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, D. C., on Tuesday, March 2, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Bryan
Mr. Daane
Mr. Ellis
Mr. Mitchell
Mr. Robertson 1/
Mr. Scanlon
Mr. Shepardson
Mr. Clay, Alternate for President of Minneapolis Bank

Messrs. Bopp, Hickman, and Irons, Alternate Members of the Federal Open Market Committee

Messrs. Wayne, Shuford, and Swan, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Brill, Garvy, Holland, Koch, and Taylor, Associate Economists
Mr. Stone, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Molony, Assistant to the Board of Governors
Mr. Farrell, Director, Division of Bank Operations, Board of Governors 2/
Messrs. Partee and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Associate Adviser, Division of International Finance, Board of Governors

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1/ Entered the meeting at the point indicated.
2/ Left the meeting at the point indicated.

Mr. Axilrod, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss Roberts, Secretary, Office of the Secretary, Board of Governors

Mr. Strothman, First Vice President of the Federal Reserve Bank of Minneapolis
Messrs. Eisenmenger, Eastburn, Mann, Ratchford, Parsons, Tow, Doll, and Green, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Cleveland, Richmond, Minneapolis, Kansas City, Kansas City, and Dallas, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Bowsher, Assistant Vice President of the Federal Reserve Bank of St. Louis
Mr. Meek, Manager, Securities Department, Federal Reserve Bank of New York

In the agenda for this meeting, the Secretary reported that advices had been received of the election by the Federal Reserve Banks of members and alternate members of the Federal Open Market Committee for the term of one year beginning March 1, 1965, and it appeared that such persons would be legally qualified to serve after they had executed their oaths of office.

The elected members and alternates were as follows:

George H. Ellis, President of the Federal Reserve Bank of Boston, with Karl R. Bopp, President of the Federal Reserve Bank of Philadelphia, as alternate;

Alfred Hayes, President of the Federal Reserve Bank of New York, with William F. Treiber, First Vice President of the Federal Reserve Bank of New York, as alternate;

Malcolm Bryan, President of the Federal Reserve Bank of Atlanta, with Watrous H. Irons, President of the Federal Reserve Bank of Dallas, as alternate;

Charles J. Scanlon, President of the Federal Reserve Bank of Chicago, with W. Braddock Hickman, President of the Federal Reserve Bank of Cleveland, as alternate;

The person who is on March 1, 1965, or who shall thereafter become, the President of the Federal Reserve Bank of Minneapolis, with George H. Clay, President of the Federal Reserve Bank of Kansas City, as alternate.

At the time of this meeting no person had as yet been named President of the Federal Reserve Bank of Minneapolis. All other elected members and alternates had now executed their oaths of office.

Upon motion duly made and seconded, and by unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after February 28, 1966, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, as the case might be, they would cease to have any official connection with the Federal Open Market Committee:

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| Wm. McC. Martin, Jr. | Chairman |
| Alfred Hayes | Vice Chairman |
| Ralph A. Young | Secretary |
| Merritt Sherman | Assistant Secretary |
| Kenneth A. Kenyon | Assistant Secretary |
| Arthur L. Broida | Assistant Secretary |
| Howard H. Hackley | General Counsel |
| David B. Hexter | Assistant General Counsel |
| Guy E. Noyes | Economist |
| Ernest T. Baughman, Daniel H. Brill, George Garvy, Robert C. Holland, Albert R. Koch, Charles T. Taylor, and Parker B. Willis | Associate Economists |

Upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Federal Open Market Committee after February 28, 1966.

Upon motion duly made and seconded, and by unanimous vote, Robert W. Stone and Charles A. Coombs were selected to serve at the pleasure of the Federal Open Market Committee as Manager of the System Open Market Account and as Special Manager for foreign currency operations for such Account, respectively, it being understood that their selection was subject to their being satisfactory to the Board of Directors of the Federal Reserve Bank of New York.

Secretary's note: Advice subsequently was received that Messrs. Stone and Coombs were satisfactory to the Board of Directors of the Federal Reserve Bank of New York for service in the respective capacities indicated.

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on February 2, 1965, were approved

Consideration then was given to the continuing authorizations of the Committee, according to the customary practice of reviewing such matters at the first meeting in March of each year, and the actions set forth hereinafter were taken.

Chairman Martin noted that a memorandum from Mr. Stone had been distributed to the Committee proposing certain revisions in the continuing authority directive regarding transactions in U.S. Government securities and bankers' acceptances, and he invited Mr. Stone to comment. (A copy of this memorandum, dated February 17, 1965, and entitled "Maturity limitation on repurchase agreements during Treasury refundings," has been placed in the files of the Committee.)

Mr. Stone said that his memorandum outlined a technical problem the Account Management often encountered during Treasury financing operations, particularly advance refundings, because of the 24-month

maturity limit on Government securities that might be held under repurchase agreements specified in Section 1(c) of the continuing authority directive. As indicated in the memorandum, this limit at times had caused the Management to terminate repurchase agreements against "rights" in refundings the day after the subscription books closed and several days before settlement. The rights in question were those that dealers had committed for exchange for new securities of longer than two years to maturity. These terminations often were burdensome to the market and inconvenient to the System. He recommended a revision of the directive that would make them unnecessary, in order to maximize the effectiveness of operations during periods when Treasury refundings were in process. From the dealers' standpoint, the change would mean that the "rights" turned in for exchange could be carried to the settlement date of the financing if the Desk chose to make agreements running that long. The simplest procedure would be to eliminate the maturity limit on Government securities held under repurchase agreements altogether. Alternatively, the limit could be waived during Treasury refundings and retained at other times. In either case repurchase agreements would continue to be made for a maximum of 15 days.

Mr. Mitchell said he had no objection to the alternative procedure Mr. Stone had mentioned but he would not favor removing the maturity limit entirely. In his judgment the latter action might encourage dealers to hold larger amounts of longer-term securities and to speculate in them, thereby hampering operations of the Committee.

Mr. Stone said that there might be occasions when a considerable part of the dealers' financing needs were concentrated in longer-term securities. But whether the Desk would help finance those holdings would depend strictly on the reserve situation at the time; the Desk would not make repurchase agreements against the securities in question if there was no need to provide reserves.

Mr. Daane agreed that it was desirable to avoid recurrences of the situation in which it was necessary to terminate repurchase agreements at inconvenient times. But he shared Mr. Mitchell's reluctance to remove the maturity limit entirely, even though the Desk would retain discretion with respect to whether to enter into particular agreements. He asked whether it would be feasible to take the more limited step of authorizing repurchase agreements only against rights turned in for longer-term securities which dealers had already sold on a when-issued basis.

Mr. Stone replied that such a procedure was a possibility. He would not recommend it, however, because it would require policing operations by the Account Management of a kind that he would not consider desirable.

Mr. Bryan said he also favored the alternative Mr. Stone had mentioned of removing the maturity limit only during the periods of Treasury refunding operations.

In response to Mr. Hayes' request that the Manager clarify his recommendation, Mr. Stone said that in the memorandum he had recommended removal of the maturity limit entirely. But he had never found the

limit to disadvantage operations except at times of Treasury financings. Accordingly, he thought the alternative to which Mr. Bryan had referred would solve the problem.

Mr. Hayes said he would register a mild dissent. As a practical matter he agreed that the alternative would meet the problem Mr. Stone had described, but he did not think any purpose would be served by retaining the maturity limit for periods when refundings were not in process. He could not believe that removing the limit entirely would have any significant effect on dealers' willingness to hold longer-term securities in their portfolios. Thus, he would prefer the broader authority.

Chairman Martin commented that, in view of the questions that had been raised about the desirability of removing completely the maturity limit on Government securities held under repurchase agreements, it might be desirable for the Committee to vote on a continuing authority directive amended in line with the alternative suggestion of removing this limit only during periods in which a Treasury refunding was in process.

Mr. Mitchell then said he would like to raise another question with respect to the directive under discussion, concerning Section 1(b) which authorized transactions in bankers' acceptances. His question was whether it would be appropriate to let the System's inventory run down by reducing holdings of the types of acceptances that the System was trying to discourage under the voluntary foreign credit restraint program. He had heard that as much as one-third of all U.S. bankers' acceptances financed third-country trade. In this connection he thought

it would be desirable at some point for Mr. Stone to report to the Committee on the nature of the bankers' acceptances held by the System Account.

Mr. Hayes commented that he was not sure about the present status of the draft guidelines for the voluntary credit restraint program, but he did not think there would be a general ban on financing third-country trade. By far the largest part of such trade financed by U.S. bank acceptances involved Japan, and as he understood the arrangements worked out on a Governmental level, it was agreed that the total amount of U.S. bank credit to Japan would be kept roughly at present levels. In his judgment it would be unwise for the System to begin making distinctions in its acceptance operations that would not be reflected in the guidelines.

Mr. Mitchell said that he did not think the System should take acceptances off the hands of banks if that would free funds for the banks to use in extending other foreign credits. The System's portfolio of acceptances should be going down; it should be buying a minimum number, reducing its purchases of those given a low priority under the program. Having launched a voluntary restraint program, the System should make sure its own actions were consistent with what it was asking others to do.

Mr. Hayes remarked that the amounts involved were quite small; the dollar maximum of System holdings of acceptances specified in the directive was $125 million, and actual holdings usually were less than

that. While the principle Mr. Mitchell had expressed was a good one, he questioned whether it was workable.

Mr. Mitchell commented that it should be workable if detailed information was available on the make-up of the System's portfolio of bankers' acceptances. Mr. Stone observed that he could arrange to have an inventory of the portfolio prepared.

Mr. Scanlon noted that when the Committee had authorized an increase in the dollar limit on System holdings of acceptances on November 10, 1964, it had agreed that it would reassess its participation in the bankers' acceptance market at the time of this annual organization meeting.

Chairman Martin indicated that the annual meeting was an appropriate time to discuss this matter.

Mr. Shepardson said that in the earlier discussion, as he recalled it, it had been noted that the Committee originally had authorized operations in acceptances to help re-establish the market for this type of instrument. But there had been a significant expansion of the acceptance market in recent years. This raised the questions of whether the Committee's objectives had been accomplished, and, if so, whether any purpose would be served by its continued participation in the acceptance market.

Chairman Martin said he questioned whether the Committee's goals had been fully accomplished. He asked whether Mr. Stone would like to comment on this general subject.

Mr. Stone observed that this market was capable of still further growth. The Committee's efforts to encourage its development had been eminently successful; it had grown to a point at which it was contributing significantly to U.S. foreign trade. Moreover, the market now could provide a highly useful supplement to the Government securities market in open market operations. As a result of the balance of payments problem the System now was operating in ways that no one had contemplated seven or eight years ago, and it was drawing on all available resources. The acceptance market had now become such a resource; by buying acceptances it was possible to supply substantial amounts of reserves at times without putting downward pressure on short-term bill rates.

Furthermore, Mr. Stone said, under the terms of the Federal Reserve Act and several Board regulations, the System was concerned with the field of bankers' acceptances. By dealing in acceptances and holding them in portfolio, the Account Management kept continuously before it a view of what was going on in the field. This continuing surveillance of the market was important in determining whether acceptance financing was in accordance with the statute and with Board regulations. In his judgment it was highly desirable for the Committee to continue to participate in the acceptance market.

Mr. Mitchell commented that the Committee's policy with respect to the acceptance market had been developed at a time when the United States had a large surplus in its international payments. But now that the nation had a deficit he doubted whether it was desirable to

continue to encourage the development of the market if such actions contributed to the volume of capital outflows. What was necessary, he thought, was an analysis of the characteristics of the System's portfolio of acceptances.

Mr. Daane observed that such an analysis would be useful. On the whole, however, he was inclined to agree with Mr. Stone; he thought the acceptance market promoted U.S. foreign trade, and that one should not consider it simply in terms of its effects on capital flows.

Mr. Hayes thought that Mr. Mitchell's argument was based on an overly short-run view of the acceptance market. In his (Mr. Hayes') opinion, its development was highly desirable from a longer-run standpoint. The market would be affected by the voluntary restraint program, but he did not think the Committee should stop participating in it and thereby diminish the vitality of an instrument that had proved to be generally useful over the years.

Chairman Martin said he doubted whether the Committee should act today to change the nature of its operations in the bankers' acceptance market; further study was required. He suggested that Mr. Stone be asked to prepare a memorandum on the System's portfolio of acceptances, and that the Committee plan to discuss the matter further at its next meeting. There were no objections to this suggestion.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Open Market Account in accordance with

the following continuing authority directive relating to transactions in U.S. Government securities and bankers' acceptances:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $1.5 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed $125 million or 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York;

(c) To buy U.S. Government securities with maturities as indicated below, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or

acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market. U.S. Government securities bought under the provisions of this section shall have maturities of 24 months or less at the time of purchase, except that, during any period beginning with the day after the Treasury has announced a refunding operation and ending on the day designated as the settlement date for the exchange, the U.S. Government securities bought may be of any maturity.

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates or indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate 1/4 of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $500 million.

Upon motion duly made and seconded, and by unanimous vote, the Authorization Regarding Open Market Transactions in Foreign Currencies, as reaffirmed March 3, 1964, was reaffirmed:

## AUTHORIZATION REGARDING OPEN MARKET TRANSACTIONS IN FOREIGN CURRENCIES

Pursuant to Section 12A of the Federal Reserve Act and in accordance with Section 214.5 of Regulation N (as amended) of the Board of Governors of the Federal Reserve System, the Federal Open Market Committee takes the following action governing open market operations incident to the opening and maintenance by the Federal Reserve Bank of New York (hereafter sometimes referred to as the New York Bank) of accounts with foreign central banks.

### I. Role of Federal Reserve Bank of New York

The New York Bank shall execute all transactions pursuant to this authorization (hereafter sometimes referred to as transactions in foreign currencies) for the System Open Market Account, as defined in the Regulation of the Federal Open Market Committee.

### II. Basic Purposes of Operations

The basic purposes of System operations in and holdings of foreign currencies are:

(1) To help safeguard the value of the dollar in international exchange markets;
(2) To aid in making the existing system of international payments more efficient and in avoiding disorderly conditions in exchange markets;
(3) To further monetary cooperation with central banks of other countries maintaining convertible currencies, with the International Monetary Fund, and with other international payments institutions;
(4) Together with these banks and institutions, to help moderate temporary imbalances in international payments that may adversely affect monetary reserve positions; and
(5) In the long run, to make possible growth in the liquid assets available to international money markets in accordance with the needs of an expanding world economy.

## III. Specific Aims of Operations

Within the basic purposes set forth in Section II, the transactions shall be conducted with a view to the following specific aims:

(1) To offset or compensate, when appropriate, the effects on U.S. gold reserves or dollar liabilities of disequilibrating fluctuations in the international flow of payments to or from the United States, and especially those that are deemed to reflect temporary forces or transitional market unsettlement:

(2) To temper and smooth out abrupt changes in spot exchange rates and moderate forward premiums and discounts judged to be disequilibrating;

(3) To supplement international exchange arrangements such as those made through the International Monetary Fund; and

(4) In the long run, to provide a means whereby reciprocal holdings of foreign currencies may contribute to meeting needs for international liquidity as required in terms of an expanding world economy.

## IV. Arrangements with Foreign Central Banks

In making operating arrangements with foreign central banks on System holdings of foreign currencies, the New York Bank shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee.

The Bank shall instruct foreign central banks regarding the investment of such holdings in excess of minimum working balances in accordance with Section 14(e) of the Federal Reserve Act.

The Bank shall consult with foreign central banks on coordination of exchange operations.

Any agreements or understandings concerning the administration of the accounts maintained by the New York Bank with the central banks designated by the Board of Governors under Section 214.5 of Regulation N (as amended) are to be referred for review and approval to the Committee, subject to the provision of Section VIII, paragraph 1, below.

V. Authorized Currencies

The New York Bank is authorized to conduct transactions for System Account in such currencies and within the limits that the Federal Open Market Committee may from time to time specify.

