, Mr. Wayne was reluctantly disposed to accept some intervention in the market for foreign credits as necessary under present conditions. At the same time the Committee should, he believed, support such efforts by moving toward a lowering of the ready availability of reserves with moderate firming in the rate structure. He concurred fully with Mr. Mitchell about the hazards of a drastic move, but that was not the kind of action that he contemplated.

Outside the area of monetary policy, Mr. Wayne remarked, a number of courses, not necessarily mutually exclusive, might be considered. Extension of the interest equalization tax to bank term loans had already been widely discussed. He was not entirely convinced that this would be wide, largely because he feared it might prejudice the financing of some U.S. exports and because it would distort the market mechanism. Action to reduce taxation incentives that favored foreign over domestic direct investment might offer a better hope. Finally, it might be possible to alleviate the problem somewhat through imposing limitations on the activities of Canadian agency banks.

In the policy area, Mr. Wayne said, it seemed clear that the money supply and bank credit had been growing at high rates in recent months. Business activity was high and the price structure was firm with some tendency to edge up. The prospect was for a substantial stimulus from fiscal policy later in the year, and that stimulus might be moved forward somewhat by discounting. All these domestic factors suggested the desirability of a modest reduction in the availability of credit and that suggestion was strengthened substantially by international considerations. The sharp deterioration in the U.S. international payments position in December, which was caused to a considerable extent by bank loans, indicated a definite need to reduce the availability of reserves. In recent months banks had had sufficient reserves to enable them to continue increasing their loans at the substantial rate which had prevailed over the past three or four years and at the same time they had stepped up the rate at which they had acquired investments. Therefore, some reduction in the availability of reserves should not impair their ability to make appropriate loans. For both domestic and international reasons Mr. Wayne favored a somewhat firmer policy for the next four weeks, with one goal being a bill rate somewhere near the discount rate. That would quite likely require net borrowed reserves, which he would not oppose.

For the directive, Mr. Wayne preferred alternative B, but Mr. Shepardson's suggested wording for the first paragraph appeared to him to be worthy of serious consideration.

Mr. Clay remarked that, following the developments of the last quarter, the international payments problem had come to the center of the stage. Even so, its ramifications had been difficult to judge adequately because of the limited information available as to the factors involved in the enlarged deficit and as to the extent that they might be of a temporary nature.

Nevertheless, Mr. Clay continued, it appeared clear that the United States needed to take action to meet the situation. Unless the Committee was willing to risk severe repercussions upon the domestic economy, the program for dealing with the deficit had to be formulated primarily in terms of special measures rather than general monetary policy. That involved action largely by the Administration and possibly the Congress rather than by the Federal Reserve. In fact, a program resting heavily upon monetary policy would appear to be out of the question. That did not mean that monetary policy could not be changed at all, but the range of maneuver probably was quite narrow.

If monetary policy were used, Mr. Clay said, it probably would involve some reduction in credit availability. That could be expected to stiffen interest rates all along the maturity scale. Under present circumstances, the impact of such action both directly and through its effect upon expectations could be severe and jolting to the money and capital markets and to the economy, unless the monetary policy move were of small proportions and deftly handled.

Apart from such an immediate risk of any pronounced move in monetary policy, Mr. Clay added, the main concern over the impact of monetary policy on domestic economic activity was with reference to activity some months hence rather than now. The strong push to economic activity at the present time from steel, autos, and inventory stockpiling was not likely to be deterred by a small shift in monetary policy. The inevitable turn-around in those sectors later would put the economy through a readjustment, however, and at that time monetary policy would have to be a supporting and not a restraining influence. Accordingly, monetary policy would need to remain flexible in the weeks and months ahead.

Under the circumstances, Mr. Clay felt some firming of policy probably was in order, although it should be viewed as only one part of a concerted attack on the international payments deficit. Alternative B of the staff drafts for the economic policy directive would appear to serve that purpose. In his judgment to go further than that would be unwise in terms of the domestic economy, and even that shift would need to be carefully implemented. At the same time, it should be recognized that that action by itself would not solve the international payments problem.

Mr. Scanlon turned directly to the staff questions.

1. Business activity and prices. Available evidence indicated that the advance in output, employment, income, and sales in the Seventh

District had continued into 1965 with considerable vigor, Mr. Scanlon said. He suspected that the Midwest was concerned, even more than the nation generally, with the fact that production of steel and autos in January had been far above the most optimistic predictions of rates for the year as a whole. Even if estimates of the year's total output proved to be on the low side, it was clear that sharp cutbacks would occur in those important industries once inventories had been increased to desired levels. An important unknown in the current picture was the extent to which the current inventory building in those commodities was responsible for the buoyant flavor of economic activity in general.

