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, June 15, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Bryan
Mr. Daane
Mr. Ellis
Mr. Galusha
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Shepardson

Messrs. Bopp, Hickman, Clay, 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. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Brill, Holland, Koch, and Willis, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

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

Mr. Patterson, First Vice President of the Federal Reserve Bank of Atlanta
Messrs. Link, Eastburn, Mann, Ratchford, Jones, Tow, and Green, Vice Presidents of the Federal Reserve Banks of New York, Philadelphia, Cleveland, Richmond, St. Louis, Kansas City, and Dallas, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Meek, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meetings of the Federal Open Market Committee held on May 11 and May 25, 1965, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market operations and on Open Market Account and Treasury operations in foreign currencies for the period May 25 through June 9, 1965, and a supplemental report for June 10 through June 14, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said the gold stock would remain unchanged this week but prospective sales between now and the end of the month might very well require a substantial reduction before the end of June. On the London gold market, demand had slackened somewhat with the price falling yesterday somewhat below $35.09. The gold pool, however, remained in deficit to the extent of approximately $170 million.

The main feature of the exchange markets had been the continued lack of buoyancy in the pound sterling, Mr. Coombs observed. Confidence remained decidedly weak with much talk in the market of a new speculative drive on sterling later in the summer. The British announcement of a $200 million reserve increase at the end of May, over and above the funds obtained from the British borrowing from the International Monetary Fund, was received with suspicion, and the cut in the Bank of England's discount rate from 7 to 6 per cent had had little effect on market thinking. The market was looking for concrete evidence of improvement in the British situation which had not been forthcoming thus far. Trade figures for May, released just this morning, were discouraging; they showed a decline in exports and an increase in imports. Since the beginning of June intervention by the Bank of England had cost more than $100 million, and a heavy volume of forward contracts was maturing this month. The British Government was anxious to avoid showing reserve losses this summer before the September meetings of the World Bank and International Monetary Fund, and hoped to show a sizable increase in reserves. Some possibilities for doing that were open to them, including the conversion of part of their portfolio of U.S. stocks into liquid assets suitable for inclusion in dollar exchange reserves. Some use also might be made of their $750 million swap line with the System.

Another noteworthy development on the exchange markets, Mr. Coombs continued, had been the gradual decline of the German mark almost to the parity level. That had reflected a deliberate policy of the German Federal Bank, which had made no special effort to resist occasional minor selling pressures on the mark. The German authorities believed that their overall balance of payments position had moved to approximate equilibrium and that such a development should be reflected in an exchange rate around the parity level. In Mr. Coombs' opinion that was a sound, healthy approach, and one that other European central banks would do well to emulate in similar circumstances, rather than resisting declines in the exchange rates for their currencies.

In the case of Japan, Mr. Coombs reported, there were some disquieting signs of developing pressure on Japanese reserves, partly reflecting increasing difficulty in securing U.S. or European financing of their sizable imports from less developed countries. Few European central banks seemed inclined at present to take over any substantial part of such Japanese trade finance, which hitherto had been largely handled in New York. If their reserve drains reached sizable proportions this month, the Bank of Japan might very well wish to draw on its $250 million swap line with the System. If the pressures continued to mount it would be well to consider what European central banks might do to help out in the event of a sudden drive on the yen.

Finally, Mr. Coombs said, he regretted the need to report that the dollar had slipped back to the floor against the French franc and that the Bank of France already had taken in $50 million in June. Presumably they would take that amount and any further accruals in gold.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period May 25 through June 14, 1965, were approved, ratified, and confirmed.

Chairman Martin noted that in response to the Committee's request at the preceding meeting Mr. Sanford had distributed a memorandum dated June 10, 1965, entitled "Renewal of System swap drawings." (Note: A copy of this memorandum has been placed in the Committee's files.) The Chairman asked if any members had questions or comments regarding the memorandum.

Mr. Shepardson said he had a question regarding the System's drawings under the swap line with the National Bank of Belgium. In May 1963, he observed, the Committee had revised its guidelines for foreign currency operations to indicate that drawings should be fully liquidated within one year of the time that any outstanding amount was first drawn. He noted from Mr. Sanford's memorandum that $60 million was now outstanding on the Belgian swap line, and it was his impression that there had been continuous use of either the

standby part or the fully-drawn part of that arrangement for a protracted period. He asked Mr. Coombs to comment on the matter.

Mr. Coombs replied that the $60 million figure to which Mr. Shepardson had referred was composed of a $50 million outstanding drawing under the standby part of the arrangement with the National Bank of Belgium and of $10 million currently disbursed from the $50 million part of the arrangement that was always fully drawn. It was unfortunate that the Belgians had preferred to have part of the arrangement drawn in full at all times because such a procedure confused matters; but in any case, it seemed appropriate to measure use of that part of the arrangement by actual disbursements. By and large, the System had let the Belgians take the initiative in indicating when disbursements would be desirable, and disbursements had been made frequently both to absorb dollar accruals on their part and to furnish them with dollars at times of need. August 1964 was the last time the System's account with the Belgian Bank had been completely clear, with no disbursements under the fully-drawn part and no drawings under the standby part. The one-year period indicated by the guidelines thus would elapse in August 1965. It was his hope that the account would again be cleared up in the first week of July by means of the U.S. drawing on the IMF that was now under consideration. The desirability of doing so was one reason he was recommending a Fund drawing by the U.S.

Mr. Coombs then noted that the $50 million standby swap arrangement with the Bank of Sweden, which had a term of twelve months, would mature on July 19, 1965. He recommended its renewal.

In response to a question by Mr. Mitchell, Mr. Coombs said that no drawings had ever been made on this swap line.

> Thereupon, renewal of the standby swap arrangement with the Bank of Sweden, for a further period of twelve months, was approved unanimously.

Mr. Coombs reported that two $150 million standby swap arrangements having terms of six months, with the Swiss National Bank and the Bank for International Settlements, would mature on July 20, and recommended their renewal. He noted that the Committee was inclined to extend the maturity of the swap arrangements to twelve months when that could be arranged, and expressed the hope that sooner or later the Swiss would agree to such an extension. However, he was not sure that they were prepared to do so at this time.

> Renewals of the standby swap arrangements with the Swiss National Bank and the Bank for International Settlements, for further periods of six months, were approved unanimously.

Mr. Coombs then recommended renewal of four outstanding drawings. They were two drawings on the Belgian swap line of $20 million and $5 million, which matured on June 30 and July 12, respectively; a $100 million drawing on the Bank of Italy, maturing

on July 1; and a $60 million drawing on the Swiss National Bank, maturing on July 20. These would be second renewals for the Belgian and Swiss drawings, and a first renewal for the Italian drawing, he noted. All four renewals would be for three-month periods, but Mr. Coombs was hopeful that it would be possible to repay the Belgian and Italian drawings early in July, if the Treasury made the recommended drawing on the Fund. No special means were available for repaying the Swiss drawing, except, perhaps, issue of a Treasury bond denominated in Swiss francs. However, the System had paid off about $135 million of its Swiss franc debt since March, and there was a good chance that the amounts still outstanding, which totaled $115 million, could be reduced substantially or repaid in full in the next few months. Market developments appeared favorable to that end; ordinarily the Swiss franc strengthened seasonally in June, but this year it had been weak despite seasonal forces.

In response to questions, Mr. Coombs indicated that the Fund held sufficient Belgian francs for purposes of the suggested U.S. drawing, and that recent Italian accruals of dollars were a result in large part of tourist expenditures there. He added that the Italian balance of payments position had been strong for over a year; there had been a pendulum effect, reversing the earlier weakness. If the System's drawing was repaid in early July it might prove necessary to make a new drawing later in that month or in

August to take care of further inflows of dollars to Italy. However, the pendulum might swing in the opposite direction in the late fall or winter, making it possible to repay any additional drawing without recourse to the Fund.

Renewal of the drawings on the National Bank of Belgium, the Bank of Italy, and the Swiss National Bank for further periods of three months was noted without objection.

Finally, Mr. Coombs recommended renewal for the third time of a $10 million sterling-Dutch guilder swap with the BIS that would mature on June 29. As indicated at previous meetings, he said, there was more flexibility in connection with this type of "third currency" swap than with the usual kind of drawing, but the swap in question had been outstanding for a rather long time and it would be desirable to liquidate it. Some progress had been made in that direction during the last month, and he was hopeful that the swap could be cleared up soon.

Renewal of the sterling-guilder swap with the Bank for International Settlements for a further period of three months was noted without objection.

Chairman Martin then noted that the Committee had held a preliminary discussion of Mr. Coombs' memorandum of April 30, 1965, entitled "Action on International Liquidity" at its previous meeting

and had scheduled further discussion for the meeting today. He invited Mr. Coombs to comment.[1/]

Mr. Coombs observed that he had made two main points in his memorandum, one of which had already been touched on today. That point concerned the desirability of opening up a new source of intermediate-term credit to take over swap drawings that threatened to run on too long. In the past such drawings had been paid off by means of Treasury gold sales or, in a number of instances, by issuance of Treasury bonds denominated in foreign currencies. There was, however, a major source of intermediate-term credit available in the International Monetary Fund--a source that had never been used by the U.S. for balance of payments purposes. To open up that source would be consistent with the frequent statements by U.S. spokesmen to the effect that the Fund should be the major source of international liquidity in the future, and it would have a number of advantages. Specifically, at present it would enable the Federal Reserve to repay short-term drawings on two swap lines--$60 million with the National Bank of Belgium and $168 million with the Bank of Italy--before those drawings ran on for periods long enough to be potentially embarrassing to the U.S. and to the foreign central banks involved. He had raised the question of a possible Fund

1/ Mr. Furth, Consultant to the Board of Governors, joined the meeting for the discussion of this subject.

drawing with the Treasury, and while there had not been an official response as yet, he understood that the prospects were good. Also, he had been advised that the Treasury had no objection to the System's embarking on discussions with the European central banks concerned. Accordingly, he had discussed the matter with officials of the National Bank of Belgium and the Bank of Italy. They had taken the initiative on the subject some months ago, and were favorably inclined toward the proposal. In Mr. Coombs' judgment, the thinking at both the National Bank of Belgium and the Bank of Italy in connection with the use of international credit facilities for dealing with problems of international liquidity was close to the philosophy of the System and the U.S. Treasury.

As yet he had no official response from the Treasury on his second suggestion, Mr. Coombs continued. That suggestion was to seek arrangements with certain foreign central banks under which they would extend credit lines in favor of, say, the Bank of England and the Bank of Japan if either of those countries encountered difficulty in coming months. Problems could arise suddenly, as was demonstrated in the case of Britain last November and in the case of Italy earlier, and it was desirable, in his judgment, to give close study to possibilities for making advance arrangements to aid a country in difficulty. Last November's crash program of help for Britain had been successful, but he did not think anyone would want to go

through such an operation again. Nor was there any guarantee that such an effort would succeed if tried a second time; it might fail simply because responsible officials of certain central banks happened to be unavailable at the moment. He did not propose large-scale international negotiations involving all central banks in the swap network; what he had in mind was approaching a few of them discreetly and informally, so that if there were an international crisis there would be a nucleus of central banks available to handle it until a larger operation could be mounted.

In response to Mr. Hickman's question as to what central banks would be approached, Mr. Coombs said that in connection with a possible drive on sterling he would suggest the Banks of Canada, Italy, and Germany; the BIS; and possibly the Banks of Austria and Sweden. In the case of the Japanese yen he would again suggest the Banks of Italy and Germany, and the BIS; and possibly the Banks of Canada and Sweden. He would hope to secure, on an entirely informal basis, an understanding that they would be sympathetic to extending credit lines to the British or Japanese in the event of sudden crisis for either currency. If the countries approached felt that such understandings would enlarge their short-term commitments undesirably, the System would undertake to reduce the maximum amounts it would draw on its swap lines with those banks by equivalent sums. Such arrangements would cost the System nothing; in effect, other central

banks would be extending credits that the System might otherwise be called on to grant.

Mr. Wayne said he thought the Banks of England and Japan had a role to play in the negotiations since the object was to build defenses for sterling and the yen, and asked whether they had been consulted regarding the proposals.

Mr. Coombs said he thought developments in the recent British and Italian crises demonstrated that the chances of success in a rescue operation were greatly enhanced if the U.S. was directly involved in the negotiations. Foreign central banks looked to this country to act as a catalyst in getting things moving. He had discussed his proposal with the Banks of England and Japan, and had found that both would be pleased to have the Federal Reserve do a certain amount of informal exploration, which would save them from possible embarrassment. If the Bank of England, say, were to approach another country with respect to a swap line, the question would immediately become a matter for formal, official negotiations, and the request might be taken to suggest that the British were on the verge of serious difficulty. The System, on the other hand, could pose the question in an informal and quiet way, without necessarily implying any reflection on the British situation.

Mr. Daane said he was fully in accord with the first proposal, for a U.S. drawing on the Fund to clear up certain swap drawings.

