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, January 11, 1966, at 9:30 a.m.

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

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

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

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Messrs. Baughman, Garvy, Holland, and Koch, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Solomon, Adviser to the Board of Governors
Mr. Molony, Assistant to the Board of Governors
Mr. Partee, Associate Director, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Adviser, Division of International Finance, Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Mr. Heflin, First Vice President, Federal Reserve Bank of Richmond
Messrs. Eastburn, Mann, Parthemos, Brandt, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Philadelphia, Cleveland, Richmond, Atlanta, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. MacLaury, Assistant Vice President of the Federal Reserve Bank of New York
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 14, 1965, were approved.

Upon motion duly made and seconded, and by unanimous vote, the action taken by available members of the Committee on December 28, 1965, approving payment of 1/8 per cent commission in a transaction undertaken to acquire guilders to pay off the System's $25 million August 1965 drawing on the Netherlands Bank and to liquidate the remaining guilder/mark swaps with the Bank for International Settlements in amount of $12.5 million each for System and for Treasury, was ratified.

Under date of December 27, 1965, there had been distributed to the members of the Federal Open Market Committee copies of the report of audit of the System Open Market Account and of the report of audit of foreign currency transactions, both made by the Board's Division of Examinations as at the close of business September 24, 1965, and submitted by the Chief Federal Reserve Examiner under date of November 1, 1965. Copies of these reports have been placed in the files of the Committee.

> Upon motion duly made and seconded, and by unanimous vote, the audit reports were accepted.

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 conditions and on Open Market Account and Treasury operations in foreign currencies for the period December 14, 1965, through January 5, 1966, and a supplemental report for January 6 through 10, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury said that the Treasury gold stock would remain unchanged again this week. The $75 million decline announced during the last statement week of December more than covered the French purchase of $67 million in that month, and the Stabilization Fund holdings appeared to be in pretty good shape to withstand anticipated drains during the remainder of January. As the Committee would recall, the Russians had made a sale of $31 million in gold through the London market on December 28. That proved to be a timely contribution to the Pool's holdings in view of the continuing gradual drain resulting from persistent private demand combined with smaller than normal amounts of new gold production coming to the market. For the future, indications were that South Africa would continue to rebuild its gold reserves by withholding from the London market some part of its new production. As a result, supplies to the Gold Pool would be more than usually dependent on Russian sales, the timing of which was, of course, quite uncertain.

Mr. MacLaury noted that the year-end pressures on the exchange markets that had come to be expected in recent years produced fewer problems this year than in the past. That welcome change resulted from a combination of factors. One of the most important, of course, was the smaller deficit in the U.S. balance of payments in the closing months of the year. And, in marked contrast to last year, the covering of short positions in sterling this year offset to a considerable extent the usual year-end repatriation of funds from London, which last year was greatly exaggerated by the speculative pressures on sterling. On the continent there was no massive repatriation of funds to Germany at year-end as there had been in the past, partly because funds had been moving into Germany in preceding months in considerable volume under the stimulus of the tight money market conditions in Germany. (The year-end pressures in Germany were relieved to some extent by the Federal Bank's action in temporarily reducing bank reserve requirements.) As a result, the Federal Bank was not required to take on sizable amounts of dollars and, indeed, as the year-end approached funds began to move out, thus permitting the underlying payments deficit to be reflected in reserve losses for the first time. Since December 27 the Federal

Bank had used $100 million in supporting the mark rate. The only instance in which the usual year-end pattern showed up was in Switzerland, where during December the Swiss National Bank took in a total of $385 million on a swap basis from Swiss commercial banks. Since those funds were immediately channeled back into the Euro-currency market via the Bank for International Settlements, the effects on exchange and money markets even of that sizable movement were largely neutralized.

Reflecting the calmer atmosphere in the markets this year-end, Mr. MacLaury said, the System had not only been able to avoid taking on new commitments to finance over-the-year-end swings, but had actually been able to make substantial progress in reducing outstanding commitments. System drawings of Belgian francs under the standby arrangement with the Belgian National Bank were reduced during the period from $50 million to $25 million equivalent, as the Belgian National Bank used dollars to support the franc in its market. As Committee members had been informed on December 27, the Netherlands Bank found itself in a position to sell guilders to the System in sufficient amount to liquidate all outstanding commitments for both System and Treasury. As in the case of Belgium, the Netherlands Bank found that it had to provide more support for the guilder during the closing weeks of the year than it had anticipated and thus could sell the System $50 million equivalent of guilders on a wholesale basis--$25 million equivalent to liquidate the System's drawing under the swap arrangement, and $12.5 million each to reverse System and Treasury swaps against marks through the BIS. In addition, the Treasury was also able to pay off the remaining $17.5 million equivalent of maturing forward Swiss franc contracts, thus completely liquidating market commitments that had first been taken on in July 1963.

As indicated in the written reports, Mr. MacLaury continued, there was a good demand for sterling in the early part of the period since the Committee's previous meeting, reflecting both covering and current commercial needs. Then there were a couple of days of mild pressure, associated primarily with the year-end demand for dollars which resulted in some swapping out of sterling. On December 20 and 21, when sterling eased down from its previous level of about $2.8030 to $2.8013 or so, the New York Bank put bids in the market for System Account to indicate to the market that the central bank support for sterling--which had made such an impression on the market on September 10--was still available. That had the effect of stabilizing the market, and only a small amount of sterling was in fact bought before the market turned around. Demand picked up once again in some volume following the Christmas holidays. During the whole period since December 14, the Bank of England took in a total of more than $200 million, and for the month of December it was able to show a reserve gain of $16.8 million after repayment of $75 million on swap drawings from the System and liquidation of further forward commitments. As the Committee knew, the $275 million drawing by the Bank of England that matured on December 30 was rolled over for four days and then paid off on January 3. At this point, it was expected that the remaining $200 million drawing, scheduled to mature on January 28, would be rolled over for a few days into early February, at which time it, too, would be liquidated--thus putting the entire $750 million swap arrangement back on a standby basis.

The good performance of sterling in the markets during the past few months and over year-end, Mr. MacLaury said, should not be taken as an indication that Britain's problems were by any means all solved. The third-quarter U.K. balance of payments deficit was a rather disappointing performance. While there was no specific reason to expect trouble in the next few months, one could not write off the possibility that market sentiment could again turn against sterling, even during its period of seasonal strength. For that reason, he felt it was vitally important that the arrangements worked out for providing a defense for sterling be in full readiness.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period December 14, 1965, through January 10, 1966, were approved, ratified, and confirmed.

Mr. MacLaury noted that two swap arrangements would mature during the early part of February: the $250 million, six-month arrangement with the German Federal Bank matured on February 9, and the $100 million, three-month arrangement with the Bank of France matured on February 10. He requested the Committee's approval of renewal of both arrangements, neither of which was in use at present.

> Renewal of the standby swap arrangements with the German Federal Bank and the Bank of France was approved.

As he had mentioned earlier, Mr. MacLaury observed, the drawings under the arrangement with the National Bank of Belgium were now down to $25 million equivalent, having been reduced since the last meeting of the Committee by $25 million. The remaining drawing would come up for its second renewal on February 10. With the Belgian franc under some mild pressure, he would hope that at least part of the drawing could be off the books before maturity, but he requested Committee approval of renewal of the drawing for an additional three months, should that prove necessary.

> Possible renewal of the $25 million equivalent drawing on the swap arrangement with the National Bank of Belgium, maturing on February 10, 1966, was noted without objection.

Mr. MacLaury said that he would note one final technical point in connection with the Belgian arrangement, for information of the Committee. At the time that arrangement was renewed, on December 22, 1965, the Belgian National Bank had requested that the interest rates applicable to drawings be adjusted upward to take account of the rise in U.S. bill rates since the previous renewal. After checking with the Treasury, it was agreed that the rate on three-month drawings under the standby portion of the arrangement be increased to 4-1/4 per cent from 3-3/4 per cent, and that the rate on the fully-drawn portion, with a term of six months, be increased to 4-3/8 per cent from 3-7/8 per cent. As the Committee knew, the Belgian arrangement was unique in a number of respects, and it was now the only arrangement under which interest rates were adjusted periodically rather than being linked automatically to the U.S. Treasury bill rate.

Mr. Hayes said he would like to add a footnote to Mr. MacLaury's remarks concerning repayment by the British of their drawings on the swap arrangement. As the members would recall, the Committee had discussed the matter at its December meeting and there had been general agreement that it would be desirable for the drawings to be cleared up as promptly as possible. He had sent a note to Lord Cromer of the Bank of England conveying that view of the the Committee. At the time of writing it had already been agreed to roll over for just a few days the $275 million drawing that came due at the end of December. With respect to the $200 million drawing due in late January, he had pointed out to Lord Cromer that the Committee placed a high value on emphasizing the short-term nature of swap drawings both by word and by practice, and that an effort to repay the drawing would be useful. He (Mr. Hayes) had just received a reply from Lord Cromer thanking him for the information on the views of the Committee and expressing full agreement with the Committee's position. Lord Cromer went on to say that the Bank of England might well ask for renewal of the drawing due on January 28, but they intended to repay it in the first few days of February. Mr. Hayes thought it was well that the Committee had taken the position it had. There was no doubt in his mind that the Bank of England viewed the matter in the same way as the Committee did.

Chairman Martin commented that the matter evidently was working out in a satisfactory fashion. The Chairman then noted that Mr. Daane had been abroad at the time of the Committee's previous meeting to attend a meeting of the Deputies of the Group of Ten, and he invited Mr. Daane to comment.

Mr. Daane remarked that the Deputies had met in Paris on December 14 and 15, 1965, to continue the discussion begun during the meeting early in November of some rather basic questions on various aspects of the subject of deliberate reserve creation that had been posed by Chairman Emminger. Those questions concerned (1) the need for new reserve assets, (2) who should be responsible for their creation and distribution, (3) what types of assets should be created, (4) the rules for decision making, and (5) the matter of multilateral surveillance. The discussions so far had been exploratory, involving a relatively free exchange of views and with no hard and fast positions taken. The general atmosphere, carried over from the November meeting, was one of actively seeking a basis for agreement that could be presented to the Ministers and Governors of the Ten sometime this year--perhaps as early as June, although that might be optimistic.

On the first question, Mr. Daane said, he thought that to date no one had come up with a good, clear measure of what the reserve needs were or might be. Some people had attempted to make an analogy to a domestic economy but others had rejected that approach. One country took the view that the concept of "global reserve needs" was, after all, a "political" concept. Mr. Daane noted incidentally that the International Monetary Fund was engaged in a parallel study of the needs for international reserves and liquidity.

The second question, Mr. Daane said, came down basically to the issue of whether responsibility for the creation and distribution of reserves should lie with the Group of Ten--or perhaps the Group plus two or three other countries--or with the IMF. Except for the French, the Deputies seemed to be generally agreed that reserves should be created "in close association" with the IMF. How individual members would define "close association" varied, but it seemed fair to say that the Group was moving closer to the view that the IMF definitely should be in the picture and perhaps in the central role.

On both the questions of who should create and distribute reserve assets and what sort of assets were envisaged, Mr. Daane continued, at the November meeting the British had recommended a dual approach, with some support from the U.S. side. Under this approach reserves would be created by and for a limited group of countries and also more widely within the structure of the IMF. The former could involve a variety of techniques but would, perhaps, come close to the "collective reserve unit" that had been under discussion over the past few years. The latter could take the form of a "floating tranche" for all IMF members, or could involve a self-qualifying principle under which those countries that had already drawn their gold tranche would not be immediately eligible but would be potentially eligible. At the December meeting there was considerable sympathy for this dual approach around the table, which meant that the possibilities of both a new reserve unit and of additional reserve asset creation through the IMF were still very much in the deliberations.