Mr. Scanlon observed that producers of durable goods other than automobile and steel--including most types of industrial machinery and equipment, railroad equipment, appliances, consumer electronic products and, especially, furniture--looked forward to further gains in output in 1965. Farm machinery firms hoped to hold even with 1964 while construction machinery producers appeared reconciled to a decline from the very high levels of last year. There was little concern in the District over prospective declines in defense orders because very few firms there were heavily dependent upon that work. Machine tool producers were running two and three shifts and would increase output further if skilled manpower were available. Reports of the Purchasing Agents Association of Chicago reflected a continuous vigorous rise in output, inventories, employment, and orders. New order lead times had lengthened further.

Forty per cent of the Chicago purchasing agents reported paying higher prices on the average for raw materials and supplies in December, compared with 28 per cent a year earlier, Mr. Scanlon noted. Announcements of price changes continued to show a ratio of increases to decreases of about 2 to 1. Prices of capital goods nevertheless had not been increased appreciably on a broad front despite heavy demand. Certainly, the situation did not resemble that prevailing in 1956 and 1957. Over-all, a moderate rise in the wholesale price index appeared likely to him. Thus, his views on the price outlook were slightly different from the staff's.

Employment gains continued in the Seventh District, given allowance for seasonal changes, Mr. Scanlon said. Unemployment compensation claims were well below a year earlier in all District States in December and January. Decreases were appreciably greater than for the nation. Want ads for employees in Chicago newspapers had been well above last year in recent months and had been at the highest level since early 1957. Lists of specific labor shortages prepared by local employment offices continued to emphasize the usual types of skilled or semi-skilled office, service, and factory workers. Employers continued to report that the bulk of the unemployed who applied for jobs or apprenticeship training were inadequately prepared in basic academic skills, including the "three rs." Supervisors of programs operating in the Chicago area under the Manpower Development and Training Act reported good results. However, those programs were still on a small scale with only "several hundred" workers placed in jobs as a result of their activities commenced over 18 months ago.

Mr. Scanlon noted that business failures had been at a low level in recent months. In the fourth quarter the number of failures in the District was 21 per cent below the level of a year earlier, compared to an 11 per cent decline for the United States. For both the District and the United States the number of business failures in the fourth quarter was the lowest for the period since 1955.

Farm land values as reported by country bankers rose in the fourth quarter, Mr. Scanlon noted, and were about 5 per cent above a year earlier in January. In contrast to expectations a year ago, a majority of those bankers expected a further rise in farm land values in the months ahead.

2. Balance of payments. Mr. Scanlon agreed with the staff views as supplemented by Mr. Hayes. The long-run disequilibrium in Britain's payments balance arose from her inability to improve the balance on current account, where surplus was necessary for financing of long-term capital outflow into the areas where Britain by long tradition had been an investor, and for reduction of the liability-reserve ratio that since the war (and particularly since the return

to convertibility in 1958) had been a source of official concern. Improvement in the current balance had to come from a greater competitiveness of British exports, the prices of which had been, since early 1963, rising relative to those of her major competitors. Decreases in costs through increases in productivity (new investment) and dampening of domestic demand were essential. Present measures, although in the right direction, probably had to be intensified in order to achieve this. Additional selective controls to stimulate exports and investment probably were necessary, to bring export prices down. A refinancing of the short-term financial assistance so far given to the pound might be necessary to gain time for implementation of these measures.

Mr. Scanlon said that the slower rise in industrial activities on the continent that might be expected as a result of strong anti-inflationary policies of most countries there probably would bring about some reduction of U.S. capital outflow due to decreasing profit prospects. Also, measures by continental countries to restrict foreign investment (such as adopted by Germany and proposed by France) might act as a deterrent. However, only an intensification of direct controls upon capital outflows (such as an increase and broadening of the present interest equalization tax) might be effective in reducing substantially the U.S. capital outflow, since the rate-of-return differential probably would remain in favor of foreign investment.

3. Bank credit and money. Mr. Scanlon agreed in general with the staff answer to the question on this item. There had been some further shift to commercial bank savings from other financial institutions in response to increased rates--a number of Seventh District banks had raised rates paid on CDs issued to individuals above 4 per cent. This shift represented a substitution of bank for nonbank credit and some reserve growth was necessary to accommodate it. Additions to share accounts at savings and loan associations and sales of savings bonds had been somewhat below the year-ago levels.

Those developments suggested that credit demands remained strong, Mr. Scanlon observed. Whether this would entail a liquidity squeeze on the banks would depend on the rate at which reserves for additional deposit growth were provided. District country banks responding to a recent survey expected a stronger demand for nonreal estate farm loans in the first quarter than in the year-ago period. Little change was expected in interest rates charged. Country banks had been increasing rates paid on savings deposits.