VI. Methods of Acquiring and Selling Foreign Currencies

The New York Bank is authorized to purchase and sell foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the Stabilization Fund of the Secretary of the Treasury established by Section 10 of the Gold Reserve Act of 1934 and with foreign monetary authorities.

Unless the Bank is otherwise authorized, all transactions shall be at prevailing market rates.

VII. Participation of Federal Reserve Banks

All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G (1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

VIII. Administrative Procedures

The Federal Open Market Committee authorizes a Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) to give instructions to the Special Manager, within the guidelines issued by the Committee, in cases in which it is necessary to reach a decision on operations before the Committee can be consulted.

All actions authorized under the preceding paragraph shall be promptly reported to the Committee.

The Committee authorizes the Chairman, and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors:

(1) With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;
(2) To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities;
(3) From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Problems.

IX. Special Manager of the System Open Market Account

A Special Manager of the Open Market Account for foreign currency operations shall be selected in accordance with the established procedures of the Federal Open Market Committee for the selection of the Manager of the System Open Market Account.

The Special Manager shall direct that all transactions in foreign currencies and the amounts of all holdings in each authorized foreign currency be reported daily to designated staff officials of the Committee. and shall regularly consult with the designated staff officials of the Committee on current tendencies in the flow of international payments and on current developments in foreign exchange markets.

The Special Manager and the designated staff officials of the Committee shall arrange for the prompt transmittal to the Committee of all statistical and other information relating to the transactions in and the amounts of holdings of foreign currencies for review by the Committee as to conformity with its instructions.

The Special Manager shall include in his reports to the Committee a statement of bank balances and investments payable in foreign currencies, a statement of net profit or loss on transactions to date, and a summary of outstanding unmatured contracts in foreign currencies.

X. Transmittal of Information to Treasury Department

The staff officials of the Federal Open Market Committee shall transmit all pertinent information on System foreign currency transactions to designated officials of the Treasury Department.

XI. Amendment of Authorization

The Federal Open Market Committee may at any time amend or rescind this authorization.

Chairman Martin then noted that Mr. Coombs had proposed certain revisions in the guidelines for System foreign currency operations in a memorandum to the Committee dated February 25, 1965, and he invited Mr. Coombs to comment. (A copy of the memorandum referred to has been placed in the files of the Committee.)

Mr. Coombs observed that the changes he proposed were primarily matters of form rather than substance. As indicated in his memorandum, they involved deletions of certain language relating to the original launching of operations, consolidation of certain material, and other clarifying revisions.

Mr. Mitchell remarked that he had no objection to the proposed changes, but would like to raise a question. It was his recollection that when the Committee began operations in foreign currencies it was concerned with the position of the dollar as such rather than in its role as a reserve currency. However, in Mr. Coombs' annual report, as submitted for publication in the Board's Annual Report for 1964, the dollar was discussed primarily from the reserve-currency standpoint. Unless this was appreciated, the purposes for which the Account Management had intervened in foreign exchange markets on many occasions during the year were rather obscure. His question was whether the proposed revised guidelines adequately reflected consideration of the dollar as such, as opposed to its reserve-currency status.

Mr. Coombs replied that he thought the U.S. gold stock was under two kinds of pressure--that of direct flows from the United States to other countries, and that of third-country flows arising because the dollar was a reserve currency. This distinction was not spelled out in the guidelines; rather, it was taken for granted that the dollar was a reserve currency and the Account Management had operated in that context.

Mr. Mitchell suggested that thought might be given to making this distinction explicit. It seemed to him that many of the Account Management's operations were concerned with the dollar in its reserve-currency role.

Mr. Coombs said he would find it difficult to make the distinction in practice, although he agreed with Mr. Mitchell that many operations actually undertaken would be unnecessary if the dollar was not a reserve currency.

Mr. Daane remarked that in talking about safeguarding the dollar one necessarily had both of its roles in view. He thought it would be unwise to attempt to make explicit the distinction to which Mr. Mitchell had referred. Messrs. Hayes and Bryan concurred in this view.

Mr. Ellis noted that in Section 4 of the proposed new guidelines it was said that transactions in forward exchange "may prove desirable" under certain described circumstances. This was a rather indefinite statement; in his judgment it would be better to indicate that forward operations were specifically authorized in the circumstances described, consistently with the construction in other passages of the guidelines.

After discussion, in the course of which the relationship between the guidelines and the continuing authority directive for foreign currency operations was touched on, Chairman Martin suggested that the Committee vote on the guidelines as proposed in Mr. Coombs' memorandum, with the understanding that revisions to deal with the problem Mr. Ellis had noted might be considered at the next meeting.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the Guidelines for System Foreign Currency Operations were amended to read as follows:

GUIDELINES FOR SYSTEM FOREIGN CURRENCY OPERATIONS

1. Holdings of Foreign Currencies

Until otherwise authorized, the System will limit its holdings of foreign currencies to that amount necessary to enable its operations to exert a market influence. Holdings of larger amounts will be authorized only when the U.S. balance of international payments attains a sufficient surplus to permit the ready accumulation of holdings of major convertible currencies.

Foreign currency holdings shall be invested as far as practicable in conformity with Section 14(e) of the Federal Reserve Act.

2. Exchange Transactions

System exchange transactions shall be geared to pressures of payments flows so as to cushion or moderate disequilibrating movements of funds and their destablizing effects on U.S. and foreign official reserves and on exchange markets.

In general, these transactions shall be geared to pressures connected with movements that are expected to be reversed in the foreseeable future; when expressly authorized by the Federal Open Market Committee, they may also be geared on a short-term basis to pressures connected with other movements.

Subject to express authorization of the Committee, the Federal Reserve Bank of New York may enter into reciprocal arrangements with foreign central banks on exchange transactions ("swap" arrangements), which arrangements may be wholly or in part on a standby basis.

Drawings made by either party under a reciprocal arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

The New York Bank shall, as a usual practice, purchase and sell authorized currencies at prevailing market rates without trying to establish rates that appear to be out of line with underlying market forces.

If market offers to sell or buy intensify as System holdings increase or decline, this shall be regarded as a clear signal for a review of the System's evaluation of international payments flows.

It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions in order that System transactions do not conflict with those being undertaken by foreign monetary authorities.

3. Transactions in Spot Exchange

The guiding principle for transactions in spot exchange shall be that, in general, market movements in exchange rates, within the limits established in the International Monetary Fund Agreement or by central bank practices, index affirmatively the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public.

Temporary or transitional fluctuations in payments flows may be cushioned or moderated whenever they occasion market anxieties, or undesirable speculative activity in foreign exchange transactions, or excessive leads and lags in international payments.

Special factors making for exchange market instabilities include (i) responses to short-run increases in international political tension, (ii) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, or (iii) market rumors of a character likely to stimulate speculative transactions.

Whenever exchange market instability threatens to produce disorderly conditions, System transactions are appropriate if the Special Manager, in consultation with the Federal Open Market Committee, or in an emergency with the members of the Committee designated for that purpose, reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified, curtailed, or eventually discontinued pending a reassessment by the Committee of supply and demand forces.

Insofar as is practicable, the New York Bank shall purchase a currency through spot transactions at or below its par value, and sell a currency through spot transactions at rates at or above its par value.

Spot transactions at rates other than those set forth in the preceding paragraph shall be specially authorized by the Committee or by the members of the Committee designated in Section VIII of the Authorization for Open Market Transactions in Foreign Currencies, except that purchases of exchange to meet System commitments may be executed without special authorization at rates above par when necessary.

4. <u>Transactions in Forward Exchange</u>

Transactions in forward exchange, either outright or in conjunction with spot transactions, may prove desirable:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;

(2) When it is deemed appropriate to supplement existing market supplies of forward cover, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;

(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;

(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies may also prove desirable in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

Upon motion duly made and seconded, and by unanimous vote, the following continuing authority directive to the Federal Reserve Bank of New York with respect to foreign currency operations was approved:

The Federal Reserve Bank of New York is authorized and directed to purchase and sell through spot transactions any or all of the following currencies in accordance with the Guidelines on System Foreign Currency Operations as amended March 2, 1965; provided that the aggregate amount of foreign currencies held under reciprocal currency arrangements shall not exceed $2.35 billion equivalent at any one time, and provided further that the aggregate amount of foreign currencies held as a result of outright purchases shall not exceed $150 million equivalent at any one time:

Pounds sterling
French francs
German marks
Italian lire
Netherlands guilders
Swiss francs
Belgian francs
Canadian dollars
Austrian schillings
Swedish kronor
Japanese yen

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $275 million equivalent, by means of:

(a) purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;

(b) purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;

(c) purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions, for the purpose of influencing interest arbitrate flows of funds and of minimizing speculative disturbances.

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

Chairman Martin then asked Mr. Stone to comment on proposed revisions in the procedures for allocations of the System Open Market Account.

Mr. Stone noted that a bill to remove the gold certificate reserve requirement against deposits at Federal Reserve Banks had passed both houses of Congress and presumably would be signed by the President shortly. Mr. Farrell and he recommended that the Committee make certain deletions in the existing statement of procedures to become effective when the bill was signed. This would be a temporary measure, pending a general review of the procedures. First, they would suggest deleting the word "combined" as a qualifier of the term "reserve ratios" in the first and second paragraphs. Secondly, since

the Account now would need to be reallocated only once a month, they proposed deleting the words in the first paragraph calling for weekly reallocations. Finally, they would delete the words "or to such higher level as may be necessary to eliminate the deficiency in note or deposit reserves" at the end of the second sentence of the second paragraph. The resulting statement then would be applicable to a situation in which gold certificate reserves were required only against Federal Reserve notes.

Chairman Martin suggested that the Committee vote on the revised procedures with the understanding that they would be employed temporarily while the general study to which Mr. Stone had referred was in process. He thought it would be desirable for this study to be undertaken immediately.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the following procedures with respect to allocations of the System Open Market Account were approved, effective upon the date at which the bill removing gold certificate requirements against deposits at Federal Reserve Banks became law:

1. Securities in the System Open Market Account shall be reallocated on the last business day of each month by means of adjustments proportionate to the adjustments that would have been required to equalize approximately the average reserve ratios of the 12 Federal Reserve Banks based on the most recent available five business days' reserve ratio figures.

2. The Board's staff shall calculate, in the morning of each business day, the reserve ratios of each Bank after allowing for the indicated effects of the settlement of the Interdistrict Settlement Fund for the preceding day. If these calculations should disclose a deficiency in the reserve

NOTE: The bill referred to was signed by the President on March 3, 1965.

ratio of any Bank, the Board's staff shall inform the Manager of the System Open Market Account, who shall make a special adjustment as of the previous day to restore the reserve ratio of that Bank to the average of all the Banks. However, such adjustments shall not be made beyond the point where a deficiency would be created at any other Bank. Such adjustments shall be offset against the participation of the Bank or Banks best able to absorb the additional amount or, at the discretion of the Manager, against the participation of the Federal Reserve Bank of New York. The Board's staff and the Bank or Banks concerned shall then be notified of the amounts involved and the Interdistrict Settlement Fund shall be closed after giving effect to the adjustments as of the preceding business day.

3. Until the next reallocation the Account shall be apportioned on the basis of the ratios determined in paragraph 1, after allowing for any adjustments as provided for in paragraph 2.

4. Profits and losses on the sale of securities from the Account shall be allocated on the day of delivery of the securities sold on the basis of each Bank's current holdings at the opening of business on that day.

Mr. Farrell left the meeting at this point.

A proposed list for distribution of periodic reports prepared by the Federal Reserve Bank of New York for the Federal Open Market Committee was presented for consideration and approval.

Thereupon, upon motion duly made and seconded, and by unanimous vote, authorization was given for the following distribution:

1. The Members of the Board of Governors
2. The Presidents of the twelve Federal Reserve Banks.
3. Officers of the Federal Open Market Committee.
*4. The Secretary of the Treasury.
*5. The Under Secretary of the Treasury for Monetary Affairs and the Deputy Under Secretary for Monetary Affairs.
*6. The Assistant to the Secretary of the Treasury working on debt management problems.
*7. The Fiscal Assistant Secretary of the Treasury.

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* Weekly reports of open market operations only.

8. The Director of the Division of Bank Operations of the Board of Governors.
9. The officer in charge of research at each of the Federal Reserve Banks not represented by its President on the Federal Open Market Committee.
10. The alternate member of the Federal Open Market Committee from the Federal Reserve Bank of New York; the Assistant Vice Presidents of the Federal Reserve Bank of New York working under the Manager of the System Accout; the Managers of the Securities Department of the New York Bank; the Vice President of the Foreign Function having supervisory responsibility for operations; the Senior Foreign Exchange Officer of the Foreign Function; the Managers of the Foreign Department; the officer in charge, the Assistant Vice President, and the Adviser of the Research Department of the New York Bank; and the confidential files of the New York Bank as the Bank selected to execute transactions for the Federal Open Market Committee.
11. With the approval of a member of the Federal Open Market Committee or any other President of a Federal Reserve Bank, with notice to the Secretary, any other employee of the Board of Governors or a Federal Reserve Bank.

The Committee reaffirmed by unanimous vote the authorization, first given on March 1, 1951, for the Chairman to appoint a Federal Reserve Bank to operate the System Open Market Account temporarily in case the Federal Reserve Bank of New York is unable to function.

The following resolution to provide for the continued operation of the Federal Open Market Committee during an emergency was reaffirmed by unanimous vote:

In the event of war or defense emergency, if the Secretary or Assistant Secretary of the Federal Open Market Committee (or in the event of the unavailability of both of them, the Secretary or Acting Secretary of the Board of Governors of the Federal Reserve System) certifies that as a result of the emergency the available number of regular members and regular alternates of the Federal Open Market Committee is less than seven, all powers and functions of the said Committee shall be performed and exercised by, and authority to exercise such powers and functions is hereby delegated to, an Interim Committee, subject to the following terms and conditions:

Such Interim Committee shall consist of seven members, comprising each regular member and regular alternate of the Federal Open Market Committee then available, together with an additional number, sufficient to make a total of seven, which shall be made up in the following order of priority from those available: (1) each alternate at large (as defined below); (2) each President of a Federal Reserve Bank not then either a regular member or an alternate; (3) each First Vice President of a Federal Reserve Bank; provided that (a) within each of the groups referred to in clauses (1), (2), and (3) priority of selection shall be in numerical order according to the numbers of Federal Reserve Districts, (b) the President and the First Vice President of the same Federal Reserve Bank shall not serve at the same time as members of the Interim Committee, and (c) whenever a regular member or regular alternate of the Federal Open Market Committee or a person having a higher priority as indicated in clauses (1), (2), and (3) becomes available he shall become a member of the Interim Committee in the place of the person then on the Interim Committee having the lowest priority. The Interim Committee is hereby authorized to take action by majority vote of those present whenever one or more members thereof are present, provided that an affirmative vote for the action taken is cast by at least one regular member, regular alternate, or President of a Federal Reserve Bank. The delegation of authority and other procedures set forth above shall be effective only during such period or periods as there are available less than a total of seven regular members and regular alternates of the Federal Open Market Committee.

As used herein the term "regular member" refers to a member of the Federal Open Market Committee duly appointed or elected in accordance with existing law; the term "regular alternate" refers to an alternate of the Committee duly elected in accordance with existing law and serving in the absence of the regular member for whom he was elected; and the term "alternate at large" refers to any other duly elected alternate of the Committee at a time when the member in whose absence he was elected to serve is available.

The following resolution authorizing certain actions by the Federal Reserve Banks during an emergency was reaffirmed by unanimous vote:

The Federal Open Market Committee hereby authorizes each Federal Reserve Bank to take any or all of the actions set forth below during war or defense emergency when such Federal Reserve Bank finds itself unable after reasonable efforts to

be in communication with the Federal Open Market Committee (or with the Interim Committee acting in lieu of the Federal Open Market Committee) or when the Federal Open Market Committee (or such Interim Committee) is unable to function.