Beyond that point, Mr. Daane said, some specific problems arose. One major problem was the question of whether the distribution or use of any new asset should be linked to gold. There was general agreement, except on the part of the French, that there should be no gold link in the creation and distribution of the new asset. The majority view seemed to be that there also should be no gold link in connection with use of the asset, except that of a gold-value guarantee. If the no-gold-link route was chosen, however, the question arose of what sort of limit should be applied; some sort of creditor limit would seem to be required. At that point the issue began to shade into some of the other more technical problems that were being considered, related to the acceptability of the asset. The French had consistently taken the position that their own proposals--which were unchanged from those they had made to the U.S. representatives at the beginning of the deliberations--were on the table, and that they were awaiting the proposals of others. Related to this, the Deputies were scheduled to have a 3-day meeting near the end of January, in which they might well come a bit closer to the negotiations stage. There would be another meeting in March, probably in Paris, and then a longer meeting in Washington, most likely in April.

Mr. Hayes asked if Mr. Daane felt that enough consideration had been given in the discussions to the possible adverse effects of a new reserve asset on the use of the dollar as a reserve currency.

Mr. Daane replied that the question of the relation to existing reserve assets was one of the basic questions considered in November and again in December. The French said at the December meeting that they had never recommended eliminating the dollar as a reserve currency. They recognized that many countries would want to maintain working balances in dollars and also that within a reserve currency "bloc" of countries there would be larger holdings of reserve currencies. They felt, however, that the Group of Ten countries should normally hold only working balances in reserve currencies and, at a minimum, not hold any more reserve currencies in their reserves than they did now. In Mr. Daane's judgment that was a somewhat milder position than they had taken at earlier meetings. Most of the other Deputies emphasized the role of the dollar in international transactions and its use in exchange markets. There was considerable sentiment on the continent for a tightening of the multilateral surveillance process, which now was rather loose, involving mainly WP-3 discussions, but the dollar's continued status as a reserve currency was clearly envisaged.

Mr. Hayes said he had raised the question because he thought there was a real risk that the U.S. might lose some of its financing flexibility, not only in connection with deficits but also when its payments were in balance. Even with over-all balance, there would always be some countries with respect to which U.S. payments were in deficit. It would be disadvantageous if a trend should develop abroad toward unwillingness to accumulate dollars to deal with swings in payments between the U.S. and individual countries, as well as between third countries.

In response to a question by Mr. Mitchell, Mr. Daane said it was his personal feeling--which would not necessarily prove to be the official U.S. position--that it would be undesirable for any new reserve asset created to bear interest, particularly if the asset carried a gold guarantee. In his judgment any new asset should stand on its own feet;and without interest it would offer minimum competition to the dollar. On the other hand, there were those who felt that a newly-created reserve asset should carry some nominal interest in order to insure its attractiveness to potential holders. That would result in three types of reserve assets: gold, bearing no interest; the new asset with a gold guarantee, offering, perhaps, a 2 per cent return; and dollars, now offering about a 4-1/2 per cent return. The question was not closed and, as he had noted, the view he had expressed was a personal one.

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 December 14, 1965, through January 5, 1966, and a supplemental report for January 6 through 10, 1966. Copies of both reports have been placed in the files of the Committee.

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

The four weeks that have elapsed since the Committee last met have been turbulent ones for financial markets and for System open market operations. The period encompassed the December tax date, the year-end statement date, a three-pronged Treasury cash financing operation, and a transit strike in New York City which still threatens the efficient operation of the financial markets themselves. During the period there were conflicting interpretations of the course of developments in Vietnam, concern and uncertainty over the likely shape of the budget, growing recognition that inflation was of major concern for 1966, and a potential conflict between the Administration and industry over steel prices. At the same time, banks in the money centers came under increased seasonal pressure and loan demands were heavy at a time when financial markets were still in the process of adjusting to the change in the discount rate.

While there were conflicting movements during the period, the net impact of all these developments was to put short-term interest rates under heavy upward pressure, while rates for intermediate Government securities also rose substantially. In the long-term area, however, rates on Governments actually declined slightly, while the corporate and municipal markets, under the influence of a seasonally light calendar, were generally steady.

Given the turbulence of the period, which, incidentally, made reserve projecting a more than usually hazardous occupation, open market operations were conducted with a view to moderating the pressures on bank reserve positions and the money market. In view of various alarms and excursions that occurred during the period, it is difficult to summarize Federal Reserve operations. Generally speaking, however, it can be said (1) that operations supplied a large volume of reserves to accommodate a far greater than seasonal expansion of required reserves, resulting from a strong rise in bank credit and a change in deposit mix as bank CD's ran down over the tax and dividend dates, and (2) they mitigated the upward pressure on short-term interest rates. One measure of this reserve supply can be seen in nonborrowed reserves, which rose at an annual rate of 21 per cent in December. Heavy use was made of repurchase agreements during the period, helping to moderate average dealer financing costs in the light of higher commercial bank lending rates. Measures of net reserve availability, as the written reports point out, varied widely over the period. The net borrowed reserve figure of $180 million published for last week was apparently taken by the market in stride, without creating the impression of any tightening of monetary policy. The results were admittedly a higher net borrowed reserve figure than we had aimed for, but it was a week in which reserves consistently fell short of projected levels by a large margin and which was thoroughly complicated by the year-end statement date and by the impact of the transit strike.

The transit strike in New York has brought to the forefront many of the technical aspects of financial market transactions that most of us normally take for granted. The dependence of these markets on bookkeepers, security handlers, and messengers was brought sharply into focus a week ago yesterday when, despite elaborate preparations, many of the employees of New York City banks and security houses were prevented from getting to work. The breakdown of mechanical arrangements resulted in a fairly large number of failures to deliver securities early in the week, but as a result of heroic efforts by banks and dealers, and individual employees, the flow of securities and money has been kept going. Early in the week the New York Reserve Bank, after consultation with the market, requested dealers to avoid trades for cash delivery while the emergency existed, in order to avoid the last minute transfer of securities and funds that such trading entails. Since last Thursday the market, following the lead of the stock exchanges, has generally been closing at 2 o'clock, and this has also helped. There is no doubt, however, that the strike has reduced the efficiency of the market and tended to make dealers very cautious. It has also limited the System's ability to operate on a normal basis. While the market continues to function, and we have not been unduly hampered in our operations, we will all breathe a sigh of relief when we can return to the normal hazards of bus and subway travel in the City.

As mentioned in the Board staff blue book1/, Federal funds, which had traded mainly at the discount rate for

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1/ The report, "Money Market and Reserve Relationships," prepared by the Board's staff for the Committee.

two weeks after the rate was raised, have again generally traded at a premium. This has not been due to any general shortage of reserves (as mentioned earlier non-borrowed reserves have risen substantially) but to the convergence of reserve pressures on money center banks, where basic reserve deficits more than doubled in the three weeks ending January 5 compared with the three weeks ending December 15. On Friday, New York City banks were running a basic reserve deficit in excess of $1.4 billion, and in addition were borrowing heavily from non-banks in the form of repurchase agreements, promissory notes, and Federal funds purchases. These pressures should subside as January progresses, but CD maturities are large and loan demands appear to be continuing contraseasonally. Until the pressures on money market banks subside, pressure can also be expected in the funds market (and on CD rates) as individual banks try to avoid excessive use of the discount window. I might mention that at least one large New York City bank went to 5 per cent on 6-month CDs yesterday.

The various written reports that the Committee has received have commented extensively on Treasury bill and other short-term rate developments in recent weeks. In yesterday's auction, enlarged by $100 million for the second week, $1.3 billion in 3-month bills sold at an average issuing rate of 4.58-1/2 per cent, while the six-month rate went to 4.74 per cent. Bidding for the new three-month bill, in particular, has been quite cautious in recent weeks, owing to the increased size of the weekly offering and the return flow of shorter bills as investors reversed pre-year-end window dressing operations. It seems also that, in the light of current uncertainties and wider rate movements, the market is exacting a larger underwriting spread from the Treasury in compensation for the increased risks and higher financing costs.

The books were open yesterday on the final stage of the Treasury's cash financing operation. The offering--of $1.5 billion 10-month certificates having a coupon of 4-3/4 per cent and priced to yield 4.85 per cent--has been very well received by the potential subscribers. With the tax and loan account privilege estimated to be worth an additional 20 basis points to the banks, a heavy oversubscription is expected, with the market estimating allotments of no more than 10-15 per cent.

As far as the outlook is concerned, I can merely echo the Board staff in saying that it is difficult to assess the potential degree of money market and rate pressures and the likely inter-relationships among money variables in the immediate future. The weeks ahead will provide a further testing period for the interest rate adjustments that have already been made. While basic market expectations at the moment appear to lean towards a further upward drift in interest rates, the present level of interest rates could prove quite attractive to investors, particularly if seasonal pressures show some signs of abating, and if other unsettling developments do not occur. At the higher rate levels, dealers have had considerable success in selling Government securities out of their portfolios. Since December 29 they have sold nearly $240 million coupon issues maturing in over one year, moving into a net short position of about $50 million by last Friday. Some of the corporate funds going into Governments appear to represent proceeds of bank loans that will not be needed for operational purposes until later in 1966.

Whether or not the rally that started in the Government bond market last week can be sustained is as yet unclear, although the market appears to be in a better technical position than it has been in for some time and the success of yesterday's Treasury financing is heartening. With its January cash needs now arranged for, the Treasury will be turning its attention to the refunding of $4.8 billion notes maturing on February 15th, of which $2.5 billion are held by the public. The Treasury will have hard decisions to make as to coupon and maturity for the new issue or issues to be offered, and much will depend on the circumstances prevailing at the time terms have to be set. A successful refunding operation could help restore a greater measure of stability in the market.

The System should, of course, give the Treasury as much support as it can in the refunding. But a definition of "even keel" at a time when the market is more susceptible to general economic, military, and budgetary developments than to small changes in monetary variables is not easily come by. Perhaps the most we can do is to be a moderating influence in what now appears to be a highly uncertain situation, but one which may settle down as the month goes on.

Mr. Mitchell asked Mr. Holmes if he thought that the Desk had given any leadership to the money market in the recent period.

Mr. Holmes replied that the Account Management had made a substantial volume of repurchase agreements on almost every trading day of the last 2 weeks. In his judgment the market understood that the System would act, and act promptly, to provide needed reserves, although it did not expect reserves to be supplied to finance any rate of credit expansion, however high.

In response to further questions by Mr. Mitchell, Mr. Holmes said he did not believe the market assumed the Committee had any specific interest rate target in view, and he doubted that a new increase in the discount rate was widely anticipated. The market was impressed by the strength of the business situation and the fact that the Administration now seemed more cognizant of the possibility of inflationary developments than it had earlier; and banks were impressed by the strength of loan demand in January and by the outlook for a substantial increase in loans in the first quarter.

Mr. Mitchell observed that at its last meeting the Committee had chosen not to give the Manager very much in the way of detailed instructions while waiting for conditions to settle down, and he gathered that the Manager thought some progress had been made in the latter respect. Was there anything the Committee could do now to tranquilize the present state of expectations?

Mr. Holmes commented that in his judgment announcement of a rather restrictive Federal budget would be more reassuring to the market than any action the System might reasonably take.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period December 14, 1965, through January 10, 1966, 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 have been placed in the files of the Committee.

Mr. Koch made the following statement on economic conditions:

> New information on past economic developments and on prospective spending plans serves to confirm the existence of a strong expansion currently and its likely continuance. As a matter of fact, both developments in the recent past and future prospects suggest a rate of economic expansion that could be creating problems of a destabilizing nature--first inflation and subsequently readjustment.
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> The significant upward revision in GNP in the first three quarters of 1965 that the Commerce Department has just announced has already led to marked upward revisions in GNP forecasts, not only in level but also in rate of increase. Prior to last summer, a common forecast for GNP in 1966 was $700 billion. After a worsening of conditions in Vietnam in mid-summer, forecasts were generally raised to the vicinity of $710 billion. Now they range from $720 to $730 billion. A $725 billion GNP this year would mean a rate of increase similar to that last year--about 7-1/2 per cent in current dollars and 5-1/2 per cent in real terms. And this is to be achieved with fewer unused resources available to draw upon than there were a year ago.

The two critical elements in one's prediction of likely economic things to come remain developments in Viet Nam and business investment--and their repercussions on the economy generally.