Chicago banks had shown fairly easy reserve positions in the past two weeks. That appeared to be largely attributable to the issuance of a substantial amount of CDs after the turn of the year. Those banks normally showed increasing reserve pressure through February and March as they acquired the bills needed prior to April 1.

If recent trends persisted, Mr. Scanlon said, the larger banks could be expected to continue to rely on CDs, and perhaps on increased purchases of Federal funds. If the current rate of reserve growth was reduced, funds from those sources probably would be more difficult to obtain and, of course, more costly. Some further liquidation of Governments was possible, although total holdings of Governments were the lowest since mid-1960.

4. Money and credit markets. Mr. Scanlon commented that he was more sanguine than the staff was that long-term rates would not rise perceptibly even with a moderately less easy monetary policy. In light of the recent and prospective demand and supply developments in long-term credit markets, the current level of long-term yields appeared vulnerable to downward pressure in coming months. The Treasury's posture probably would be seasonally passive in the first half, mortgage demand probably would show little change, and business demand for long-term funds was expected to remain moderate. This left State and local government uses of long-term funds as about the only major category expected to display continued vigorous expansion. Given those considerations, and the likelihood that savings growth would continue during the period at its recent rate, long-term interest rates could well soften somewhat.

The Treasury would borrow about $2.2 billion on February 15, Mr. Scanlon noted, through cash sales of new 4 per cent notes maturing

November 15, 1966. The notes were to be priced below par to yield 4.09 per cent and could not be paid for by credit to Treasury tax and loan accounts. The funds would be used to redeem the maturing 2-5/8 per cent bonds which would be accepted at par in payment for the new notes. Books were open Monday, February 1, only. With the notes attractively priced (the 3-3/8 per cent bonds on November 15, 1966 yielded 3.88 per cent while the 4 per cent notes of August 15, 1966 yielded 3.98 per cent) and with the books closed before today's Open Market Committee meeting, it did not seem that monetary policy had to be greatly concerned with this financing during coming weeks. Policy actions probably did not need to be restrained by the January advance refunding any longer.

5. Monetary and fiscal policy. Mr. Scanlon's views on this subject were consistent with those of the staff. The President's Budget Message described a generally expansionary fiscal program. Reductions in Federal excise taxes and stepped-up benefits under the Social Security program appeared likely to exert a distinctly stimulative effect once they took effect.

For the first half of calendar 1965, however, it seemed probable that the Federal sector would provide little additional thrust toward economic expansion, Mr. Scanlon remarked. For one thing, underwithholding of individual income taxes last year meant that perhaps three-quarters of a billion dollars in 1964 tax payments would have to be made by April 15. Furthermore, the excise tax cuts that the message promised were not to take effect until the beginning of fiscal 1966. Uncertainty over which taxes would be reduced or eliminated might induce some would-be buyers to postpone purchases until final action had been taken, or until the second half. Finally, the proposed 7 per cent increase in benefits under the O.A.S.D.I. program, retroactive to January 1, was expected to be disbursed in a lump sum at about mid-year.

Prospects for the second half of 1965 were that Federal fiscal operations would be expansionary because of the factors mentioned above, Mr. Scanlon continued. The impact might be even greater than the Budget Message and supporting materials implied if, as was widely supposed, Congress widened the range of excise tax reductions, and if expenditure programs now largely in the planning stage were firmed up and adopted. Thus, intensified emphasis upon the poverty program, aid to Appalachia, education aids, and similar measures seemed likely candidates for spending beyond that now proposed. If the private economy was headed for a sidewise movement after the first half of 1965, as many analysts appeared to believe, emergence of a strong expansionary impulse from the Federal sector--after relative quiescence during the continued upward thrust from the private sector in the first half--should have a salutary effect.

With respect to policy, in Mr. Scanlon's judgment there appeared to be a close choice as this time between "no change" and "slightly less ease." He would favor a very modest change in policy, but the evidence of need for a change was not so persuasive as to call for quite as severe a move as alternative B seemed to suggest to some people around the table. He agreed with the changes in the directive suggested by Mr. Shepardson, but his ideas as to the appropriate degree of change coincided more closely with those of Mr. Hickman and Mr. Wayne.

Mr. Strothman said his comments would relate primarily to the first and third of the staff questions. Information for the Ninth District suggested that the economic outlook, for the coming few months at least, was essentially encouraging. The Minneapolis Bank's District survey pointed toward continued economic expansion and price stability. A majority of the respondents believed that coming months would bring advances in output, employment, and, to a lesser extent, profits. This sentiment seemed compatible with what available statistics suggested.

There was one cautionary note with respect to the outlook, Mr. Strothman said. He seemed to detect the incipience of a "poor talk" psychology based on apprehension about the results of underwithholding on Federal income taxes. Some of the comments suggested a possible dampening of demand disproportionate to what would be justified by the actual figures.