Such an action would validate the position the U.S. consistently had taken that Fund drawing rights were a usable reserve asset. Noting that a country drawing on the Fund normally had the right to use the proceeds in any way it chose, he said there was some question in his mind as to whether a clear link should be made in the first instance between the Fund drawing and repayment of the swap drawings. But a Fund drawing would be appropriate, he thought, with or without such a direct link, and could still be used for the same purpose.

On the second point, Mr. Daane continued, he was sympathetic with the objective of making some advance preparation to assure that credit facilities would be available to countries in need of them, and he thought it would be useful to open discussions in a limited and exploratory manner as a precautionary measure. As he had indicated at the previous meeting, if the matter was pressed too far there might be an adverse reaction in the form of a belief that the U.S. was trying to assure the availability of credit facilities to Britain regardless of the policies that country followed. However, the approach Mr. Coombs described seemed to be reasonable. Mr. Daane thought the effort was worthwhile, although he was, perhaps, less sanguine than Mr. Coombs about the prospects for success. Nor was it entirely clear to him that the proposed arrangements would relieve pressure on the dollar. There would be some initial

relief of pressure in that the credit of another country would be substituted for that of the U.S., but that effect would disappear, he thought, once the proceeds of any loan had been used.

Mr. Coombs agreed with Mr. Daane's final point, but said that the proposal would have the advantage of making it unnecessary for the System to do a certain amount of lending and an equivalent amount of borrowing. As to the prospects for success, he thought the BIS was ready to go along with the proposal. He was not certain about the Bank of Italy, but felt they might also be agreeable; it was their view that any breach in the present system would make difficulties for all, including Italy.

In response to questions by Messrs. Mitchell and Hickman, Mr. Coombs said he was not proposing to ask for unconditional commitments for credit extensions to countries in difficulty; indeed, even drawings under the present standby swap arrangements were always subject to the approval of the lending country. Nor did he suggest written documents in which the U.S. would agree to reduce its maximum drawing rights under existing swaps by the amounts of any credits extended to third countries. He proposed only informal, oral understandings to that effect.

Mr. Bryan remarked that he agreed with Mr. Coombs' first proposal, for a U.S. drawing on the Fund. He was not sure of his position on the second proposal, but could see no reason for not exploring that avenue.

Mr. Ellis observed that there obviously was a sensitive relationship between the positions of the dollar and the pound, but it was not clear to him that weakness in the yen, which was not an international currency, would have serious implications for the dollar. He questioned whether a parallel should be drawn between the situations with respect to the yen and the pound.

Mr. Coombs replied that the yen certainly did not play a role such as that of sterling in international finance, but it nevertheless was an important currency. Japan had a large population, was the world's third largest steel producer, and was a major participant in world trade. Accordingly, difficulties for the yen could have repercussions on the whole pattern of international trade and finance, including a possible sharp curtailment of U.S. exports to Japan. Moreover, with Japan's heavy borrowing in the Euro-dollar market, a collapse of the Japanese credit structure could have serious consequences in that market. Such a collapse thus could have far-flung effects.

Mr. Ellis then asked whether third countries might not be willing to extend credits to Britain or Japan without informal agreement by the U.S. to reduce its maximum drawings under existing swap lines. It would be preferable, he thought, to increase the total volume of funds available on a standby basis in that manner, rather than to shift U.S. drawing rights to other countries.

Mr. Coombs agreed that such a course would be better if it was feasible. But a number of countries had been reluctant to offer standby facilities to nations other than the U.S. He did not think that the chances for successful negotiations would be as good if the U.S. did not provide the inducement of assuring no increase in the total commitments of the lending countries. He considered the proposal to shift some of this country's drawing rights to others more or less as a useful tactical approach; the alternative that Mr. Ellis described did not seem to be a realistic possibility for the next two or three years. In his judgment the best hope for moving in that direction would be to increase further the size of the Federal Reserve swap lines.

Mr. Ellis commented that a particular System swap line would not be available for the defense of, say, the pound if it happened to be fully drawn by the U.S. Thus, he thought the System would be leading toward an increase in its swap lines, if, in effect, it made some of its drawing rights available to other countries.

Mr. Scanlon asked if the action Mr. Coombs was proposing would impair the chances for eventual development of larger System swap lines, and Mr. Coombs replied that he did not think so. The System was continually reappraising the size of its various standby swap lines, and from time to time circumstances might suggest the need for increasing particular swaps. At the moment, for example,

the line with the German Federal Bank appeared to be on the low side, in view of the fact that the Germans had extended a $500 million credit to the British. The question here was what route offered the best possibilities for getting the Germans to help the British.

Mr. Scanlon then asked about the long-run prospects for a standby swap arrangement between Britain and Germany. Mr. Coombs replied that he had been optimistic on that score earlier but now was rather pessimistic. The atmosphere with respect to the British had changed recently; other countries noted the continuing difficulties in the U.K. situation and were concerned that the British were not taking sufficiently strong steps to deal with them.

In response to Mr. Swan's question about the probable attitude of France toward the proposal, Mr. Coombs said he thought the French would not be particularly surprised by it and were not likely to have a strongly adverse reaction.

Chairman Martin observed that the discussions proposed were exploratory in nature, and that everything possible had to be done to promote unity and coherence in the international payments mechanism. He thought it was necessary to recognize the current degree of interdependence in world monetary affairs and the importance of psychological factors; a cautious approach was required because of the risk of undesirable reactions. In that connection, he was sure the Committee could depend on Mr. Coombs' negotiating skill.

Mr. Mitchell remarked that the risks involved in the proposed negotiations might be reduced by keeping the discussions general rather than couching them in terms of possible future difficulties for one or two particular currencies. There were good grounds for a general approach; Germany and Italy, for example, might find themselves in trouble at any time.

Chairman Martin said he agreed with Mr. Mitchell's suggestion. The Chairman then proposed that Mr. Coombs be authorized to explore the matter with other central banks in a judicious manner, keeping the discussions in terms as general as possible and. meanwhile, staying in close touch with the Treasury and reporting back to the Committee from time to time on the status of the negotiations. No disagreement with the Chairman's proposal was expressed.

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 May 25 through June 9, 1965, and a supplemental report for June 10 through June 14, 1965. Copies of both reports have been placed in the files of the Committee.

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

System operations during the past three weeks were conducted against a background of declining bill rates and rather congested long-term capital markets. In maintaining steadily firm conditions in the money market (with Federal funds trading mainly at 4-1/8 per cent and member bank borrowing hewing close to $500 million), the System injected a net of some $800 million of reserves. In view of the condition of the bill and bond markets it was both desirable and feasible to effect this reserve injection through a variety of means. Thus, while outright holdings of bills were increased by about $370 million, the System also bought about $230 million of coupon-bearing securities. Extensive use was made of repurchase agreements through the period, resulting in a net addition of about $200 million to reserves in this form.

The persistent demand for Treasury bills, which has brought the rate on three-month bills down about 10 basis points in the last three weeks and 20 basis points in the last few months, remains quite remarkable in the face of consistent firmness in the money market. Earlier this year, the repatriation of funds placed abroad and unusually heavy public fund buying appeared to be factors of some importance. More recently, it appears that the bill market and other short-term Treasury issues may also have been affected by demand from investors who were holding back in the placement of funds in the long-term market. In addition, there may have been some purchases of bills by sellers of stocks. Whatever the source of demand, it has clearly been active enough to keep dealer positions turning over so rapidly that financing costs have proved to be no great burden.

Other short-term securities have not shared the strength exhibited in the bill market, although there have been some reports of switching from bills into other investments such as acceptances, commercial paper, certificates of deposit, and Government agency issues. These other short-term investments have held about steady in yield at the higher levels reached somewhat earlier this year.

Recent developments in the longer-term debt market offer a more or less typical example of reaction to suddenly enlarged supplies. The "Fanny May" announcement of a $525 million sale of 1 to 15 year participation notes was followed in quick succession by capital offerings by two of the country's largest banks--aggregating another $1/2 billion--and these announcements were

augmented by additional primary and secondary stock offerings, interspersed with a number of private placements of long-term debt. With this plethora of new issues, it is not surprising that corporate bond prices have declined, and that concessions have also been required in order to distribute bonds from slower-moving tax-exempt accounts.

Treasury issues retreated only slightly in price, in part because official purchases helped to relieve some of the overhang; dealers' holdings of Treasury bonds remain quite large, however, as dealers absorbed some selling by investors who were switching into corporate issues. On the whole, the Government securities market has performed quite well as the capital markets have adjusted to shifts in the supply-demand balance.

In the last few days a better tore has developed in the bond market--in part, because of the further drop in stock prices. Corporate bonds seem to have found a level where investors are willing to commit funds. Indeed, the recent pickup in sales of slow-moving issues and the good interest indicated in the $525 million Fanny May issue being offered today suggests the market atmosphere could improve substantially. Once underwriters have waded through the current heavy backlog, the calendar ahead--as far as things now stand--is much less crowded.

The next few weeks should be of more than routine interest in the market on several counts. First, the redistribution of reserves after today's quarterly tax date may produce some increased pressure on money center banks that in turn could be helpful in raising their dealer loan rates and in holding up bill rates. Second, there will be a further opportunity to test the viability of the corporate bond market, and to see whether greater investor interest may then develop in Treasury issues. Third, with the projections pointing to a large reserve need building up toward the July 4 week end, System operations may have to be on a scale that crowds the edges of the usual "marginal" role that it is preferable to maintain. As in the past three weeks, the purchase of coupon securities and extensive use of repurchase agreements will have to be employed as well as outright purchases of Treasury bills to meet these large needs.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period May 25 through June 14, 1965, were approved, ratified, and confirmed.

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

Mr. Brill made the following statement on economic conditions:

My appraisal of the economy at midyear can be summarized briefly: "Things are not as bad as they seem, but they could become so." Gyrations in financial markets in recent weeks suggest, at a minimum, substantial uncertainty about the near-term future, and at worst, expectations of an imminent downturn. The worst may turn out to be the case, but at the moment there is little hard evidence of it in the facts we have on the recent performance of the economy, or what we have in the way of portents for the future.

True, the pace of economic and financial growth is down from that in the first quarter. But few, if any, observers thought earlier in the year that we could keep up such a frenetic pace, induced by the aftermath of an auto strike and anticipation of a steel strike. In the event, production and sales have held up surprisingly well. Steel output has increased after a modest decline, and automobile sales appear to have leveled out at a very respectable rate. Sales of consumer nondurable goods have risen sharply, offsetting the drop in auto sales. In aggregate terms, the change in GNP, both in total and in major components, seems to be proceeding astonishingly close to the staff projections made at the turn of the year--about a $14 billion rise in the first quarter and about a $7 billion rise in the second.

You will recall that the rest of the projection suggested further steady increases over the balance of

the year, at a dollar rate close to the $10 billion average of the first half and a percentage rate only slightly smaller. What clues we have as to the near-term future are, by and large, consistent with this outlook. The latest surveys of business plans for capital spending are, if anything, more buoyant than we projected earlier, and surveys show consumer spending plans for durable goods remaining strong. Consumption-bolstering reductions in excise taxes and increases in Social Security benefits, both assumed in the projection, are closer to realization.

It is difficult, therefore, to see cause for immediate alarm. Yet, while alarm may be premature, there are some disquieting possibilities that make one cautious about deprecating the recent behavior of the stock market. It may be just the semiannual recurrence of an occupational ailment, but once again I find myself seriously concerned about the possibility of declining rates of resource utilization accompanied by upward pressure on prices. Let me make it clear that I am not talking of "inflation amidst recession." Neither extreme seems likely. But I can see an economic performance inadequate to absorb our growing labor and plant capacity, yet accompanied by some further upcreep in industrial prices.

As to the inadequacy of performance, gains in GNP at the projected rate noted earlier, 5-1/2 per cent in current dollars but less than 4 per cent in real terms, would probably not match the rate at which industrial capacity is expected to grow this year if the latest spending plans are realized. Even during the extra-ordinary volume of output in the first quarter of this year the average capacity utilization rate in manufacturing, as best we can measure it, did not reach the peaks of the mid-1950's, and the rate is likely to drift off from here on out. Capacity could become underutilized rather quickly; order backlogs are much smaller now, relative to capacity, than at the peaks of activity in 1956. A final settlement of the steel wage contract in the fall could significantly depress activity in the later months of the year.

Similarly, we haven't achieved as high a rate of labor utilization in this upswing as in earlier cycles. The unemployment rate has not gotten down as low as it did in the mid-1950's, and expected growth in the labor

force is likely to keep it from doing so. The drop in the unemployment rate in May is less heartening than appears on the surface, since it reflected principally a lagging growth in labor force rather than a spurt in new jobs. Employment has not been rising as rapidly in recent months as earlier. Slowing in the pace of economic activity would limit job opportunities further, resulting in larger reported and concealed unemployment, particularly among the difficult-to-employ teenage group--not a comforting outlook for the hot summer months.