As for the likely impact of Viet Nam on fiscal policy, the Administration has dropped specific hints over the last week or so as to the prospective size of the administrative budget in both the current and the next fiscal year. The total expenditure figures on an administrative budget basis most frequently mentioned are around $105 billion for fiscal 1966 and up to $115 billion for fiscal 1967. Even with no tax rate increase, the rise in revenues resulting from further growth in the economy will be large. But it is not likely to quite match the jump in spending.

It is difficult to translate these fragmentary clues on the budget into national income and full employment terms, which are more meaningful for economic analysis. Nevertheless, they suggest some increase in the net stimulative nature of fiscal developments this year. With a booming private economy and with the full employment budget likely to be in deficit under current tax rates and prospective Federal spending, even a modest increase in net fiscal stimulation this year might prove excessive.

One major uncertainty in this area is the possibility of peace in Viet Nam. In event of such a happy development, private expectations and spending plans would no doubt be deflated, but Federal fiscal policy might well remain stimulative. Defense spending would likely continue higher than in the recent past and expenditures on the Great Society programs would increase. However, there is every indication that, with current and prospective military spending as large as it is, every effort is being made to limit other Federal spending programs. A sharp worsening of the situation in Viet Nam, on the other hand, could lead to speculative buying on the part of consumers as well as businesses.

As for business investment, the recent GNP revisions raised earlier figures sharply for both fixed outlays and inventory accumulation. According to the revised figures, business fixed investment in the third quarter of 1965 was 15 per cent higher than a year earlier. It amounted to about 10-1/2 per cent of the GNP. In the current quarter, this percentage may edge up further. Such percentages are similar to those that prevailed during the investment boom of 1956 and 1957.

The relationship of these fiscal and capital spending developments to monetary policy lies mainly in their likely effects on expectations, resource utilization, and prices. Here the situation looks better from the point of view of current employment and output levels but more troublesome from the point of view of longer-run economic stabilization. We have been achieving our goals of an increased standard of living and reduced idle resources. But the closer we get to full utilization of resources, the more we have to watch out that the pace of economic expansion remains sustainable and its character balanced and the more we may have to worry about the trade-off between reduced unemployment and price stability.

Assuming a rate of increase in dollar and real GNP this year roughly comparable to that last year, capital utilization rates are likely to edge up further, employment should continue to advance rapidly, and the unemployment rate should decline significantly more. To illustrate, total manufacturing capacity might well increase 7 per cent or more this year if current spending plans are realized. This would not likely be quite as large as the projected rate of increase in manufacturing output, assuming the specified rise in GNP. Moreover, pressures would be more acute in some specific manufacturing lines where utilization rates already exceed 90 per cent of capacity.

In the labor field, the armed services and the anti-poverty programs alone could push the unemployment rate down 2 or 3 tenths of a percentage point and a rapidly increasing employment should contribute 3 to 4 more tenths to the decline, depending on the rate of labor force growth. Thus, the overall unemployment rate might well drop to, say, 3.5 per cent by summer from the 4.1 per cent rate in December.

These likely developments in resource use would no doubt put additional pressure on wages and prices. Recent wage increases in some nonmanufacturing lines have already been exceeding the Administration's guideposts. Moreover, the rate of rise in productivity in the total private economy appears to have slowed somewhat. The average increase in the years 1961 through 1964 was 3.8 per cent, but the rate last year fell to 3 per cent or lower.

Although the rise in prices in general continues to be moderate and selective, it is persistent. The increase in the wholesale price index for industrial commodities, for example, amounts to 2 per cent now since the upcreep began about 15 months ago. Continuing shortages of supplies of copper and other materials, and the most recent steel price flare-up, suggest growing pressure on the guideposts.

From the point of view of the domestic economy, the actions increasing discount rates and Regulation Q ceilings last month look to have been more and more appropriate and timely with each passing day and each available new statistic. As for the policy over the next three weeks, current Treasury financing suggests, although it probably does not dictate, one of an even keel nature. Even in the absence of Treasury financing, however, such a policy would seem to me appropriate. First, we need to know more about the lagged effects of last month's actions in dampening the growth in reserves, deposits, credit, and spending over the longer run. Second, and even more importantly, we need to know more about the course of nearby developments in Viet Nam, and whether, if inflationary forces appear strong, the Administration will attempt to seek some fiscal restraint through a tax increase and/or expenditure limitations.

Mr. Holland made the following statement concerning financial developments:

In the tightening money market of recent weeks, one contributing factor of key importance has been the powerful groundswell of credit demands. Statistics are gradually becoming available to reveal just how strong and pervasive those demands have been.

By way of perspective, newly available figures for the fourth quarter show total net funds raised by the nonfinancial sector mounting above an $80 billion annual rate. This is sharply higher than the reduced third-quarter rate, and reflects the fourth-quarter concentration of Treasury financings that helped to aggravate the money market pressures. Private borrowing also climbed back up in the fourth quarter to a $67 billion annual rate, matching the peak of last spring that was swollen by borrowing to stockpile steel. At this level, private borrowing equaled 11 per cent of private GNP, extending the slowly rising trend in this ratio that has prevailed since 1962. The chief reason for this uptrend in private borrowing is not hard to pinpoint: it parallels very closely the vigorous rise that also has been taking place in the total of net private physical investment. Viewed against the perspective of the new GNP figures, these latest borrowing and investment figures do not suggest a sudden new outburst of activity so much as a fairly steady, substantial, almost inexorable-appearing rise in private investment and its financing to places of importance in the over-all economic picture that have not previously been touched except near the peaks of cyclical surges in the earlier postwar years.

It is trite to say that bank credit expansion has contributed importantly to this over-all credit expansion. It is not as trite to point out that bank credit growth in the fourth quarter does not appear to count for any greatly different share of total credit flows than would be true for the preceding nine months of 1965 taken as a whole. While this comparison implies a continuing very vigorous bank credit expansion, I daresay it sounds less imposing than the recent flow of bank reports might have led one to expect. On reflection, I think three elements have been at work enhancing our sense of a very expansive banking performance.

To begin with, detailed weekly figures suggest that the increases in bank balance sheets are being concentrated particularly in two items that are accorded special cyclical significance: business loans, and the money supply. Business loans were up by a seasonally adjusted $1.4 billion in December, and the first January week also looks strong. Meanwhile, the demand deposit category also started to expand more sharply during December. Both of these are magnitudes that might be expected to be moderated a bit, I think, by higher interest rates being paid. Their brisker growth, in the face of such added rate disincentives, therefore, is probably a tribute to short-term customer desires for cash for transactions purposes--and perhaps indirectly reflective of the vigor of current spending intentions.

A third special development affecting appraisals has been the sharp step-up in the ratio of reserve use by the banking system. On average, banks needed considerably more in the way of required reserves to support each dollar of deposit expansion in December and early

January than was true in previous months. This resulted partly from the slowdown of time deposit growth and the pickup in demand deposit expansion. In addition, within the demand deposit total, there was a deposit shift that favored higher-requirement reserve city banks more than low-reserve-requirement country banks. As can be judged, therefore, such an increased "consumption ratio" for reserves has both some purely technical overtones and also some underlying policy implications.

The combination of these influences on reserve use added up to a striking total, and the Desk responded by injecting nonborrowed reserves at an annual rate above 20 per cent during December. Nearly as high a rate of reserve rise seems to be persisting into January. Our standard reserve projection and estimation procedures fall short of allowing for so great a reserve appetite on the part of the banking system, and consequently the Manager, as he has already indicated, repeatedly found himself faced with after-the-fact downward revisions in net reserve availability. Time after time during this interval the market ended up with less reserves than either it wanted or we intended. The result was to compound the prevailing degree of market tightness.

In the event, given the strength of money and loan demands that were contributing to the increase in reserves demanded, I would argue that the more or less automatic additional degree of reserve restraint resulting from the misses in reserve projections was a constructive outcome--and one that might work to similar advantage in the weeks immediately ahead. However, whether or not individual members of the Committee might agree that these reserve shortfalls can be constructive, it seems to me and to some others of the more embattled members of the staff that it would be helpful if the Committee could take a more explicit stand as to whether the tendency for reserve misses to be more or less automatic, and approximately countercyclical, should be acquiesced in, or perhaps even welcomed; or, alternatively, whether the Committee would prefer an adjustment of reserve projection procedure that would try to minimize such misses by "aiming ahead of the banking system," so to speak, whenever we sensed that its demand for reserves was beginning to rise or fall by more than seasonal proportions.

I would not presume to attempt to crowd all the pros and cons regarding such a proposal into a briefing such as this. If this suggestion finds favor, however, perhaps some kind of staff or Committee study of the matter could be undertaken.

Mr. Galusha commented he did not understand the proposal Mr. Holland had advanced. Was he suggesting that the Committee should encourage imperfection in the projections of reserve figures?

Mr. Hickman said that, as he understood it, Mr. Holland would like to attempt to reduce the rate of growth of nonborrowed reserves by encouraging misses of deeper net borrowed reserves.

Mr. Holland replied that that was in fact what had happened recently. He was suggesting that the Committee might want, not to encourage such misses, but to acquiesce in them. The result would be symmetrical; if reserve needs turned down suddenly, the misses would be in the opposite direction and policy would in effect be eased more rapidly than if there were no misses.

Mr. Ellis said he gathered that what Mr. Holland actually would like was some guidance as to how the Committee felt on the matter, and Mr. Holland agreed.

Mr. Holland also concurred in Mr. Mitchell's observation that one burden of his (Mr. Holland's) comments was that the Committee's posture was tighter than it would have been if there had not been a relative shift of deposits from country to reserve city banks.

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

> Along with the news that the domestic economy has been expanding more rapidly than earlier supposed has come news that U.S. foreign trade was also expanding surprisingly rapidly during the second half of 1965. This news has both favorable and unfavorable aspects for the balance of payments; merchandise exports as well as imports have shown unexpected buoyancy.
>
> Acceleration in the growth of exports last fall fits with other information suggesting that the pace of economic expansion in the rest of the world as a whole was still rapid and may have been accelerating after an earlier slowdown. If this expansive world economic situation persists into 1966, as now seems likely, it will present the United States with new opportunities for balance-of-payments improvement.
>
> But, at the same time, the gathering boom at home and the consequent buoyancy of imports emphasize the standard *caveat* of recent years: that fundamental improvement in our international transactions depends heavily upon the avoidance or containment of domestic inflationary pressures. In my view, the main link between monetary policy and the balance of payments now runs more clearly than ever through costs, prices, and the current account, rather than through interest rates and capital movements. Domestic expansion seems to have removed whatever conflict there was earlier between domestic and international goals of economic policy.
>
> From the third quarter to October-November, U.S. merchandise exports increased at a 15 per cent annual rate, and in the latest 5 months for which we have data--probably a more representative period--exports were up 8 per cent from a year earlier. Thus, annual reviews that dwell on the increase of only 4 per cent from the full year 1964 to the year 1965 tell us mainly about the set-back in the first half of last year rather than about the recent trend.

Agricultural exports--about one-fourth of total exports--were at near-record levels in October-November, having rebounded in the summer. The rapid advance in October-November came in exports of nonagricultural goods.

Data on the geographical destination of exports through October show that shipments to Canada were expanding particularly rapidly, and a renewed expansion of exports to continental Europe seemed to be getting under way, no doubt related to recent upturns in French and Italian imports and continued strong demand from Germany. Exports to Britain, like total U.K. imports, remained at about year-earlier levels. And U.S. exports to Japan also showed no significant recent increase, although total Japanese imports began to expand again last summer.

U.S. imports did not rise as rapidly as exports in October-November. But they rose pretty fast nonetheless--at an annual rate of more than 10 per cent--thus disappointing hopes of a marked slowdown after the steel settlement. Total imports in the latest months were up one-sixth from a year earlier. Steel imports, though down a little from the second-quarter peak, were up by about 50 per cent from a year earlier, or by about $1/2 billion at an annual rate. Machinery imports were up by more than 40 per cent, and imports of non-ferrous metals and of consumer goods were each up about one-fourth.