As to District banking developments, Mr. Strothman noted that bank credit, which typically declined in the beginning of the year, actually increased rather considerably in the first half of January. Moreover, loans increased much more than investments. The increase in loans was concentrated in the commercial and industrial category which, of course, usually declined in the first part of the year. Still, it appeared that District banks were not under undue pressure. The loan-deposit ratio for weekly reporting banks was well below its post-1959 high and well below the national average for such banks. Similarly, District nonweekly reporting banks, if somewhat tighter relatively than reporting banks, were less fully loaned up than all U.S. nonweekly reporting banks were on the average.

Mr. Strothman noted that total deposits in the District declined slightly over the first three weeks of January as a reduction in demand deposits was almost offset by an increase in time deposits. This behavior of deposits was much the same as in the like period of 1964 but was contraseasonal on a longer-term basis.

There was no evidence, Mr. Strothman said, that interest rates on savings deposits had been increased. Rates on corporate deposits probably had edged up slightly, however, for there had been not a loss of such deposits but a gain.

Mr. Strothman concluded with a comment on possible means of improving the balance of payments situation, especially as it related to bank credit. He shared the view of those who feared that hortatory measures would not be truly effective in the face of competitive pressures. Possibly, however, something along the lines of the old Voluntary Credit Restraint program might succeed. Through such a program it would seem that lenders could act in concert without being inhibited by anti-trust law considerations.

Mr. Swan observed that it was unnecessary to elaborate further on the strength of the current expansion. He would note only that the indications given in the staff document of inventory accumulation in addition to that of autos and steel struck him as significant. The strength of the expansion in the Twelfth District was indicated by the fact that in December the employment figures rose faster than in the nation and the rate of unemployment dropped somewhat more--although he should add that the December figures were still tentative. He agreed that the economy could stand some lesser availability of credit, whether or not it required it.

Mr. Swan said that weekly reporting banks in the Twelfth District had shown a substantial further increase in savings and time deposits in the first three weeks of January, although not as large an increase as in the rest of the country. However, if one considered time deposits other than savings deposits and other than the negotiable CDs of $100,000 and over, the increase since the beginning of the year was much larger in the Twelfth District than in the country as a whole. The reasons for this were not entirely clear, but in part it seemed to reflect some response by individuals and small businesses to the offering of deposit certificates bearing higher interest rates than straight savings accounts did. Despite the fact that loan demand had been holding up well in the first three weeks of January, District banks had borrowed only modestly at the discount window and had been active sellers of Federal funds.

Mr. Swan observed that he found it difficult to come to a firm conclusion as to the best course for monetary policy at present. He felt as Mr. Scanlon did that there was a narrow choice between no change and a slight lessening of ease. The latter alternative disturbed him on two grounds. First, as others had said, it was necessary to look elsewhere for measures that would have a significant effect on capital outflows; to attempt to do the job with monetary policy alone would require much more drastic action than was desirable in terms of the domestic situation. But if the Committee made only a modest step--which was all he would be prepared to do--the situation might not be significantly improved, and the Committee then would have to take another modest step. He thought that less would be accomplished by two such modest steps than by one larger step later.

Secondly, Mr. Swan said, a broader Governmental program to deal with the payments problem, involving measures in other areas, presumably would be announced shortly; moreover, the Government was on the eve of action with respect to the gold reserve requirement. There already had been some anticipatory reactions to the expected program, including some firming in the money market--the bill rate currently was close to 3.90 per cent compared with 3.77 per cent at the time of the previous meeting. He suspected that the reaction would proceed further even if the Committee did not change policy, and thought it would be wise not to try to offset it. However, if a broad program was announced promptly, at the next meeting the Committee would be faced with the questions of what sort of market reaction had developed and what sort of supporting action was needed, whatever decision it might make today.

As he had noted, Mr. Swan continued, the issue came down to a choice between no change and a modest move. His feeling at this point was that action might better be delayed until the next meeting. Accordingly, he favored alternative A for the directive. If, however, the Committee decided that it was desirable to change policy today and adopted alternative B, he would agree with Mr. Shepardson's proposed revision of the first paragraph. He agreed also with the proposal to eliminate the reference to moderating the impact on intermediate- and long-term security markets, both because he thought this would be difficult to do and because, if policy was changed, in his judgment the Committee had to expect some reaction in longer-term markets.

Mr. Irons remarked that the general picture of economic conditions in the Eleventh District was one of strength and optimism; all indicators were at high levels or were showing further increases. In that respect District conditions were quite similar to those in the nation as a whole. Nationally, there were some disturbing factors, including the rate of inventory accumulation and the level of automobile sales, but the outlook for several months and perhaps for a year was on the strong side rather than on the weak or questionable side. He did not think the domestic situation called for a stimulative policy at this time; money was so readily available that stimulation was hardly necessary. In his judgment the domestic situation did not call for a restrictive policy either.