(1) Whenever it deems it necessary in the light of economic conditions and the general credit situation then prevailing (after taking into account the possibility of providing necessary credit through advances secured by direct obligations of the United States under the last paragraph of section 13 of the Federal Reserve Act), such Federal Reserve Bank may purchase and sell obligations of the United States for its own account, either outright or under repurchase agreement, from and to banks, dealers, or other holders of such obligations.

(2) In case any prospective seller of obligations of the United States to a Federal Reserve Bank is unable to tender the actual securities representing such obligations because of conditions resulting from the emergency, such Federal Reserve Bank may, in its discretion and subject to such safeguards as it deems necessary, accept from such seller, in lieu of the actual securities, a "due bill" executed by the seller in form acceptable to such Federal Reserve Bank stating in substantial effect that the seller is the owner of the obligations which are the subject of the purchase, that ownership of such obligations is thereby transferred to the Federal Reserve Bank, and that the obligations themselves will be delivered to the Federal Reserve Bank as soon as possible.

(3) Such Federal Reserve Bank may in its discretion purchase special certificates of indebtedness directly from the United States in such amounts as may be needed to cover overdrafts in the general account of the Treasurer of the United States on the books of such Bank or for the temporary accommodation of the Treasury, but such Bank shall take all steps practicable at the time to insure as far as possible that the amount of obligations acquired directly from the United States and held by it, together with the amount of such obligations so acquired and held by all other Federal Reserve Banks, does not exceed $5 billion at any one time.

Authority to take the actions above set forth shall be effective only until such time as the Federal Reserve Bank is able again to establish communications with the Federal Open Market Committee (or the Interim Committee), and such Committee is then functioning.

By unanimous vote the Committee reaffirmed the authorization, first given at the meeting on December 16, 1958, providing for System personnel assigned to the Office of Emergency Planning, Special Facilities Branch (formerly, Office of Civil and Defense Mobilization--Classified Location) on a rotating basis to have access to the resolutions (1) providing for continued operation of the Committee during an emergency and (2) authorizing certain actions by the Federal Reserve Banks during an emergency.

There was unanimous agreement that no action should be taken to change the existing procedure, as called for by resolution adopted June 21, 1939, requesting the Board of Governors to cause its examining force to furnish the Secretary of the Federal Open Market Committee a report of each examination of the System Open Market Account.

Reference was made to the procedure authorized at the meeting of the Committee on March 2, 1955, and most recently reaffirmed on March 3, 1964, whereby, in addition to members and officers of the Committee and Reserve Bank Presidents not currently members of the Committee minutes and other records could be made available to any other employee of the Board of Governors or of a Federal Reserve Bank with the approval of a member of the Committee or another Reserve Bank President, with notice to the Secretary.

It was stated that lists of currently authorized persons at the Board and at each Federal Reserve Bank (excluding secretaries and records and duplicating personnel) had recently been confirmed by the Secretary of the Committee. The current lists were reported to be in the custody of the Secretary, and it was noted that revisions could be sent to the Secretary at any time.

It was agreed unanimously that no action should be taken at this time to amend the procedure authorized on March 2, 1955.

This concluded the consideration of the continuing authorizations of the Open Market Committee, and the Committee turned to a review of operations during the period since the meeting of the Committee held on February 2, 1965.

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 February 2 through February 24, 1965, and a supplemental report for February 25 through March 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 might be reduced this week by $125 million in order to replenish the Stabilization Fund, which ended the month of February with a balance of $56 million. Scheduled sales of gold during March already amounted to $270 million and the French would probably request--either in March or April--an additional $150 million, which would lift the total to $420 million. This would increase gold losses since the beginning of the year to nearly $900 million. Meanwhile, pressure was continuing on the London gold market. The cost of intervention in February was $86 million, and the U.S. share of Gold Pool sales came to $43 million. The drain on the Gold Pool had now reached the figure

of $160 million out of the $270 million available. Most of the pressure on the market was attributable to continuing French attacks on the dollar and sterling; as far as he could tell only a minor part originated in the Viet Nam situation. In recent weeks, the Chinese Communist Government had also exerted further pressure on the market by regular purchases of gold, which now totaled more than $30 million. He was not sure how much the Chinese had in the way of funds to continue such purchases, but he suspected their resources were meager and soon would run out.

Mr. Coombs reported that at Basle this coming weekend (March 6-7) there would be discussions of the future of the Gold Pool if the $270 million should be exhausted. He thought it would be highly advisable in the present atmosphere to prevent the London price from going over $35.20 even if this country's Gold Pool partners were unwilling to continue to share with the U.S. the cost of intervention in the London gold market, so that the full cost of intervention had to be absorbed by this country.

Thus, Mr. Coombs remarked, the immediate outlook in general was for very heavy pressure on the U.S. gold stock, further aggravated by speculative pressure on the London gold market. Confidence in the dollar, which had become rather shaky in the past two or three weeks, could be undermined still further, and in the next few weeks the U.S. could be brought dangerously close to another crisis such as was experienced in the fall of 1960.

On the exchange markets, Mr. Coombs continued, the Bank of England had taken in about $145 million in February but it was now faced with the first maturities of a huge volume of forward contracts initiated early last December. In view of the lagging recovery of confidence in sterling, Mr. Coombs thought it was problematical whether it would be possible for the British to pay off these forwards from current receipts, and further rollovers might be necessary. Much would depend upon the tax measures to be announced in the new budget, due in early April; the importance of the effect of the budget on the factor of confidence could hardly be overestimated.

In other exchange markets, the dollar had remained on or close to the floor against the French franc, the Dutch guilder, and the Belgian franc, and all three countries had continued to take in dollars which from now on probably would be entirely converted into gold. The U.S. had about used up its credit facilities in the Netherlands and Belgium, and, of course, the French were continuing to convert dollar accruals into gold. The only encouraging feature in the present situation had been the strength of the dollar against the Swiss franc. This reflected seasonal factors as well as the underlying deficit in the Swiss balance of payments which reappeared whenever short-term capital inflows tapered off. Here again, however, very little scope remained for financing any renewed flow of money to Switzerland through swap arrangements or other credits; outstanding commitments in Swiss francs now amounted to $250 million out of the $300 million available under the Swiss swap arrangements. On the exchange markets generally, as in the gold market, the

U.S. might have to pass through a fairly dangerous period before the new balance of payments measures became fully effective.

Chairman Martin asked whether the identity of the purchasers on the London gold market was known. Mr. Coombs replied that it generally was possible to learn of any purchases by central banks. As far as he knew, the only sizable central bank purchases recently were by the Chinese. In general, the demand appeared to be world-wide, and there were indications that cash balances were being accumulated by people who feared trouble and were ready to come into the market. Anyone could buy gold through the agency of, say, a Swiss or Dutch bank. There was no indication that any American buyers were involved.

Mr. Swan asked about the significance of the $35.20 price for gold which Mr. Coombs had suggested should not be exceeded. Mr. Coombs replied that that was a fairly arbitrary ceiling. The gold price had risen close to $35.20 on at least two previous occasions, one of which was at the time of the Cuban crisis, and in recent years the market and the financial press had tended to view this figure as an informal ceiling. The figure also had some significance in that the New York gold price of $35.0875 plus costs of shipping gold by a routine method added up to a London price of about $35.18. It was possible, of course, to ship gold to London by cheaper means. But if the London price went much over $35.20, expectational factors such as those seen in 1960 would be triggered off, and events probably would move much faster than in 1960 because of that earlier experience.

In response to a question by Mr. Mitchell, Mr. Coombs said that the total of System drawings under the swap arrangements would come to $535 million after a drawing planned for next week of $50 million equivalent on the swap with the Bank of Italy. Mr. Mitchell then asked whether Mr. Coombs thought these drawings, other than that on the Bank of Italy, ought to be paid off in gold. Mr. Coombs replied in the negative. He was hopeful that if the new balance of payments measures proved effective much of the total would prove reversible. The main significance he saw in the $535 million figure was that the U.S. gold stock would have been that much lower if the System had not made the swap drawings.

In reply to other questions by Mr. Mitchell, Mr. Coombs noted that all earlier System drawings had been completely paid off in June 1964. Subsequently, except for a September drawing of guilders to deal with a special situation, there were no substantial drawings by the System until November and December. No drawings had been renewed more than once, although he planned to recommend certain second renewals today. In general, System drawings had been repaid within the time span the Committee had in mind although some small part of them had been funded by issuance of Treasury bonds denominated in foreign currencies.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period February 2 through March 1, 1965, were approved, ratified, and confirmed.

Mr. Coombs then noted that the System's $100 million standby swap arrangement with the Netherlands Bank would reach the end of its term on

March 15, 1965, and he requested approval of its renewal for another three months.

> Renewal of the $100 million standby swap arrangement with the Netherlands Bank for a further period of 3 months, as recommended by Mr. Coombs, was approved.

During March, Mr. Coombs said, a number of drawings matured which should be renewed if the U.S. was to avoid paying them off in gold. These included a $100 million drawing on the Bank for International Settlements and two drawings totaling $45 million on the National Bank of Belgium. Each of these would be a first renewal.

> Renewal of the drawings on the BIS and the National Bank of Belgium was noted without objection.

Mr. Coombs then noted that three drawings upon the Netherlands Bank, totaling $65 million, matured in March. These already had been renewed once, but he thought they should be renewed again. There was some prospect, however, that the Dutch government might make a debt repayment to the U.S. of roughly $60 million some time in April which would provide the funds to liquidate these drawings in advance of their next maturity. Thus, even though these drawings were renewed a second time he would hope that they would not be outstanding for a full nine months but would be paid off about seven months after they initially were made.

Mr. Mitchell asked whether Mr. Coombs would plan to liquidate these drawings if the Dutch debt repayment was not made, and Mr. Coombs replied affirmatively. It was a basic principle, he thought, not to

let drawings run on; the integrity of the whole swap network rested on this principle. If it proved necessary to liquidate these drawings with gold after this renewal, he would want to consult with the Treasury on specific timing in the interests of orderly procedure, but the basic decision on liquidation would be the System's. To his mind the principle was quite clear that the drawings should be liquidated at the earliest possible moment, and he certainly would not anticipate coming back to the Committee to propose a third renewal.

Mr. Shepardson remarked that in his judgment the Committee should plan on paying off the drawings even if the potential Netherlands debt repayment was not made. He thought it would be undesirable to get into a position in which swap drawings were used to finance basic positions that should be covered by other means.

Mr. Coombs replied he agreed completely with this view, and that it was shared by all other countries in the swap network.

Renewal of the three drawings totaling $65 million on the Netherlands Bank was noted without objection.

Mr. Coombs then reported that a $10 million swap of sterling against Dutch guilders matured for the second time at the end of the month, and he felt that in this case also he must recommend renewal for another three months. However, this was a type of arrangement that in the past had been allowed to run on somewhat longer than drawings on the regular swap lines. A greater degree of flexibility seemed appropriate for such third-currency swaps than for regular swap transactions because they permitted the System to shift its holdings among currencies.

Renewal of the $10 million swap of sterling against Dutch guilders was noted without objection.

Finally, Mr. Coombs said, he expected to send a memorandum to the Committee before the next meeting suggesting the desirability of increases in the swap lines with the Bank of Italy and the Bank of Japan.

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 February 2 through February 24, 1965, and a supplemental report for February 25 through March 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:

Financial markets have come to understand that monetary policy has undergone a modest but distinct shift toward less ease. The change has been interpreted as a step aimed at supporting the more general program undertaken to deal with the balance of payments. The shift in policy was widely expected. Indeed, as I indicated at the last meeting, the market had already, by the beginning of February, undergone a good part of its adjustment to a somewhat less easy policy stance.

Marginal reserve availability has now moved down to a range surrounding zero free reserves, Federal funds have been trading most often at or above the 4 per cent discount rate, and member bank borrowing has increased. Bill rates have risen about 10 basis points, putting the 3-month rate in the neighborhood of 4 per cent, while other short-term rates have moved up about 1/8 per cent. Yields on short-term coupon issues, maturing within a year or two, also have moved up about 10 basis points, but throughout the rest of the Treasury list there have been yield increases of only a basis point or two for the most part.

While the market's adjustment to the policy shift has been very smooth, there remains an undertone of caution, based partly on uneasiness over the situation in the Far East and over recent and prospective gold losses. Furthermore, there is a feeling that unless the payments deficit is reduced substantially, and soon, further monetary policy action may be needed. On the other hand, the market continues to see large amounts of savings seeking employment, and it retains the view that, barring some kind of crisis, longer term rates are not likely to change much and might even edge down as the year goes on.

Whatever the longer-range view about rates, there is a feeling in the market that the next few weeks may see some intensification of money market pressures, and possible rate increases, for seasonal reasons. Corporate cash needs over the dividend and tax dates this month may be at least as great as in other recent quarterly months, and there may be somewhat less of a cushion of liquid holdings to fall back on, given the build-up in other demands on corporate liquid resources. Issuing rates on time certificates of deposit have edged into new high ground as banks have sought to replace actual and anticipated maturities of outstanding CDs. With major banks paying 4-1/4 per cent or more for 3-month money, and corporations in a period of net cash drain, it is possible that short rates might press a bit higher during the period of seasonal pressures ahead. On the other hand, there has been a tendency during several recent tax and dividend periods for a number of large money market banks to move gradually to surplus basic reserve positions to enable them to accommodate without strain the pressures that converge upon them on the tax and dividend dates. If this advance preparation happens again, the upward rate pressures could well turn out to be both mild and brief.

Recent price declines have been somewhat more pronounced in corporate and tax-exempt bond markets than in the Treasury bond area. Tax-exempt bonds have been in large supply and a reaction seemed overdue after the price rise in this market which followed the raising of Regulation Q ceilings last November. Recent price cuts seem to have been successful in stimulating demand, but the calendar remains substantial. Public offerings of corporate bonds have not been heavy, but private bond placements and stock or convertible debt offerings have competed for investible funds and produced some rise in rates.

The Treasury financing calendar is clear of all but routine bill roll-overs for the next three weeks, and indeed the next significant debt operation is not likely to come until late April, when the Treasury will announce plans for refunding its May 15 maturities.

Mr. Ellis asked whether his understanding was correct that Mr. Stone thought the market had completed its adjustment to the recent shift in monetary policy, and Mr. Stone replied affirmatively.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period February 2 through March 1, 1965, were approved, ratified, and confirmed.

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

Mr. Noyes made the following statement on economic conditions:

After four years of almost incredibly stable expansion, there is growing concern that our economy may be developing a classic form of instability--the boom-bust inventory whipsaw that so often frustrated our efforts to maintain stable growth. The fact that some observers are inclined to focus their attention on the boom side of this cycle and its inflationary potential, while others are preoccupied with the subsequent bust and its impact on our employment and growth objectives, should not trap us into the comforting but erroneous conclusion that these concerns can be offset against one another.

It is impossible to establish with any precision the size of the inventory build-up that has already occurred. The most recent comprehensive data presently available are for December. These were just revised upward by a substantial amount and there are indications that before they are final they will be revised still further. Taken at their face value, they would indicate that inventories were being accumulated on a GNP basis at a $9 billion annual rate in November and December. The staff reply to the first question1/ suggests that the annual rate of accumulation in January and February may be about $10 billion, and that over $6 billion of this is in lines other than steel and autos. These are high rates, by any standards--about equal, for example, to the second quarter of 1959, when inventory policy was influenced by both widespread inflationary expectations and the prospect of a prolonged steel strike.

1/ The staff's prepared comments on certain questions considered by the Committee at this meeting are given at a later point in these minutes.

I do not wish to leave you with the impression that all of the strength we see in our economy should be associated with inventory accumulation, or that the absorption of the inventories thus far accumulated would necessarily produce a recession in economic activity. The staff answer I referred to earlier estimates that we might see "an initial downdrag of some $8 billion annual rate," but the staff has, wisely in my judgment, declined to specify at this stage the period over which such a downdrag might be felt. Similarly, they omit any consideration of the immediate or ultimate consequences of a further acceleration in the rate of inventory accumulation.