What is the range of possible developments for exports and imports in the months ahead? On the most optimistic assumption, that further intensification of domestic inflationary pressures can be avoided, I think we could expect to see an appreciable slowing down in the rate of import expansion. Steel imports might fall back half-way toward their year ago level, and even if other imports continued to rise somewhat faster than GNP, the total might not go up at an annual rate of more than about 7 per cent. In that setting, exports would probably rise somewhat faster than imports in percentage terms, and even more in dollar terms. Acceleration of expansion in Japan, Italy, and France might about offset possible slowdowns in Britain and in such important peripheral countries as Australia and South Africa, to keep our total exports rising fairly steadily, though probably not at the very rapid rate of last fall.

This cheerful combination of events could improve the trade balance by $1 billion or so over the year from last October-November, and produce an even larger improvement between the full year 1965 and the full year 1966.

The more pessimistic possibility is that there will be little if any improvement in the trade balance. If boomy conditions should be accentuated in this country, both our exports and imports would do less well. Even if price changes were not markedly adverse, lengthening of delivery dates and reduced eagerness of U.S. producers to cultivate foreign and domestic markets could have important adverse effects.

Evidently, the Administration's target of a further substantial reduction in the U.S. payments deficit in 1966 implies a foreign trade performance near the optimistic end of the range I have given--an improvement much nearer to $1 billion than zero. This is so because no substantial improvement on capital account is to be expected, and there may instead be some net deterioration from recent levels, as explained in the green book.1/ Despite the stress in official statements on the beneficial effects to be expected from voluntary programs, they represent a holding operation this year--an effort to hold net capital outflows down to roughly last year's reduced rate, rather than to achieve further net improvement in this area.

Mr. Maisel remarked that it seemed to him from the statements of Messrs. Koch and Reynolds that there was a real conflict between the country's domestic and balance of payments goals. Wouldn't an increase in exports be inflationary? Where would the real resources needed to improve the trade surplus come from if the domestic economy would be in a state of over-full utilization of resources?

Mr. Reynolds replied that the importance one attached to that problem would depend on how one weighed an improvement of, say, $1 billion in the trade surplus. The effect obviously would

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

be in the inflationary direction, but an export increase that would result in a large improvement in the balance of payments would involve a very small part of total domestic activity.

Mr. Mitchell commented that if the economy was really struggling to meet domestic demands and the demands related to Viet Nam he thought there would be little room left for an increase in exports. He was somewhat surprised by the fact that exports had been expanding recently, but in any case the country was now in a new situation.

Mr. Reynolds remarked that if the point was reached where exports could not rise because of the pressure of domestic demands, the inflationary environment that would exist would be unfortunate wholly apart from balance of payments considerations.

Mr. Daane asked whether, on the whole, Mr. Reynolds expected the U.S. balance of payments in 1966 to be improved over 1965, and if so whether he thought a position within $250 million of equilibrium would be attained.

Mr. Reynolds replied that he was optimistic about the balance of payments in 1966 in the sense that he expected some improvement in the trade surplus, but he was not prepared to say how much improvement there was likely to be. Given the changed situation abroad, and assuming there would not be inflation in this country, he certainly was not worrying much about deterioration in the trade surplus, as he had been a year ago.

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

> In a few days the President's Economic and Budget messages should shed some light on the way in which the Administration proposes to handle the demands of the Great Society programs and the war in Viet Nam. This does not necessarily mean an end to the uncertainty and sensitivity that have characterized financial markets since the discount rate action was taken. Budget estimates for fiscal 1967 will clearly be predicated on uncertain judgments as to the future course of events in Viet Nam. They will, in any case, for some time be exposed to critical scrutiny pending Congressional action. It is not unlikely that explorations of a possible Viet Nam settlement will drag on for some time, giving rise to divergent and shifting expectations and judgments. Moreover, the impressively strong note on which the economy comes into the new year and the exuberant outlook are bound to raise questions about the possibilities for continued orderly expansion in 1966.
>
> I will not try to add to the staff's penetrating review of the closing phase of the past year. This makes it easier to focus on the problems and possible perils of the future. Clearly, we are entering a new phase in which economic balance is likely to be endangered by converging demand pressures more than at any time since this expansion started almost five years ago. I am encouraged by the new evidence suggesting that productivity has in 1965 increased somewhat more than originally estimated, and I am hopeful that this favorable development will continue. The cumulative effect of the recent flow of fixed investment, supported by substantial expenditures for research and development, promises to continue increasing the capacity of our industry and of the economy as a whole. But right now there remains little slack in plant capacity and in the labor force. The easy absorption of excessive steel inventories, the continuous rise in the backlog of unfilled orders, and the further decline of inventory-sales ratios all testify

to the fact that the economy is avidly absorbing the ever-rising output of final products.

In the current economic climate of an unexpectedly favorable profit experience and strong consumer demand without any significant problem areas, businessmen and market participants tend to become exuberant. Add to this the near-certainty of a substantial Treasury deficit, and you have a situation in which inflationary expectations are almost bound to win the upper hand. Recent stock market performance reflects this atmosphere.

Prices of goods and services are now clearly reflecting the pressures of demand, the existence of supply limitations, and the search for opportunities to improve or protect profit margins. Consumer and wholesale prices, and prices of industrial raw materials, have risen in 1965 more rapidly than in the immediately preceding years. Wage guideposts have served a useful purpose in helping to preserve price stability, but experience, here and abroad, shows that a taut labor market is conducive both to over-generous wage settlements and to less publicized wage advances--what the British call "wage drift."

Yet, preservation of cost stability is essential both for sustained growth and for further progress in moving toward international balance. In 1966 we will have to work harder to protect, and, indeed, expand our trade surplus. But the over-all outlook for the balance of payments is not good, even though the December performance looks encouraging on the basis of fragmentary data. In the immediate future we shall be living with the effects of postponed Canadian issues held over from the fourth quarter; and this factor, together with larger imports and larger military spending abroad, will probably offset gains painfully made in reducing direct investment outflows and in keeping other capital movements tending in the right direction.

All the economic data that have become available since the discount rate action add to its justification. Indeed, public criticism of it has ebbed considerably, with increased public and Administration recognition of the problems of maintaining a balanced expansion in 1966. But the adjustments in the financial markets have been turbulent, prolonged, and complex. It is always difficult to disentangle the different influences affecting market psychology and expectations. Certainly our action came at a time when business expectations were in the process of widespread upward revisions, as exemplified by the successive escalations of the "consensus estimates" of 1966 GNP. The implications of a prolonged conflict in Viet Nam for the economy and for the budget are now more broadly recognized. Credit demands continue strong even at the higher costs that have been established in all sectors of the market and for all maturities and instruments. Something of a scramble has developed among financial institutions in various parts of the country to hold and to attract funds, thus compounding pressures and causing chain reactions. Banks continue to bid aggressively for time deposits, apparently in the belief that credit demand will continue to expand strongly. In recent days, the chaos created by the New York transportation strike has added to difficulties in estimating reserve positions and needs, and has threatened the technical ability of securities markets to perform in the efficient manner which we normally take for granted.

I believe that in these difficult and confusing circumstances the Desk has done the right thing in deemphasizing marginal reserve measures and by focusing on market performance. Rates have risen more rapidly than some of us expected, but no useful purpose would have been served by trying to block the kind of market pressures that actually developed.

We must look forward to a trying period immediately ahead. The Treasury is now engaged in a series of refunding and new money operations. Even aside from the usual even-keel considerations, the proper policy appears to be one of "steady in the boat on a rough sea." The Manager will need again to have more than usual latitude in conducting operations in a period when official pronouncements, actual Treasury operations, and the ups and downs of peace explorations in Viet Nam buffet the market. At the same time, market participants will try to assess the longer-run outlook for the supply of and demand for funds at a time when bank loan demands normally decline. This will be a difficult period and we will have to tread a narrow path between resisting market pressures that might tend to drive rates up further and providing reserves in such a way as to reduce, rather than to stimulate, the rate of bank credit expansion. The continuing objective should be to maintain net borrowed reserves, but given the

> uncertainties of demand and of technical factors we should be prepared to see larger swings in weekly reserve figures.
>
> The draft of the directive proposed by the staff[1/] seems entirely satisfactory.

Mr. Hayes added that he was not sure he understood all the nuances of Mr. Holland's suggestion, but he believed the Committee had been doing the right thing in tending to cushion some of the effects of the exuberant credit demand, given the recent discount rate and Regulation Q actions and the various uncertainties existing in the market. A certain amount of cushioning also would be appropriate in the period immediately ahead. For the longer term, he would question the desirability of letting reserves go up as rapidly as they had recently, but for the time being the Committee was locked in.

Mr. Hayes then reported briefly on the effects of the present New York City transit strike on the operations of the New York Reserve Bank. He indicated that the Bank had been successful in performing all essential operations but at the cost of a great deal of staff inconvenience and fatigue.

Chairman Martin said he thought everyone was proud of the manner in which the New York Reserve Bank was performing during the present difficult period.

1/ Appended to these minutes as Attachment A.

Mr. Ellis remarked that the accelerated pace in manufacturing activity appeared to color the New England economic picture more and more. As expected, rising defense expenditures were showing up in subcontracting and research and development as well as in direct procurement contracts. The factory workweek increased contraseasonally in November to register a 5.3 per cent year-to-year gain and the manufacturing index chalked up an 8 per cent corresponding gain. By far the largest gains had been registered by aircraft manufacturers. With the exception of apparel factories, each of the compiled industry groups showed substantial year-to-year increases.

Looking to non-manufacturing activities in the region, Mr. Ellis said, the overriding impression was of prosperity--perhaps even expectant prosperity in the sense that it was here to stay. Construction contracts, paced by both public works and residential awards, posted a 10 per cent year-to-year gain in the average for the three month periods ending in November. Total employment was up contraseasonally, and unemployment declined more than seasonally. Department store sales over the four weeks including Christmas registered a 6 per cent gain.

In the banking sector, Mr. Ellis continued, the dominant theme had been adjustment to higher rates and the year-end financial turbulence. During the first half of December the four

Boston money market banks made fewer short-term business loans than in the first half of September, but a substantial increase in average loan size brought a 40 per cent gain in new loan volume compared with a 17 per cent gain by their New York City counterparts. Their average interest rates rose 9 per cent compared with the 7 per cent rise in New York in the same period.

Of the banks responding in the First District rate survey, Mr. Ellis said, 24 per cent had increased or planned to increase their interest rates on deposits. Even after such changes, however, only a handful of banks--mostly the larger ones--paid more than 4.75 per cent on negotiable CDs and only a handful--mostly small--paid more than 4.5 per cent on non-negotiable CDs. Three banks had announced rates of 5 per cent or higher, one non-member going to 5.375 per cent on 5-year CDs with $5,000 minimum deposit size.

Savings bankers, for their part, had been raising their rates reluctantly and with loud complaints, Mr. Ellis remarked. The Massachusetts Banking Commissioner had requested the Federal Reserve Board to limit CDs to a minimum amount of $30,000. The manager of the savings bank pool for investing in mortgages outside of New England reported that his normal placement of $10-$20 million in an average week had been reduced to almost zero. He blamed that reduced outflow on slower deposit growth due to competition from commercial banks. So far, only three of 80 reporting savings banks paid 4-1/2 per cent. The great bulk paid 4-1/4 or 4 per cent.

Turning to monetary policy, Mr. Ellis remarked that conventional wisdom over the past few months had progressively matured into a view that virtually all major segments of the economy would be expanding in the next several months. In the absence of data on total credit flows--and he was grateful to Mr. Holland for beginning with that subject in his remarks today--it appeared safe to judge that demands for credit would be swelling to a point where the banking system would be under pressure to secure expanding reserves to support continued rapid credit expansion. In that context it was refreshing to be able to agree with those who concluded that further efforts to reduce unemployment by monetary policy would incur a serious risk of a faster upcreep in prices. From that viewpoint, the realistic alternatives were to hold policy unchanged or to seek some lessening of reserve availability. The realities of present Treasury financing and prospective refunding counseled an effort to maintain a facilitating even keel. As he read the market reports, however, the even harder reality was that it was difficult to define the component parts of an even keel policy.

To the extent that the reserve projections were reliable, Mr. Ellis continued, failure to take any action to offset currency return flow would result in net free reserves for the next several weeks. Such an outcome would by itself be both confusing and misleading to the market. The meaningful question, therefore, concerned the volume of reserves the Account Management should seek to absorb by sale of securities into a market where short-term rates already were substantially bolstered by expanded Treasury offerings.