Yet these developments are not inconsistent with some further price creep. To date, significant price increases have been concentrated, mainly in commodity areas that usually respond widely and sensitively to cyclical forces, rather than diffused throughout the structure of prices and costs. The nonferrous metal group, for example, accounts for 40 per cent of the rise in the total industrial materials index over the past year. The rate of wage increase has shown little tendency to accelerate, and productivity has gained consistently and rapidly. As a result, unit labor costs, even including large fringe benefits, have drifted down.

But this decline in labor costs has depended importantly on rapidly rising rates of production, as well as restraint in wage settlements. In the 1954-57 upswing unit labor costs in manufacturing declined over the first year of expansion, when output was rising rapidly. But the rise in production slowed markedly in 1956, while the rate of wage increase accelerated. As a result, unit labor costs also accelerated, and so did the price rise. Prices and costs continued to drift up in 1957 even after production turned down.

Once again we appear faced with the prospect of slower rates of growth in production, the possibility of reduced rates of increase in productivity, and the possibility of large wage settlements. The outcome of the aluminum wage negotiations is disturbing, particularly since it may set the pattern for a steel settlement a few months from now.

I do not assess the outlook as inflationary, in the sense that term describes the mid-1950's. There do not appear to be either the general economic preconditions of the pervasive psychology to support a repeat performance. Price pressures should continue selective--largely confined

to the metal areas, and for some time ahead, also to meats. But in aggregate these selective pressures could well produce a continued crawl in the total industrial price index at about the 1-1/2 per cent annual rate we have had since last fall.

Such price, production, and employment possibilities as I have described would leave monetary policy impaled, as usual, on the horns of the price stability-full employment dilemma. It would be nice if there were some tried and true textbook guide for policy in a situation of mild but possibly persistent slackening in resource utilization and mild but possibly persistent upcreep in prices, but I don't know of any. I have faith in monetary policy as a stimulant and as a restraint, but not in its capacity to do both at the same time. Perhaps this is one of those occasions when it is best to stand pat and wait to see how conflicting forces seem to be balancing out, before throwing the weight of our economic influence in one direction or the other.

Mr. Hickman said he completely endorsed Mr. Brill's statement, which he considered excellent. He then asked if the industrial production index for May was available as yet.

Mr. Brill replied that the May index, which would be released tomorrow, was 141.3, up 0.5 from April.

Mr. Partee made the following statement concerning financial developments:

The period since the last meeting of the Committee has been an eventful one in financial markets. The stock market has extended its decline--dating from mid-May--to a little over 6 per cent, which amounts to a sizable technical correction in average stock prices. The capital markets have been confronted with an upsurge in new corporate issues, and with continuing heavy inventories and indifferent retail demand in the tax-exempt area; yields in both markets consequently have adjusted significantly upward. And the Treasury bill market has continued exceptionally strong, with yields on the 3-month issue

falling to around 3.80 per cent, partly in response to the cut in the British Bank rate.

These developments, to some extent, are interrelated. The strength in demand for bills, for example, probably reflects in part shifts of funds by sellers of stocks, particularly institutional investors. But, for the most part, the adjustments that have been taking place appear to me attributable to independent, and at least partly temporary, pressures at work in each market. A good case can be made for expecting stabilizing tendencies to appear before long in each case, though the changed yield relationships among markets that has emerged may prove more enduring. If the market adjustments do in fact prove progressive rather than limited, of course, the implications for monetary policy would be quite different.

In the stock market, technical corrections are to be expected in the course of a long upswing in prices. Five such corrections have occurred earlier in the current bull market, the most recent one in November-December 1964. This year the market moved strongly upward again, buoyed by excellent earnings reports and the ebullient business sentiment of the first quarter. Over the whole upswing, however, the price advance has considerably exceeded gains in earnings, so that the ratio of prices to earnings rose from 15 in the fall of 1962 to 18 times estimated earnings for 1965 in mid-May. This is well below the end-of-1961 relationship, but it is fully as high--in fact, somewhat higher--than the ratios reached toward the ends of earlier business expansions, in 1960 and 1957.

Therefore, it is not surprising that investors have shown increased nervousness this year as the stock price rise continued. The recent slowing in the business advance, uncertainties about the international situation, and sensitivity to statements, rumors, and other factors--all have induced some investors to play it safe and sell. To date, however, the decline has been led by investment grade rather than speculative stocks, and on relatively moderate average trading volume. Stock market credit is in good shape, and institutional buyers, with their constant press of new funds, have become increasingly important factors in the market. The price-earnings ratio has already fallen one full point, to 17, and, given the basic differences cited, the odds would seem to be against a sharp cumulative sell-off such as occurred in 1962.

In the bond market, the calendar of new publicly-offered corporate issues had already been running heavy, with volume up 40 per cent from last year in the March-May period. This larger volume was being moved only with some difficulty, even before the two big bank offerings were announced. At this point, the market broke and yields rose around 10 basis points to the highest level since the summer of 1961, when new offerings were also unusually large. In addition, continuing high dealer inventories and an apparent slackening of bank demand in the municipal market brought an upward adjustment in tax-exempt yields, also by roughly 10 basis points. Government bond prices have changed little thus far, perhaps mainly because there has been no evidence of a volume market at slightly lower prices and because dealers are able to carry their still substantial holdings of the 4-1/4's and other issues at a small net profit.

We can expect a continuing large volume of new corporate offerings, though with some seasonal slackening, in view of rising capital expenditures and the probable current leveling in earnings and internal cash flow. But there has been no diminution in the flow of investment funds, except possibly for bank buying of municipals, and the volume of mortgage funds demanded and supplied seems still to be slackening. Therefore, the upward yield adjustment in capital markets is likely to be limited, though new shocks could certainly have a further impact. Whether the Government market will join in the adjustment depends importantly on whether dealers will be able to distribute the 4-1/4's in a gradual and orderly manner.

In the Treasury bill market, in addition to a continuing good demand from public funds, corporations, and other buyers, recent strength also reflects the limited supply of bills available to the public. In May, the total of bills held by the public declined by nearly $700 million, as compared with increases or only small decreases in the same month of other recent years. This mainly reflected purchases for the Federal Reserve Account, but there will also be a substantial decline in June as the tax bills mature. An unusually high Treasury cash balance suggests that there is no need for new financing in the immediate future, and the cut in Bank rate has given some in the market confidence that a somewhat lower level of bill yields will be tolerable from a balance of payments point of view.

The relative shortness of bill supply has persisted all year, and downward pressures on yields would doubtless have been stronger had it not been for large-scale selling by commercial banks. Bank liquidation of bills through April amounted to $3.1 billion, and we estimate that net sales may have amounted to another $600 million in May. Reflecting this continued liquidation, and also a decline in net purchases of other securities, bank credit in May again increased at an annual growth rate of only about 8 per cent, well below the first quarter and slightly less than the average for 1964. Bank loan expansion also has moderated considerably since the first quarter, and business loans, though still rising vigorously in April and May, appear from the weekly reporting bank fugures to have shown somewhat less strength in late May and early June. The important comparison in such loans is over the tax date, of course, for which no information is yet available.

More moderate growth in bank assets has been matched on the liability side by smaller expansion in private deposits. Despite continuing sizable net sales of CDs by the New York City banks, total time and savings deposit growth slowed in May to a rate well below the 12-1/2 per cent average for 1964. As for private demand balances, the May decline appears to have been an aberration, and already had been recouped by a sharp rise in late May and early June. As of the first week in June, however, the money supply was less than 1 per cent above the December average, and even with substantial increases in the next month or two, growth since year-end would remain well below the apparent increase in money transactions.

Given the recent moderation in the banking figures, the uncertainty in securities markets, and the evident exposure of the Government bond market, an unchanged monetary policy seems fairly clearly indicated at this time. To adopt a more restrictive policy could risk serious market disturbances, which seems unnecessary in view of the slower pace of bank credit and monetary expansion already realized. Nor does it seem to me that the financial indicators clearly call for an easing in policy as yet, especially in view of other domestic economic considerations discussed by Mr. Brill.

At the same time, this does appear to be an appropriate occasion for the Committee to consider giving more

formal recognition to the possible provision of reserves through operations in longer-term markets, as is implied in the last parenthetical phrase of alternative A of the staff's draft directives. 1/ Downward pressures on bill yields may well be reasserted once the tax date is past, and the Government bond market is, I think, in a vulnerable position. Only a small proportion of the reserves needed over the next four weeks could be accommodated by purchases in the longer-term market, but these amounts could potentially have an important conditioning effect in both short and longer maturity areas.

In any event, an unchanged monetary policy would seem currently to call for net borrowed reserves of around $150 million and continued firmness in those money markets closest to the reserve adjustment process. I do not think that the term "money market conditions" should be taken to encompass the whole range of instruments traded at this time. If bill rates do continue in the current lower range, this could carry some other money market rates, such as on finance company paper and bankers' acceptances, down a bit as well.

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

It is now clear that the United States will have a payments surplus in the second quarter of 1965. The "flash report" for May, compiled yesterday, shows a surplus of about $90 million on the conventional "regular transactions" basis. This brings the preliminary April-May total to $230 million. And there was a further surplus during the first 9 days of June, according to weekly figures. We should be prepared for the possibility of weekly deficits later this month when large new foreign security issues are scheduled, but they are unlikely to wipe out the surplus for the quarter as a whole.

The figures for the balance settled by official transactions will be similar to the conventional ones, since net changes in foreign private balances in this

1/ The two alternative drafts of the directive prepared by the staff are appended to these minutes as Attachment A.

country have been small so far this quarter. And net seasonal influences on both balances are also small at this time of year.

Thus, as a result of events already largely past, newspaper readers seem assured of a steady flow of good news about the U.S. balance of payments for some weeks to come. They have already learned of the March and April surpluses. They will learn in due course of the May surplus, and perhaps even of a June surplus. The preliminary second-quarter figures, to be published in August and then refined in September, will be by far the most cheerful in 8 years. They will no doubt set off resounding echoes at the IMF annual meeting of the unexpected praise for U.S. policies that has recently graced the BIS annual report.

Yet I am afraid that I and my colleagues in the Division of International Finance must continue to croak Cassandra-like warnings in the weeks ahead. It is not merely that one swallow does not make a summer. The point is that we cannot yet be sure that we have seen a swallow at all, in the form of any lasting turn for the better. There have been so many strictly temporary influences working in our favor, as noted in the staff comment on the third question 2/ on today's agenda; and there have been so few evidences of any underlying improvement. Mere waning of temporary influences--quite apart from seasonals--could plunge us back into deficit by the end of the year unless underlying improvements do take hold.

One striking new indication of the magnitude of recent temporary influences is provided in detailed balance of payments figures to be published in the June Survey of Current Business in about 2 weeks. These figures will show that U.S. direct investment outflows rose to $820 million (seasonally adjusted) in the fourth quarter of last year, and to an even more startling $1 billion in the first quarter of 1965. Thus, U.S. corporations pushed out $1.8 billion of direct investment capital in 6 months, nearly 70 per cent more than in the preceding 6 months. Clearly, they were acting in anticipation of a possible imposition of controls or special taxes. Clearly also, they can temporarily cut their outflows a

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2/ Certain questions suggested for consideration by the Committee, and staff comments on them, are given at a later point in these minutes.

good deal in the current quarter and in several later quarters without this indicating any underlying change in the previous uptrend of U.S. direct investment outflows. In the direct investment sector, we simply cannot know for months how the trend is going.

Merchandise trade is another sector where we have been in the dark for months. Fortunately, we can hope for a trend reading here fairly soon, as the dock strike recedes into the past. A tentative reading from data through April is disquieting. April exports, while still reflecting effects of the port-strike catchup, were already off considerably from the March peak, and more so than imports, contrary to earlier hopes. As a result, the trade surplus for the period from December through April--a period during which strike effects might have been expected to wash out--was less than $5-1/2 billion at an annual rate, compared with $7 billion last fall. Exports in these 5 months were only 2 per cent larger than a year earlier, presumably owing to some slackening of demand from Europe and perhaps also from less developed countries. Imports meanwhile were up 10 per cent on the year, having bulged in response to enlarged inventory demands here and perhaps also as a result of keener competition from abroad.

Obviously, trade trends will bear very close watching in the next few months. So also, I think, will the distribution of the payments deficits and surpluses of foreign countries. As noted in the green book 3/, the payments surpluses of continental European countries diminished sharply in March-April. But temporary factors were operating there as here. And Italy and France have continued to run substantial surpluses, while Japan and Britain continue to show payments weaknesses. As Mr. Coombs noted, we have just received very disappointing U.K. trade figures for May, with imports up to a new high and exports down a little.