Obviously, I have no better basis for projecting these magnitudes than they had. Nevertheless, it seems quite possible that we may shortly find ourselves in a situation in which aggregate demand is being inflated by inventory accumulation at an annual rate of as much as $15 billion. If this should continue for a period of several months, it would almost certainly have current inflationary consequences, and if it were rapidly reversed, it would produce at best a short recession.

What can monetary policy do to forestall such a misfortune? It is difficult to conclude that it can do much. At the heart of one's conclusion lies a judgment as to whether a more restrictive monetary policy now would (a) moderate somewhat the rate of inventory accumulation, or (b) effectively defer some other demands to be released when inventory demand disappears, or both.

There is very little evidence to suggest that changes in the overall cost and availability of credit exert much influence on inventory policy in the short run. While judgments differ as to the extent of the influence, if any, I doubt that anyone would wish to argue that inventory accumulation can be effectively regulated by general credit policy.

Whether other types of expenditures can be deferred and later released by a tightening and subsequent easing of credit is a much more controversial question. It seems to me that the question cannot be answered dogmatically in the negative. To deny that some deferral could be accomplished by alternating the posture of policy would be to deny any anticyclical role to monetary action. But the risks involved in attempting to push some part of the demand pressures that are present and in immediate prospect ahead for several months are formidable. We know very little about the so-called lags in the impact of monetary policy, but we have every reason to believe that they vary considerably among the components of aggregate demand. The studies that have been made suggest that the lags may be longest in the very areas in which we might hope to accomplish some deferral, creating a danger that the major impact of a policy change intended to push demands ahead might come at the very time the additional demand was needed.

> There is also the danger that a policy change sufficient to accomplish any significant deferral of demand would itself cause the expansion to lose momentum and thus precipitate the downturn it was intended to prevent.
>
> These dangers must be weighed against the strong possibility that in the absence of restraint and subsequent stimulation from public policy, the process of inventory accumulation and decumulation will again upset the smooth course of economic progress.
>
> I have no answer to suggest to you today and any attempt to deal with the problem now would probably be premature. It may be that this threat to stability will be wiped out, as others have, by some fortuitious event that cannot be foreseen at this stage. I am afraid, however, that the more likely possibility is that it will loom much larger three weeks from now than it does today.

Mr. Robertson entered the meeting during the course of Mr. Noyes' remarks.

Mr. Swan asked if Mr. Noyes would clarify the basis on which he estimated that inventory accumulation might rise to a $15 billion annual rate. Mr. Noyes replied that the latest inventory figures available related to November and December, and the Board's staff had estimated that the accumulation rate had risen from $9 billion in this period to $10 billion in January and February. However, there was some evidence to suggest that inventory investment in the first two months of 1965 was higher than that estimate. The evidence did not consist of hard figures, but rather of comparisons of current rates of production and final takings. He personally had suggested that there might be a gradual snowballing, with the rate rising to something on the order of $15 billion in March.

Mr. Mitchell remarked that most analysts expected the rate of inventory accumulation to peak out in March and April, and then to turn

down of its own weight. Evidently it was Mr. Noyes' view that the current high rate would continue for a longer period.

Mr. Noyes said he thought there was some danger that it would. The staff's answer to the first question was in accord with the expectation that Mr. Mitchell had described and on that basis they had concluded that there might be a downdrag on GNP of about $8 billion, at an annual rate, in late spring and early summer. What he suggested was that the problem would be more serious if the high rate of accumulation continued or accelerated. Whether it would or not depended on many factors which he could not forecast with confidence, including the nature of developments in the steel industry labor negotiations. But he had several reasons for fearing that a snowballing might be in process. First was the evidence to which he had referred suggesting that current accumulation rates might be even higher than the high staff estimates. Second was the apparent fact that inventory investment outside of steel and autos was going forward at the high rate of $6 billion. It was necessary to assume that this was voluntary accumulation not directly associated with anticipations of a steel strike, and there was no reason to suppose that it would not continue, as it had in past inventory cycles.

Mr. Mitchell remarked that there were no suggestions of such a development in the most recent surveys of expectations or in data on final sales, and Mr. Noyes agreed.

Mr. Hickman remarked that if the rate of inventory investment in February was $10 billion it was quite reasonable to expect it to be on the order of $15 billion in March, considering both the auto-steel

situations and the accumulation in other lines. This was the sort of situation that had been foreshadowed by developments over the past six months and about which the Committee had been concerned.

Mr. Koch then made the following statement concerning financial developments:

> Open market operations over the past few weeks have achieved the slight firming in money market conditions sought at the last meeting of the Committee. Three-month Treasury bill rates have edged up near the 4 per cent discount rate, and free reserves have fluctuated around the zero level. Most other money market rates of interest have also risen between an eighth and a quarter of a per cent.
>
> The effect of this slight firming in money market conditions on interest rates on longer-term Government securities has thus far been moderate. The average yield on U.S. Government bonds with maturities of over 10 years, for example, is up only about 3 basis points from its late-January low. Investors and dealers apparently became convinced that the Government bond market had found a viable level when official purchases of the 4-1/4 per cent bonds offered in the January advance refunding were undertaken when they hit par.
>
> Corporate and municipal bond yields have experienced a somewhat larger upward yield adjustment in recent weeks, due in large part to factors other than the recent adjustment in policy. Sluggishness has developed in the distribution of some recent new issues, particularly in the municipal area where dealer inventories are at a record level.
>
> It is still too early to tell whether the recent policy adjustment has had the effect of moderating the pace of expansion in the complex of variables that make up the other basic financial objectives of policy, namely, the reserve base, bank credit, and the money supply. Over the 3 months ending with February, total reserves and total bank credit expanded at high annual rates, 6 per cent in the case of reserves and 10-1/2 per cent in the case of bank credit. Demand for bank loans by businesses was especially strong. The sharp contra-seasonal rise in business loans was no doubt sparked chiefly by heavier inventory accumulation, due in part to the dock strike and the strike threat in the steel industry, and by accelerated foreign lending in anticipation of Governmental curbs. Some of these temporary factors that have strengthened business loan demand are either abating or will probably do so in the not-too-distant future, but other factors, reflecting the stepped-up over-all economic expansion, are likely to be more long-lived.

In contrast to the sharp growth in reserves and bank credit, there has been no net growth in the money supply over the past 3 months, as compared with over a 4-1/2 per cent annual rate of increase in the preceding 3 months. Indeed, in February the money supply actually declined. This recent behavior in the money stock was no doubt accompanied by some further increase in income velocity although the bank debit and deposit turnover figures do not show it.

The explanation for the leveling off in the money stock despite the higher rates of growth in bank reserves and bank credit lies mainly in the sharply higher rate of increase in time and savings deposits at commercial banks induced by the impact of rising rates of return. The annual rate of growth of these deposits amounted to 20 per cent over the past 3 months.

One's judgment as to the likely inflationary effects of recent Federal Reserve policy must rest in large part on his interpretation of these divergent developments in the course of bank reserves, bank credit, the money supply, and savings. That is to say, it must rest mainly on one's judgment as to the differential effects on the cost and availability of credit and on spending of the leveling off in the money stock, on the one hand, and of the rapid increase in time and savings deposits, on the other.

In evaluating the characteristics of the recent growth in time and savings deposits of commercial banks, it is of relevance to note that the turnover of savings deposits of commercial banks in the Chicago Federal Reserve District, the only data of this kind that are available on a current basis, has shown no rise and is still only about 1/70 as rapid as that in demand deposits. Of course, time certificates of deposit, particularly negotiable certificates, turn over more rapidly than savings deposits, but even these deposits have fixed maturities that are much longer than the average life of a demand deposit. Moreover, negotiable certificates of deposit, although now totaling almost $14 billion, still make up only a little more than 10 per cent of total outstanding time and savings deposits.

Thus, not only are consumers and businesses saving more in depository type assets, but commercial banks are playing a much more important role now than earlier as savings intermediaries. In other words, the recent increase in the rate of bank credit expansion represents mainly the investment of savings that would otherwise have been invested directly by savers or by nonbank financial institutions.

The existence of a large outstanding volume of time and savings deposits at commercial banks does pose a potential inflationary threat if the holders of such deposits decided to spend them in large volume. But the continuing low turnover rate of savings deposits as well as recent

> reduced rates of growth in savings at other depository-type institutions suggest that most commercial bank savings deposits probably represent funds that would more likely flow to competitive savings institutions or directly into purchases of securities rather than into the spending stream if they suddenly left the banks. At least there is no reason for assuming that most savings deposits at commercial banks are potentially more inflationary than shareholdings at savings and loan associations, deposits at mutual savings banks, or savings bonds.
>
> If one accepts this interpretation of recent developments in the course of the reserve base, bank credit, money, and savings, they do not appear to pose as much of a destabilizing and inflationary threat to the continuance of sustainable over-all economic expansion as the high rates of expansion in bank credit and time deposits in and of themselves might suggest.

Mr. Hickman commented that aggregate savings, ex post, equaled aggregate investment, and any increase in bank deposits contributed to the funds available for investment whether it was in the form of time and savings or demand deposits. In his judgment the recent 20 per cent growth rate in time and savings deposits and the concurrent rapid increase in total assets held by banks were an inflationary development.

Mr. Koch said he would agree that the time and savings deposit growth would have expansionary implications to the extent that they were not held idle but, as he had noted, the limited data available suggested that their turnover had not increased recently. It was true that the increases in savings deposits were financing investment. However, they did not involve money creation but rather abstention from spending by the savers, and thus, in his judgment, were no different from increases in flows of funds through other financial intermediaries.

Mr. Mitchell remarked that the banks were buying these deposits from the public; with higher ceiling rates on time and savings deposits

banks were able to participate in intermediating the flows of funds to a greater extent than before. He agreed with Mr. Koch that the basic question was whether the recent rise in deposits primarily reflected money creation; if he thought it did he would favor a much tighter monetary policy. But since the turnover of these deposits evidently was stable he concluded that they represented savings which the depositors were not inclined to spend.

Mr. Hickman said he would agree that one could not push on a string; the situation would be different if there was no outlet for these funds. But they were flowing into domestic business investment, into mortgages, to outlets abroad, and so forth. He added that the ratio of aggregate liquid assets to GNP was rising in this expansion period, for the first time in any expansion on record.

Mr. Hayes commented that even if the accelerated rise in time and savings deposits merely represented a greater degree of intermediation by banks it resulted in some increase in the liquidity of the nonbank public. At some point this could have inflationary consequences; it apparently had not thus far, but one could not be sure how long this situation would continue. Mr. Mitchell concurred in this statement.

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

> The unadjusted payments deficit on "regular" transactions in January-February now appears to have totaled \$600-\$700 million. This is much larger than a year earlier, during the period when the deficit was temporarily very small, and about the same as in January-February of 1963, when things were going rather badly.

The deficit was swollen by a rush of long-term bank lending to beat the Gore Amendment. New commitments were enormous, $575 million through about February 10th, and much of this was probably disbursed. The deficit may also have been swollen by other anticipatory outflows, and by the port strikes, which always delay more exports than imports. These adverse influences may have been partly offset by some favorable developments, including a return flow early in January of very short-term capital that went out over the year-end, receipt of dividends earlier postponed to take advantage of U.S. tax cuts, and a pause, at least, in capital outflows during the latter part of February after the new balance of payments program was announced.

As is usual early in the year, net "official settlements" were small in January-February; but within this category there were very large transactions. The U.S. gold stock declined by about $480 million, more than in any other two-month period since late 1960, and U.S. official holdings of convertible foreign currencies (mainly sterling) were reduced by about $200 million. This drop of nearly $700 million in reserve assets was more than matched by a reduction in U.S. liabilities to foreign monetary authorities.

The behavior of the gold stock will continue to attract much attention in coming months, and it may be helpful to review the recent and prospective reserve behavior of those countries that are in a position to make substantial gold purchases.

France has sought and achieved the limelight in this area. Its announced policy is to take all reserve gains in gold this year, and in addition to reduce its official dollar holdings. In January-February, France bought $250 million of gold from the United States; the likely purchase of an additional $250 million in March would bring French dollar balances down to about the desired level of $1 billion. Thereafter, France would buy gold to the extent of its reserve gains, which could well amount to an additional $300 million or so.

Canada has larger official dollar holdings than any other country--$1.6 billion that are counted as reserves plus $200 million of additional U.S.-dollar Roosa bonds. Canada is not expected to continue adding to its total reserves this year, but will probably build up its gold stock slowly out of current domestic production.

After Canada, the three countries with the largest official dollar holdings are Italy, Germany, and Japan, each holding about $1-1/2 billion. Total Italian reserves

are rising rapidly, and Italy has not repurchased either the $200 million of gold that it sold last spring or the $200 million of Roosa bonds that it then redeemed. Its gold stock is lower, both absolutely and relative to total reserves, than at any time since 1960, and its dollar holdings are larger. With the best will in the world, Italy may be sorely tempted to take some of its reserve gains in gold this year, even though the renewed expansion of Italian economic activity--when it comes--seems likely to eliminate the payments surplus.

Unlike Italy, Germany has not been gaining reserves, and it reduced its official dollar holdings during 1964 by more than $1 billion, while adding about $400 million each to its gold stock, its holdings of deutschemark Roosa bonds, and its IMF position. Germany is unlikely to have new dollar gains to convert into gold this year, and the internal argument will be whether to convert existing holdings, as the French are urging.

Japan also seems unlikely to add much to total reserves this year. Its ratio of gold to total reserves is smaller than that of any other leading country--only 15 per cent--but in view of its special dependence on U.S. markets, it seems likely to continue to eschew gold purchases.

To summarize for these five countries, which account for about half of foreign official dollar holdings, I think we may expect that France will buy roughly $800 million of gold this year, that Italy may buy at least the $200 million it sold last year, and that Canada will absorb domestic gold production of about $150 million, while it may be hoped that Germany and Japan will sit tight.

Among a second group of foreign countries--those that hold large reserves almost entirely in gold--the United Kingdom will probably not be selling gold as it did last year, but will have to use any reserve accruals this year to repay debts. Other countries in this gold-holding group--Switzerland, the Netherlands, and Belgium--added some $500 million to their total reserves last year, largely during the sterling crisis, but took less than $100 million of it in gold. This year, their reserve gains may be smaller, but they may still make sizable gold purchases. They purchased $85 million from us in January-February.

A third group of countries have more modest total reserves but relatively large dollar holdings. Of these, Spain has the largest holdings; it is not expected to add greatly further to its total reserves this year, but is buying $180 million of gold during the first half. Sweden and Denmark have taken reserve increases largely in dollars, and each holds less than

one-fifth of its total reserves in gold, but they have given no recent indication of being restive about their dollar holdings. Austria took reserve gains of $90 million in 1964 mainly in gold, but is currently purchasing another $50 million of Roosa bonds instead of gold. In Venezuela, officials are encountering local pressures to add to the gold stock and may do so.

Adding up these rough impressions, and making some allowance for gains and losses by other countries, I concluded that foreign monetary authorities may well buy as much as $2 billion of gold, net, this year (including gold to be subscribed to the IMF). Free world production plus Russian sales will probably be about $1-3/4 billion, but industrial uses and hoarding typically take about half of the new supply in good years and three-fourths of it in years of market disturbance, which 1965 has certainly started out to be, so that less than $1/2 billion may be available for central banks. Thus, the U.S. gold stock could well decline by more than $1-1/2 billion this year, even allowing for the fact that our gold subscription to the IMF will be offset by a gold deposit here by the Fund.

Most of this projected $1-1/2 billion decline in our gold stock seems to me already in the cards, even if no one else follows French advice, and even if the U.S. payments situation develops favorably. The importance of making sure that it does develop favorably lies in the imperative need to avoid further foreign official dollar gains and gold conversions next year.