Once more, Mr. Ellis said, the answer had to emerge from judgments based on imperfect information and comprehension. For his part, he liked Mr. Holland's concept of "constructive shortfalls." Bank needs for reserves were met in December, as indicated by the rise in nonborrowed reserves at an annual rate of over 20 per cent. But, except for the last statement week, those needs were met against an objective of not showing a sharp drop in net reserve availability. In his judgment the Manager should not work solely with a rate objective in mind. The historic pattern of a seasonal weakness in bill rates in January might be overridden by the expanded Treasury bill action and by the current increases in other rates. Although the present rate level exceeded earlier expectations, he saw no reason to attempt a roll back in rates. Secondly, during the current Treasury financing action the Manager should strive not to lose too much ground, and should hold as a target net borrowed reserves averaging near

$150 million. Finally, for the immediate future, the principal objective of operations should be to preserve orderly conditions in the money market by moving to resist sharp movements of rates in either direction.

Mr. Ellis added that he had enjoyed Mr. Holland's analysis today and hoped that similar analyses would be included in future green books. Also, he would like to see a study of the type Mr. Holland had suggested the staff might undertake in connection with his proposal.

Mr. Irons reported strong optimism in the Eleventh District on the part of businessmen and bankers. All of the main economic indicators were at high levels and tending to inch up. Economists were upgrading their forecasts for the coming year for sectors ranging from industrial production through trade into agriculture, where the returns were coming out very favorably.

Bankers generally reported heavy demands for loans in all categories, Mr. Irons said, and they expected loan demands to continue strong. Banks had reduced their holdings of Governments but had increased holdings of other securities. Last month there was a slight decline in negotiable CDs, but demand deposits continued up.

The demand for Federal funds was very strong in the District, Mr. Irons continued, with banks tending to relieve their liquidity bind by purchasing Federal funds rather than by borrowing at the discount window. Last week purchases of funds amounted to about $1 billion and sales to about half that sum. Borrowings from the Reserve Bank were small; the larger banks, which tend to have most need for borrowing, were meeting their requirements primarily through the Federal funds market. In his judgment it would be desirable to have more borrowing at the discount window as an alternative to purchases of funds. It seemed to him there had been a change in the banks' concept of appropriate use of the Federal funds market. A short time ago banks would enter that market to make an adjustment for one day--or perhaps a few days--and then they would move out. But now, with banks operating with a built-in deficit, they needed funds on a continuing basis and used the Federal funds market to obtain them. That situation might be leading to problems. He would not want to have the current practice changed suddenly, but he would like to see some move taken with respect to the administration of the discount window that would result in greater reliance on borrowing from the Federal Reserve.

With respect to the consequences in the District of the recent change in Regulation Q, Mr. Irons said, there had not been much disturbance in the attitudes of savings and loan associations or banks. Only one bank had moved its time deposit rate up to 5-1/2 per cent, and that rate applied to deposits with some contractual limitations. A few small banks had gone to a 5 per cent rate. On the whole, the situation seemed to be quieting a bit, although the adjustments had not all been made. Over the past several weeks there had been very few direct or indirect contacts on the subject made with the Reserve Bank.

On the national situation, Mr. Irons remarked that it was unnecessary to review in detail the elements of strength in the economy, which were outlined in the green book. In general, there was virtually full employment and production, and further demands were being and probably would continue to be placed on the economic system. From the standpoint of economic factors alone, one might conclude that a slightly firmer policy and some additional restraint were warranted. However, if one looked to financial developments, and also took account of the fact that Administration policies would be set forth in a number of messages over the next few weeks, it would seem that the System's policy should be one of moderating changes in financial markets. Interest rates had risen sharply recently, and more than he had wished at the time of the last meeting. He had expressed the hope then that the discount rate would serve as a ceiling for other short-term rates, but the other rates had broken through that ceiling.

For the next three weeks, Mr. Irons continued, an even keel policy was called for by the Treasury financing schedule.

He was inclined to gear policy largely to rates, trying to moderate any further strong upward movements. He recognized that with the Treasury adding to bill supplies there might be difficulties in achieving that objective, and he would be satisfied for the time being with smaller net borrowed reserve figures than had occurred last week; he would not be disturbed by marginal reserve figures in a range of $50 million around zero, if that was necessary to moderate rate movements and to help maintain orderly conditions in the market.

In concluding, Mr. Irons said that the Manager should be given a considerable amount of leeway with respect to his operations. The draft directive submitted by the staff was acceptable to him.

Mr. Swan commented that in the Twelfth District, as in the rest of the country, business seemed to be expanding strongly even though the District unemployment rate continued to be one percentage point or so above the national level. Despite the still high, although declining, unemployment rate, there were reports of increasing difficulty in obtaining skilled workers--including not only scientists, engineers, and the like, but production-line workers as well. That situation might present some problems to the aerospace industry in realizing the employment increases it hoped to make in 1966. One Seattle company had announced that it would like to add some 1,500 workers a month in 1966 because of its backlog of non-Government orders, but there was some question as to whether that could be accomplished, given the labor situation in the Seattle area.

Mr. Swan noted that there was considerable interest on the West Coast in the adjustments of product prices recently announced by the U.S. Steel Company--not so much in the price increases, but in the decreases that were announced in prices of cold rolled sheets, amounting to $9 per ton or about six per cent. That reduction was particularly interesting because imports of cold rolled sheets and strip had amounted to about one-fourth of West Coast consumption in 1964. Figures for 1965 were not yet available but the import proportion probably was still higher in that year. The price reductions should improve the competitive position of domestic production in the western market relative to Japanese imports.

District banks entered the new year under considerable pressure, Mr. Swan said. As Mr. Irons had indicated was the case in the Eleventh District, Twelfth District banks were net buyers of Federal funds on quite a consistent basis. Loan demands were strong and there were no signs as yet of the seasonal decline that usually occurred early in the year. The response to the increase in Regulation Q ceilings had been quite widespread. A few banks raised their CD rates to 5-1/2 or 5-1/4 per cent, and more went to 5 per cent.

By and large, however, those were smaller banks. So far, the larger banks had not increased CD rates to that extent, nor were they pushing savings certificates in one form or another very vigorously.

As to policy, Mr. Swan agreed in general with the views already expressed. It seemed to him the Treasury financing schedule required an even keel posture. With the Budget Message just ahead and with the possibility that some of the existing uncertainties might soon be resolved, the best course for the Committee to follow in the next few weeks would seem to be to seek again to moderate any of the changes that might develop in financial market conditions. He agreed with Mr. Irons that in the coming period some attention had to be paid to interest rates. He thought that a posture of even keel, however defined, would not necessarily call for a roll back of rates from their present levels, but it would seem to call for doing what could be done to prevent further rate increases. He hoped that could be accomplished with net borrowed reserves in the area of $50 million--or, more broadly, in a zero to $100 million range. But if it became necessary to introduce a little more ease in marginal reserves in order to keep the bill rate in the upper 4.50s, or somewhat below that level, he would not be disturbed.

Mr. Swan was not sure whether or not Mr. Holland's prescription for a "constructive shortfall" involved a contradiction in terms, except for the isolated case. In other words, although the Committee might happen to feel that the consequences of an individual miss were desirable, he did not see how it could utilize possible shortfalls in the reserve estimates systematically, as an operating device. He saw no objection to further attempts to improve the estimates if it was thought that something could be accomplished in that direction. Such improvements would, of course, reduce rather than increase the possibility of shortfalls.

Mr. Galusha observed that the response of Ninth District commercial banks to the December change in Regulation Q had of necessity been uneven. Some District banks--those in South Dakota and those with Minnesota charters--were at the moment precluded from paying more than 4 per cent on time and savings deposits. He understood that many Minnesota chartered banks were quite anxious to have their ceilings raised, but the South Dakota banks, feeling themselves to be at sufficient remove from Twin Cities competition, evidently were urging that their ceilings remain unchanged.

Among District banks legally able to respond to the change in Regulation Q, many had already done so, Mr. Galusha said. Nearly all Twin Cities area banks were offering 4-1/2 per cent on 90-day (non-negotiable) time deposits and 4 per cent on savings deposits. One of the smaller banks in the area had gone to 4-3/4 per cent on 90-day time deposits. Also, the Twin Cities banks were aggressively seeking, by major advertising campaigns, very small denomination time deposits.

Twin Cities area savings and loan associations, Mr. Galusha continued, had generally responded to bank deposit rate changes by increasing their share rates to 4-1/2 per cent. The one mutual savings bank in the District, which had over $400 million in deposits, had increased its rate for six-month time deposits to 4-1/2 per cent and reported a much greater than normal year-end loss of funds. That report--highly impressionistic, he suspected--was among the few thus far received. Most banks had indicated that it was much too early to tell how their deposit totals were changing under the new rate structure. One bank reported considerable gains, particularly in large time deposit accounts.

As yet, Mr. Galusha said, not all District country banks that were legally able to respond to the Regulation Q change had done so. Many had, of course, and he thought many of those that had not would before very long. Casual evidence suggested that country banks would be bothered more by competition this time than they had been following the changes of mid-1963 and late 1964. There was an indication that structural changes in the District banking industry were being accelerated. Mr. Galusha's impression was that, to hold deposits, country banks as a group would have to increase deposit rates relatively more than they had last November and December. Then, too, those banks were apparently not in as good a position to increase gross earnings as they were late last year. The once-over shift to longer-term, higher-yielding assets was largely an adjustment of the past. And excess cash had, to a considerable extent, already disappeared. Seemingly, therefore, the profits of District country banks would be squeezed more relatively than those of city banks in the year immediately ahead. Not that there was any longer anything the Federal Reserve could do about that. But he thought it would, perhaps, be well to keep in mind the possibility of increased resentment among banks which, even before the revision of the Regulation Q ceilings, weren't altogether happy with System membership.

Among all the innovations being seen for the first time in the Ninth District, Mr. Galusha said, the guaranteed time deposit rate appeared to be the most serious. One large bank presently was advertising a five-year guarantee of 4-1/2 per cent on time deposits which could, at the owners' option, be liquidated any time after 90 days. The advertisements were hasty and ill-considered, with innocent but unfortunate conflicts between the claims made in them and the instruments involved; the Minneapolis Reserve Bank had called those conflicts to the attention of the bank, and they had been corrected. Were that practice of long-term rate guarantees to spread now, while interest rates were very high by historical standards, the Federal Reserve could find itself in something of a dilemma the next time the economy sagged and the need for monetary ease became apparent. Giving consideration to precluding long-term rate guarantees on short-term borrowings might therefore be worthwhile.

About open market policy, Mr. Galusha said, it was possible to be very brief this morning, reiterating what had been said already. He was impressed by the fact that the Committee's policy would be only one influence, and a relatively minor one, on developments ahead, and that its posture would be a reactive one in the period to come. So it would appear that the Desk would have to have a considerable degree of latitude. That was how he would define "no change" in policy; and with that interpretation in mind he was agreeable to the staff's draft directive.

Mr. Scanlon said that recent weeks had produced further evidence that Seventh District business activity had moved very close to practical capacity. Labor turnover had increased and hiring standards had been lowered. Delivery lead-times on new orders had lengthened, particularly in the machinery and equipment industries. Since early December, there had been a pronounced revival in steel orders--much earlier than had been generally expected--from virtually all steel-using industries. Allowing for the holiday let-down, there had been an upswing in steel output since mid-November. Even in the week ending January 1, output of steel ingots was at a 114 million ton annual rate despite continued inventory liquidation by some steel users. Production of autos in January was scheduled at 830,000 units, slightly above the number for the year-ago month when strike-depleted inventories were being replenished.

New claims for unemployment compensation in the District were far below the previous year's low level in December, Mr. Scanlon reported. The usual year-end rise in the proportion of covered workers receiving unemployment payments was much less than usual. In the week ending December 18, insured unemployment in the District ranged from 1.3 per cent in Indiana and Iowa to 2.0 per cent in Wisconsin, compared with 2.8 per cent for the U.S. Those totals were far below other recent years. In the comparable week of 1955, the previous record low, the range for District States was 1.9 to 2.6 per cent, compared with 3.1 per cent for the U.S.