Mr. Irons noted that the Committee had to take international developments into consideration along with domestic, and on international grounds he had reached the conclusion that it might well attempt to bring about a situation of less ease now. He did not favor an overt action--a sudden, sharp, or substantial move. But he did favor a move in the direction of somewhat reduced reserve availability, with free reserves declining to about zero, give or take $50 million on either side. He would not be concerned if free reserves were negative. He would expect short rates to be slightly higher, pushing up toward the discount rate.

Such action would not correct the balance of payments problem, Mr. Irons said, but it was the only means the Committee had for contributing to improvement with respect to capital outflows. Other measures might also be required, such as extending the interest equalization tax to banks and using moral suasion to limit foreign lending. But it was desirable for the Committee to act within its own sphere, by taking a small step in the direction of making bank reserves less readily available than they had been for some time.

Mr. Irons said he would accept alternative B for the directive. He had not been particularly happy with the language of the staff draft for the first paragraph, but Mr. Shepardson's proposed revision met his objections. He would delete the last clause in the second paragraph. The Desk probably would act to moderate the impact of the policy change on longer-term markets in any case, but he questioned the desirability of spelling out such an instruction in the directive.

Mr. Ellis reported that economic activity in New England continued strong--somewhat stronger, in fact, than was normal for the winter season. The open winter that lasted through December advanced construction projects and supported employment levels. Machinery and equipment manufacturing also expanded in December, reflecting continued expansion in orders. The late arrival of good snow cover had caused serious concern in the many new ski developments, some of which had made substantial investments in new equipment and depended on liberal bank credit. Having lost the entire month of December, it would be difficult for them to meet their debt obligations unless the ski season lasted unusually late into the spring this year.

First District banks, matching national experience, were finding their loan run-down so far this year substantially less--specifically, 50 per cent less--than in 1964, which itself was a year of strong loan demand. With demand deposits declining, District banks had looked to expanding time deposits and borrowings in the Federal funds market to meet loan demands. Short-term Government securities had been sold off even more sharply than last year. The average loan-deposit ratios of District weekly reporting banks, at 70 or 71 per cent, were running 3 points above both the national average and year-ago levels. At Boston banks the ratio averaged 75 per cent or higher in January.

Mr. Ellis said he would comment on the first three of the staff's agenda items. The principal new development he saw in the area of business activity and prices--a development that was well documented in the staff materials--was a strengthening of the business outlook for the second half of 1965. The Federal budget proposals pointed in that direction and seemed to have carried the outlook consensus along the same path. By the same token, immediate prospects seemed stronger and the latent danger of acceleration of the gradual price rise seemed somewhat greater.

With regard to balance of payments developments, Mr. Ellis noted that the chart in today's presentation dealing with the competitiveness of manufacturers in various countries had shown recent trends in these countries' shares of world markets. The main thing the chart revealed, of course, was the difference in the trends for Germany and France on the one hand, and the United States and the United Kingdom on the other. But he had been struck by the relative trends for the U.S. and the U.K.--the British experience had been quite similar to that of the U.S. in a period when the U.S. trade balance had been strong. He was more optimistic about the British position than the staff had been in the presentation today. Recently several knowledgeable economists had expressed the judgment that British products were not materially overpriced in world markets and that resolution of their balance of payments problem rested more on a slowing in their rate of income advance than on a roll-back of incomes and dramatic productivity advances. He was optimistically inclined to the views that the 15 per cent import surcharge and related measures would right their payments balance in the near term, and that their longer-term problem would be tractable.

The U.S. balance of payments problem, Mr. Ellis said, now seemed to require specific action if the capital outflow was to be slowed down. He was inclined to favor actions in the tax sphere, including taxes on corporate investments abroad.

Mr. Ellis observed that it was apparent from recent credit developments that banks were competing actively and successfully both in placing loans and in securing funds. He noted that there had been a sharp run-up in CDs so far this year.

As to policy, Mr. Ellis thought no one was suggesting that monetary policy itself could do the whole job of correcting the payments deficit. But, as Mr. Shepardson had indicated, the Committee did have a role to play; a move toward less credit availability would help at the margin. He had been thinking about the "moot question" Mr. Holland had posed at the preceding meeting--whether or not a reduction in credit availability would focus on foreign lending--and had come to believe that banks generally would tend to meet the needs of domestic customers first, and would be inclined to curtail their foreign lending. That conclusion--which was fortified by Appendix B of the green book--coupled with the current surge in borrowing and credit expansion, led him to favor a move toward less ease. Such a move would restore policy to a posture that could be relaxed if the recession that had been mentioned did occur. The Committee did not now have a policy with sufficient leeway for it to be relaxed if necessary.