A key question for international adjustment this year will be whether Britain and Japan, in addition to the United States, can strengthen their positions while surpluses diminish in such countries as France and Italy. If, instead, Britain and Japan continue to

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

experience difficulties, they may have to turn to us for assistance, and may have to pursue policies that will significantly depress world trade, including our exports to them and to less developed countries. We must hope that adjustments in international trade will come largely via renewed expansion of demand in the surplus countries (and maintenance of expansion elsewhere). Since data for the summer months are usually unreliable because of difficulties in allowing for seasonal influences, it may well be autumn before we can judge whether this hope is being fulfilled.

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

(1) Business conditions--How do business developments since the interim steel wage settlement alter the prospects for sustainable economic expansion?

Expansion in business activity has slowed somewhat in the six weeks or so since the interim steel wage settlement, confirming earlier expectations, but on present evidence it appears that the current pace is likely to be maintained. Most of the slowing reflects the decline in auto sales from the exceptionally high rates earlier in the year. The decline in auto sales seems to have halted, however, with May sales about equal to those in April. Moreover, consumer spending for nondurable goods recently has risen appreciably.

Business accumulation of inventories is apparently continuing at a rate not much below that in the strike-threat period. Steel output has continued high and user inventories have not yet been reduced. Order backlogs in the industry suggest that, after allowing for seasonal changes, high operating rates and large inventories will be maintained through early summer. Auto output is also continuing at a high level even though sales have declined.

Latest surveys of business capital spending plans indicate that expenditures for plant and equipment will rise more rapidly over the second half than in the year to date, and surveys of consumer buying plans indicate a continued high level of demand for

autos and other durable goods. While the effects of the prospective excise tax cut and increased Social Security payments cannot be estimated with any precision, they should, of course, operate to buttress consumer demands. Thus, both recent and prospective developments suggest continued economic expansion over the summer months, although at a slower pace than in early 1965. Sustainability of the expansion beyond the summer depends importantly on the sharpness of the prospective inventory adjustment in the steel industry, and on whether growth in aggregate final demands will keep pace with the large additions to industrial capacity now in train.

(2) Prices--What do recent wage negotiations, changes in farm and nonfarm prices, and proposals for excise tax cuts portend for the course of prices over coming months?

Industrial price increases in recent months, concentrated mostly in markets for metals and metal products, have continued to reflect selective demand pressures relative to limited supplies, rather than generally rising production costs. Unit labor costs in manufacturing have moved lower, as gains in productivity have continued to outrun rising wages. The aluminum wage settlement, while above the Administration guideposts based on national productivity changes, was below the estimated productivity increase in the industry. This suggests that the aluminum price increases--both before and after the wage settlement--reflected principally strong demands rather than the pressure of labor costs. The slower pace of economic expansion in prospect over coming months should serve to limit and keep selective any further industrial price increases.

The recent rise in food prices also reflects changing demand-supply relationships, particularly in meat products. Reduced production of meat at a time of rising incomes is being reflected in a surge in meat prices, which are likely to continue upward to a seasonal peak in the summer. Further rises in meats alone could raise the total consumer price index by as much as .5 per cent.

The proposed excise tax reductions on a variety of goods and services would provide a partial offset to the index-raising effect of meat prices. The impact on the consumer price index, if all tax cuts were passed on to consumers, could be as much as .5 per cent. Further reductions for autos through January 1, 1969, could amount to an additional .2 to .3 per cent in the index.

(3) Balance of payments--How close was the United States to balance in its international transactions in April and May, after allowing for influences that may be considered temporary?

Preliminary data indicate that the United States had payments surpluses in both April and May, averaging perhaps $50-$100 million per month on either the conventional "regular transactions" basis or the "official settlements" basis. Net seasonal influences are very uncertain, but adjustment would perhaps diminish the surplus in these months.

Effects of the voluntary programs for restraint of capital outflows, both by banks and others, were very substantial in the first few months of the programs, producing sizable reflows of corporate liquid funds in March and April and net repayments of bank credit in April. Meanwhile, new issues of foreign securities exempt from the I.E.T., which are expected to increase in later months, remained relatively small through May. Strictly temporary favorable influences of these kinds, together with the unwinding of the port-strike tie-up in merchandise trade, may have swung the balance toward surplus by more than $200 million a month in April-May, so that without them there might have been a sizable deficit, particularly on the conventional basis of measurement.

Fragmentary evidence suggests that U.S. corporations may have repatriated additional amounts of liquid funds in April, perhaps around $100 million. If there were further reflows in May, they probably were smaller, since corporations are approaching the goals set for them in this sector. Also, indications that corporations made sizable advances to direct investment subsidiaries in the early months of 1965, covering future needs, suggest that direct investment outflows since the voluntary restraint program began may have been below normal.

U.S. banks reduced their outstanding credits to foreigners by about $150 million in April. For all banks together, this left scope within the VFCR targets for a renewed net outflow that could average $30-$40 million a month during the rest of the year.

New issues of foreign securities sold to U.S. residents in April-May were only $80 million a month, about $50 million below the average rate expected for both the first half year and the year as a whole. Particularly heavy offerings of about $300 million are scheduled for June.

As to merchandise trade, further progress was made in April in clearing export and import shipments held up by the port strike. The catch-up to be made by exports was greater than for imports, and the trade surplus was still swollen in April, perhaps by as much as $50-$100 million, despite an unexpectedly large drop in exports. A similar relationship probably prevailed in May.

While the merchandise trade position has been unusually favorable in a strictly temporary sense because of the strike after-effects, the underlying cyclical trends, now beginning to be discernible with the April statistics, appear to have been a leveling off in exports and a further rise in imports--the latter reflecting enlarged inventory demands for steel and other materials. This recent unfavorable development in U.S. foreign trade may prove temporary, in a longer time perspective, but it is too early to venture a judgment on this.

(4) Bank credit--How are banks adjusting to the combination of reduced marginal reserve availability, slower saving deposit growth, and less strong loan demand that has prevailed since the first quarter?

Banks are adjusting to changes in supply and demand conditions in part by seeking funds more aggressively in money and capital markets and in part by shifts in investment policy. Earlier in the year, banks, were able to accommodate peak loan demands and add substantially to their holdings of municipals with funds provided by the exceptionally large inflows of time and savings deposits and liquidation of short-term Government securities. Beginning in March, inflows of time and savings deposits slackened, and more recently, so have loan demands. With marginal reserve availability also reduced, and with the bill yield remaining below the discount and Federal fund rates, banks have continued to liquidate short-term Governments, but in May, they also sharply reduced the rate of acquisition of municipal and agency issues.

A few large banks, particularly in New York City, adjusted to heavy actual and anticipated loan demands and to sizable basic reserve deficits by aggressively issuing CDs. In New York City, as a result, time and savings deposits increased in April and May at an even faster rate than in the first quarter; borrowings at the Federal Reserve have been reduced to nominal levels; and banks have switched from being heavy net purchasers to small net sellers of Federal funds. In contrast, in reserve cities outside New York, the outstanding volume of CDs has changed little; borrowings, recently around $375 million, have been about double the first quarter level; and banks have been heavy net purchasers of Federal

funds. These differences are partly explained by indications that loan demand has been less strong outside New York and that issuance of CDs (by non-prime banks) may have been inhibited to some extent by interest rate ceilings and other factors.

(5) Interest rates--What are the principal factors that recently have raised interest rates in the capital markets and lowered yields on Treasury bills, and how do these developments appear to be influencing the near-term outlook for long- and short-term interest rates?

To some extent, recent increases in corporate and municipal bond yields and declines in Treasury bill rates have reflected seasonal pressures, which tend to work in opposite directions at the two ends of the yield spectrum at this time of year, but other factors have reinforced seasonal influences. The current widened yield spread now appears likely to persist, for a time at least, barring unexpected increases in the supply of bills or other securities or a change in monetary policy.

On the supply side, short-term Treasury securities available to the public are being reduced by the largest net repayment of Federal debt for any second quarter since 1957. Substantial Federal Reserve purchases of bills have also reduced the supply available to the public. At the same time, demands for short-term securities by public funds and corporations have been heavy, with corporate demands augmented by preparation for tax payments on the exceptionally high corporate earnings so far this year. Temporary investment of proceeds from heavy capital market financing, repatriation of liquid funds from abroad, and transfers of funds from the stock market also have been factors in the recent demand for short-term securities. Net bill sales by banks and by foreign accounts have only partly satisfied these demands.

Such downward pressures on Treasury bill rates were accentuated by the recent reduction in the British Bank rate, following which the outstanding U.S. 3-month bill declined almost 10 basis points to around 3.80 per cent. The market appears to have adjusted to a lower bill rate range, at least over the near term, than was believed sustainable earlier in the spring.

During the period when bill rates eased there was some slight reduction in dealer lending rates at New York banks, reflecting in part their changed basic reserve position (discussed above under Question 4), but other short-term rates have remained firm. The unusually large spread between Treasury bill rates and other money market rates that now prevails will no doubt inhibit further declines in bill rates and may exert some upward pressure.

The recent rise in corporate and municipal bond yields has been associated with a bulge in capital market financing in the second quarter. Such a bulge is not unusual at this time of the year; in fact total new security offerings, stocks and bonds together, were significantly larger in the second quarter of last year. But particular pressures have been exerted on yields this year by the sharp rise in the share of total offerings represented by corporate bonds--particularly publicly offered issues--and by an apparent cut-back in the share of new municipal issues being taken by banks.

Looking ahead, the immediate supply of municipal offerings is expected to decline moderately. And there is as yet no evidence of any large individual offerings for this summer similar to the Treasury's advance refunding and the public power issues which enlarged the summer calendar a year ago. On the other hand, underwriters anticipate a heavy continuing volume of new offerings of corporate securities through the summer. This expectation is supported by projections of corporate sources and uses of funds showing rising investment outlays and dividend payments in the face of an expected level of profits below the very high first quarter rate. Moreover, a relatively large supply of U.S. Government securities maturing in over 5 years--almost $700 million as of June 10--remains in dealer hands, and a heavy supply of Federal Agency issues has come or soon will be coming to market.

(6) Money market relationships--Assuming a continuation of current monetary policy, what range of money market conditions, interest rates, reserve availability, and reserve utilization by the banking system might prove mutually consistent during coming weeks?

Continuation of current monetary policy, with net borrowed reserves averaging around $150 million, is not likely to be accompanied by any significant change in domestic interest rates during the next few weeks, barring a shift in interest

rates in leading financial centers abroad or a sudden change in investor psychology. In this environment, Treasury bill rates could continue low relative to other money market rates.

After the mid-June tax and dividend pressures, a number of market influences may be tending to exert downward pressure on bill rates. Among these are a probable post tax-date resurgence in corporate demand, reinvestment demands following maturity of the June tax bills (the volume outstanding is substantially in excess of the amount expected to be used to pay tax liabilities), and sizable System buying for reserve purposes in late June and early July. Working in the other direction, a return to a more usual position of basic reserve deficiency by New York City banks would put upward pressure on dealer loan rates and, to some extent, on bill rates.

On balance, it appears that in the absence of any significant change in the level of net borrowed reserves, the 3-month bill rate will remain in the 3.78 - 3.90 per cent range that has prevailed over the past month, with the odds seeming to favor the middle or lower end of the range. Bill rates in this range obviously will not be transmitting upward pressures to long-term rates, but current congestion in the corporate and municipal markets will tend to keep long-term rates at least around present levels over the near term.

Under the money market and marginal reserve availability conditions postulated above, total bank credit expansion in the months ahead would probably be no larger, and perhaps somewhat smaller, than the 8 per cent rate of April-May and the year 1964 as a whole. With respect to money supply, data for early June indicate a sharp rebound after the sharp May decline. Even with bank loan expansion moderating, further substantial growth in the money supply is likely over the summer months, as excise tax reductions and retroactive Social Security payments result in a more than seasonal reduction in the Treasury's cash balance. The rise in private demand deposits over the next month or two is likely to be substantially in excess of a 4 per cent annual rate, since the influence of some of the factors that led to the slight decline in these deposits through May has waned.

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:

Despite the current jittery state of the stock market and the appreciable drop in stock prices in recent weeks, the underlying business situation continues to develop about as expected. Business is strong, though growth is not quite so rapid as in the first quarter, and prospects for further significant expansion over the balance of the year remain good. Though available production figures for May are mixed, retail sales moved up sharply. Strong consumer buying intentions and the latest reading of business spending plans for plant and equipment support an optimistic appraisal of the months ahead. It seems to me much too early to conclude that the capital spending surge has gone too far and is due for some readjustment next year. The drop in unemployment in May to 4.6 per cent was especially gratifying in view of the unusually rapid growth of the labor force since the beginning of 1965. (I am aware that here our research people have come to a conclusion different from that of the Board's staff.)