Chairman Martin noted that at the joint meeting of the Board and the Reserve Bank Presidents on February 18 Mr. Young had reported on the recent meeting of Working Party 3 in Paris. There had been a subsequent Paris meeting, on February 17 and 18, of the Economic Policy Committee, which Mr. Daane had attended. He invited Mr. Daane to comment on that meeting.

Mr. Daane said that he would summarize briefly the flavor of the discussion at the E.P.C. meeting, which covered some of the same ground as the meeting Mr. Young had reported on. First, some dissatisfaction was expressed with the short-term measures the British had taken to deal

with their balance of payments problem. The feeling was quite general that they had not done enough. The focus of attention was on the U.K. budget; there were repeated admonitions to the effect that a tougher budget was necessary and that it should be redesigned to release resources for production of exports.

With respect to the U.S. situation, Mr. Daane said, the attitude seemed to be one of welcoming the program the President had outlined and hoping that it would prove successful. At the same time, there seemed to be general skepticism regarding the effectiveness of moral suasion, particularly with respect to its probable impact on U.S. direct investments abroad. The view was expressed that the U.S. should have included monetary policy in the program and should definitely resort to monetary policy measures if evidence appeared that the President's program was not having sufficient effect.

A final highlight, Mr. Daane remarked, were the signs, particularly with respect to the Germans, of real sensitivity to continued direct investment by U.S. corporations.

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--To what extent does the present pace of economic activity depend on production for inventories, and what are the prospects for the economy when the rate of inventory accumulation is reduced?
>
> Accumulation of inventories, particularly of steel in anticipation of a strike, has been and continues to be an important element sustaining the advanced level of industrial production, but it is important to note that the rise in output over the past six months has been widespread among major

industries. Steel's principal contribution to rising output came early in 1964. Since July further increases in steel output have been limited by capacity considerations, while the production of consumer durable goods, apparel, and business equipment has accelerated. It therefore is an oversimplification to assume that the current rapid pace of expansion in industrial activity is primarily dependent on inventory adjustments to past (auto) and prospective (steel) strikes.

Nevertheless, the substantial accumulation of inventories now going on is distorting the structure of production suff - ciently to pose a potential problem for coming months. Staff estimates based on detailed study of production trends by industry and by stage of fabrication suggest that industrial output currently is exceeding consumption by a margin equal to about 4 per cent of output as against a more usual margin of about 1 per cent. The annual rate of inventory accumulation in January and February may well have been on the order of $10 billion on a GNP basis, triple the rate prevailing through most of 1964, with about a third of the total occurring in steel and autos, mainly the former.

If steel accumulation continues at current rates until the official contract termination date of May 1, stocks would then be higher than they were at the earlier peaks in 1962 and mid-1963, when strike threats also induced accumulation. A wage settlement, or even a temporary continuation of the present contract under conditions which suggest ultimate settlement without a strike, probably would result in sharp cutbacks in steel orders and production--perhaps enough a depress the total production index by as much as two percentage points. If this were concomitant with a cutback in auto production from present exceptionally high levels because, say, dealers' stocks finally reached their usual spring peak, another one-half of a point would be subtracted from the index. To these direct effects must be added also the effect of declines in supplying industries. In dollar terms, the combined effect of such a reduction in steel and auto output with accompanying inventory decumulation might exert an initial downdrag on GNP by some $8 billion, annual rate, in late spring and early summer. In the event of a strike, the amount of inventory liquidation, and the consequent impact on GNP, would obviously be much sharper.

In light of the continuing strength being displayed in other sectors of output and demand, the rough orders of magnitude cited above do not suggest the inevitability of recession when steel inventory accumulation ceases and/or auto production adjusts downward from its present phrenetic pace. They do, however, suggest a check to the rate of economic expansion, unless other forces, including fiscal policy, provide a sufficiently stimulative offset.

(2) Prices--In view of the current high rate of capacity utilization in many industries, what are the prospects for price stability?

Present high rates of industrial capacity utilization have not upset the general stability of prices that has prevailed over the past six years. The rise in the industrial wholesale price index last fall--sparked mainly by shortages and production bottlenecks in nonferrous metals--has not been reversed, but neither has the price advance become cumulative or broader in scope.

Utilization rates implied in most forecasts for further economic expansion are not, in themselves, inconsistent with continued overall price stability. Moreover, some of the important cases of current high utilization rates are clearly temporary.

One of the fortunate developments of this business expansion has been that spending for plant and equipment picked up, and presumably the rise in capacity accelerated, long before output generally reached high rates in relation to capacity. By the end of 1962 output of business equipment was up more than a tenth from the highs of 1957 and 1960, and since 1962, such output has increased nearly a fifth further. Prospects for increases in capacity commensurate with rising output are more favorable than in earlier expansions in the postwar period.

Rates of capacity utilization, however, are only one of many important influences on prices. In recent years business pricing decisions have been strongly conditioned by longer term competitive considerations, including the development of new products and new methods, the installation of new, cost-reducing equipment, and increased substitutability of other products and other sources of supply, foreign as well as domestic.

Potential destabilizing forces could, however, develop out of changes in international tensions, particularly the Southeast Asian situation. Another important influence on the future course of industrial commodity prices is what happens to steel wages and prices this spring, in part because of the potential repercussions on other wage settlements and in part because of the cost impact of price changes in so important a material as steel. Both last year's auto settlement and the current record activity in the steel industry no doubt strengthen the union's case for increases in wages and fringes above the 2 - 2-1/2 per cent per year increases of the 1962 and 1963 contracts, and internal union dissension may result in large demands. But management resistance may be fostered by uncertainty over the extent to which any cost increases can be passed on to buyers under present competitive

conditions. The Administration's wage and price guideposts may also serve to moderate the terms of the settlement and its consequences for prices.

(3) Balance of payments--To what extent does the fourth-quarter deterioration in the U.S. balance of payments now appear to have resulted from temporary influences?

In the fourth quarter, the seasonally adjusted deficit on "regular" transactions was $1,450 million, $770 million larger than in the third quarter and $700 million larger than the quarterly average for the year. At least $500 million of the fourth-quarter deficit (i.e., two-thirds of the deterioration from the third quarter) is attributable to certain definable temporary influences. Even without these influences, however, the fourth-quarter deficit still would have been disturbingly large--about $900 million.

The main temporary development was the bulge in new foreign security issues to $585 million, seasonally adjusted, up $420 million from the third quarter and $320 million above the average for the year. The bulge occurred mainly in Canadian issues, which had been postponed earlier pending enactment of the IET. The expectation that new foreign issues in 1965 will be at about the same rate as in 1964 implies that the temporary element in fourth-quarter issues may be put at something over $300 million. In January-February 1965, new issues were again large--$300-$350 million--but this sum includes $181 million of a single IBRD issue; the remainder, seasonally adjusted, is not very different from the average expected for 1965.

A second adverse factor in the fourth quarter was the waiver of the scheduled U.K. year-end debt service payments of $138 million.

Capital outflows reported by U.S. banks rose much more than seasonally in the fourth quarter, but it is hard to say how much of the rise could be regarded as "temporary." Net long-term bank lending of $330 million, seasonally adjusted, was up about $100 million from both the third quarter and the quarterly average for the year, but much of this increase should probably be viewed as part of a rising trend. If there was any acceleration of term-loan disbursements in anticipation of Government measures to restrain capital outflows, it was far smaller than in January 1965, when long-term bank lending shot up to $215 million in a single month.

Short-term outflows reported by U.S. banks of $440 million, seasonally adjusted, were up about $250 million from the third quarter and $60 million from the quarterly average for the year. Unadjusted, the outflow was heavily concentrated in December,

and some of it (in addition to the portion allowed for by seasonal adjustments) may have been temporary, flowing back rather early in the new year. The January 1965 return flow of $170 million (unadjusted) points in this direction. There have been similar large January reflows in some other recent years, but this year's net reflow occurred despite reported efforts of some institutions to place funds abroad in anticipation of Government restructions.

So far there is little evidence on which to judge whether there were temporary movements, favorable or unfavorable, in other "regular" transactions during the fourth quarter. The balance of these transactions, on which little detail is yet available, was about the same as in earlier quarters of 1964.

(4) Bank credit and money.

A. Is the recent contraseasonal strength in bank loan demands likely to continue, or has it been a response to special influences likely to diminish in the near term?

Available information suggests that a good part of the recent unusual strength of bank loan demand is temporary. This increased demand has been confined almost exclusively to business loans, where borrowing has been affected by a combination of special circumstances. These temporary factors, however, do not account for all of the loan bulge. With the economy recently showing an accelerated rate of expansion and with internal sources of business funds probably growing less rapidly than financing needs, a strengthening in the underlying trend of business loan expansion may also be in progress.

The recent acceleration in business borrowing has been much sharper than usually has been associated with increases in business activity at present rates. From a fairly steady pace of $400-$500 million per month over the first 11 months of 1964, the seasonally adjusted increase in business loans rose to $800 million in December, $1.7 billion in January, and $1.1 billion (preliminary estimate) in February.

Factors which probably accounted for most of this year's bulge are the following: First, the dock strike, which tied up a substantial volume of both incoming and outgoing merchandise shipments, is reported to have been mainly responsible for the contraseasonal rise in commodity dealer loans this year. The strike may also have contributed to the recent strong loan demand by food processors and possibly trade concerns as well. Second, inventory accumulation to hedge against a possible steel strike probably accounts for most of the contraseasonal rise in the metals group. The contribution of such borrowing to the January-February loan bulge may have been on the order

of $150 million a month. Third, the pace of foreign lending rose rapidly in recent months, presumably in anticipation of restrictive Government measures. Foreign term lending in January amounted to more than $200 million according to preliminary estimates. Fourth, a loan of about $100 million was extended to a petroleum company in mid-February to acquire a large block of its stock.

The impact of some of these factors on loan expansion may continue for a while, but at a diminishing rate. Liquidation of the loan bulge connected with the dock strike may be expected shortly. Steel inventory accumulation presumably will continue until a strike occurs or the threat of a strike is removed. Foreign lending will need to taper off soon if banks are to hold outstandings within their proposed ceilings, although some further expansion may occur in the near term because of prior commitments.

The total impact of these temporary influences on business loan expansion since the turn of the year may have amounted to as much as $600 million per month. But this still leaves a residual expansion substantially larger than the average monthly increase in 1964. Some of this residual may reflect early borrowing in anticipation of large tax payments in March and April, but some undoubtedly reflects the general strength in business activity.

B. To what extent has the reduced rate of expansion in the money supply since November been a reflection of the higher rates offered on time and savings deposits? What are the implications of probable time and savings deposit growth in the near term for the money supply?

Preliminary estimates indicate a substantial decline in the money supply in February, offsetting the moderate increases in December and January and bringing the money stock back to the November level. This recent money supply performance in large part probably reflects the accelerated growth in time and savings deposits. However, a rise in U.S. Government deposits (seasonally adjusted) also has tended to moderate money growth over this period.

The months following previous increases in Regulation Q ceilings also saw sharp increases in time and savings deposits and moderation in the growth of money as the public adjusted its liquid asset holdings to changed market alternatives. Much of the initial adjustment takes the form of one-time shifts out of money and other highly liquid financial assets into time and savings deposits. The pattern of changes since November suggests that the public's response to this change in Regulation Q is broadly similar to that following earlier revisions.

Rate increases, together with the extensive publicity accorded them, presumably account for most of the surge in savings deposit inflow since year-end. Banks generally also have increased their outstanding negotiable CDs substantially since year-end. Some banks have been promoting new nonnegotiable savings and investment certificates, designed to attract funds from small businesses and other investors unable to acquire negotiable CDs.

Judging from the limited historical experience, it seems likely that the recent rates of growth of savings and time deposits will moderate soon. In periods following previous ceiling rate increases, the influence of one-time shifts from other assets lasted about one quarter. Moreover, as loan demands from the temporary influences discussed above in answer to question 4A recede, banks probably will reduce their issuance of relatively high-cost CDs.

Correspondingly, growth in the money suppy over the near term may accelerate. Additional economies in cash utilization stimulated by current higher yields on liquid assets may have some moderating influence on money growth, but transactions needs for money, related mainly to the pace of business activity, are likely to be more directly reflected in demands for cash balances in coming months.

(5) <u>Money and credit markets</u>.

A. Has the recent shift in policy been fully reflected in the principal money and capital markets, or are further market adjustments likely?

Market participants generally have come to the conclusion that a mild policy shift toward less ease has been effectuated. Most assume the policy objectives include a lower, and at times negative, level of free reserves, and a 3-month bill rate in the neighborhood of the discount rate. In other words, market participants do not now seem to expect much more firming than already has developed during the past three weeks.

Partly because the recent policy shift has been only moderate in scope and is being so interpreted by active investors, the related adjustment in capital markets also has been moderate. The upward movement in long-term U.S. Government rates has been relatively small, despite the unfavorable technical position of the Treasury bond market. Adjustments in corporate and municipal bond markets have been larger, in part reflecting the unusual strength in these markets in December and January, and in part the growing calendar of new corporate and municipal issues. Upward pressures stemming from those forces have been tempered, however, by Treasury and System purchases of coupon issues during the past two

weeks; these purchases have tended to buttress a market view, encouraged by Administration statements, that long-term rates are not likely to rise much.

Assuming no further change in policy, short-term rates might still show some seasonal rise, with the most likely time coming around the March tax and dividend dates. But if the rise is small enough to avoid generating expectations of a discount rate increase, the odds are against a significent further weakening in the long-term market. The technical position of the U.S. Government securities market is gradually improving, with dealer holdings of over-20-year maturities reduced to under $300 million. However, further enlargement of the calendar of corporate and municipal issues and/or continuation of strong bank loan demand could produce new upward rate pressures in both intermediate- and long-term maturity areas.

B. Assuming that the somewhat firmer policy adopted at the last meeting has been communicated to and fully reflected in the money market, what interest rate structure and conditions of reserve availability would be mutually consistent and best designed to maintain the present policy posture?

Some moderate additional pressure upon the money market is likely to develop between now and the mid-March tax and dividend dates. This will result primarily from the needs of corporations to make higher outlays for dividends and taxes; their Federal income tax liability in March is estimated at some $6.9 billion, about one-tenth higher than last year. While the existence of a $2.5 billion tax anticipation bill will help smooth the pattern of payments, the period is nonetheless likely to produce its usual temporary concentration of pressures on Government security dealers and a temporary rise in the basic reserve deficiency of major New York City banks.

In recent years, such March tax date pressures have tended to be reflected more in day-to-day financing rates than in Treasury bill rates. This could be the pattern again in 1965, particularly since major city banks have already pared their Treasury bill holdings considerably in recent weeks in adjustment to tauter money market conditions and higher levels of borrowing both by member banks and their customers.

In view of recent business loan strength, it seems reasonable to assume a larger amount of business borrowing for tax purposes from banks in March. The likely pattern of loans demand, however, is complicated by several temporary factors (discussed in the answer to question 4A). Assuming these special

demands recede as the weeks progress, large banks may accommodate the tax-associated demands in the first half of March more by bidding aggressively for short-term funds and borrowing from the System than by further adjustments in investment portfolios. In these circumstances, one might expect average borrowings from the Reserve Banks to fluctuate around the $400-$450 million level; reserve availability to move into the $0-$50 million net borrowed range; dealer loan rates to advance to around 4-1/2 per cent; and the Federal funds rate often to be at 4-1/8 per cent, even though bill rates might not move outside a 3.95-4.05 per cent range. After the tax date pressures are past, the money market might be expected to return to the conditions prevailing in late February. Long-term interest rates probably would be little affected by these money market developments.

Assuming no change in the posture of monetary policy and continued large inflows of time and savings deposits, the interest rate and marginal reserve developments outlined above could be consistent with little change in reserves behind private demand deposits, apart from seasonal movements. Such reserves declined a little in January and substantially in February.