Specifically, Mr. Ellis suggested lowering the free reserve target to zero, plus or minus $50 million. He would expect Federal funds to trade consistently at 4 per cent and higher; dealer loan rates to rise slightly; the Treasury bill rate to rise to 4 per cent; and member bank borrowings to average $400 million or higher.

Mr. Ellis urged the Committee to consider again the desirability of a second paragraph for the directive that specified its intent in this direction. The directive might call for operations to be conducted with a view to reducing free reserves gradually to the range from minus $50 million to plus $50 million, with freedom to move outside that range if necessary to permit Treasury bill rates to rise gradually to the level of the discount rate or even above. He noted that this language was patterned after alternative B of the "trial" directive that had been prepared for this meeting, and he favored it because it was a more direct description of the Committee's intent than was contained in the draft of the regular directive. He also favored retention of the concluding statement relating to markets for intermediate- and long-term securities, because in his judgment the Committee did want to moderate the impact of the policy change on those markets. If the Committee was asking the Desk to accept this as a part of its instructions it was appropriate to include it in the directive. Any concern about possible conflict in the instructions could be met by inserting the words "while seeking to" before "moderate and impact of." Mr. Shepardson's suggested revision of the first paragraph was acceptable to Mr. Ellis.

Mr. Balderston noted that three weeks ago he had observed that the time was approaching for a policy change, and in his view that time now had arrived. The U.S. representatives at the mid-February meeting of Working Party 3 in Paris might well be met by strong and incisive questioning about American monetary policy. It was hard to see how their answers could carry conviction in the light of U.S. inaction after seven years of high balance of payments deficits, except for the actions of 1963 that had not borne much fruit. Perhaps they could sketch another paper program, but the facts would seem to belie this country's determination to put its house in order. He agreed with Mr. Mitchell that higher returns on capital in foreign countries would tend to draw resources abroad for a long time. He also agreed that selective controls had to be used, as much as he disliked them. But the System had a responsibility of its own; after all, the System and the Treasury were the two arms of the Federal Government that were primarily responsible for the nation's financial husbandry, and the Committee should not expect other agencies to take the lead. In his judgment the System should stand up and be counted--it should lead the way with monetary policy.

Mr. Balderston thought that the policy action should be clearly perceptible. He favored a free reserve target around the zero level with the expectation that there would be net borrowed reserves in some weeks and that the bill rate would go to or above the discount rate;

he would not consider a bill rate of, say, 4.10 per cent to be undesirable. He thought that Mr. Shepardson's suggestions for the directive were appropriate to that end. Such a policy action would support by actual evidence the belief that the System was providing such underpinning to the solution of the balance of payments problem as was within the power of monetary policy.

The crisis was so serious, Mr. Balderston continued, that he would recommend consideration of a further step--limiting Federal Reserve discounting privileges of the banks that were pushing funds abroad. Nine banks apparently had accounted for 80 per cent of the large volume of foreign term loan commitments in the fourth quarter. In general, Mr. Balderston said, what he was urging was that the Federal Reserve be not the last but the first to join in putting together the package of measures that was required.

Chairman Martin commented that the Committee always was faced with the problem of timing, and he personally was never sure that any particular moment was the perfect time to take action. He disagreed with some members of the staff with respect to the domestic economy; in his judgment there was some evidence of overheating in the economy right now. When he heard the question raised as to whether a small policy change would help the balance of payments he recalled the issue the Committee had faced 14 years ago, when it was working toward unpegging the Government bond market. The argument had been made then that a change of, say, 3/32 in bond prices would have no effect at all on the economy, and that it would be necessary to raise interest rates by three percentage points to have any effect. As things worked out, small changes in security prices did produce slight reactions all along the line.

Everyone agreed that monetary policy alone could not deal with the balance of payments problem, the Chairman continued. Again using the analogy to the situation in the early 'fifties, he noted that then, after the domestic economic problem finally was widely recognized, many had urged use of various types of selective controls but had opposed use of general monetary policy. However, without the support of general monetary policy the selective controls had proved inadequate, and it became necessary to use every weapon.

In his judgment, the Chairman said, there was a similar situation today with regard to the payments deficit. Both general and selective measures were needed; and the quicker the country came to grips with the problem the less painful would be its solution. As to the argument that a policy change would retard the domestic expansion, he did not think that a change in interest rates of 1/4 per cent in either direction would make or break the economy. What was at issue was the flow of funds, and one could make a good case to the effect that pulling the sails in a bit would make the boat go faster, rather than the reverse. This admittedly was a difficult area and one could not be sure of his judgments.

Mr. Ellis had made a point that was in his own (Chairman Martin's) mind when he suggested that the Committee should have a little ammunition to deal with any recession that might develop. Although he of course did not favor tightening policy just to be able to ease it if a recession came, he did think that policy had to have some flexibility in both directions if it was to be effective.