Labor market classifications for November, recently released by the Department of Labor, showed that Milwaukee was raised to the "B" category--"relatively low unemployment" of 1.5 to 3.0 per cent, Mr. Scanlon continued. Of 23 District centers only Chicago, Detroit, South Bend, Terre Haute, and Muskegon were placed in the "C" category--"moderate unemployment" of 3.0 to 6.0 per cent.

Classifications for Chicago, Detroit, and South Bend appeared inaccurate; in each of those centers local agencies rated unemployment at less than 3 per cent. A careful review of all the available evidence lead to the conclusion that District labor markets probably were the tightest since World War II.

Mr. Scanlon went on to say that evidence of continued strong demand for credit, especially by businesses, was contained not only in the loan figures but also in banker comments about full loan portfolios, tight money, and--in some cases--rejections of loans that would have been made a few months ago. However, apparently there was little inclination to cut back on term lendings, and a substantial part of the demand seemed to be for term loans.

Despite the fact that money market conditions had generally been described as tight, Mr. Scanlon remarked, borrowing at the discount window had not been very heavy or very general. The large banks in the District appeared to have been generally unaggressive in selling CDs.

Nationally, Mr. Scanlon continued, monetary and credit expansion had occurred at a rapid pace even though interest rates had been increased, indicating a strong demand for credit, probably a strengthening demand. In light of the anticipated continuation of heavy credit demands in the near future and the threat of accelerated price increases, it appeared desirable in the long run to moderate the rate of monetary expansion. However, the Treasury's January cash financing program was yet to be completed, financial markets were still in process of adjusting to the discount rate change, and announcements on important Government decisions were forthcoming. All of those factors seemed to dictate an even keel posture for the next three weeks.

Mr. Scanlon said that while he would prefer to have the directive call for "maintaining current conditions in the money market," he could accept the staff's draft if it was clear to the Manager that its wording did not suggest a forced roll-back. He agreed that the Manager should continue to have more than the usual amount of latitude in moderating any pressures that might develop in financial markets.

Mr. Clay said that in the months ahead the formulation of monetary policy, and public policy more generally, would be based on an economic situation markedly different from that prevailing during the previous years of the current business upswing. The military developments and expenditures imposed upon an economy already operating with relatively small margins of unutilized resources had brought about a pronounced change. The exact outline and proportions of those economic developments could not be fore-seen, quite apart from the possibilities of the military situation changing in either direction. On the basis of present indications, it was reasonable to assume that the processes of orderly economic growth would be much more difficult to maintain than earlier, and the risk of price inflation would be distinctly greater.

Monetary policy in the period immediately ahead would be conditioned substantially by Treasury financing already under way and forthcoming, Mr. Clay remarked, and that would point to maintenance of "even keel" conditions over the period. Apart from that fact, it would appear logical to maintain money market conditions compatible with the recent discount rate action. Significant easing in the money market from seasonal forces appeared doubtful, and there was a possibility that market forces pushing rates upward might prove to be more powerful. Under those circumstances, it was difficult to state policy targets. A range of 4.45 to 4.60 per cent would appear appropriate for the Treasury bill rate. The draft economic policy directive appeared satisfactory to Mr. Clay.

Mr. Heflin reported that Fifth District business remained strong through the final weeks of 1965. In the Richmond Bank's latest survey, manufacturers on balance reported further small gains in orders, shipments, employment, wages, and prices, and declines in finished-goods inventories. The panel, however, displayed somewhat less optimism than in previous surveys. The Defense Department recently announced intentions to purchase

120 million linear yards of textiles in the first quarter of this year, instead of the 6.6 million yards announced in September. Military needs would amount to only about 3 per cent of the total first-quarter output of broad woven cottons, but apparently would take from one-third to three-fourths of the normal output of a few specified fabrics. Since virtually all of the industry's anticipated output of such goods had already been sold, producers undoubtedly would be forced to ration available supplies of those fabrics, and the upward pressure on prices would probably increase significantly.

There was little he could add to what had already been said about the national economy, Mr. Heflin commented. Activity continued brisk and the over-all business environment appeared even more buoyant than it had before the discount rate was raised. Despite sharp upward rate adjustments, bank credit had continued to climb rapidly in response to strong loan demand. It also was reasonably clear that market expectations had shifted more in the direction of rising rates, and that might be encouraging some anticipatory financing. Over the past few weeks the market had been subjected to a number of random and extraordinary influences, including the New York transit strike, which complicated the problem of evaluating the market relationships that would emerge from the System's recent rate action.

Mr. Heflin thought that for the coming period the Treasury financing was clearly the controlling factor in the policy area. In the light of recent market conditions the important question now appeared to be what constituted "even keel." It seemed to him that a policy of "no change" for the period should be interpreted primarily in terms of feel and tone of the market, although he would expect that bill rates would not be allowed to rise above their recent highs. Over a longer period, however, it seemed important to bear in mind that if the recent restraining moves were to be effective, they had to be reflected in reduced rates of expansion in bank credit and the money supply.

Mr. Robertson then made the following statement:

> I, for one, have been much impressed by the signs of a stronger and stronger business situation that have reached us in the last few weeks. Both the contents of the green book and the briefing this morning reinforce my feeling on this score. GNP has been marked up sharply, both in terms of current dollar levels and past and prospective rates of advance. Employment is up significantly further, and the long-hoped-for breakthrough to an unemployment rate below 4 per cent is finally said to be "just around the corner" of the next month or two's reports. Thus far, our price performance has continued on the moderate side, despite our narrowing margins of unused resources, but I note that in looking ahead (in the green book) the staff has now come to say flatly, "...upward pressures on prices appear likely to be strong."
>
> My own judgment is similarly shifting in this direction. Accordingly, I am prepared to have monetary policy make a substantial and positive contribution to damping such inflationary pressures as they emerge.

Precisely how much--or perhaps I should say, how much more--monetary policy might need to be tightened to serve this purpose depends importantly on two issues that are still up in the air at this moment:

(1) how much counter-inflationary help we will get from the Federal budget, and
(2) how much restraint is resulting from the monetary tightening that has already taken place.

We now have accomplished a significant second round of money market tightening, at least from a "rate" point of view, layered on top of the earlier firming of conditions that began last summer. Regardless of whether the System was right or wrong in its policy actions, and in the timing thereof, the wise thing to do now is to try to gain all the positive benefits we can by holding firmly to this posture of restraint for the time being.

Consequently, I would favor the adoption of a policy designed to hold money market conditions at about their current degree of firmness until the next meeting of the Committee. This kind of policy should serve three immediate objectives: (1) preserving an "even keel" posture in connection with the Treasury financing; (2) permitting a careful judgment of the content of the new Federal budget and of public reaction thereto; and (3) allowing time to appraise the effects of the current degree of monetary tightness.

By perhaps two meetings from now, these immediate objectives should be fulfilled and a hard look at the future course of policy should be possible. While I favor a pattern of interest rates as low as possible, compatible with sustainable growth in the economy and price stability, if credit demand prospects at that time still appear excessive, we may have to tighten even further. With interest rates already near historic highs, such further tightening should not be undertaken lightly. We shall have to be especially watchful for signs that our restrictive actions might be having cumulative effects that could give rise to a credit crisis and even an eventual recession. These considerations ought to make us careful, but not timid or inactive when the proper time for action arrives.

With these thoughts in mind, I would favor a directive that called simply for maintaining about the current degree of firmness in money market conditions until the next meeting of the Committee.

Mr. Robertson added that he would prefer language such as he had suggested to that contained in the second paragraph of the staff's draft directive. In his judgment it would be desirable to place emphasis primarily on net borrowed reserves rather than on short-term interest rates. The current Treasury financing was a relatively minor operation and he would not be disturbed if short-term rates moved higher. As he had indicated, it seemed to him that the Committee should be holding firmly to the degree of restraint that had developed.

Mr. Shepardson said he had little to add to the discussion of the general economic situation. He thought the staff reviews of that situation in the green book and in this morning's presentation were excellent. They pointed clearly to a strongly expanding economy at near-capacity levels with increasing possibilities of price advances. In that light the Committee certainly should be looking not toward maintaining but to further restraining the rate of credit expansion. He recognized, however, that with the Treasury financing situation no active change in policy could be made at the moment, and the directive proposed by the staff seemed appropriate.

If he understood Mr. Holland correctly, Mr. Shepardson continued, as a result of market pressures rather than deliberate action the situation in the money market was a little tighter than might have been envisioned at the last meeting; and the proposal was that the Committee should contemplate accepting the same kind of tightening in the future if the pressures of demands were strong. In other words, while the Committee would not act to create firmer conditions, if the market firmed by itself the Committee would expect to moderate the change but not to roll conditions back. Similarly, in a situation in which demand pressures eased significantly, the reaction would be moderated. If an alternative interpretation was put on the proposal--namely, of asking the Desk deliberately to overshoot when the market tightened--he would not favor it. He did favor what had been done in the recent period--working to moderate expansion when demands outran the projections.

Mr. Mitchell said that the country was in a period of inflamed expectations and it was that fact that had made it so difficult for the Desk to deal with the problems facing it recently. Current expectations ranged from a belief that the economy was heading for a Korean-war type of inflation, involving increases in wholesale prices of about 15 per cent over a six-month period, to a belief that there would be some acceleration from the recent rate of price change but no increases as spectacular as those during the Korean period. Whether or not either of those expectations were valid no one could say at the moment. The Manager had implied that monetary policy could do little to tranquilize such expectations, and he (Mr. Mitchell) also saw little that could be done, so perhaps the Committee had to lay the problem aside for the moment.

The real economy was performing well, Mr. Mitchell continued, and perhaps too well, when judged against the standard of moving on to a full-employment path. The present climate of expectations was vulnerable to change as a result of the President's Budget Message. He agreed with Mr. Hayes that an absolute reading on fiscal policy would not be obtainable from the Message, because the budget proposed would have to be considered by Congress. Nevertheless, he did expect a tough budget, and he thought that it would have a substantial effect on psychology and expectations.

Under those conditions, Mr. Mitchell said, he was willing to go along with the staff's draft directive. However, he would be inclined to advise the Manager to expect that marginal reserves would have to be positive rather than negative to implement the directive. He would favor bill rates under the discount rate--in the 4.35-4.45 per cent range--rather than in a 4.50-4.60 per cent range. He thought the former was likely to prove a better operating range, and that rates in that area would be easily arrived at if the budget was as restrictive as he expected. If the budget was not restrictive, the Committee would be faced with a serious problem and might find it necessary to reconvene to adopt a somewhat different policy. He agreed with Mr. Robertson on the possible need for restraint on credit growth.

Mr. Mitchell indicated that he was somewhat dubious about Mr. Holland's suggestion. But Mr. Holland had alluded to a very real problem in commenting on the reasons for the recent market firming. An environmental change had developed gradually over the past few years, involving progressive reductions in the liquidity of banks and businesses. The staff analyses tended to be short-run in nature, implying no change in the general environment. What troubled him was that if the Committee made decisions on the basis of such analyses when the environment had in fact changed, it might take actions that were extremely damaging to the economy. It was necessary to be careful, for example, in using growth rates in bank credit and the money supply as criteria for policy actions. When banks were extremely illiquid the alternatives before the Committee might be to act to ease that illiquidity or to face a financial crisis, and the first was obviously the better choice.

Mr. Daane said he had little to add to what had been said. It seemed to him in the light of the Treasury financing schedule and the uncertainties as to the shape of the Administration's projected fiscal policy--whether it was achievable or not--the Committee should follow an even keel policy at this time. He had a great deal of sympathy for Mr. Robertson's statement and like Mr. Robertson he, too, was somewhat unhappy with the staff's draft directive.

From time to time, Mr. Daane continued, at least some members of the Committee had expressed dissatisfaction with the final clause of the first paragraph, which read "while accommodating moderate growth in the reserve base, bank credit, and the money supply." He was particularly unhappy about that clause in the current context; it should read "by moderating growth in the reserve base, bank credit, and the money supply" if the Committee was trying to ward off incipient inflation. In the second paragraph he would prefer to use the customary language, calling for "maintaining about the current conditions in the money market," rather than language calling for resisting further firming and possibly implying some rollback in market conditions. The danger of incipient inflation was clear, and the Committee's main task was to keep monetary policy sufficiently flexible to do what it could to contain inflationary pressures.