The price situation continues to give cause for concern. The overall industrial wholesale price index moved up again in May, and the predominance of specific price announcements on the upside indicates that producers feel the atmosphere continues to be favorable to testing markets. An example is the series of increases for aluminum products following the recent labor contract settlement. Moreover, the settlement itself has revived fears of a spreading pattern of wage increases in excess of the Council of Economic Advisers' guidelines. In taking a somewhat longer-run look at movements in industrial wholesale prices, it is apparent that the index has been on a mild but persistent uptrend for two years, following a four-year period of gentle decline. While increased nonferrous metal prices have been an important factor in this rise, this is by no means the full story. Our analysis indicates that two-thirds of the increase in the index in the past year, and three-fourths of the increase since September, reflects higher prices for items other than nonferrous metals. Consumer prices probably moved up even faster in May than in April--although the July cut in excise taxes should provide some partially offsetting decline on a one-shot basis.

Preliminary statistics indicate that our international transactions showed a small surplus in May. There are indications that bank loans to foreigners declined, and reports suggest that one important factor in this drop was the sale by several large New York banks to their foreign branches of parts of their loan portfolios in order to get below their 105 per cent quotas. Without such temporary factors as restraint in bank lending abroad and in corporate investments in foreign money and deposit markets, our balance of payments would probably have shown sizable deficits in both April and May.

There seems to be little doubt now that the rate of growth of bank credit has dropped back from the very rapid first-quarter pace to roughly the 8 per cent annual rate that has been typical of the current expansion. Business loan demand, both actual and projected, however, continues strong and broad-based, although a little less buoyant than it was. The slackening of bank credit growth during the past two months has to some degree reflected increasing pressure on the liquidity position of the banking system. The dwindling holdings of Government securities continue to be liquidated and loan-deposit ratios are still rising. Recent data on the quality of credit give no clear indications of any significant deterioration. Although the money supply declined during May on a daily average basis, it rose toward the end of the month; and in viewing the virtual absence of growth in the money supply during the first five months of this year, I think we must give considerable weight to the unusual rise in Treasury deposits during this period. The effects of this build-up may be reversed by the normal unwinding of Treasury balances after June 30.

In considering policy, I think we can regard the business situation and outlook as clearly favorable; and it seems to me that such weakening of sentiment among some analysts as has occurred has been mainly an over-reaction to the slowing from the abnormal first quarter rate of expansion. While we cannot overlook the possibility that the stock market's performance itself could be a significant adverse influence, I doubt very much whether we can regard it in this light today. In the meantime, the balance of payments problem, although continuing to show marked statistical improvement in response to the President's voluntary restraint

program, is still extremely serious. There is no evidence as yet of more basic forces working toward equilibrium, and this accentuates the disturbing character of the stepped-up pace of price advances in the last few months and the very real risk of added wage and price pressures in the coming months. In a sense, time is running out, since it will be harder and harder to finance deficits without gold losses, and the voluntary restraint program cannot be expected to be effective indefinitely. The domestic economy seems amply able to withstand a somewhat firmer policy; and it is by no means clear that we have succeeded in slowing the pace of bank credit growth to appropriate levels.

Under these conditions, I think the Committee should move toward a slightly firmer policy, symbolized perhaps by an increase in borrowing from the Reserve Banks and by net borrowed reserves fluctuating on both sides of a $200 million average, rather than around $150 million. I would expect swings on both sides to be rather wide and am merely using these figures as illustrative of some slight policy change. In view of the combination of factors creating downward pressures on bill rates and the doubtfulness of a near-term reversal of these pressures, despite the June tax and dividend dates, it would probably be unwise to set any particular goal in terms of the bill rate. The Treasury's high balance naturally hampers it in any move to increase the supply of bills. However, I would hope that we could see a gradual upward rate trend develop, partly because it would provide valuable psychological support for the voluntary restraint program.

The directive should be modified to reflect a slightly firmer policy, if the Committee agrees that such a move is desirable. The staff's alternative B seems quite satisfactory.

Mr. Shuford said the most recent data showed that the national economy had not been advancing at the unusually rapid rate of last winter. He believed that such a change had been desirable; dependable continued growth required a return to the rate of the past two

or three years. The recent progress of employment and production had been possible despite the more restrictive fiscal situation and the sluggish behavior of the money supply. It seemed fortunate to him that neither fiscal nor monetary conditions had been any easier.

As for the near future, Mr. Shuford continued, it now appeared that the fiscal situation would be easier in the second half of the year. Accordingly, it seemed to him that for the time being the Committee might well keep monetary policy much as it was. He would expect that posture to involve moderate growth in reserves, bank credit, and the money supply. As the Treasury reduced its balances with the commercial banks and as the new seasonal adjustment factors were adopted, he believed it would be seen that there had been some monetary increase. In his judgment a failure of the money supply to show some increase over the next few months would be undesirable.

As for interest rates, the recent weakness of bill rates seemed to Mr. Shuford to have been due to an unusual demand, and partly seasonal in nature. He thought some strengthening in bill rates might be expected.

Mr. Shuford said he had been inclined to the view that the country was experiencing an excessive total demand for goods and services, evidenced in part by stronger wholesale prices. He also had thought it would be undesirable for total demand to continue to

increase at the rate of early this year. Now, however, while the threat of price rises had not abated, he considered it appropriate to continue recent moderate policies and to see what the next few weeks revealed. He did not believe that the international situation required any other policy at this time.

Mr. Shuford did not favor a change in discount rate at present and he found alternative A of the staff drafts of the directive satisfactory. He recognized the observations that Mr. Partee had made with respect to the parenthetical final clause of that draft, but, while he did not have strong feelings on the matter, he would be disposed to exclude the clause in view of his position of favoring no change in policy.

Mr. Bryan said that the pace of economic activity in the Sixth District seemed to be well maintained. The most eloquent figure was that revealing a continued reduction in the rate of insured unemployment; the figure fell to 2.4 per cent in the latest report, for April--not a banner month in itself by any means.

Mr. Bryan did not detect from the reports of Reserve Bank and branch directors that there had been any marked deterioration of business sentiment in the District. However, there did seem to him to be less ebullience in sentiment nationally, and some slow-down in the rate of national economic advance. Accordingly, speaking in qualitative terms, he would advocate no change in policy at this

time, especially in view of existing uncertainties, which might be partly psychological in character. He advocated no change in the discount rate, and he doubted that there should be any considerable change in the free reserve target. Instead, speaking in quantitative terms, he advocated a continuation of net borrowed reserves in the $150-$200 million range for the short term.

Mr. Bryan remarked that he would comment on only two of the questions posed for this meeting, relating to prices and the balance of payments. As the Committee knew, he had for some time taken a dim view of price developments. The staff at the Atlanta Reserve Bank told him that the development of new plant capacity, the wage guidelines, the decline in unit labor costs, and the fact that price increases had been selective should be reassuring. The facts were, he thought, quite plain, as some of them had always been. The wage guidelines were essentially meaningless, and elements of Government policy fully attested to the fact that they would become even more meaningless. The classic creeping inflation of the consumer price index was now being compounded by a rapid movement in the manufacturers' wholesale price index, which was up on a three-months basis at an annual rate of 2.8 per cent. The consumer price index, which would have an upward trend even if the wholesale index were entirely stable--as it had during periods when the wholesale index in fact had been wholly stable--had to

ride on the back of the wholesale price increases and reflect not merely its own upward slant but the increase in wholesale prices as well. Accordingly, he looked for a combination of factors of either the cost-push or demand-pull variety--probably both--to increase the rate of price increases. The thought of what that could do to the American dollar in a brief span of, say, twenty years, was extremely disturbing.

Mr. Bryan remarked that he had come to the conclusion that the policies of the Government made inflation ultimately inevitable. He had one other comment--the so-called "selective" price increases were exactly the kind of increases that consumers would not be able to resist.

With respect to the balance of payments, Mr. Bryan noted that the Committee was confronted with good news of surpluses. But when those surpluses were cut down to size by obvious adjustments, it was clear, he thought, that the country's payments position was not in as good shape as one would like to assume. Quite obviously, the voluntary restraining program was setting up countervailing forces that would have their effect. It should be remembered that tying foreign aid dollars to onshore purchases of American goods, while it would be too much to describe as useless, did not--for what were now obvious reasons--produce the dramatic results that had been hoped for. He was frankly of the opinion that in the end measures

other than the voluntary restraint program would have to be taken, measures that would be distasteful. Among such measures, he thought, sooner or later there inevitably would have to be an extraordinarily large reduction in the nation's nonmilitary grants-in-aid program.

Mr. Bopp reported that reserve pressures on Third District member banks had increased markedly thus far in the second quarter, relative to those prevailing in the first quarter. On a daily average basis, reserve city banks incurred a basic reserve deficit in the second period over twice that which prevailed in the first quarter ($88 million vs. $42 million), and in the past three weeks those pressures had intensified even further ($144 million on a daily average basis). Pressures on country banks also had increased with borrowing at the discount window for the latest reporting period reaching the highest level since mid-1960.

The pressures had been intensified, Mr. Bopp said, by a relatively strong loan demand in the second quarter, superimposed on a leveling in time deposits and a sharp downturn in recent weeks in the level of demand deposits. Reserve pressures at the reserve city banks had been funneled primarily into the Federal funds market, with average daily borrowings in the second quarter almost double those in the first.

On the labor relations front, Mr. Bopp continued, a discussion with an outstanding authority this past week elicited his

feeling that the steel settlement would not be quite so generous as that in the aluminum industry. However, that authority thought the companies would be anxious to avoid a strike--and perhaps pay a little more to do so--in order to place Mr. Abel in a solid position and thus hopefully bring greater stability to labor relations in the industry. He was somewhat pessimistic over prospects for longer-term success of the guidelines, feeling that costs of fringe benefits were underestimated in figuring the guidelines and that the guidelines in general rested on too narrow a base of agreement between Government, business, and labor.

Turning to policy, Mr. Bopp said that the moderate restraint now prevailing appeared appropriate to the unfolding economic situation, characterized as it was by a slowdown from the very rapid growth of the first quarter. Although upward pressures on wholesale prices had become evident in recent months, he continued to be impressed by the moderate and selective nature of pressures in the industrial sector. He was encouraged also by the improved unemployment picture, although his encouragement was tempered by the recent slowdown in the rate of growth of the labor force--a situation which might reflect decreasing growth in job opportunities--and by prospects for a large summer influx of teenagers into the labor market. A weighing of the merits of further restraint at this time also had to consider the facts that rates of growth in

money and bank credit already had declined and that there existed some congestion in markets for corporate and municipal securities as well as some concern over the future of common stock prices. Given those factors, and also considering the apparent continued success of the voluntary restraint program, he would make no change at present in the general posture of monetary policy. He favored alternative A of the staff drafts of the directive, including the final clause.

Mr. Hickman commented that the pace of business activity was in the process of leveling off, as the discussion in the green book clearly indicated. The slackening of the business advance in April provided a hint of the types of readjustment the economy would probably undergo later on this year. On the other hand, the figures for May could turn out to be deceptively buoyant, as readjustments in steel and autos had been delayed.

Mr. Hickman noted that auto sales, seasonally adjusted, had declined for four successive months, but production remained high and inventories were establishing new records. Steel production rebounded in late May, and to judge by early portents June might be equally strong. After several weeks of decline, incoming orders were moving up once again, according to confidential reports received from steel companies in the Fourth District. Steel inventory accumulation was renewed in May, partly because of the

fear that the steel industry would take a strike rather than accept the settlement in the aluminum industry. Mr. Wernick's analysis in the appendix of the green book was particularly helpful in evaluating the present wide gap between labor demands and the steel industry's ability to meet those demands.

Mr. Hickman remarked that additional light on changes in the business climate was provided at a joint meeting last Thursday of the directors of the Cleveland Reserve Bank and the Cincinnati and Pittsburg branches. For the first time in many months, the industrial directors expressed uncertainty and nervousness about the business outlook, for reasons apparently not directly related to the stock market slump. Several directors noted that rising wage rates in the current expansion had been offset, in unit labor costs, by an even stronger rise in volume. Those directors were apprehensive lest a downturn in volume, coupled with rigid wages and other costs, might result in a drastic squeeze on profits, which in turn might trigger a decline in capital spending. It was noted that the most recent Commerce-SEC survey of capital spending showed no upward revision from the previous survey, and thus failed to confirm the earlier optimistic McGraw-Hill release.

The recent softening of the 91-day bill rate could be explained as a conjuncture of special circumstances, Mr. Hickman said. For one thing, liquid tax and dividend funds of corporations apparently

increased more than seasonally this year, reflecting exceptionally high first quarter profits. Also, the demand of public funds for short-dated securities had continued unabated. In addition, the recent Treasury advance refunding had reduced the supply of short-term issues in dealers' hands. At the same time, long-term markets had become congested due to the large volume of corporate and municipal securities being brought to market and the open-end nature of the advance refunding, which resulted in larger subscriptions to the 9-year bond by dealers and speculators than could be absorbed by regular investors. The massive advance refunding lengthened the maturity of the debt by a month or two, but it had less fortunate effects on prices and yields of Government securities. Thus, once again, the System had been placed in the undesirable position of trying to bail out the dealers in the long-term market, while trying to prop up yields in the short-term market. Unfortunately, there had been only mixed success thus far.

Mr. Hickman went on to say that the present limited flexibility of monetary policy also stemmed in part from the fact that the Committee had not done all that it should have last summer and late last year. He then had felt that greater restraint was needed to moderate the unsustainable pace of the business advance, and had recommended such restraint. Because the Committee had not moved then, it was less free to move in the opposite direction as the level of business activity showed signs of turning down.

Within the present environment of business and financial uncertainty, Mr. Hickman recommended that for the directive the Committee adopt the staff's alternative A, calling for no change in policy, but he would instruct the Manager to resolve all doubts on the side of ease. Within the context of alternative A, he recommended that borrowings, on average, be allowed to drift down to about $400 million and that net borrowed reserves be permitted to subside to about $50-$100 million. He added that the objective stated in the last clause of alternative A might be difficult to achieve over the next four weeks and for that reason it probably should be deleted.

In that connection, Mr. Hickman said, he would like to remind the Committee that $3.2 billion of tax anticipation bills were due to mature on June 22. He would recommend that the Treasury, despite its large cash balance, consider issuing additional short-dated securities, preferably a strip of bills.

Mr. Maisel said he was in general agreement with the basic staff presentation indicating that the expansion in business activity had slowed. It was clear from the index of industrial production, as well as from most other current series, that the rate of expansion had fallen.

Two most important conclusions might be drawn from the recent period, Mr. Maisel observed. First, prior levels of more adequate monetary reserves did not lead to an excessive expansion in the

economy. Price pressures in spheres related to expansions of overall demand were minimal. Most increases could be related directly to special situations such as in agriculture and beef prices and were not such as to be responsive to monetary policy.

Secondly, Mr. Maisel continued, the present levels of production and current trends were following very closely the forecasts made at the end of last year. If the current and projected trends continued, percentage utilization of plant capacity and the labor force would decline. There would still be a considerable gap between actual production and the potential GNP for the economy. At least $30 billion or more of potential goods and services would not be produced this year. He believed that it would be improper to tighten money when the prospects for the future showed no likelihood of undue pressure on resources but rather a shortfall of demand below capacity.

As he had indicated at the last meeting, Mr. Maisel said, in situations such as this, when no clear movements had occurred, he preferred to avoid changing the policy statement. He hoped, however, that as a result of its discussion today the Committee could agree that net borrowed reserves during the next month would move back closer to the Committee's initial concept under the current policy directive. That would mean that net borrowed reserves should approach more nearly $100 million than their current levels.

In order to return the directive as close as possible to its initial form and to make certain that it was clear that no basic change had been directed, Mr. Maisel would prefer alternative A. However, in the first sentence he would retain the phrase proposed for deletion, namely, "although at a somewhat slower pace," which qualified the reference to continuing expansion of the domestic economy. He agreed that more of the additional reserves could be supplied through purchase of coupon issues, but felt that the addition of the last parenthetical phrase could be misinterpreted as indicating a tighter general policy. Therefore, he would omit that phrase.

Mr. Daane said that like Mr. Maisel he agreed with the basic staff presentation but perhaps interpreted it a little differently. He understood the staff to be saying quite clearly that recent developments on the domestic economic and financial scene as well as in the U.S. balance of payments suggested the maintenance of the status quo with regard to monetary policy. As Mr. Brill had suggested, the Committee should stand pat until it could see how the various present cross-currents were sorted out. In the current atmosphere of uncertainty, and with the sort of psychology that seemed to be prevailing--as evidenced by the over-reaction to Chairman Martin's recent remarks at Columbia University--it was particularly important that there be no change in policy, overt or otherwise.

If one looked beyond the factor of business sentiment, Mr. Daane continued, one found reinforcement for the view that policy should not be changed. The rate of domestic economic expansion had slowed down somewhat, although the pace of both recent and prospective expansion was still substantial. In the domestic financial area, bank credit and monetary expansion also had slowed from the unsustainably rapid rates of the early months of the year. The stock market decline probably had been the most noteworthy event since the last meeting of the Committee. While he would not try to forecast stock prices, it seemed to him that the decline reflected a reaction from the market's own long-sustained rise to record highs more than a basic fear of imminent economic reversal.

Mr. Daane found the April and May figures for the balance of payments to be encouraging, although he agreed that in and of themselves they did not mean the problem was solved. At the moment, however, the payments situation did not call for any increased monetary restraint despite the recent decline in bill rates. Recent bill rate levels had not been an accurate indicator of conditions in the money market; other money market measures indicated that conditions had remained quite taut. In any case, the recent decline in bill rates apparently had not prompted any significant short-term capital outflows.

Current conditions in bond markets, like those in the stock market, also suggested the wisdom of holding fast to the current course of monetary policy, Mr. Daane said. Corporate and municipal bond yields had risen in reflection of increased flotations. Although thus far the rise had not affected the long-term Government market, that market was still threatened by a relatively large overhang of dealer holdings of bonds and by a low level of retail demand.

To Mr. Daane such circumstances added up to an economic situation that did not warrant a change in monetary policy in either direction. Whether one emphasized the underlying economic situation or, as he would, the prevailing general uncertainties, the answer was the same. Neither the rates of domestic business and financial expansion, which were reduced, nor the balance of payments situation, which was improved, called for more restraint. On the other hand, they did not call for less restraint. In view of the continuing precarious state of the balance of payments, domestic conditions should clearly call for more ease before the Committee actively sought it. He still believed that relative price stability was the key to the eventual solution of the U.S. balance of payments problem, and he shared Mr. Bryan's concern over price developments. In his judgment, the Committee should continue to seek price stability, although he recognized the difficulties of achieving it.

Mr. Daane favored alternative A for the directive. While he clearly would be sympathetic to conducting operations as far as possible in the coupon area to avoid putting downward pressure on bill rates, he did not believe it was necessary to include the final clause in the directive.

Mr. Mitchell indicated that, like some others, he felt a certain amount of uneasiness about the business outlook. He thought it was not going to be easy to keep the economy expanding, and that the difficulties were likely to increase with time. The decline in stock prices had jolted confidence, and in his opinion if it continued it definitely would have some effect on spending plans. The inventory situation also was somewhat alarming. The continued growth in steel stocks was unfortunate, and inventories seemed to be getting a bit out of hand in other areas.

The Committee's real objective, Mr. Mitchell said, was to promote as full utilization of the nation's resources as possible, in an environment of reasonably stable prices. With the uncertain business outlook and present state of psychology, he thought that monetary policy at this time should be directed more to the problem of resource utilization than to that of price stability.

Mr. Mitchell remarked that he found himself in agreement with Mr. Hayes on the points that the balance of payments situation appeared better than it actually was and that a basic cure was not

in sight. However, the voluntary restraint program was never expected to be a permanent solution to the problem, but rather was intended to buy time for the development of other solutions. That was exactly what the program was accomplishing; it was providing a breathing spell, which was all that could be expected of it.

Mr. Mitchell preferred alternative A for the directive. However, he thought that it would be appropriate at this time to delete the rather sterile clause at the end of the first paragraph reading, "while accommodating moderate growth in the reserve base, bank credit, and the money supply." In place of that clause he would simply say "while accommodating resumption of growth in the money supply." There had been no increase in the money supply or in its demand deposit component through May of this year, he noted, but the staff anticipated an increase in June as Treasury deposits were drawn down. He thought it would be desirable for the Committee to be on record as favoring such an increase; a five-month interruption in money supply growth was long enough.

Mr. Mitchell added that he would omit the last clause of the second paragraph. The Account Management had performed remarkably well recently, giving proper regard to conditions in both the bill and bond markets, and the Manager had indicated that it was his intention to buy coupon issues during the coming weeks, as implied by the clause in question. Omitting the clause would give

a little more emphasis to reserve objectives and less to bill rate fluctuations.

Mr. Shepardson said he agreed in large part with the staff analysis of the domestic economy, except that he felt more concern about the price situation than the staff had indicated. He was disturbed by the continuing, and apparently accelerating, advance of prices--not only from the standpoint of the domestic economy but also because price stability was a vital factor in achieving improvement in the balance of payments. Some of the causes of the currently favorable payments statistics were temporary, and the underlying situation was still one of great concern.

Notwithstanding the indications of less ebullience in the economy, Mr. Shepardson observed, the balance of payments and price situations inclined him toward a further slight firming of policy, as indicated by alternative B of the draft directives. However, certain other considerations suggested alternative A. Those were the overall uncertainties and the general state of psychology existing at the present time, and the fact that a slightly firmer policy now probably would not have significant implications for longer-run balance of payments prospects. As had been stated repeatedly, a fundamental solution to the balance of payments problem would have to come largely from sources other than monetary policy. His position was close to the line between the two

alternatives. On the whole, however, despite the factors inclining him toward alternative B, he felt that it might be preferable to adopt alternative A today.

In Mr. Shepardson's judgment the last clause of alternative A was unnecessary; the Manager presumably would continue to operate as he had recently. As to Mr. Mitchell's suggestion for replacing the final clause of the first paragraph with a statement on resumption of growth in the money supply, Mr. Shepardson noted that the money supply often fluctuated in the short run as a result of a variety of factors not related to monetary policy actions. It was true that the money supply, narrowly defined, had not grown recently, but time deposits had continued to increase at a significant rate and so had total bank credit. He considered the original phrase appropriate and would leave it unchanged.

Mr. Robertson made the following statement:

> Domestic business activity seems to have been in the process of shifting gears--downward to a slower but hopefully more sustainable rate of economic expansion. I judge this slowdown is undeniable--the only point for debate concerns how much. Some may feel the deceleration of demand is sufficient to call for a little precautionary anti-recession planning at this juncture. My own feeling is that such concern is not yet necessary. I think current levels of demand are likely to prove adequate to sustain the economy through the summer, particularly with the impetus of major steel inventory liquidation apparently deferred until fall and some added fiscal stimulus scheduled this summer. We shall need to keep a careful watch over developments this fall and winter, however, for a considerable variety

of influences could then be combining to exert more significant deflationary pressure on the economy.

I think these overall prospects for business activity are not sufficiently strong to either engender or sustain a general price spiral. At the same time, I do recognize that some recent price increases have been occurring. I am not so troubled about the livestock price advance, for such increases usually give rise to market supply responses that soon provide a natural correction. The aluminum wage and price increases, however, are typical of the kind of mark-ups we can yet experience in some industries, even though the worst of demand pressures on resources may already be behind us. I think we are already evolving the kind of environment of market demands that will constrain this type of price action, and so I would not favor any further monetary tightening as a gesture of resistance. On the other hand, I would not want to take any major easing step, at this particular time, that might tend to give succor to business and labor inclinations to try for big administered wage and price increases.

This analysis of the domestic business situation leads me to advocate a policy of "no change" in the monetary sphere. Such a policy seems equally appropriate to national and international financial developments. Our international payments have been about in balance for three months now. How temporary that improvement may be only time can tell for sure. But I do not believe such temporary improvement would be rendered more permanent by tightening monetary policy further now.

In the domestic financial sphere, bank loan and deposit expansion have slackened significantly. While these magnitudes continue to fluctuate considerably over short spans of time, I think the changes in the six or seven weeks since late April are distinctly more moderate than previously in the year. I believe our policy at this meeting has to take into account such a slowing down in bank performance. When that is done, I believe the logical conclusion is that, under current demand conditions, the monetary policy adopted at the end of the first quarter is about as restrictive as should be tried.

Thus, on all counts I end up favoring a monetary policy of "no change" between now and the next meeting of the Committee. Accordingly, I would approve the alternative A directive as drafted by the staff--but deleting the final parenthetical phrase worrying about the bill rate. As analyses presented to this Committee have repeatedly demonstrated, the bill rate has not been a reliable indicator of general money market conditions this spring, and it also seems increasingly less pertinent as a basis for comparing international rate differentials. I take its latest decline to reflect, perhaps as much as any other single factor, temporary buying interest of a hedging nature by investors who have been made cautious for a time by the uncertainties in long-term debt and equity markets. As we found out on previous occasions, the most therapeutic treatment for this kind of buying is to allow the resultant lowering of bill rates to exert its natural and gradual deterrent effect, and consequently I propose deleting the final parenthetical phrase.

I would also suggest that in the first sentence of the directive where we refer to the continuing expansion of domestic economy, we retain the words "although at a somewhat slower pace" and add "than in the first quarter." This would seem to be in line with the actual situation reflected in the analyses of current economic data.

Mr. Robertson added that he agreed with Mr. Hickman that the Manager of the Account might be directed to resolve doubts on the side of ease. He also agreed with the suggestion of Mr. Mitchell that the Committee might well use this opportunity to delete the phrase it had used for so long in the directive--"while accommodating moderate growth in the reserve base, bank credit, and the money supply." He would substitute the phrase, "while accommodating growth in the money supply."