In general, the Chairman said, he thought the present was a good time for a policy change. He assumed that the Administration would announce a program of selective measures soon. Most people who had worked in this area seemed at one time or another to come back to the point that selective measures had to be buttressed by general monetary policy. One or the other could be emphasized, and the present situation seemed to require emphasis on selective measures; but without support from general policy the latter were likely to be ineffective. The Administration had come to that conclusion in preparing the balance of payments program of July 1963, and a reference to an increase in the discount rate had been included in the President's message then. In the Chairman's judgment, if there had been no discount rate action at that time the program would have been much less effective, and it still had not solved the problem.

What he advocated, Chairman Martin continued, was restoring reserve availability to about where it was before the increase in the discount rate in November. The second paragraph of alternative B of the draft directive appeared consistent with that objective, as well as with a higher bill rate. The Committee had tended to feel that an easier policy was required after the discount rate action because of the suddenness of that action and because of the sterling crisis and it had deliberately permitted free reserves to go up. That judgment had been quite proper; while it was not possible to separate cost and availability of credit entirely, it was necessary to take expectations into account. It would have been unwise to let free reserves become negative following the discount rate increase in November because such a development might well have upset the market drastically under the conditions existing then. But a restoration of the earlier level of reserve availability was now required, he thought. By adopting the alternative B approach today the Committee would not be leading the Administration; rather, it would be buttressing the actions that would be taken. Today's action could, of course, be reversed at the next meeting if that appeared desirable.

The Chairman then noted that Mr. Shepardson had proposed both a revision in the language of the first paragraph of alternative B and deletion of the last clause of the second paragraph, relating to intermediate- and long-term security markets. He liked Mr. Shepardson's first paragraph. However, the second-paragraph clause appeared to be consistent with the way the Committee had been operating.

Mr. Swan commented that the question of consistency could be argued both ways. In view of the success thus far in keeping long-term rates from rising, inclusion of the final clause now might imply that no rise at all in such rates was expected. He saw no point in taking such a step.

In reply to a question by Mr. Hayes, Mr. Stone remarked that, as he interpreted the discussion today, the Committee recognized that if it adopted alternative B for the directive there would be some reflection of its action in longer-term markets. Accordingly, the Desk would not attempt to offset such a development completely. However, he understood that the Committee would be concerned with the nature and extent of the response and would not want conditions in the longer-term markets to degenerate or run away. The Desk would make an effort to moderate any movement that appeared to be proceeding too rapidly or too far.

Mr. Hayes commented that the latter possibility arose mainly from the fact that dealer inventories of securities issued in the Treasury's advance refunding were still relatively large.

Mr. Daane suggested that the words "while taking into account Treasury financing" be inserted after "To implement this policy," in the second paragraph. This language, he thought, would convey the desired implication that the Committee was aware of the current refunding and the overhang of the advance refunding, and it should give the Desk sufficient guidance on the matter at issue. The final clause then could be omitted.

Mr. Hickman remarked that he had some doubts about the phrase, "the generally strong and continuing expansion of the domestic economy" in Mr. Shepardson's proposed first paragraph. He did not think there was clear evidence that the expansion would continue. In his judgment, the economy was over-heated, and a reduced rate of growth, if not a turn-down, seemed likely.

Mr. Hayes replied that the phrase seemed appropriate to him because the economy clearly was continuing to expand strongly at present. He did not think the phrase implied that the expansion would continue indefinitely.

Mr. Swan asked what the Committee members meant to imply for free reserves by the phrase, "moving toward slightly firmer conditions." Chairman Martin remarked that there obviously were shades of difference in the targets different members had in mind. He personally was thinking in terms of a range within $50 million of zero--the general range prevailing before the discount rate action.

Mr. Daane noted that free reserves at present were in the neighborhood of $50 million. The important point in which he thought a majority concurred was that, against the background of Treasury financing, free reserves should be moved cautiously in the direction of zero, plus or minus. He would prefer to see negative figures appear only after the digestion of the advance refunding issues was completed, but he favored a move in this direction and would be willing to accept negative figures whenever they appeared.

Mr. Shuford asked Chairman Martin what level of bill rates he had in mind, and the Chairman replied that he was thinking in terms of bill rates around the 4 per cent discount rate.

Mr. Swan said he felt obliged to return to the question of a numerical free reserve target. If what the Committee had in mind was a target range of zero to plus $50 million, he would find that acceptable. Mr. Balderston said such a range would not suit him.

Mr. Daane remarked that he would consider a $50 million range to be too narrow. If it was necessary to quantify he would favor a range from minus $50 million to plus $50 million.