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. The domestic business situation remains favorable--perhaps, if anything, a bit more favorable than at the beginning of the year. The prospects for first-half growth being sustained in the second half of 1965 now seem brighter than they did. Production gains in January were well diffused throughout the economy. Retail sales appear to continue at the high January level, and a record auto year is generally forecast. There are further signs that the decline in residential construction may be bottoming out. Unemployment in January was at the lowest level since October 1957. The chief uncertainty is of course steel, with further delays in a wage settlement now indicated. Steel inventory accumulation was substantial in the fourth quarter of 1964 and is probably continuing; but for manufacturing as a whole inventory-sales ratios in December remained at a low level.

2. Prices. Industrial wholesale prices were about unchanged in January, but readings thus far in February suggest a renewed rise, after allowance for seasonal factors. Price announcements continue to be predominantly on the upside.

Clearly we must be alert to the threat of more intense cost and price pressures.

3. Balance of payments. Our basic balance of payments position has been obscured by the very large transfer to foreign accounts in January and more particularly in early February in anticipation of various measures that had been rumored would be part of the President's balance of payments message. It was unusual to have an overall deficit in January despite the reversal of special year-end outflows. For the first half of February the deficit may well have exceeded $500 million. Our large annual deficits have continued almost unchecked, and as a result our ability to finance the deficit by any means other than gold sales has been severely curtailed. The outlook is for further heavy gold sales in the coming months. Sterling has strengthened, but many uncertainties remain and the international situation, both financial and political, is tense and potentially explosive. In these circumstances we must be prepared for quick defensive action.

Fortunately the program of voluntary restraint on foreign bank lending is off to a good start and, together with the related programs with respect to corporations and nonbank financial institutions, should begin to produce significant results in a few months; but these programs will not be easy to administer and will call for steady resistance to pressures by various interests, public and private, that would water down their effectiveness.

4. Bank credit and money. Total bank credit advanced very strongly in January on a seasonally adjusted basis, with total loans (adjusted) showing the largest increase on record. For the thirteen months ending with January the net increase in bank credit was at an annual rate of 8.3 per cent, as compared with 7.4 per cent for the same period a year ago. Although the growth of business loans in January reflects several special factors--including a spurt in bank loans to foreigners, and the effects of the steel strike threat and the actual dock strike--basic domestic loan demand also appears to be strong. This impression is confirmed by the results of our recent survey of loan projections at eight large New York City banks.

The money supply was still on a 4 per cent per annum growth trend in January; but time deposits scored a record advance in the month. Undoubtedly the higher interest rates offered on time and savings deposits have been an important cause of this time deposit growth. Banks seem to have been able even to attract some funds from savings and loan associations.

5. Money and credit markets. The financial markets have concluded that a mild shift in policy has taken place and have about completed their adjustment to it. Some further firming of intermediate and long rates could take place, especially if short rates should push somewhat higher in view of the tax and dividend dates that loom ahead. On the other hand, continued substantial flows of funds into the longer-term markets seem to provide a good deal of insurance against any substantial upward rate movements in this area.

Monetary policy. For the time being the System should focus its efforts on making the restraints on capital outflows work and might well leave monetary policy about where it is. As the Chairman wisely and realistically stated before the Joint Economic Committee the other day. if the program does not work we shall probably have to move to a policy of tighter money in order to make the attack on the problem a full success. In my judgment the balance of payments problem is now too critical to permit the risk of failure.

We should also be scrutinizing closely the rate of bank credit expansion over the coming months. Some slowdown would be desirable, apart from the expected slowdown in foreign lending; but we may find that credit demand is so strong that a slowdown will require a somewhat more restrictive policy.

Open market operations should be conducted in the next three weeks in such a way as to confirm the modest change of posture voted at the last meeting. To me this means that free reserves should be more often below zero than above, and the bill rate should fluctuate around 4 per cent, with swings above that level more frequent than dips below 4 per cent. From a psychological standpoint this sort of confirmation of posture seems to me very important as we embark on the voluntary restraint program. Such criticisms as are heard of the program are usually based on the contention that Government, including monetary policy, is not contributing enough to the payments solution while a heavy burden is being placed on private finance and industry. We should make clear that we are doing our part.

I like the wording of the directive as drafted by the staff, which takes note of the President's balance of payments program and expresses the System's support, besides dropping the reference to Treasury financing and indicating a need to maintain the firmer money market conditions established in recent weeks.

Mr. Ellis reported that steady expansion continued to prevail in the New England economy with manufacturing employment and output

pushing to new highs. Further expansion was anticipated in the views of manufacturers reporting in the Boston Reserve Bank's quarterly survey of expectations. Fourth-quarter 1964 sales substantially exceeded earlier expectations of these manufacturers and buttressed their outlook for the present quarter. Their preliminary reports concerning capital outlays for 1965 suggested a further rise in the rate of such investment but the returns were too incomplete to support an estimate of how much.

Savings deposit balances in the Bank's reporting sample of 80 mutual savings banks rose by 0.7 per cent in January, Mr. Ellis continued. New deposits, interest credits, and withdrawals all increased from December; the net result brought gains in deposit balances from January of last year to almost 9 per cent. This flow of funds was sufficient to hold unchanged at 5-1/4 per cent the interest rates Boston savings banks charged on conventional type mortgage loans even though demand, as reflected in contract awards, was running impressively above a year ago.

Mr. Ellis commented that total residential contract awards in New England were 34 per cent higher in December than a year earlier. Their total for 1964 was 19 per cent above that for 1963, compared with a national increase of only 0.3 per cent. As of February 17, this strength in demand had been translated into an 18 per cent year-to-year growth in real estate loans at First District weekly reporting banks; such demand had been especially strong in the last several weeks.

Turning to the agenda questions, Mr. Ellis noted that the first question, relating to business activity, naturally focused on inventories. Granting that the special situations in steel and autos dominated immediate prospects for the economy, the fundamental strength underlying the whole spectrum of demand was what in his judgment would predominate during the months further ahead. There did not appear to be any substantial reason to question that strength for the rest of the year. Incomes were high and rising, consumer spending expectations were optimistic, and all of this was contributing to the inventory surge.

As to the second question, concerning prices, Mr. Ellis thought the price stability rested on capacity and output high enough to outweigh rising demand, both real and speculative. The trend of events in Viet Nam raised new threats that speculative demands, reinforced by ready credit availability, would tip the scales toward price increases, and toward the boom-bust cycle referred to by Mr. Noyes.

The staff response to the third question suggested, Mr. Ellis said, that because the fourth-quarter surge in the balance of payments deficit appeared largely traceable to capital outflows, including bank lending, it seemed logical to expect the voluntary credit restraint program to have the effect of making the fourth-quarter deterioration temporary. However, he failed to find in the present program any measures that offered reassurance that the $2 billion rate of deficit existing prior to the special events of the fourth quarter was being resolved.

Mr. Ellis observed that the agenda question on bank credit was concerned with possible reasons for "the recent contraseasonal strength in bank loan demands." Quite obviously such temporary factors as the dock strike, the steel labor negotiations, and foreign lending had contributed extra strength to demand. But the more important underlying and longer-run consideration was the continuation of very sharp rates of bank credit expansion. Since July total bank credit had expanded at an annual rate of almost 9 per cent and this was almost by definition unsustainable. He was concerned about the large increase in Federal Reserve credit on the basis of which this bank credit expansion had occurred.

That, Mr. Ellis said, raised the issue of the appropriate course for monetary policy. Mr. Noyes had posed the controversial question of whether or not some demands could be deferred; in his judgment one certainly could hope that that was possible. The Committee might already have waited too long, particularly if there were lags in the effects of policy actions. The positive response of bankers to the voluntary restraint program seemed to assure that there would be some reduction in foreign lending by banks. To the extent such reduction was achieved, more funds would be available to domestic borrowers. The recent degree of credit availability, in his judgment, would continue to support unsustainable expansion in domestic lending.

Mr. Ellis said that he had been disappointed to hear from Mr. Stone that the market adjustment to the action taken at the previous meeting had been completed; he would rather have heard that it was still

in process. He thought the slight firming trend in policy should be continued for the next three weeks. Differences in viewpoints as to the appropriate degree of firmness were small but important, and the Committee's targets should be defined carefully in the instructions given to the Manager. In this connection, he regretted that the staff had not prepared a "trial" directive for this meeting, but he understood the frustrations involved in laboring over a document that was rarely considered.

His own preferences for policy targets, Mr. Ellis said, would be net borrowed reserves generally in the range of zero to $50 million; short-term bill rates in the range of 3.95-4.10 per cent, and generally above the discount rate; Federal funds rates usually at or above the discount rate; and member bank borrowings averaging $400 million or more. He favored no discount rate action at this time.

Mr. Irons reported that the general economic situation in the Southwest was one of strength. Activity was at high and relatively stable levels. Industrial production was holding steady, and there were indications that it might move up slightly further over the next month or two. Employment promised to show some improvement in the next few months and perhaps to move up to record levels. The District's unemployment rate was below that of the nation. There had been a decline in construction contracts from the very high levels of the past few months. Agricultural conditions were spotty, depending on the amount of rain in particular areas, and cash farm receipts currently were running below a year ago, but it was too early to say whether the change was significant.

Retail sales at department stores in the District were at record levels, and new car registrations were quite high.

Mr. Irons observed that bank loan demand was very strong in the District, as it was in the nation. As elsewhere, time and savings deposits were up substantially at District banks and demand deposits were down a bit. Demand for Federal funds was strong, and the average volume of discounting had risen in the past three weeks. Apparently, as soon as the market showed signs of firming, the larger banks found it necessary to restore their reserve positions by buying funds at rates up to 4-1/8 per cent or by borrowing from the Reserve Bank. However, discounting was limited primarily to a relatively small number of banks.

The national situation, Mr. Irons said, also showed evidence of strength and the trend certainly was expansionary. As to monetary policy, he noted that the Committee had made a significant move toward less ease during the past four weeks. The market situation was now firmer, and participants in the market had recognized the change. He favored continuing the degree of firmness that had existed in recent weeks. He agreed with the figures the staff had given in response to the final question on likely developments under the present posture of policy, and, more generally, he agreed with their conclusions in answering all of the questions. He favored maintaining marginal reserve availability fluctuating around zero, and on the negative side more often than on the positive. He thought dealer loan rates might rise a little, and would expect the Federal funds rate to be at 4 per cent and occasionally higher.

Mr. Irons said that he had some qualms about permitting the bill rate to move significantly above the discount rate at this time to the 4.10 or 4.15 per cent area, except perhaps for a day or two. Such a development might engender the feeling that a further move toward restraint was being made and might stimulate speculation about the possibility of another change in the discount rate. That would be undesirable, in his judgment, in view of the fact that the voluntary credit restraint program had just been launched. Were it not for that factor, he definitely would favor a firmer policy. He did not favor a change in the discount rate at this time.

Mr. Swan commented that the basic economic situation in the Twelfth District seemed to be good but it was not entirely consistent with that in the nation. The unemployment rate in the Pacific Coast States, which had dropped in December, increased again in January in contrast with a decrease at the national level. Agricultural employment declined in January, and while nonagricultural employment as a whole rose slightly manufacturing employment again went down rather significantly. There had been a much larger decline in housing starts, relative both to December and to January 1964, in the West than in the rest of the nation. Lumber prices were reduced from the highs reached after the recent floods but were still somewhat above pre-flood levels.

As spring approached, Mr. Swan said, there was a good deal of uncertainty about both the availability and cost of agricultural labor with the end of the bracero program. This uncertainty seemed to be reflected in the attitudes of processors with respect to their contracts

with growers and in the attitudes of lending institutions with regard to financing arrangements. It was too early to say exactly what effect the labor situation would have on those areas but there did seem to be somewhat more caution than there was a year ago. The nonferrous metals markets remained tight and the copper situation was being aggravated by the dock strike. Steel production in the District remained at high levels with some indications of shipments of structural steel to the Midwest.

Mr. Swan remarked that weekly reporting banks in the District, as elsewhere, had large increases in commercial and industrial loans in the four weeks ending February 17--much larger than in the equivalent period a year ago. However, there was a slight decline in real estate loans in contrast to a very substantial increase in the same period last year. Borrowings from the Reserve Bank in the last three weeks had not risen at the same rate as in the rest of the country.

Mr. Swan said he was still uncertain as to how to interpret the inventory situation. He could not arrive at an adequate explanation of the increase in inventories other than of steel and autos; perhaps it simply reflected the general rise in business activity. He had been unable thus far to find any evidence of speculative inventory accumulation in anticipation of higher prices. As a negative conclusion this might be considered a little suspect, but at least in the Twelfth District there was not much indication of overheating.

Mr. Swan was inclined to agree with Mr. Koch's analysis of the significance of the recent acceleration in growth of time and savings.

deposits. Developments in the Twelfth District were consistent with the staff's conclusion that the time deposit growth rate might well moderate somewhat after the one-time adjustment to higher interest rates, although some further growth in savings deposits might be expected.

It seemed to Mr. Swan that, following the shift in policy at the previous meeting in support of the national balance of payments program, it would be desirable to hold policy unchanged until some indication was available of the effectiveness of that program. He did not think there had been enough change in the domestic situation to warrant a further policy shift. Like Mr. Irons, he would not quarrel with the quantities mentioned in the staff response to the last question, and he endorsed Mr. Irons' remarks about the undesirability at the moment of having a bill rate constantly above the discount rate. He agreed that the slightly firmer conditions recently achieved should be maintained but he did not think that the firming should be carried further at this point. In this connection he noted that the staff's expectations with regard to levels of borrowings, free reserves, Federal funds rates, and so forth, were related to some extent to the fact that the period immediately ahead included the March 15 tax date. The staff response said that "After the tax date pressures are past, the money market might be expected to return to the conditions prevailing in late February." It was useful to note that the conditions referred to were those existing subsequent to the change in policy. The staff's draft directive was satisfactory to Mr. Swan.

Mr. Strothman commented that the present continuing economic expansion in the Ninth District would seem to be explainable in part, but by no means entirely, as stemming from construction and the steel-related industries--notably mining. Employment in those industries had improved markedly. However, other industries, including retail trade, services, and durable goods, also had shown sharp employment increases. January unemployment in Minnesota was at the lowest rate in 13 years. The Minneapolis Bank's opinion surveys continued to reflect modest optimism but with some pessimism from predominantly agricultural areas.

In banking, Mr. Strothman said, in recent weeks the District had experienced a heavier-than-usual decline in demand deposits and a more-than-seasonal increase in loans. The extent to which inventory buying had spurred loan demand was not clear. Nor was it clear from available data that demand deposit growth had slowed in the District because of the availability of higher time-deposit rates.

Mr. Scanlon, in commenting on the first question, reported that the trend of business in the Seventh District appeared to be vigorous and healthy, aside from unsustainable rates of inventory accumulation in the steel and motor vehicle industries. Employment in most areas continued to edge up, and unemployment rolls continued to be reduced gradually. Retail sales had been strong.

There had been a tendency to raise projections of activity both for the economy as a whole and for individual firms and industries, Mr. Scanlon observed. There was less concern about a leveling or decline

in general business in the second half of the year. Forecasts of sales of passenger cars close to the 9 million level in 1965 (down from the rate thus far) were widely thought to be possible of achievement. A large Chicago steel firm expected 122 million ingot tons of steel to be produced this year with a 17 per cent decline from the first half of the year to the second. Orders for business equipment had been higher than expected, and a 10 per cent rise in total capital outlays from 1964 to 1965 seemed reasonable to informed people with whom he had talked.

Mr. Scanlon remarked that a vague uneasiness existed among bankers and businessmen concerning the balance of payments situation and the problems of Southeast Asia. It was suggested that these conditions constituted a threat to the continuance of prosperity, but there was little evidence that such fears had influenced business decisions.

Statements of executives of General Motors and Ford, issued early last week, that they had reached their goals of acquiring an additional 60-day supply of steel were greeted with surprise and outright skepticism in trade circles, Mr. Scanlon said. Reports persisted that steel producers were falling further behind on promised delivery schedules. Allocation procedures were being enforced strictly and many smaller users of steel had not been able to build inventories. Except for steel and autos there was little evidence of inventory building in excess of operating needs.