Mr. Maisel commented that the monetary picture since the Committee's last meeting seemed most disheartening. Interest rates on most money market instruments rose by nearly the full amount of the discount rate change. On the other hand, the expansions of reserves, of the money supply, and of bank credit were far larger than in most recent months and far above the average for the prior policy period. Thus, it seemed, the worst of both possible worlds had been experienced, with higher rates and an increased money and credit availability.

The Committee was now pausing temporarily in a period of even keel. It was important that it look ahead and consider what sort of policy made sense for the next quarter or six months. Since the final fiscal picture was lacking, the Committee could only make tentative plans. Contrary to Mr. Mitchell, Mr. Maisel would expect that there would be a tendency to look to the Federal Reserve System for maximum constraint, since the Committee had made it evident that it preferred to take the lead in that matter. It offered the choice of a high interest rate-higher deficit economy. If that policy was picked, he did not think the Committee should be too concerned with the height of the interest rate necessary to support such a policy.

Mr. Maisel felt, therefore, that the Committee ought immediately to start to consider, looking toward the next meeting, the question of how large a cutback in the level of credit expansion was feasible. Mr. Holland's report was particularly worrisome. In the light of that type of credit movement, the Committee ought to determine what types of quantitative goals it thought were necessary for monetary policy in the period. He would hope that in choosing its policy the Committee would put more stress on the indexes of nonborrowed reserves, money supply, bank credit, and total deposits of all financial institutions. It seemed to him necessary that the rate of expansion in those series be cut back sharply from that of 1965 and particularly its last month toward or below the rates that had prevailed in the policy period prior to December 3. The present seemed to be a period of overly high expectations. The Committee should ask what attitude or action it could take to cut back on expenditures based on those expectations.

While it was thinking about credit flows, Mr. Maisel continued, it might be proper for the Committee to consider the required reserve ratios. He recognized that was the ultimate responsibility of the Board, not the Committee. However, in order to curtail the rate of expansion in credit while at the same time getting the best possible distribution between small and large users, the Committee ought seriously to consider the advantages of moving as far as legally possible to a graduated reserve system. Mr. Galusha had alluded to a problem that might be ameliorated by such a change. In addition, the monetary advantages of moving to such a system in the next month or two were likely to be so clear that many fewer complaints would be encountered than if the move was made at other times.

Mr. Maisel noted that his remarks had been aimed primarily at planning for the period immediately following that of "even keel." For this meeting he agreed generally with the directive as submitted, but he would judge that more stress should be placed on the quantity of reserves created than on interest rates, particularly in the period ahead before the impact on the next Treasury financing became critical. If Mr. Daane's suggestions did that, he would go along with his proposed wording.

Mr. Hickman said it was now clear that the economy was moving forward at an accelerated pace and was rapidly approaching the limits of its capacity. The forward momentum of recent months, coupled with new higher estimates for GNP for 1965, had caused most analysts to make almost daily revisions in their projections for 1966. The Cleveland Reserve Bank's latest reading (already out of date) showed that most GNP forecasts for 1966 clustered around $720 billion, with the more sophisticated forecasts usually well above that, including Walter Heller's, which was announced in advance of the revised GNP figures for 1965. Since last year's rise in GNP brought forth some upward price pressure, and since there was now less slack in the labor force, any rise on the order of last year's increase of $47 billion (i.e., to a GNP of about $723 billion) would imply a risk of serious price inflation, on the basis of information now available.

While prices were relatively stable during the summer months of 1965, Mr. Hickman continued, there were renewed signs of rise in the autumn, as reflected in all of the major price indexes. In the most recent three months, consumer prices had risen six-tenths of an index point, wholesale prices about one index point, and the industrial component of wholesale prices about one-half of an index point. Spot prices of raw industrial materials had moved up at a very rapid pace since early December, with the index in early January at a 14-year high. The latest diffusion indexes for spot prices and manufacturers' prices also showed sharp increases.

In addition to the recent record of price advances, Mr. Hickman said, expectations regarding future prices had clearly been on the rise. For example, Dun and Bradstreet's most recent quarterly survey showed that the percentage of businessmen expecting price increases was the highest since early 1957. Steel magazine's fall survey of metal-working industries indicated that selling prices were expected to rise by a larger amount in 1966 than in any year since 1959. Walter Heller, in his GNP forecast, assumed that the price deflator would increase by 2.1 per cent, which was high by recent standards except possibly for 1965. Incidentally, Paul Samuelson's forecast, published yesterday, stated that the country would be lucky if prices rose by no more than 2-1/2 per cent.

Against that background of rising output and price pressures, the accelerated pace of monetary expansion that had characterized the past month or so seemed clearly inappropriate to Mr. Hickman. As a matter of fact, most major monetary variables--bank credit, money supply, and nonborrowed reserves--showed larger gains in the month following the latest change in the discount rate than in comparable periods following other recent discount rate advances. Moreover, the annual rates of increase of those variables over the past month had equalled or exceeded the annual rates of increase since World War II. He deduced from all of that that the current thrust of monetary policy--as distinct from the intent of the Committee--was inflationary.

Admittedly, Mr. Hickman said, it was difficult to determine the appropriate course for public policy in the weeks ahead. With an apparent administrative budget of $110-$115 billion, it now seemed fairly evident that the burden of restraint had to fall either on increased taxes, on tighter monetary policy, or on some judicious combination of the two. Because of the range of alternative choices involved in a major policy move at this time, and because of the errors that were inherent in the basic economic information, it would be extremely helpful if the Committee had before it a continuing review of the Administration's position on the economic outlook and the appropriate mix of fiscal and monetary policy. Perhaps brief statements on that subject could be included in the green book from time to time; it was difficult for those outside of Washington to obtain such information directly.

In the weeks immediately ahead, Mr. Hickman remarked, the Treasury financing schedule suggested "even keel" as the appropriate policy guide. Nevertheless, the perils of further overheating of the economy seemed to him to be so great as to outweigh the short-run objectives of the Treasury. If the Committee did nothing until the Treasury was out of the market, in, say, mid-February--which implied that it continue to pump up bank credit and the money supply at current inflationary rates--the Committee might find itself in the position of being able to do too little, too late. He, therefore, recommended some moderate tightening, with an immediate objective until the next meeting of the Committee of moving toward net borrowed reserves of $200-$250 million.

The staff's policy directive implied to Mr. Hickman that market rates would be pegged around current levels, with the result that credit availability might expand excessively. He would prefer to reduce the current rate of expansion of the credit base even if it meant higher interest rates and deeper net borrowed reserves.

Mr. Bopp remarked that it seemed only a few months since forecasters were predicting a gross national product in 1966 of not much more than $700 billion. Now expectations had changed dramatically. The recent revision of the figures on last year's performance, coupled with the swelling of expenditures in Viet Nam and expectations of a rapid forge ahead in capital spending, made the staff prediction of a $707 billion GNP (annual rate) for the first quarter seem quite reasonable.

The rapidly changing business environment also was evident from the summary of forecasts compiled and published by the

Philadelphia Reserve Bank, Mr. Bopp said. A median figure drawn from that Bank's collection of forecasts produced a GNP in 1966 of $710 billion. Considering only the more recent of those forecasts, a GNP of around $713 billion emerged. Now even that figure appeared too low, perhaps in the order of $10 billion.

With such a rapidly changing business environment, Mr. Bopp observed, the question arose of how quickly monetary policy should respond, particularly during a period like the present, when a strong economic advance seemed likely to be accompanied by pressures on labor markets and prices. For the next few weeks, however, prospective economic messages and Treasury financing called for a policy of even keel. The draft directive seemed appropriate to Mr. Bopp with the modifications suggested by Mr. Daane.

Mr. Patterson reported that by almost any measure business activity in the Sixth District was booming. In fact, it topped the national performance where it counted the most. Not only was the District's insured unemployment less than the nation's, but every category of manufacturing employment had shown a larger increase than nationally.

For reasons cited around the table, Mr. Patterson said, the national business picture had taken on boom proportions. Nor could the universal prediction that another substantial rise of GNP lay ahead be ignored. The Committee members were all aware that such an advance, however desirable, might also harbor serious problems. As others had noted today, price pressures had been increasing. And they would become even more intense as the economy got closer to the limit of productive capacity.

The role the Federal Reserve should play in the broader public effort directed against inflation had, to Mr. Patterson's way of thinking, been made a matter of public record. The System committed itself on that score when the Board, in taking action on the discount rate, indicated that the move was intended to back the Government's efforts to prevent inflationary excesses. In his opinion, those efforts had received a considerable setback in recent weeks. First, it seemed clear that Federal spending and credit needs would be very much higher than the Committee was made aware at the last meeting. Secondly, the failure to achieve a complete rollback on the price increase of structural steel underscored the difficulty of using direct pressure to hold down prices. Under those circumstances, the System would bear greater responsibility in coping with inflationary pressures than one might have concluded a few short weeks ago.

Short-term rates had increased more than many of the Committee members had expected, Mr. Patterson continued, especially when viewed against the liberal supply of reserves provided by the System. Therefore, strong credit demands rather than System action seemed to account for the rate adjustments. In that context, the Desk had allowed interest rates to go higher without trying to curtail the growth rate of bank credit. Since most people chose to pay a higher rate rather than do without the funds, that would not restrict credit very much. And yet, if his interpretation of the economy and credit climate was correct, the growth in total credit had to be held down. How should the Committee go about accomplishing that? If bills were sold, short-term rates would be pushed up further and the System might eventually feel obligated to raise the discount rate again. If reserve requirements were raised, in meeting the higher requirements banks would be compelled to sell off coupon issues. Yields on such securities currently were about 5 per cent and under those conditions would go even higher. As interest rates increased, banks would be compelled to bid for CDs at increasingly higher rates, unless the banks were prepared to curtail their lending or to see their corporate customers put CDs into other money-market instruments. On the other hand, interest rates might not push upward at all, if the relaxation of seasonal pressures at this time of year could be counted on.

Since the dust had not yet settled from the two December actions and the Treasury's financing calendar permitted little, if any, overt action today, Mr. Patterson favored maintaining the "status quo," with the idea that the Desk should absorb reserves quickly and to a greater degree than was usual for this time of year, unless that disturbed the Treasury financing and pushed up rates unduly.

Mr. Shuford commented that as noted by the staff and others at the table, national economic activity had continued to expand at a rapid pace. The current rise in activity appeared to be on a broad front, with significant gains occurring in most major lines of business. In view of the strong upward momentum and the great optimism, it appeared that total spending would continue to rise in early 1966.

Economic activity in the Eighth District had continued to expand since summer, Mr. Shuford said, with significant gains in manufacturing. Since August, employment by manufacturing firms had risen at a 4.8 per cent annual rate, and manufacturing output had risen at a 6 per cent rate. Total deposits at District banks had risen at a 6 per cent rate in the same period. Demand deposits, which had remained on a plateau during early 1965, had risen at a 4 per cent rate since late summer, and time deposits had increased at a 9 per cent rate.

Nationally, demands for goods and services appeared to Mr. Shuford to be excessive, as evidenced by price developments. In recent months, prices had been rising at an accelerated rate. Consumer prices rose at a 2.2 per cent rate from October to November, despite no change in the food price index. That was the third consecutive monthly increase at the advanced rate of 2.2 per cent. Wholesale prices rose at a 4.8 per cent rate from October to

November, with increases occurring in most of the major components. Preliminary data for December indicated a further increase in wholesale prices.

Rising prices, in conjunction with a high level of resource utilization, indicated that expansion in total demand for goods and services was outrunning the nation's capacity to meet such an expansion, Mr. Shuford continued. When prices rose moderately, a case might be made that the increases were a calculated cost of encouraging fuller employment of the economy's resources. However, when spending was rising so rapidly that price increases began to accelerate, there was little doubt that the country was experiencing undesirable inflation, and that steps should be taken to curb the excessive demands.

Fiscal and monetary actions were contributing significantly to increase the total demand, Mr. Shuford said. The Federal budget, as measured by the full-employment surplus, turned more stimulative in the last half of 1965 and was expected to be still more expansionary in early 1966. The nation's money supply had continued to rise sharply since the increase in the discount rate. Money rose at a 7 per cent annual rate from June to December, the highest rate for any six-month period since 1952. Such a rapid expansion of money operated with a lag and its main effect might yet be felt.

In view of the exuberant economic situation and the expansionary Governmental actions, Mr. Shuford believed that some further monetary tightening would be desirable. More restraint also would be beneficial to the U.S. balance of payments, both because of interest rate effects and restraint on the price level. However, because of the factors others had mentioned--the Treasury financing, conditions in financial markets, and forthcoming economic messages--it was clear that a change in policy would not be appropriate at the present time. In his judgment, however, unless the rates of reserve injection and money growth slowed, the Committee would have to take another tightening action soon. As far as the directive was concerned, he thought that either the staff's draft or the revised version proposed by Mr. Daane would be satisfactory.

Mr. Balderston commented that the Committee had had the task, following the discount rate action of December 3, of easing the economy over the year-end seasonal bulge. But actual events at the turn of the year differed markedly from what either the Committee or the Desk had reason to anticipate; history did not repeat itself. The chart of Federal Reserve credit (weekly averages of daily figures) from 1957 to date revealed a sharp decline starting either at the beginning of each year or just prior to that time. Moreover, Federal Reserve float exhibited a peak at the end of each year, followed by a rapid decline immediately thereafter. The Committee and the Desk had reason to expect that such a seasonal pattern would be repeated.

But the demand for bank credit apparently overwhelmed and distorted the usual seasonal behavior, Mr. Balderston continued. On December 14, 1965, the Committee had directed the Desk to moderate "any further adjustments in money and credit markets that may develop." He would interpret "adjustments" to include not only rates of interest but the volume of credit. Rates had increased considerably, with bill rates some 20 basis points higher, but what had really got out of hand was the flow of reserves, bank credit, and money. Nonborrowed reserves increased at an annual rate of 20.7 per cent in December, total reserves at 18.8 per cent, bank credit at 10.9 per cent, and money supply at 12.3 per cent. Those rates were clearly unsustainable and prompt correction was indicated even though the Treasury was in the midst of a financing. With payment scheduled for January 19, there were just a few days to get those percentages back on the beam again before the important Treasury refunding to be announced January 26. In short, he hoped the Committee would not feel it necessary to hold the keel even for the current financing, which was modest in size and involved a rich offering. He would prefer to see such action as was indicated taken despite the financing, and then anticipate achieving stability for the February refunding.

The year-end escalation of reserves, bank credit, and money supply, Mr. Balderston said, reflected the increase in the

System's portfolio between December 15 and January 5 of about $2 billion of repurchase agreements in addition to the acquisition of some bills. On a net basis, the portfolio grew during the period by $3/4 billion, whereas in the comparable year-ago period it had shrunk by $1/4 billion. In the light of those actions, the Committee needed to restrict bank credit to the amount required for growth in output without adding to inflationary pressures. With mounting war demands superimposed on private demand, it would appear that current market forces would continue to press interest rates upward. Should the level of interest rates be prevented from rising? Even if the System could succeed in keeping such rates stable in the present climate, the effort would tend to induce inflation. On the other hand, monetary policy needed the support of higher taxes if the current war-supported demand was to be curbed. However, the System should not shirk its part of the task, which was to assist the forces of the market to determine new rate levels in an orderly fashion.

The data now coming to light seemed to confirm that the discount rate action was in the nick of time, Mr. Balderston commented. That event drove home once again that the System's success turned on its luck in doing the right thing at the right time and often before all the facts were available. Now that the economy had passed the Christmas hump, it would seem appropriate to rediscover what level of reserves would keep the economy strong without overheating, without relying on the Administration to curb spending or to increase taxes sufficiently. In wartime actual spending tended to outrun budgets, and tax increases--if made in an election year--were tardy in both adoption and effect.

Mr. Balderston would, therefore, permit any further increase in demands for reserves to firm money market conditions. By the word "conditions" he meant not only short-term interest rates but also excess reserves and bank borrowing. Hopefully, a return flow of funds in late January and in February would be of assistance, but even with such aid the System needed to act.

As to the directive, Mr. Balderston said that Mr. Daane's proposed change in the first paragraph was acceptable to him, but that he would like to submit for the Committee's consideration the following substitute wording for the second paragraph: "System open market operations until the next meeting of the Committee shall be conducted with a view to permitting any further increase in demand pressures to firm money market conditions."

Chairman Martin asked Mr. Holmes what implications he thought Mr. Balderston's proposed language would have for operations.

In reply, Mr. Holmes said that one problem was that it was not easy to sort out demand pressures from other forces that might be tending to firm money market conditions, particularly over short periods; over longer periods it could be done more accurately. He would be willing to try, but he could not guarantee the results. The underlying principle--letting net borrowed reserves deepen and money market conditions firm in a period of strong credit demands--certainly could be a useful one, and was similar, he thought, to the objective of Mr. Holland's proposal.

Mr. Daane said that as much as he sympathized with Mr. Balderston's view, and with the view Mr. Robertson had expressed earlier on the desirability of deriving all possible advantages from the System's recent rate action, he did not think the Committee could ignore a Treasury financing even though it was a modest one. He asked Mr. Holmes whether a deviation from even keel at present would lead to difficulties for the Treasury.

Mr. Holmes replied that any operations that were interpreted by the market as signifying an overt change in policy would tend to confirm the extreme view in the present range of expectations regarding future interest rate levels, and might make things quite difficult for the Treasury in connection with the February refunding. The refunding could be important in bringing greater stability to the interest rate structure, if the issue was realistically priced. At the same time, if overriding forces were pushing interest rates up efforts by the System to offset those pressures would not be helpful to the Treasury in pricing the new issue.

In response to a question by Mr. Daane, Mr. Holmes said that on the basis of the discussion today he would not interpret an "even keel" decision as calling either for rolling back rates from their present levels or for preventing them from rising further if market conditions worked in that direction.

Mr. Mitchell commented that the Committee lacked the facts necessary to define the circumstances that were likely to prevail in the coming period. There would be no great problem with respect to bill rates if market psychology changed because a restrictive budget was announced, and it might be difficult to hold bill rates up at a reasonable level if developments suggested that the peace offensive was likely to be successful. It seemed desirable to him to give the Manager more leeway than usual until some of the present uncertainties were resolved.

Mr. Balderston noted that the second paragraph of the staff's draft directive called for "moderating any further firming of money market conditions that may develop." At the same time the blue book cited the unusually large percentage increases in financial aggregates in December that he had quoted in his earlier comments. Future historians might well ask what firming the Committee had in mind today when they noted that nonborrowed reserves, for example, had increased at an annual rate of over 20 per cent in December.

Mr. Robertson then suggested calling for operations "with a view to maintaining about the current conditions in the money market." He noted that at least some members had indicated a preference for placing primary emphasis on net borrowed reserves rather than on interest rates as such, if it proved necessary to make a choice.

Mr. Balderston indicated that he was agreeable to Mr. Robertson's suggestion.

Chairman Martin said he thought the wording Mr. Robertson had proposed for the second paragraph was appropriate. He continued to be impressed by the difficulties posed for the Committee by the fact that particular words meant different things to different people. The longer he worked in the area the more perplexing he found the problem of specifying the Committee's intentions.

On the whole, Chairman Martin believed that monetary policy had performed well during the past year. As he had indicated in his memorandum to the President that he had read to the Committee on October 12, the flow of funds was being constricted in an undesirable way. The role of interest rates was being viewed wholly out of perspective, and unwarranted claims about the power of interest rates were being made by people on both sides of the policy debate.

There had been real progress in freeing the flow of funds during the last six weeks or so, Chairman Martin continued. No one had expected the December rate actions to work miracles; but it was clear that there had been factors constricting the flow of funds, and that the rate actions had alleviated the problem.

Fiscal policy, debt management policy, incomes policy, and monetary policy all were in play all of the time, the Chairman said, and all four were fluid. Developments could not necessarily be attributed to any one of the four, and judgments might differ on their interrelations at any one time. Business outlays on plant and equipment were moving up rapidly and if Federal expenditures rose substantially further there would be a sizable full employment budget deficit about which something would have to be done. Certainly monetary policy alone could not cope with that problem; at some point action might be called for on all four fronts. He agreed with Mr. Hayes that the proper course for monetary policy now was "steady in the boat"; the best the Committee could do at the moment was to maintain conditions as steady as it could, and contribute as much as possible to the maintenance of reasonable flows of funds through the markets.

It was not the Committee's job to tell the Administration what policies it should follow, the Chairman continued, but debt management was in a knot at present. Because of the 4-1/4 per cent interest rate ceiling on Treasury bond issues, any new Government financing had to involve maturities of five years or less.

Chairman Martin observed that he felt more and more humble as time went on about what really could be accomplished in the area of monetary policy. He often had remarked that he did not fully understand the role of the money supply in the economy, and he had to say now that after having been concerned with the subject for many years he understood it less than he had twenty years ago. One was dealing with human choices and value judgments, and that required the ability to change one's conclusions from day to day and month to month. He did not mean that one should not have convictions on the subject, but that there should be flexibility in views. In his judgment one ought to worry most about the man who was sure he knew the answers; the nature of the policy problem was such as to preclude fixed positions. He, for one, did not think he had the answers, any more than anyone else. It was necessary to maintain an open mind and to probe constantly for new approaches, new devices, and new instruments.

Chairman Martin thought the Committee was more or less in agreement on policy today. The members might best concentrate on what policy would be appropriate in the future, in light of the new factors in the situation and considering the contents of the coming Budget Message. The System now would be operating in an entirely new environment--one that had not been contemplated a year ago--of full employment generally and over-full employment of skilled workers. He personally would favor a little inflation if he thought it would benefit the unemployables, but he did not think it would; rather, it would do them harm. He had debated that issue for years with academicians, some of whom, he believed, had an emotional bias on the subject. In his opinion there was some justification for their view in the short run but not in the longer run.

The Chairman then suggested that the Committee vote on a directive consisting of the staff's draft with amendments along the lines of those proposed by Messrs. Robertson and Daane.

> 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 that domestic economic expansion has strengthened further in a climate of optimistic business sentiment and with some further upward creep in prices. Interest rates are higher in most markets in response to strong credit demands and recent official rate actions. Our international payments position improved considerably during 1965 but further progress is needed to attain effective balance. In this situation, it is the Federal Open Market Committee's policy to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by moderating the growth in the reserve base, bank credit, and the money supply.

> In light of the Treasury financing schedule, System open market operations until the next meeting of the

Committee shall be conducted with a view to maintaining about the current conditions in the money market.

Mr. Swan said that it would be useful if the staff could provide some indication of the effects on seasonal factors for financial series as the economy approached full utilization of resources. In particular, he would like to know whether seasonal fluctuations tended to be damped under those circumstances. Mr. Holland replied that the staff would develop information on that subject.

It was agreed that the next meeting of the Committee would be held on Tuesday, February 1, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.

Ralph A. Young
Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

January 10, 1966

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on January 11, 1966

The economic and financial developments reviewed at this meeting indicate that domestic economic expansion has strengthened further in a climate of optimistic business sentiment and with some further upward creep in prices. Interest rates are higher in most markets in response to strong credit demands and recent official rate actions. Our international payments position improved considerably during 1965 but further progress is needed to attain effective balance. In this situation, it remains the Federal Open Market Committee's policy to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

In light of the Treasury financing schedule, System open market operations until the next meeting of the Committee shall be conducted with a view to moderating any further firming of money market conditions that may develop.

Note: The second paragraph of this draft directive is intended as one possible interpretation of an "even keel" policy stance under the conditions existing at present. Alternative possible interpretations might involve instructions to maintain "about the current conditions in the money market" or "about the same conditions in the money market as have prevailed on average since the preceding meeting" with guidance given to the Manager as to whether emphasis should be placed primarily on net borrowed reserves or on short-term interest rates if the current or recent relations prove inconsistent.