Mr. Wayne reported that Fifth District business continued to improve, although at a slower pace than earlier in the year. Employment apparently was rising at about a seasonal rate, but insured unemployment continued to decline more than seasonally. Contract awards rose to a new all-time high in April after a mediocre first quarter. Retail trade increased moderately in May, as indicated by a new high in department store sales and favorable reports from retailers on the Richmond Reserve Bank's survey panel. Survey respondents in general were less optimistic than five weeks ago, but manufacturers describing current developments in their own industries showed that distinct improvements had occurred since the previous round of reports. The evidence included recent increases in factory orders, shipments, employment, and hours. A special questionnaire on prices paid, included in the latest survey, showed that about two-thirds of the respondents were now paying more for materials and for factory and office supplies, while nearly three-fourths reported prices up for machinery and equipment. From one-half to two-thirds anticipated additional increases in the near future in those same prices, and three-quarters expected wage increases. Nearly nine out of ten believed that prices would rise in the months immediately ahead in the national economy as a whole, but in their own industries only half of the respondents thought that price increases were imminent.

The interim wage settlement in steel reduced somewhat the pressure under which the economy had been operating, Mr. Wayne commented. The smooth and mild adjustment which took place after the settlement indicated substantial basic strength and a stable equilibrium in the economy. The small increase in defense expenditures which had already occurred, and the prospects of much larger increases, should help support economic activity in the second half of the year. Economic strength was indicated also by the high level of manufacturers' new and unfilled orders, the continuing high levels of business investment plans and consumers' buying intentions, some renewed strength in construction especially in the residential sector, and the record level of retail sales in May. Two potentially troublesome developments, however, were the high level of consumer and mortgage debts with their rapid increases in recent months, and the growing upward pressures on wages and prices.

Upward price pressures were likely to continue, Mr. Wayne said. The wage settlements in the can, aluminum, and rubber industries had already been reflected in the selective price increases and carried disturbing implications for the steel settlement. The southern textile industry was making its third wage increase of 5 per cent within 18 months. Those increases probably reflected a decision to pass on profits resulting from

"one-price cotton" in wages rather than prices. Short supplies of several major farm commodities should keep farm prices on the rise. The increases in farm prices as well as those in metals and other industrial raw materials could push through to the retail level. Finally, increased Government spending for defense and welfare would add to demand.

The recent modest improvement in the balance of payments was encouraging to Mr. Wayne. The available evidence suggested, however, that most or all of that improvement stemmed from the working of the voluntary foreign credit restraint program or from temporary influences such as the unwinding of the dock strike situation. Thus, the basic problem of the balance of payments was still unresolved and in view of the probability of new strains on the international financial system in the next few months, that must remain a matter of deep concern to the Committee.

Loan expansion had slowed somewhat in the second quarter, Mr. Wayne observed, but there was little evidence that the growth of bank credit had been restricted by monetary policy. Banks had now developed so many ways of mobilizing reserves and of shifting reserves among banks that the effect of traditional credit restraint measures was considerably diluted.

In the policy domain, it seemed clear to Mr. Wayne that the rate of financial expansion definitely slowed in April and

May, accompanying a similar reduction in the rate of business expansion. The abnormally low bill rates and net sales of Federal funds by New York banks, among other things, would suggest that the slower financial growth was the result of lower demand rather than reduced reserve availability.

As for proper policy for the next four weeks, it seemed to Mr. Wayne that the overall situation did not require any additional restraint at this time in view of the slight reduction in rates of growth in both business and financial areas in the past two months. Accordingly, he would favor continuing present policy with a recommendation to the Desk, in supplying reserves, to use all possible methods to avoid depressing the bill rate. Alternative A seemed appropriate to him. The proposed addition to the concluding sentence seemed unnecessary; he would leave that matter in the hands of the Manager.

Mr. Clay said that under present circumstances it would appear best to continue the monetary policy of the last three weeks. The transition in the domestic economy from the surge of the first quarter had brought a more moderate pace of activity. While it was expected that the economy would continue to advance in the months ahead, there was no assurance that the present transitional phase had been completed. In any event, the pace of future advance would be slower than early in the year. While

there had been some firming of industrial prices, it had been on a selective basis. Moreover, the slower rate of business advance should help to limit upward price pressures, particularly in view of the continuing expansion in industrial capacity.

Changes in both economic activity and in special situations affecting the first quarter also had brought a slower rate of growth in bank credit and in its business loan component, Mr. Clay noted. It remained to be seen whether still further adjustments might be under way in the rate of bank credit expansion.

Evaluation of current developments relative to the international payments problem obviously was very difficult, Mr. Clay continued. The voluntary credit restraint program had brought substantial gains in the last three months, but there was a question as to what proportion of those early gains were relatively easy to accomplish. Granting the limitations of such a program, it appeared probable that there would be significant continuing gains. Without arguing that that program would solve the U.S. international payments problem, it did afford additional time to develop new avenues to deal with the problem and currently facilitated the continuation of present monetary policy.

Mr. Clay believed that money market conditions and reserve availability should be continued within the range of recent weeks. If Treasury bill rates should rise relative to other short-term

open market rates, that would be entirely acceptable, but reserve availability should not be restricted in an attempt to force upward movement of Treasury bill rates. In view of the bill rate level, operations should be conducted in longer maturities as feasible to reduce pressure on bill rates. The present sensitivity of longer-term interest rates should make it possible to carry out such operations.

Alternative A of the draft policy directive appeared satisfactory to Mr. Clay, and he thought it would be appropriate to include the last phrase, on minimizing downward pressures on Treasury bill rates. Presumably the latter would come within the general money market conditions and reserve availability of recent weeks, however.

Mr. Scanlon remarked that he was in general agreement with the comments the staff had prepared on the questions suggested for consideration at this meeting. As far as the Seventh District was concerned, substantial declines in output of steel and autos in the second half of 1965 had been taken for granted since the start of the year. Now that the first half was ending and those declines were closer at hand, they appeared to be playing a larger role in current thinking about economic prospects. That was somewhat surprising in view of the fact that output estimates for both of those industries had been raised since early this year.

Local steel analysts now anticipated production at a new record of 128 million tons of steel ingots in 1965, Mr. Scanlon reported. Output was expected to decline about 10 per cent in the third quarter, and about 16 per cent in the second half. The usual July plant-wide shutdowns had been eliminated by the major producers as orders for steel had accelerated again in recent weeks, perhaps indicating renewed concern about a possible strike. The increase in orders had been rather general and, surprisingly, included the auto industry, which had been believed to have ample stocks of steel.

Capital goods producers in the Seventh District continued to report increases in order backlogs, Mr. Scanlon observed. Inventories of components were said to be moderate and producers of "stock" components, who normally experienced declines in orders about six to nine months before machinery producers, were still on a rising trend. There continued to be a strong interest in locations for new industrial plants. A factory locating service, headquartered in Chicago, reported a very strong demand for its services.

Mr. Scanlon reported that evidence on employment trends, personal saving, and retail sales indicated no substantial change from the favorable picture of recent months.

Credit outstanding at District banks had expanded at a moderate pace since the end of April, Mr. Scanlon continued. Loans rose by about the same amount as a year ago, with a large portion

due to borrowing by finance companies. Business loan growth had continued at the slower pace evident in April. The major Chicago banks had not acquired any additional funds through CDs, and their outstandings remained in the narrow range that had prevailed since the beginning of the year. They had reported some loan contraction and their investments were also down somewhat. While two banks had been rather heavy buyers of Federal funds, another bank had maintained a substantial net selling position since late April. Those large banks in Chicago had borrowed very little at the discount window, although other District banks had stepped up their borrowing.

As to policy, Mr. Scanlon thought the System should provide the normal seasonal amount of reserves in the weeks immediately ahead. He recognized that this would pose serious problems for the Manager, who, he thought, had to be given substantial latitude in which to operate. Mr. Scanlon certainly would not retreat from the position that had been attained in recent weeks; as a matter of fact, he would resolve doubts on the side of firmness. However, he would not change policy under current conditions, and he found alternative A of the directive drafts acceptable but would delete the final phrase.

Mr. Galusha remarked that he would report first on agricultural prices in the Ninth District, and, in particular, on livestock prices. While the index of District crop prices was

below its year-ago level, the index of livestock prices was up sharply from last year and from mid-April as well. For livestock producers that was heartening, although, of course, it was unlikely that the recent increase in livestock prices, being largely the result of reduced supplies, would result in a dramatic increase in District farm income.

Ninth District personal income was virtually unchanged in April, Mr. Galusha said. That constancy concealed a variety of minor offsetting changes, however, including an interesting increase in wage and salary disbursements of manufacturing firms. On the whole, the outlook for the District's nonagricultural economy appeared favorable. An impressive increase in output apparently was recorded in May, with durable goods producers seemingly leading the way. Moreover, businessmen seemed to be optimistic about the third quarter of 1965. The Minneapolis Bank's most recent opinion survey suggested that a considerable majority of businessmen were expecting further increases in output and employment and, surprisingly enough, in profits. The great majority of the survey respondents continued to report no price changes for their products, but some were reporting higher raw materials prices.

Mr. Galusha commented that the new cars sold in such large quantities recently would be on the road this summer, if travel bookings were any indication. The increase in reservations at

western National Parks had continued, and at several it was now impossible to get reservations for July and August.

Mr. Galusha noted that the Reserve Bank recently had made an informal survey of the consumer and trade credit situation. The respondents reported that the totals outstanding of consumer and trade credit had increased considerably in recent months, but that they were, perhaps surprisingly, not at all concerned. To date there evidently had been no increase in default experience, although it might be too early to expect such a development. On a related point, the credit deterioration evident in the agricultural sector earlier in the year had been relieved somewhat by the improvement in the livestock situation.

District member bank credit increased in May, Mr. Galusha remarked, but on a seasonally adjusted basis it apparently declined. Also, the rise in total credit fell far short of the sharp expansion recorded in May 1964. At reporting banks total credit actually fell a bit in the past month, so the increase was experienced by nonreporting banks. The latter, it appeared, were now in a fairly tight position, with their average loan-deposit ratio higher now than at any time in the period from 1960 to date. Reporting banks were only slightly better off; their position appeared to be tight in large part because they did not experience the usual May increase in time deposits, but a decrease. On the whole, then,

District member banks appeared to be under some pressure, and it was doubtful that they were still aggressively searching out new loans.

In Mr. Galusha's view monetary policy, defined in terms of the average level of free reserves, should remain about as it had been of late during the coming several weeks. He saw little reason for changing policy, and certainly none for increasing monetary restraint. He thought the decline in the bill rate was not a cause for alarm and noted that the recent reduction in the British Bank rate was of considerable significance in that connection. The domestic outlook seemed to him to be for moderate growth over the remaining part of 1965, and for a rate of growth of demand no greater than the rate of increase of capacity. Whether growth would be sufficient to keep the unemployment rate from creeping up during the summer and fall, he did not know. Recent price increases might be disturbing but he believed that sharp increases had remained rather selective--too selective to warrant application of further general monetary restraint. And such widespread creep in prices as there had been of late was a reflection not so much of the current economic situation as that of the recent past. Nor did recently-struck labor bargains seem sufficient to warrant action at this time. In particular, they did not seem to be indicative of a sharp jump in the rate of increase of money wages. In sum,

Mr. Galusha favored no change in monetary policy and alternative A for the directive.

Mr. Swan reported that in May the rate of unemployment dropped in California--the only District State for which data were as yet available--as it had in the nation, but still continued well above that of the country as a whole. The level of private housing starts declined sharply in April following improvement in February and March. While a one-month development of that type was not necessarily significant, in view of the earlier improvement it was worthy of note as indicating that weakness in the housing area had not disappeared.

The District's weekly reporting banks had shown a less rapid rise in loans than those in the country as a whole for most of the year to date, Mr. Swan said. However, in the three weeks ending June 2 the increases in both loans and total bank credit at District banks were much more rapid than nationally, and they also were much greater than in the District a year ago. District banks were under considerable reserve pressure, and their borrowings from the Reserve Bank continued at a relatively high level.

Mr. Swan remarked that, along with others, he was impressed by the recent slowdown in the pace of national economic activity and by the slackening in the growth of bank credit. Price increases were a real cause for concern, but among industrial commodities

they still were largely confined to metals and metal products, and the increase in meat prices was primarily a result of reduced supply. While the factors producing the recent improvement in the balance of payments might be temporary, the facts remained that the U.S. currently was experiencing a continuing surplus and that immediately unfavorable developments were lacking.

Those considerations, Mr. Swan continued, along with the decline in the stock market and the uncertainties generated thereby, as well as the current congestion in capital markets, all indicated to him that the Committee's policy should not be changed. Consequently, he favored alternative A of the draft directives. He would go along with Mr. Robertson's suggestion that the domestic expansion should be described in the first sentence as proceeding at a slower pace than in the first quarter. As to Mr. Mitchell's suggestion, there was some attraction in the proposal to change wording that had been used for some time. Nevertheless, he would not want to confine the reference in the final phrase of the first paragraph to the money supply. For one thing, there were shifts in the money supply resulting from factors beyond the Committee's control, such as changes in Government deposits. Secondly, the Committee remained interested in accommodating moderate growth of bank credit and the reserve base. As to the parenthetical phrase at the end of the second paragraph, he did not think it belonged

in the directive. As others had noted, the Committee could rely on the Manager to conduct operations in the manner indicated.

Mr. Irons reported that conditions in the Eleventh District generally were very strong, and the prevailing mood was of confidence and optimism. According to the Reserve Bank's estimates, the production index for the District probably rose two percentage points in the past month, partly because of an increase in crude oil production. Construction contract awards had moved up substantially and employment was slightly higher. Retail trade, as reflected by department store sales, had increased, and automobile sales were unchanged at a high level.

Agricultural conditions had improved, Mr. Irons continued, and generally were good. Developments with respect to livestock prices were highly encouraging to livestock people. Heavy, widespread rains had helped range conditions.

Mr. Irons went on to say that loan demand at District banks, while not as strong as in the first quarter, was still strong, and total loans were at a high level and rising slightly to moderately. There had been an increase in demand deposits but the volume of CDs outstanding had declined.

District banks apparently were under some reserve pressure, Mr. Irons said, and they were becoming reconciled to the necessity of buying deposits rather than getting them gratuitously. Banks

had been heavy net buyers of Federal funds, with purchases running about $750 million per week and sales about $500 million. Borrowings from the Reserve Bank were not particularly excessive. The large banks tended to rely mainly on the Federal funds market, coming into the discount window only when necessary. Some of the smaller banks, however, were borrowing.

The national situation seemed to Mr. Irons to be one of strength, and the outlook was favorable for further expansion although at a rate below that of the first quarter. There had been some noticeable edging up of prices. Defense expenditures and business outlays for plant and equipment could be expected to increase, and consumer spending was heavy. From all reports, businessmen were optimistic.

Mr. Irons doubted that the basic international situation had improved much, if at all. The balance of payments appeared better as a result of the favorable consequences of the voluntary credit restraint program, but whether the gains made would be held remained to be seen.

Given those domestic and balance of payments situations, Mr. Irons said, the choice between the policies described by alternative A and B for the directive was a close one. At the same time, the differences in the policies called for by the two alternatives did not strike him as being highly significant. In

view of the uncertainties that existed at present, and of the fact that the economy was undergoing a transition from its earlier unsustainably high rate of expansion, he was inclined to make no change in policy at this time but, rather, to favor a continuation of conditions in the ranges that had existed during the past three weeks. He would like to see net borrowed reserves in the area of $150 million or above--he certainly would not want to have them worked down to lower levels--and would expect borrowings to be in the $450-$500 million range. He would accept alternative A for the directive, with the understanding that it called for no lessening of the degree of firmness from that existing in the past few weeks, and no overt strengthening from that degree. If there were to be deviations, he was inclined to Mr. Scanlon's view that they should be in the direction of firmness rather than ease.

Mr. Ellis remarked that he could make a capsule description of economic conditions in New England by reporting that strengthening manufacturing activity was being translated into widespread strength in employment, income, spending, and credit generation. In April, for the first month in a considerable time span, the seasonally adjusted index of manufacturing production for New England matched the year-to-year gain in the national index, which was 8.4 per cent. Credit for that achievement had to go to the nondurable industries of textiles, apparel, and leather, each of which gained several percentage points from March to April.

In the financial sector, Mr. Ellis said, perhaps the most notable--and still unexplained--development was that all District banks outside Boston had just completed their fifth consecutive week of negative free reserve positions, joining the Boston banks in a debtor position the latter had held since February (except for a two-week zero position in April). Despite that tightness, member bank loan positions had continued to expand in the three weeks ending June 2, with each category except business loans showing plus signs.

Turning to the policy issues highlighted by the staff questions and comments, Mr. Ellis said that the issues posed by the first three questions were so interwoven that he would consider them as a composite. In his judgment the wording of the third question tended to direct attention too narrowly to the preliminary and obviously distorted developments of the first two months of the voluntary foreign credit restraint program, months in which the initial effects of that program were registered. Perhaps it was inevitable that the Committee should lean most heavily on very recent data in seeking to project what was ahead, but it was necessary to dwell simultaneously on longer-range and more basic factors. He complimented the staff on the fact that in its comments it had avoided the trap of exclusive focus on short-term considerations. One of the most troublesome of the long-range

factors was the possibility that continued upcreep of domestic prices would take some of the edge off of this country's competitive position in export markets. And the immediately past and forthcoming wage negotiations on balance would strengthen the trend of price advances.

The prospects for sustainable economic expansion undoubtedly were brightened by a return to the "ordinary" boom conditions of last fall, Mr. Ellis remarked, in contrast with the first quarter credit explosion. To paraphrase a remark of Mr. Brill's, things were not as bad as they could have been, but might become so. Still unanswered was the question of the potential cumulative effect of long-continuing expansion of bank credit in excess of real growth rates.

Concerning the areas of bank credit, interest rates, and money market relations, Mr. Ellis commented that each area might be registering the cumulative effect of a long-continuing high rate of bank credit expansion, and of an active and long-continuing joint effort by the System and the Treasury to support short-term interest rates. Past relationships suggested that a net borrowed reserve level of $150 million traditionally had been associated with lower short-term rates. The gradual decline in Treasury bill rates in the past six weeks probably confirmed the view that a bill rate of 3.90 per cent or higher was not consistent with net

borrowed reserves of $150 million. On the other hand, commercial bank holdings of Treasury bills had been so reduced that a further lowering of reserve availability might very well be found not to promptly release bills in a volume that would materially affect short rates. As an additional complication to the unknown amount of repatriated capital lodged in the bill market, there now was the probability that a substantial volume of funds withheld from the stock market was temporarily lodged in the bill market awaiting more permanent commitment. To the extent that some investors were anticipating future increases in long-term bond rates, it was probable that they were holding funds in bills while awaiting clarification of the outlook.

As he looked to the immediate future, Mr. Ellis said, he saw two forces in the market that were likely to depress short-term bill rates in addition to those he had mentioned. First, in July, traditionally, bill demand was strong and the Treasury conducted a financing. Absent that financing because of the strong Treasury cash position, rates were likely to sag. Secondly, before the Committee next met seasonal factors, including currency outflows, would require injection of $1.1 billion of additional reserves.

Mr. Ellis went on to say that it was stimulating to speculate on the advantages of meeting the seasonal reserve needs by a reduction in reserve requirements, and face the happy prospect

of later reabsorption by sales of bills. In the absence of such an approach, his personal choice would be to continue intermittent purchases of coupon issues as available; to meet the seasonal need as much as possible by repurchase agreements; to adopt a net borrowed reserve target range centered on $200 million; to expect borrowings to range from $500 to $600 million; and to be reconciled to the prospect that even with such an approach bill rates might shade off a few points further.

His discussion had centered around rate prospects, Mr. Ellis continued, but it was premised on a recognition that, while weekly and monthly gyrations tended to obscure the basic strengths, the excessive rate of credit expansion of the first quarter had dropped back in April and May only to an annual rate of 8 per cent. While that rate was somewhat less than earlier, in his judgment it was still excessive at a time when GNP was growing at an annual rate of 4.7 per cent. His analysis was that the fever had subsided but the temperature remained high; and his conclusion was that medication should be continued in the form of further probing toward firmness. Accordingly, alternative B of the staff drafts was his choice for the directive. However, if alternative A was adopted, he would hope that the concluding phrase of the first paragraph would not be confined to the narrowly defined money supply, neglecting the reserve base and bank credit.

Chairman Martin commented that there appeared to be a large measure of agreement in the views that had been expressed today. In his judgment there had been no significant change in the economic situation since the previous meeting of the Committee, except possibly with respect to psychology; many people who had been over-confident a few weeks ago now were less so. That was not necessarily a good thing, but it was not necessarily bad. With respect to policy, he was in complete agreement with the judgment that the suggested alternative A was the preferred directive for the next four weeks, while the Committee awaited the opportunity to make a better assessment of conditions.

The Chairman added that he became concerned whenever he heard comments such as those that had been made in the discussion today about resolving doubts on the side of ease or firmness. Such comments, of course, were made from time to time to reflect shades of difference in views on policy. In his judgment, however, the objective should be for the Manager to make no mistakes at all and not to deviate in either direction.

As to the comments on the money supply, the Chairman said, he had to admit that his understanding on that subject was not as full as he would wish; the more he thought about it the less confident he was that he understood all of the elements of money supply determination. In any case, he thought that the three

measures--the reserve base, bank credit, and the money supply--provided a better basis for policy formulation than the money supply alone, and he did not favor Mr. Mitchell's suggestion that the concluding phrase of the first paragraph of the directive be confined to the latter.

Chairman Martin then noted that some members had suggested retaining the phrase indicating that the domestic expansion was proceeding at a slower pace. While he did not consider the matter to be of great importance, he would prefer Mr. Robertson's suggestion--retention of the present clause and addition of the words, "than in the first quarter." The statement then would be more precise. He did not favor including in the second paragraph of the directive the final parenthetical clause shown in the suggested alternative A.

Mr. Hayes noted that the phrase "but with gold outflows continuing" had been deleted from alternative A but retained in alternative B. The facts were not changed by the policy decision of the Committee, he said, and if the statement would be warranted under the policy indicated by alternative B he thought it belonged in alternative A also.

In response to Mr. Mitchell's question about the prospects for gold outflows, Mr. Coombs said there was likely to be another sizable reduction in U.S. gold holdings by the end of this month.

As he had indicated earlier, France probably would buy at least $50 million of gold in June, and there also might be purchases by other countries.

Mr. Mitchell then asked if the staff would explain the rationale underlying the deletion of the phrase in question from alternative A and its retention in alternative B.

Mr. Noyes responded that there was no question about the facts; there had been some gold outflow recently and some was still in prospect. At the time the draft was drawn up, however, it appeared that the rate of outflow would be somewhat less this month than it had been earlier. The staff had felt that members who favored further firming would do so partly because some outflow was continuing, and therefore would want to refer to that fact in the directive. Accordingly, the reference was retained in alternative B. It was omitted from alternative A, on the other hand, because it was thought that members favoring no change in policy would tend to place primary emphasis in their thinking on the reduction in the rate of outflow, and might consider the reference to be no longer appropriate.

Several members indicated that they thought the reference in question should be retained in the directive even if the decision was to make no change in policy.

The Chairman then proposed that the Committee vote on a directive based on alternative A, but incorporating the phrase relating to gold outflows, including the statement that the domestic expansion was continuing at a slower pace than in the first quarter, and omitting the final parenthetical clause.

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

> The economic and financial developments reviewed at this meeting indicate continuing expansion of the domestic economy, although at a somewhat slower pace than in the first quarter, and maintenance of earlier improvement in our international balance of payments, but with gold outflows continuing. In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

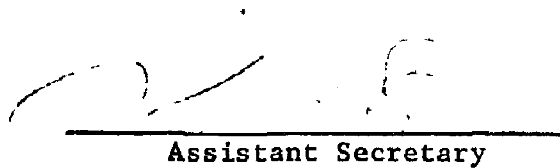
> To implement this policy, System open market operations over the next four weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Mr. Hayes said that, while his inclination toward further firming was clear from his earlier comments, he had voted in favor of the directive because he thought that under present conditions there was much to be said for unanimity in any policy action the

Committee might take. Messrs. Ellis and Shepardson commented that they wanted to associate themselves with Mr. Hayes' statement.

It was agreed that the next meeting of the Committee would be held on Tuesday, July 13, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.



Assistant Secretary

CONFIDENTIAL (FR) ATTACHMENT A

June 14, 1965.

Drafts of Current Economic Policy Directive
for Consideration by the Federal Open Market Committee
at its Meeting on June 15, 1965

Alternative A (no change in policy)

The economic and financial developments reviewed at this meeting indicate continuing expansion of the domestic economy and maintenance of earlier improvement in our international balance of payments. In this situation, it remains the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations over the next four weeks shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks (, while minimizing such downward pressures on Treasury bill rates as may develop).

Alternative B (firming)

The economic and financial developments reviewed at this meeting indicate continuing expansion of the domestic economy with some upward pressure on prices, a large expansion of bank credit thus far this year, and maintenance of earlier improvement in our international balance of payments, but with gold outflows continuing. In this situation, it is the Federal Open Market Committee's current policy to reinforce the voluntary restraint program to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, by moderating growth in the reserve base and bank credit.

To implement this policy, System open market operations over the next four weeks shall be conducted with a view to attaining slightly firmer conditions in the money market.