Mr. Scanlon agreed with the staff statement on the second question, relating to prices.

On the balance of payments question, Mr. Scanlon agreed generally with the staff reply although he was not thoroughly convinced that several of the factors described as temporary in nature actually were as temporary as the staff response implied.

Mr. Scanlon also agreed generally with the staff answer to part A of the fourth question, relating to bank credit and money. However, he felt the underlying trend in bank loan demand might be stronger than was implied in the staff statement and that corporate tax needs in mid-March might be greater than usual. The widespread distribution of the loan increases, both geographically and by industry group, suggested that they were due not only to special and temporary influences but also to a basically strong demand that was likely to persist at least for some weeks ahead.

With respect to question 4B, Mr. Scanlon said he was unable to provide a satisfactory answer to the first part, regarding the relation between the higher rates on time and savings deposits and the reduced rate of expansion in the money supply. For the near term, he did not foresee any unusual movements in time and savings deposit growth that would have material implications for the money supply. This assumed, of course, that the level of short-term yields would remain roughly where it was at present in relation to ceilings under Regulation Q.

The "reduced rate of expansion in the money supply since November" appeared to Mr. Scanlon to be noticeable for the most part because it occurred against the backdrop of the unusually large monthly gains around the middle of the year, particularly in June and July. The substantial

increases that took place at that time might well have been related to the March tax cut, then working itself out in terms of its impact upon aggregate income.

Mr. Scanlon said he had nothing to add to the staff comment on part A of question 5 beyond noting that the municipal market might show some further upward rate adjustment as a result of the tighter bank reserve positions. He was in general agreement with staff statement on part B, except that if the underlying loan demand was strong, as he suspected it was, following the March tax payments banks' reserve positions would not return promptly to the conditions prevailing in February.

Mr. Scanlon said he agreed with those who favored continuation of the policy in effect over the past three weeks. He was a little unhappy about the reference in the directive proposed by the staff to accommodating growth in the money supply "at a more moderate pace than in recent months" when the most recent money supply figures showed a decline. However, he was inclined to accept the draft directive because he thought the Committee's position was made clear in the second paragraph. he did not favor a change in the discount rate at present.

Mr. Clay said it would appear appropriate to him to continue monetary policy unchanged at this time. A policy move had been made at the last meeting, and that change apparently had been implemented. It remained to be seen, however, how sensitive longer-term interest rates might prove to be. That policy move was only a part of a larger package of special measures designed to deal with the international payments

deficit. It would appear logical, he thought, to maintain the new monetary policy posture essentially unchanged at this juncture as the new program of special measures was applied. In the meantime, a close watch could be kept on both domestic and international developments.

The performance of the domestic economy was in some ways rather impressive, Mr. Clay said. It was impressive to observe the ability of the economy at this advanced stage of the upswing to absorb the impact of recent developments in steel and autos without exhibiting the serious strains characteristic of a boom. It also was impressive in terms of the widespread nature of industrial activity as discussed by the staff's response to the questions submitted for consideration. The latter aspect might help cushion the inevitable readjustment in the steel, automobile, and related industries. Nevertheless, it would be very important to keep the expected readjustments in those industries in perspective in formulating monetary policy in the months ahead. The growing capacity of the economy pointed to the need for continued expansion in aggregate demand, particularly when those immediate factors had run their course.

Price developments also were on the encouraging side, Mr. Clay said. The staff answers rightly suggested the possibility of a continuation of favorable price developments so far as demand forces were concerned, apart from possible international tensions. It remained true that the more serious threat of upward price pressures rather came on the cost side, from the outcome of the steel industry labor contract negotiations.

The staff analysis of the current loan expansion appeared logical to Mr. Clay in view of the special developments that had taken place in the economy. The impact of the temporary factors could not be measured, but they must be very large, as suggested by the staff estimates. The temporary acceleration in loan expansion resulting from the dock strike and the threatened steel strike would appear to have limited meaning for the formulation of monetary policy. The bulge that apparently took place in loan volume in anticipation of international payments restrictions presumably should work itself out in the period ahead as the international payments program went into effect.

In carrying out monetary policy for the period ahead, Mr. Clay said, it should be the aim to maintain money market conditions in line with those that had prevailed in recent weeks. This would include a 90-day Treasury bill rate in the range of 3.95 to 4.05 per cent. The staff draft of the economic policy directive would be suitable for a continuation of the current policy posture. In his judgment no change should be made in the discount rate.

Mr. Wayne remarked that, in view of the past month's developments, it would seem that the move toward a slightly firmer policy made at the Committee's last meeting was an appropriate one. The balance of payments problem remained the key element in the present situation. If the voluntary program was reasonably successful in reducing the outflow of funds and perhaps in producing some return flow, a considerably slower rate of growth in total bank lending would be necessary to prevent

an undue expansion in domestic credit. A lower availability of reserves would be the most appropriate way to encourage and induce such a contraction.

Domestically, Mr. Wayne observed, economic and financial developments of recent weeks also indicated the desirability of a firm policy, but those conditions could change quickly. If a continued high level of activity could be counted on some credit restraint would be in order to curb domestic prices.

But the present level of activity could not be taken for granted, Mr. Wayne said. Almost certainly, steel production would be cut back rather sharply in the next two or three months. It was doubtful whether automobile sales could be maintained for long at the present feverish pace. Construction, even if it could hold its present level, did not promise any significant gain. Stagnation or declines in those three major areas at the same time would spell trouble for the economy, in his opinion. While the optimism of businessmen seemed to be rising sharply, a condition which often produced excesses in the final phase of a period of expansion, such precarious optimism should not be encouraged by any easing of credit.

As noted by Mr. Stone, Mr. Wayne continued, the market seemed to have completed the adjustments, at least in the short end, needed to reflect fully the recent shift in policy. The current relationship of short-term rates to the discount rate was approximately what it had been a few weeks before the last change in the discount rate. In the

long end, the continued heavy flow of savings approximately balanced the strong demand and kept rates fairly stable. But further increases in short rates must exert considerable pressure on the longer rates.

Taking into account the need for a lower availability of reserves to offset or induce a reduction of foreign lending, Mr. Wayne said, net borrowed reserves of sizable amounts might be required to keep short-term rates where they were or to raise them a little. He would not be averse to seeing such net borrowed figures and would not like to see any substantial amounts of free reserves. Even so, he recognized that it would be necessary for the Desk to provide considerable amounts of reserves to offset the large gold losses which apparently lay ahead. He favored a continued firm policy but no change in the discount rate for the present. The draft directive was acceptable to him.

Mr. Robertson made the following statement:

> In this past month both we and the Administration have taken major policy steps that, hopefully, will deal adequately with the balance of payments deficit without handicap to the achieving of our twin objective--continued vigorous, noninflationary economic growth. Nobody is sure these measures will work effectively. The particular combination of actions is well-nigh unique; and like any other compromise package, probably nobody favors all parts of it. Certainly I am not particularly fond of the general monetary tightening that went along with the package. But having come forth with this combination, I think it now behooves us to give it a chance to show what it can do.
>
> Insofar as the voluntary foreign loan restraint program is concerned, our early experience reminds me of an old saying we have out in Broken Bow country, "You can tell how much a hog is hurt by how loud he squeals." Judging on that basis, the restraint program is already doing some pinching. And, frankly, I hope we can manage to administer our parts of it in a way that cuts very substantially into capital outflows.

> The only reason I can see for not holding monetary policy steady while waiting for our latest actions to take effect is if new or exaggerated forces appear that would push us into an inflationary spiral or a run on the dollar if we did not act. I see no such developments. We are probably already past our peak rates of acceleration in inventory accumulation, business loans, and bank lending abroad. Once the first quarter is past, I suspect we could be seeing more comforting statistics in all these areas. Now is not the time to compound pressures by further action based on statistics that are still describing pre-February 12 performance.
>
> With these considerations in mind, I would vote for a monetary policy that continued to maintain money market and bank reserve conditions about as prevailed in the past few weeks. While I did not favor last month's move to tighten money market conditions further, I do not think it would be constructive at this juncture to try to undo that action. Looking ahead, however, I would lay emphasis on the Manager's meeting the reserve needs as they emerge in March without allowing any extra measure of market pressure to develop. Modest net borrowed reserves might result in a week or two, I recognize, but I would not want to see a steady string of net borrowed reserves from now until the end of March. With this understanding, the draft of the current directive as distributed by the staff is satisfactory to me.

Mr. Shepardson observed that the indications of the staff reports and other information were of a continuing strong--although possibly not sustainable--expansionary condition in the economy. As Mr. Ellis had pointed out, if the program for arresting capital outflows was effective it would result in a greater availability of funds in the domestic market. For that reason he thought it would be desirable to continue the present directive, calling for moving toward slightly less ease. He favored a range of zero to minus $50 million for free reserves, a bill rate in the 3.95-4.10 per cent range, and borrowings at the level necessary to produce such conditions. He thought the Committee's policy move at the

previous meeting had been appropriate, but he questioned whether it should consider the move to have been completed by the attainment of the conditions prevailing since that meeting.

Mr. Shepardson thought that Mr. Hayes' remarks had tended in a similar direction, although Mr. Hayes had found satisfactory the proposed directive calling for the maintenance of current money market conditions. Along with Mr. Ellis, he (Mr. Shepardson) would prefer to go a step further and move toward slightly firmer conditions, although a drastic move certainly was not in order until there was an opportunity to observe developments under the voluntary credit restraint program.

Mr. Mitchell said that monetary policy and expectations in the securities market had been buffeted about on a sea of words--official and unofficial--and as a result the market had been moving on a trend with an ambiguous destination. Perhaps he should defer to Mr. Stone's judgment that the market had completed its adjustment to the recent policy action, but he could not quite believe it; it seemed to him that the market was highly uncertain. Probably the best contribution official action could make at this time would be to maintain the current degree of uneasiness.

The country's foreign friends would be happier if they believed that the voluntary restraint program was being buttressed with some tightening of policy, Mr. Mitchell said, and those at home who were fearful that the domestic economy was peaking out would feel that monetary policy was not a factor pushing the economy inexorably toward

recession as long as bond prices, particularly in the tax-exempt field, did not break. But he thought a great deal of caution had to be exercised in connection with any further move toward tightening, for one reason because there still was a considerable overhang of longer-term securities in the market.

In any case, Mr. Mitchell said, there was not too much in the way of action on the domestic or foreign front that could be justified in the Committee's present state of knowledge. Domestically, the leads and lags were such that if a recession was going to come in 1965 it was almost here. He did not agree with Mr. Noyes' analysis; in his judgment a possible downturn was dangerously close. On the foreign front the Committee could hardly imply that the newly-conceived plan for checking capital outflows would fail before it was off the launching pad. Temporarily, for better or worse the posture of general monetary policy had hardened.

One could hope for an abatement of the recent rate of expansion in business loans at banks, Mr. Mitchell continued. He had been inclined to agree with the staff's conclusion that much of the recent growth was temporary. He noted, however, that several of the Reserve Bank Presidents who had spoken thus far thought there was more underlying strength than the staff had suggested, and he gave credence to their judgment. But assuming that judgment was correct, he still did not see how one could advocate a move to reduce the rate of bank credit growth if that would mean a more drastic contraction in the money supply than had occurred

in the past eight weeks. His preference for money supply figures was the seasonally adjusted series prepared at the St. Louis Bank; in his judgment they gave a consistently better picture of developments than those compiled at the Board. This series had declined at an annual rate of about 10 per cent in the last eight weeks, after seasonal adjustment.

Mr. Mitchell said he felt a little nostalgic about the "trial" directives that now had disappeared. They had had a clear, positive approach; there was no yielding before the hard questions. With respect to the draft of the regular directive, he strongly recommended deleting the reference to accommodating growth in the money supply; in his judgment it would be a mistake to ignore the fact that it had declined recently. He suggested ending the first sentence with the phrase "to accommodate growth in the reserve base and total bank credit." Also, he thought the next sentence would be a little more forthright and stronger if it simply read "This policy seeks to support fully the national program to strengthen the international position of the dollar," deleting the words "and to avoid the emergence of inflationary pressures."

Mr. Daane complimented the Desk on what in his judgment had been a highly skillful implementation of the directive the Committee had adopted at the previous meeting; they had achieved some snugging up in reserve availability and money market conditions while reinforcing the general expectation that longer-term rates would prove viable. Looking back, he had to confess that he was a bit unhappy about the official purchases of longer-

term securities for Treasury account since the beginning of the year, and he was not completely convinced that the maturities chosen in purchases for System account had been completely appropriate. On the whole, however, he thought the Desk had done an excellent job in attaining the objectives the Committee had indicated.

Mr. Daane said his policy prescription was similar to that a number of others had expressed. He would favor having free reserves fluctuate close to zero but on the negative side. With this end in view he found the directive prepared by the staff acceptable, but he had no strong objections to the revisions suggested by Mr. Mitchell.

Referring to the discussion after Mr. Koch's presentation of the implications of the recent growth rate of time and savings deposits, Mr. Daane said he found it difficult to translate the *ex post* equality of saving and investment into thinking of all savings as automatically flowing into investment and being income generating. He preferred the analytical approach which treated today's savings as a function of yesterday's income and as accommodating today's investment. In this light he derived comfort from the high current level of savings and viewed it as a healthy factor, necessary to accommodate a desired non-inflationary expansion in investment.

Mr. Hickman commented that it might be better to say that today's inventory excesses were a function of yesterday's savings and yesterday's monetary policy. He hoped the Committee was not accentuating the unsustainability of present conditions.

Mr. Hickman then complimented the staff on the excellence of their answers to the questions posed for discussion. He had little to add to those answers, but thought that an independent approach perhaps might turn up a few points that otherwise might have been overlooked.

Business conditions in the Fourth District and in the nation were still dominated by superheated activity in autos and steel, Mr. Hickman said. Since the last meeting of the Committee steel deliveries had been lengthened, allocation systems had been reinstated, and orders had been trimmed or rejected. Steel production continued to run at the annual rate of 135 to 140 million ingot tons, but most analysts believed that output would decline sharply to aggregate about 115 to 120 million tons for the year. The close union election had been a highly unsettling factor. Extension of the bargaining beyond May 1, as some had suggested, might aggravate the situation still further by expanding the time for hedge buying of inventories.

Mr. Hickman noted that the auto industry also appeared to be operating above sustainable levels, although the excess was less marked than in steel. Despite record sales in the past three months, inventories by the end of February had climbed to about the year-ago level. Both production and sales had pretty much caught up from the strike interruption, and some letdown in the auto industry was to be expected. Nevertheless, production schedules for March continued at very high levels.

Accompanying the lush but ominous developments in steel and autos, other industries, including machinery, had continued to show moderate advances, Mr. Hickman said. In the months and calendar quarters ahead their continued advance would be required even to maintain the current level of industrial production.

The question of the trend of prices was still unresolved, Mr. Hickman continued. There had been a number of flurries of price increases, followed by periods of relative calm, one of which the economy seemed to be enjoying now. Despite near-capacity production in autos and steel the price line appeared to be holding at the moment. On the other hand, prices of aluminum products and nonelectrical machinery, where operations were also near capacity, had been inching up.

On the balance of payments front, Mr. Hickman remarked, part of the fourth quarter deterioration was temporary, possibly as much as $1.5 billion of the $5.8 billion annual rate of deficit, counting factors that contributed temporarily on both the plus and minus sides. But that was surely academic at this juncture. Foreign confidence had been shaken and massive steps were needed to restore faith in the dollar.

Insofar as bank credit was concerned, Mr. Hickman expressed the view that part of the recent strength in business loans and in consumer credit undoubtedly could be traced to the overheated atmosphere in autos and steel, as well as to the dock strike and the bulge in foreign lending. Some of the strength in business loans also could be explained by the narrower spread in recent months between the prime rate and open-market

rates on commercial and finance company paper. Selective adjustments in bank lending rates now seemed to be in process.