Mr. Wayne commented that alternative B of the directive called for moving toward slightly firmer money market conditions, and he thought such an instruction would suffice. Mr. Hayes added that it was not practicable to pinpoint a free reserve target narrowly.

Mr. Swan said he was prepared to grant that precise performance could not be expected, but he was still concerned about the target range to be aimed for.

Chairman Martin said he doubted that it was feasible to get agreement on precise figures; the Committee had been facing this problem all along. He thought the Committee should have a full debate on the subject of quantifying its instructions, but not in connection with a discussion of the directive for a particular meeting.

Mr. Hickman said he understood that the free reserve estimate for the week ending tomorrow was about $50 million at the moment and Chairman Martin asked Mr. Stone whether this estimate was likely to be revised. Mr. Stone said he had just received a report from the Desk indicating that there had been another "miss" on the low side yesterday. After taking into account an upward revision of $70 million, the free reserve estimate for the current week was zero, and the Desk had gone into the market this morning to buy more bills. In connection with the preceding discussion, Mr. Stone added, he quite agreed that the free reserve figures could not be pinpointed; they swung around vigorously. However, if the Committee adopted the directive before it the Desk would undertake to move toward slightly firmer conditions in the money market.

In reply to Mr. Mitchell's question as to how he would interpret that phrase, Mr. Stone said he would anticipate that the bill rate, which was 3.89 per cent now, probably would move up to the neighborhood of the discount rate; that the Federal funds rate usually would be at the discount rate, and sometimes at a premium; and that member bank borrowings might average about $100 million above the levels at which they had been running. The level of free reserves that would be compatible with those conditions would vary widely, depending on the distribution of reserves and the intensity with which they were utilized. Free reserves might come out at zero in one week, minus $25 million in the next, and perhaps plus $45 or $50 million in the week following.

Mr. Shuford said that these guidelines were quite acceptable to him, and Mr. Hickman also expressed agreement with them.

Chairman Martin then proposed that the Committee vote on a directive consisting essentially of Mr. Shepardson's first paragraph and of the second paragraph of the staff's alternative B, with Mr. Daane's amendments.

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

In light of the economic and financial developments reviewed at this meeting, including the generally strong and continuing expansion of the domestic economy and the continuing adverse position of our international balance of payments, it remains the Federal Open Market Committee's current policy to accommodate growth in the reserve base, bank credit, and the money supply but at a more moderate pace than in recent months. This policy seeks to avoid the emergence of inflationary pressures and to support other measures that may be taken to strengthen the international position of the dollar.

> To implement this policy, while taking into account Treasury financing, System Open Market operations over the next four weeks shall be conducted with a view to moving toward slightly firmer conditions in the money market than have prevailed in recent weeks.

Mr. Mitchell said that he had voted against this action because he thought the directive called for more than an imperceptible change in policy and he found it difficult to believe that a perceptible change would really aid the balance of payments situation or the domestic economy.

Mr. Shuford, who had voted affirmatively, said he was not certain that this was the proper moment to change policy. However, he would go along with the majority judgment on the question of timing. Mr. Swan concurred in this statement.

Chairman Martin suggested, for reasons that he mentioned, postponing the discussion of the general subject of specifying quantities in the Committee's directives that tentatively had been scheduled to follow today's meeting, and no objections were made to this suggestion.

The Chairman then noted that barring unforeseen circumstances today's meeting of the Open Market Committee was the last that Mr. Mills would attend. He knew that all of the members had considered it a privilege to work with Mr. Mills and everyone would miss him.

It was agreed the next meeting of the Committee would be on Tuesday, March 2, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.

Ralph A. Young

Secretary

Attachment A

CONFIDENTIAL (FR)

February 1, 1965

Draft Current Economic Policy Directives for Consideration by the Federal Open Market Committee at its Meeting on February 2, 1965.

Alternative A (No change in policy)

In light of the economic and financial developments reviewed at this meeting, and taking Treasury financing operations into account, it remains the Federal Open Market Committee's current policy to facilitate continued expansion of the economy by accommodating moderate growth in the reserve base, bank credit, and the money supply, while seeking to avoid the emergence of inflationary pressures and to strengthen the international position of the dollar.

To implement this policy, System open market operations over the next four weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Alternative B (some firming of policy)

In light of the economic and financial developments reviewed at this meeting, it is the Federal Open Market Committee's current policy to strengthen the international position of the dollar by accommodating growth in the reserve base, bank credit, and the money supply at a somewhat slower pace than in recent months. The Committee also seeks to facilitate continued expansion of the economy and to avoid the emergence of inflationary pressures.

To implement this policy, System open market operations over the next four weeks shall be conducted with a view to moving toward slightly firmer conditions in the money market than have prevailed in recent weeks, while moderating the impact of these conditions in markets for intermediate- and long-term securities.