In Mr. Hickman's opinion, the money market had largely adjusted to the slight shift in policy adopted at the last meeting. But the market for longer-term U.S. Treasury issues still had a way to go, to judge by past experience in a free market economy. Whether past experience was a useful guide under conditions of a controlled market was a moot question. Both the Administration and the System had endeavored to hold long-term interest rates below the rates that would prevail under free competitive conditions. The excellent chart show presented at the last meeting raised some questions about the appropriateness of that approach, since major adverse capital flows in the balance of payments had occurred in the intermediate- and long-term areas.

Aside from his reservations about operations in the intermediate- and long-term market, Mr. Hickman thought monetary policy had been executed appropriately and adroitly in the four weeks since the last meeting. Over the next three weeks, because of his concern about the domestic situation, he would prefer to see free reserves in the range of zero to plus $50 million most of the time, but he would not be disturbed if there were net borrowed reserves occasionally. The bill rate should remain close to or slightly below the discount rate, as Messrs. Irons and Swan had suggested, and the Federal funds rate should hold at 4 per cent most of the time. Under the slightly firmer conditions now emerging in the money market, Mr. Hickman thought that borrowings again would serve as a good indicator of the degree of tightness or ease. He would prefer to see

borrowings at $400 million or above rather than $300 million or below. The staff draft of the directive was acceptable to him, and he did not regret the demise of the "trial" directive.

Mr. Bopp reported that in the Third District the strong economic upsurges of recent months had slowed substantially. Unemployment had begun to increase moderately in some of the District's less-advantaged areas, and had stopped declining in the rest. Output remained strong but might have leveled off in January. Department store sales had dropped well below the national rate of advance, and in the latest week declined slightly from year-ago levels.

Rather than comment on each of the questions prepared by the staff, Mr. Bopp said, he would limit his further remarks primarily to the question of bank credit. From a review of both national and District trends, it appeared to him that the recent contraseasonal upturn in bank loans and deposits was symptomatic of special circumstances superimposed upon an otherwise moderate further expansion in business activity. On the national scene, the near-record expansion in business loans stemmed largely from inventory expansion associated with strikes--the dock strike and the threat of a steel strike--and from the apparent sizable upward movement in foreign business loans anticipating implementation of the Gore Amendment.

Contrary to the national picture, Mr. Bopp remarked, business loans in the Third District had shown no more than moderate strength this year. One reason for this apparently was that the special factors

stimulating loan demand in the nation were less evident in the District. Both business loans abroad and loans to finance domestic inventories had shown little strength. These facts were revealed both by an examination of the Reserve Bank's own figures and by a survey of District reserve city banks. Bankers with whom he had talked made only minor references to financing steel inventories or carrying merchandise tied up by the dock strike. The loan categories which had increased in the District were those characteristic of a moderate business expansion.

As for other factors bearing upon the pace of economic activity, Mr. Bopp said, commodity price indexes remained roughly stable, suggesting that further increases in production could be sustained before overall capacity pressures became pronounced. Admittedly, however, the picture was obscured by inventory building in anticipation of a steel strike and by the aftermath of the auto strike.

On the international front, continued balance of payments pressure was evident. In Mr. Bopp's opinion, however, any further shift in monetary policy aimed at reducing the deficit should be deferred until some indication was available of the success or lack of success of the package of measures introduced by the President.

Another aspect of the President's program which had to be watched, Mr. Bopp continued, was its possible impact on the domestic economy. It was possible that some loan and investment funds would be diverted from foreign to domestic uses, producing some excess in credit availability. This development, however, remained only a possibility. There was no

certainty that such a redirection would occur, and if it did, that it would in fact be excessive.

On balance, it seemed to Mr. Bopp too early to consider a change in monetary policy based either on the international or domestic implications of the President's payments measures. Therefore, bearing in mind both the currency pace of business activity and the evolving international climate, Mr. Bopp recommended no change in the present posture of monetary policy. The figures on money market conditions mentioned by the staff in response to the final question seemed appropriate. He thought the reference to the money supply in the draft directive implied a factual inaccuracy, and accordingly either should be deleted or replaced with a different statement.

Mr. Bryan said he thought the economy of the Sixth District could be described properly as being in a state of boom. Loan demand in the District was particularly strong, and the figure on insured unemployment was much better than that for the nation as a whole.

Although the data were subject to revision, Mr. Bryan said, the national money supply narrowly defined evidently had declined in the latest month, whereas the series including time and savings deposits had risen substantially, and time and savings deposits themselves had gone up like a rocket. The question of the appropriate definition of the money supply could be debated for a long time. However, he would suggest that the Committee simply recognize that the money supply was indeterminate. As had been pointed out in the past, "money" was anything

that did money work, and since money had a number of functions the appropriate definition would vary from narrow to broad depending on the particular functions one had in view.

As to policy, Mr. Bryan thought that at the present time the Committee ought to maintain approximately the existing degree of firmness, with free reserves fluctuating around zero and more often negative than positive. However, he would like to repeat an observation he had made before--at this particular juncture free reserves were a dangerous measure, since they represented a residual after the System had supplied all of the reserves demanded. He also would repeat his belief that the more fundamental measures, such as total reserves, were growing at unsustainable rates. Mr. Bryan thought the reference to the money supply in the draft directive was inappropriate in light of the recent decline in the money stock.

Mr. Shuford reported that economic activity in the Eighth District had advanced rapidly since early last fall. Payroll employment had risen at a 6.7 per cent annual rate since September, with significant increases shown in both the durable and nondurable goods industries. Manufacturing output had gone up at nearly a 10 per cent rate, with gains in the Little Rock and Memphis areas particularly large. Spending, as measured by the volume of check payments, had increased markedly in most major cities of the area.

Since September, Mr. Shuford continued, deposits at weekly reporting banks in the District had risen at a rate a little faster than in the nation. Expansion centered in time deposits, which had

risen sharply; demand deposits had grown only slightly. Business loans at weekly reporting banks had moved up at about a 12 per cent annual rate, as an unusually sharp gain at banks in St. Louis was partially offset by declines at Louisville and Memphis banks.

Nationally, Mr. Shuford said, economic activity had continued to rise during the first two months of the year, as already had been noted. Production, sales, and incomes all were markedly higher now than before the auto strike. The expansion in activity reflected production for a precautionary buildup in steel inventories, but there was strength in other areas as well. Wholesale prices had increased since last summer, and industrial prices had moved up significantly.

As had been discussed, Mr. Shuford said, the balance of payments problem remained serious. It was hoped and expected that voluntary credit restraint and other aspects of the Administration's balance of payments program might result in a reduction in the outflow of funds, but developments in those areas warranted close attention.

In late November and again in early February, Mr. Shuford noted, the Committee had made moves toward slightly firmer money market conditions in response to the acceleration in the outflow of funds from the country and the strength in the domestic economy. It probably was too soon to judge accurately the total impact of those actions. Few figures were available either on domestic economic conditions or on the balance of payments since the Committee's most recent action. Short-term interest rates had moved higher, but most other yields had changed little. Total

member bank reserves, time deposits at commercial banks, and bank credit, particularly business loans, had continued to rise markedly. On the other hand, growth in the money supply had slowed considerably.

Mr. Shuford said he had found Mr. Koch's observations on recent banking and money supply developments valuable. The February decline in the money supply undoubtedly was due, at least in part, to the recent rapid increase in time and savings deposits and the recent larger-than-usual rise in U.S. Government deposits. Moreover, there frequently were periods in which the money supply showed sharp short-run fluctuations and perhaps the present was one of those periods. In his opinion it was too early to be concerned about the decline in the money supply, but if the recent trend was prolonged unduly it would need attention.

Mr. Shuford said he appreciated Mr. Mitchell's remarks about the usefulness of the St. Louis Bank's money supply figures. The St. Louis Bank probably had done more work in the area of the money supply than most Reserve Banks because of their particular interest in the subject, and he was grateful to the Board's staff for their encouragement and help in this work. He had found the discussion of the money supply this morning useful and thought that further discussion of a similar nature would be desirable. In his judgment the money supply was an important factor for the Committee and the Federal Reserve System to keep in view; there was evidence in historical studies of a significant relation between its changes and business cycle fluctuations. However, he certainly did not think that the money supply, however defined, should be considered as the

exclusive guide to policy. Other variables also were important, including flows of funds, total bank credit, business credit, aggregate reserves, and, in the short run, free reserves and measures of the tone and feel of the market. All of these were matters that the St. Louis Bank tried to take into consideration in its analyses and which the Committee had to consider as it reached its conclusions on monetary policy.

As Mr. Mitchell had mentioned, Mr. Shuford continued, the St. Louis Bank's figures showed a decline in the money supply at about a 10 per cent rate in the most recent eight weeks. However, the staff members at the Bank who followed the situation were not greatly concerned about this development, for reasons similar to those Mr. Koch and others had mentioned. Considering a somewhat longer period, from the average for the four weeks ending October 7, 1964, to the average for the four weeks ending February 24, 1965, the money supply had increased at an annual rate of 1.6 per cent. One would, of course, find other rates of change if the comparison was made with different starting dates.

Mr. Shuford thought it would be a mistake to delete the reference to the money supply from the directive. It was an important variable over which the Committee had influence; and as he read the draft language it did not imply either that the money supply had not declined in recent weeks or that it would decline in coming weeks.

Mr. Shuford said he favored continuation of the policy of the past four weeks, with money market conditions about the same as they had been recently, including a Treasury bill rate around the discount

rate. He would be willing to accept the figures the staff had provided in the answer to the last question, i.e., average borrowings around the $400-$450 million level, dealer loan rates around 4-1/8 to 4-1/2 per cent, and the rate on Federal funds at about 4 per cent and at time 4-1/8 per cent. He favored no change in the discount rate.

Mr. Balderston remarked that Chairman Martin had observed, in his February 26 statement before the Joint Economic Committee, that since the middle of last year the averages of both industrial material and product prices had edged up and that he could not avoid feeling that the country had been, and still was, sailing very close to the edge in this area. Earlier in his statement the Chairman had indicated his belief that "monetary policy did what it could and should do to facilitate healthy economic growth within the United States. In our effort to try to do all that we could, I only hope that we did not do a little more than we should have."

The burden of Mr. Balderston's concern today was that now, after a business expansion entering the fifth year of its life, bank credit continued to expand at an annual rate of about 8 per cent whereas real GNP had been rising at an annual rate of only about 5 per cent. It was to this basic fact that he wished to call the Committee's attention; it was portrayed in the first of the two pages of charts he had had distributed. (Note: A set of the charts to which Mr. Balderston referred has been placed in the files of the Committee.) Whether or not the cumulative effect of those two trends had by this time created pools of liquidity that might cause inflation, he did not know. What was fairly clear to

him was that, even though only 28 per cent of total credit was bank credit, the increase in the latter that the System had permitted was sufficiently great to add to the volume of dollars seeking investment abroad. It also was clear to him that the relation to GNP of the money supply narrowly defined was a deceiving guide. Corporations had learned to economize in the use of cash, and so the stock of money now did not have to be as large proportionately to GNP as once was the case. How to obtain an adjusted figure for money supply and its rate of growth seemed to him to defy solution, but he did suggest that some adjustment was needed, at least to give some weight to corporate funds invested in negotiable CDs. Thus, he had had CDs included along with the narrowly defined money supply in the middle panel on the second page of the charts, showing recent monthly percentage changes in various monetary series. Some weight might also be given to savings accounts of individuals, the recent growth in which had been stimulated to some extent by the monetary policy of the System, in his opinion. If future events should reveal that the tinder had been laid for a speculative outburst it would be, in his view, a fair criticism of the System that it permitted the relationship between growth in bank credit and in GNP, as depicted in the first chart, to exist too long.

Now that the nation faced an international liquidity crisis that threatened to shrink further the already shrunken stock of gold, Mr. Balderston said, it seemed to him to be high-time that the policy adopted four weeks ago should be implemented more vigorously. In concrete terms, he thought that in coming weeks free reserves should be negative most of

the time even if that resulted in some further stiffening of bill rates. He would be willing to accept some stiffening of long-term rates also if that were to develop. To make clear that the Committee wished no cessation in the application of the policy adopted on February 2, Mr. Balderston suggested that the second paragraph of the draft policy directive be modified to read, "To implement this policy, System open market operations over the next three weeks should be conducted with a view to extending the recent firming of conditions in the money market." He would delete the reference to the money supply in the first paragraph because, as he had noted earlier, he considered the money supply figures to be a deceiving guide.

Chairman Martin said he thought that Mr. Balderston's charts were interesting and that the Committee should keep them in mind. As to policy, evidently the Committee felt that it should not retreat from the step taken at the previous meeting, but the majority apparently did not favor going as far as Mr. Balderston had suggested. As to the directive, he would prefer not to eliminate the reference to the money supply. As he had said before, words meant different things to different people, and he did not see how the semantic problem could be resolved today. What was necessary, he thought, was to try to put together the best possible language, recognizing that there inevitably would be some gray areas.

Mr. Mitchell said he had not meant to imply that money supply references should be excluded from all of the Committee's policy directives; he had suggested omitting the reference from this particular directive because recent changes in money were difficult to interpret. By calling for

accommodation of growth in total bank credit the Committee would be recognizing what was happening to deposits, including CDs and other time deposits.

Mr. Koch noted that the staff had debated the question at issue in preparing the draft directive and he might try to clarify the rationale of the proposed language. The thought was that the phrase "to accommodate growth in the reserve base, bank credit, and the money supply," could be reasonably taken to refer to the three variables as a group and not individually, and with respect to a longer time period than just a few weeks.

Mr. Mitchell commented that the problem under discussion pointed up the desirability of employing an alternative form for the directive, such as that of the "trial" directive, which was more specific.

Mr. Hayes remarked that the staff's memorandum on member bank reserves indicated that the aggregate money supply had increased in every recent month except February, and the figure for that month was labeled "estimate." He thought that these data did not invalidate the general proposition that the money supply had increased in recent months. Accordingly, he did not consider the reference to be objectionable.

Chairman Martin said that that was his view also. He then noted that Mr. Mitchell had suggested deleting the proposed phrase "and to avoid the emergence of inflationary pressures" from the first paragraph. He (Chairman Martin) would prefer to retain that phrase because he thought there still were inflationary pressures in the economy. In his judgment the volume of credit, however measured, was dangerously high at present

and this would be revealed by coming developments. He hoped he was wrong, but that was his conviction.

After further discussion Chairman Martin suggested that the Committee vote on the directive as drafted by the staff.

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

> 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 support fully the national program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures.

> To implement this policy, System open market operations over the next three weeks shall be conducted with a view to maintaining the slightly firmer conditions in the money market that have prevailed in recent weeks.

> Votes for this action: Messrs. Martin, Hayes, Bryan, Daane, Mitchell, Robertson, Scanlon, and Clay. Votes against this action: Messrs. Balderston, Ellis, and Shepardson.

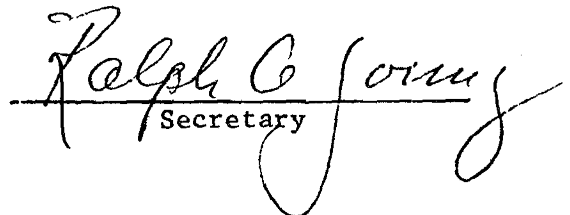
Mr. Balderston said that he had voted against this action because, as he had indicated earlier, he thought a further move to tighter conditions was required at present. Mr. Shepardson observed that he had dissented on the same grounds.

Mr. Ellis said he had dissented for two reasons. First, he also favored a firmer policy. Secondly, he did not believe that the present directive form was sufficiently clear and definite to serve adequately as an instruction to the Account Manager. To the extent that his dissent was on procedural grounds, he proposed to limit it only to this occasion and not to repeat it at subsequent meetings, even though he might continue to object to the form of the directive.

Mr. Mitchell commented that he shared Mr. Ellis' views on the directive but had voted favorably because he thought the policy decision was appropriate. Mr. Bryan indicated that he had voted favorably on the same basis as Mr. Mitchell had.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 23, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary