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, February 8, 1966, at 9:30 a.m.[1/]

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

Mr. Young, Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Messrs. Baughman, Holland, Koch, Taylor, and Willis, 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. Hersey, Adviser, Division of International Finance, 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

1/ This meeting, originally planned for February 1, 1966, had been postponed one week because of adverse weather conditions affecting travel.

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

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on January 11, 1966, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period January 11 through 26, 1966, and a supplemental report for January 27 through February 4, 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 this week. During January, the Stabilization Fund made gold sales amounting to $37 million, which were more than offset by a purchase of $50 million in gold from the Bank of Canada, leaving a month-end balance of $79 million. During February, an order of at least $34 million from the Bank of France was expected. On the other hand, a second $50 million of gold had been acquired from Canada last week so that, on present prospects, there should not be any decline in the stock this month.

Looking farther ahead, however, Mr. MacLaury continued, one could not ignore the implications for the United States gold stock of the situation in the London gold market. During 1965 a record volume of private demand for gold absorbed virtually the entire new supply coming from South African and other mines and from Russian sources, with the result that the Gold Pool ended the year with virtually no net accumulation of gold. As demand continued to run ahead of supply, the $40 million reserve in the Gold Pool at the beginning of 1966 had been exhausted and it again became necessary to reactivate the gold sale consortium. Since then the Pool had lost another $19 million net. There still was reason to believe that Russia would need to sell another $200 million or so of gold between now and April, which might provide some further breathing space. Over the longer pull, though, unless international political and financial tensions moderated considerably during the spring and summer months, there could be fairly heavy pressure upon the Gold Pool arrangements.

On the exchange markets, Mr. MacLaury said, sterling had continued to show strength. From September through January, the swing in the Bank of England's exchange position had amounted to more than $2 billion. Of that amount, $420 million had been reflected in reserve increases,1/

During January, the Bank of England made repayments of central bank debt totaling $325 million--$275 to the Federal Reserve and $50 million to the Bank for International Settlements--2/

That still left, at month-end, a net drain of roughly $90 million on British reserves.

Mr. MacLaury reported that there was general agreement among most of the British and American officials involved that the British would run a serious risk of damaging the recovery of confidence in sterling if they were to show a sizable reserve decline for January. To avert that risk, several courses of action were open. First, the Bank of England might have made a new drawing on the swap line; but that course was opposed both by the Bank of England and by the System, on the grounds that it would represent a leapfrogging procedure of employing a new drawing to pay off an earlier drawing. Second, the British Government might have drawn on its portfolio of United States

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1/ Part of one sentence has been deleted at this point for one of the reasons cited in the preface. The deleted material referred to ways in which the Bank of England's dollar gains had been employed.

2/ One sentence and part of another have been deleted at this point for one of the reasons cited in the preface. The deleted material referred to other operations of the Bank of England in January.

securities, but that alternative was flatly rejected by Chancellor Callaghan. Third, the British Government might have drawn on its $250 million line of credit with the Export-Import Bank, but that course was opposed for U.S. balance of payments reasons by the U.S. Treasury. There remained the fourth alternative of employing the joint Treasury-Federal Reserve authorization granted last September of $400 million for exchange operations to support the recovery of sterling. As it turned out, the $90 million needed to prevent a British reserve decline was provided from this source on a one-day swap over the month-end, divided equally between the Treasury and the Federal Reserve.

In February, Mr. MacLaury continued, the Bank of England again started off the month with outpayments of $290 million, of which $200 million reflected repayment of the remaining debt under the $750 million swap line with the System and $90 million repayment of the one-day swap with the Treasury and Federal Reserve. In addition, a sizable volume of forward contracts would come due in February. In the past February generally had been a seasonally favorable month and the Bank of England might well take in sufficient funds before the month-end to avoid any net reserve loss. In the first few days they already had taken in not quite $100 million. If, however, a short-fall should materialize, arrangements had been made with the Bank of England and the Bank of Italy for a triangular operation, having the dual objectives of strengthening the British reserve position and enabling the Federal Reserve to liquidate the bulk of its swap drawings on the Bank of Italy. As part of the credit package put together last September, the Bank of Italy committed itself to provide support for sterling, if needed, up to the amount of $70 million. If circumstances required, the Bank of England would draw $70 million of lire from the Bank of Italy at the end of February and sell the lire to the Federal Reserve against dollars, thereby strengthening the British reserve position by $70 million and enabling the Federal Reserve to pay off that amount of its lira debt to the Bank of Italy.

During the four weeks since the last meeting, Mr. MacLaury observed, the dollar had continued to show strength against nearly all of the continental currencies. Although the unwinding of year-end positions undoubtedly had contributed to that strength, the improvement went beyond such technical factors. In part, he thought, the dollar was benefiting from the continued reversal of short sterling positions. In addition, he could not help but believe that the effects were being seen of the improvement in the U.S. balance of payments situation. The voluntary foreign credit restraint program with respect to corporations seemed to be biting harder, and the movement of rates in both the exchange markets and the Euro-dollar market indicated that there was, if not a growing scarcity of dollars, at least a cessation of excessive dollar availabilities. Even in the case of Italy, the huge dollar inflows of previous months had ended; in fact, there had been a slight net decline in dollar holdings in the first three weeks of January. And, in the case of France, the rate had been off the ceiling now for more than a month. Likewise, with the Belgian franc under some pressure, the System was able to buy from the Belgian National Bank sufficient francs to pay off the remaining $35 million equivalent debt under its standby facility with that bank. In addition, the Account Management was in the New York market more or less continuously during the period, buying marks for Treasury account to build up the balances that were used on February 1 to repay a $50 million equivalent mark-denominated bond maturing on that date.

As the Committee would recall, Mr. MacLaury said, at a recent meeting Mr. Hayes had mentioned that discussions were taking place among central bankers at the Bank for International Settlements in an effort to find a way of dealing with the threat to sterling of possible drains of sterling balances. A package of credits was now shaping up, based on the roughly $1 billion of credits made available to the Bank of England last September. The United States had participated to the extent of $400 million--$200 million each for System and Treasury--under an authorization to purchase sterling on a covered or guaranteed basis. The other participants in the arrangement set a time limit of six months on the facilities that they provided. Present indications were that they would agree to extend their credit arrangements for a one-year period from March 15, the current expiration date, channeling any assistance that might in fact be required through the BIS on the basis of sterling swaps. U.S. participation would continue as at present, on a bilateral basis with the Bank of England.

In response to questions, Mr. MacLaury said that about $2 billion of gold had come onto the London market in 1965--$1.2 billion from new production, $375 million from Russian sales, and about $500 million from other sources. The off-take also was about $2 billion, absorbing virtually the entire supply. Of the latter amount, mainland China had accounted for a relatively small part of the total--somewhat over $100 million. Final figures were not yet available on the change during 1965 in the volume of gold held in official reserves by non-Communist countries, but he thought it would show a small increase. South Africa had contributed between $200 and $300 million of gold to the market in the first half of 1965, but in September that country began to rebuild its own holdings, and thus far had withheld about $125 million of new production from the market. With respect to Canada, there was some possibility of additional sales of gold by that country to the U.S.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period January 11 through February 7, 1966, were approved, ratified, and confirmed.

Mr. MacLaury then reported that a System drawing on the swap arrangement with the Bank of Italy, in the amount of $100 million equivalent, would mature on February 28, and he requested the Committee's approval to renew the drawing a second time, if that should prove necessary. As he had indicated earlier, there was a possibility that transactions between the British and the Italians might permit reduction, if not full repayment, of the drawing in the near future.

Mr. Shepardson remarked that he hoped the System would repay the drawing as soon as possible, and Mr. MacLaury replied that that was the intention of the Account Management.

> Possible renewal of the $100 million drawing on the Bank of Italy was noted without objection.

Chairman Martin invited Mr. Daane to comment on developments at the recent meeting of the Deputies of the Group of Ten.

Mr. Daane said that the Deputies had met in Paris on January 31, February 1, and part of February 2. As he had indicated to the Committee earlier, the discussions at the previous meetings--in November and December--had involved rather frank and exploratory exchanges of views. At this meeting a long step had been taken toward the negotiating phase. The meeting consisted mainly of a searching question-and-answer review of four papers that had been put forward, including one containing a U.S. proposal.

He would outline the U.S. proposal first, Mr. Daane observed, although it was not in fact the first advanced at the meeting. Under Secretary of Treasury Deming had made clear that the proposal was a serious one, arrived at carefully by the U.S. Government. It had been reviewed thoroughly at a series of meetings--nine or ten in number--of the so-called Dillon Advisory Committee to the Treasury; and it had been given painstaking consideration by representatives of the Government agencies concerned, including the Federal Reserve. Also, it had been discussed with interested members of Congress and reviewed by the President.

In essence, Mr. Daane said, the proposal called for a dual approach, with the first part involving the creation of special drawing rights for all member countries of the

International Monetary Fund, both Group of Ten countries and others. Those rights would be distinct from all existing drawing rights in the Fund. In operation they would resemble the drawing rights under the present gold tranches; unlike the latter, however, there would be no input of gold in connection with them.

The other part of the dual approach would involve the creation of a new reserve unit, Mr. Daane continued. The new unit would constitute a claim on a pool of currencies paid in by a group of advanced countries. The U.S. had not taken a hard and fast position on the question of the exact composition of that group, but had suggested that a small number of countries in addition to the members of the Group of Ten might be brought in. The new units would be allocated on the basis of IMF quotas, and would carry a gold-value guarantee. Among a number of technical provisions, there would be one establishing limits on holdings by creditor countries, of perhaps 2 or 3 times the amount of units allocated to the country. Another provision was intended to enable the U.S.--or any country that made its currency convertible into gold--to avoid excessive accumulation of the new units by selling them to other countries against its own currency. In addition, the U.S. proposal called for a "set-aside" of new units or currencies by the limited group for the benefit of the rest of the world.

Some figures had been advanced in connection with the U.S. proposal for the sake of illustration, Mr. Daane said. Thus, it was noted that total world reserves, consisting principally of gold and reserve currencies, were about $70 billion at present. If one reasoned that reserves should be increased at a 3 per cent annual rate, slightly over $2 billion of new reserves would be needed each year. Allowing for additions to the monetary gold stock at the recent average rate of $500-$600 million a year, it would be necessary to create about $1-1/2 billion in new reserves each year. It was suggested that that amount be divided equally between new drawing rights and new reserve units, each of which would then amount to $750 million per year. Similarly, if one started with a 4 per cent rate of reserve growth, about $1 billion each would be created annually in the form of drawing rights and new units.

The first paper actually discussed at the meeting, Mr. Daane continued, was put forth by the Canadians, who made clear that it was not an official proposal but simply a collection of views--largely those of the Finance Ministry. The Canadian proposal concentrated on the construction of a new unit, somewhat similar to the one contemplated in the U.S. proposal but with a few interesting differences. Of these, the most important was the provision for the new unit to carry a rather high rate of interest, set one or two percentage points below the U.S. Treasury bill rate. The U.S. proposal had not involved an interest return, although the U.S. delegation had indicated that its position on that question was neutral. The Canadians stressed the desirability of an interest return in order to make the new unit more acceptable. As to the make-up of the group of participating countries, the Canadians, like the U.S. representatives, were searching for some criteria for qualification, and were thinking in terms of about 15 or 16 countries.

The third paper, Mr. Daane said, was an official proposal put forward by the British. Again, there were a number of points of similarity with the U.S., as well as the Canadian, proposals, and some points of difference. One distinctive feature was a requirement that any holdings of the new unit in excess of the holding limit would be converted directly into gold. Another interesting variant reflected the British concern with the problem of conversion of sterling balances, to which Mr. MacLaury had alluded, and of dollar balances. They proposed that the new units be available not only to increase reserve assets but also to provide an alternative asset for countries wanting to convert reserve currency holdings.

The fourth proposal, Mr. Daane noted, was advanced by Mr. Emminger, the Chairman of the Group of Ten Deputies, who said that it represented his own views. It was concurred in by a number of delegations, however, and could be considered to represent a synthesis of the views of the continental Europeans excluding the French--and, it was learned later, the Belgians. The Emminger proposal called for a new reserve unit whose initial creation would require a unanimous vote, with subsequent decisions made by majority vote. The unit would be used by and allocated to only a limited group of countries, and it would be used in transfers in a one-to-one ratio with gold. The needs of countries outside the group would be met by providing for set-asides of the new unit.

Mr. Daane remarked that the French made no new proposals at the meeting. They noted that they had had a proposal on the table for a year and a half, and that there was no change in their position.

In sum, Mr. Daane said, the meeting pointed up both the areas of agreement and the areas of division. As to the former, all of the proposals provided for reserve units to be created under the responsibility of a limited group of countries. All were reasonably close with respect to the membership of the group that would receive the units, and all implied a search for some qualifying criteria that pointed to inclusion of roughly 15 or 16 countries. There was a fair consensus that the amounts of the new reserve asset created should be established in terms of a growth trend, rather than decided *ad hoc* each year; and that the purpose was to provide for global needs rather than just those of a particular group of countries.

As to the differences, Mr. Daane continued, the major one was in the attitude taken to the dual approach recommended by the U.S. The U.S. proposal was labeled by some as "quadrilateral" because it provided for drawing rights both for the group and for other countries, for distribution of the new units to the group, and for a set-aside of the units for other countries. There was much sentiment for a simpler procedure, perhaps involving a set-aside of the new units to finance drawings by the countries outside the group, and only units for the group.

Other major differences, Mr. Daane said, related to the holding limit that the U.S. had suggested as a means of safeguarding against abuses, and to the gold link which the Emminger proposal would involve. Speaking for the U.S., he (Mr. Daane) had raised a number of questions regarding the gold link. His basic question was whether that link was intended simply to provide further discipline on the actions of deficit countries. The second was whether such a gold link would not in effect induce much larger holdings of gold--both by the countries within the group, particularly those with low gold ratios at present, and by countries outside the group. Dr. Emminger answered those questions quite vigorously and effectively. He argued, in effect, that if the new unit had a gold link and also carried an interest return, one could expect that the unit would become more desirable than gold, and that its creation therefore would be constructive rather than disruptive.

Mr. Daane added that Mr. Polak spoke on behalf of the Managing Director of the IMF, mainly on two points. First, he noted that the Director was anxious that there be recognition of the reserve needs of countries beyond a limited group, a view to which the U.S. had been fully sympathetic all along. Secondly, it was the Director's view that the decision-making process should be broadened to involve more countries. Near the close of the meeting one of the German representatives had made a provocative and thoughtful statement. He noted that the group was faced with the momentous decision to create money, and raised the question of whether it would not be better to do so in the traditional way--which Mr. Daane interpreted to mean within the framework of the IMF. That position, Mr. Daane thought, was premised on the fear that the other route would lead to excessive world liquidity.

Mr. Daane concluded by noting that there would be another meeting on March 7 and 8, in which, he presumed, the group would move a little closer to negotiations. That would be followed by a longer meeting in Washington during the third week of April. He was happy to note that the U.S. delegation now included Mr. Robert Solomon of the Board's staff, in addition to the customary participants--Under Secretary of the Treasury Deming, Messrs. Willis and McGrew of the Treasury, and himself.

In answer to Mr. Ellis' question as to how it was proposed to execute the provision for an interest return on the new unit, Mr. Daane said the group had not got down to the point of working out all of the mechanics on that question. In general, the debtor would pay the interest on any credit received--that is, on assets used. That, of course, could be done on either a gross or net basis.

Mr. Galusha commented that recent news stories had suggested that the Deputies had made far greater progress in their discussions than had been anticipated, and that the solution to the problem now appeared possible. He asked whether that was Mr. Daane's impression.

Mr. Daane replied that he thought such an appraisal was correct if the progress was measured in terms of the original charge given to the Deputies, to search out areas of agreement. There had been forward movement at each of three recent meetings and, as he had indicated, there was clear progress toward agreement in several important areas. There also, however, were some important disagreements. In the words of one participant, used in a personal conversation at the end of the meeting, there had been both progress and retrogression.

Mr. Hayes said he agreed with Mr. Daane's appraisal. It should be borne in mind, he thought, that some of the differences between the positions of the U.S. and some other countries were exceedingly important to the U.S. In his personal view, it was far better to make progress slowly toward the right decision rather than to accelerate the proceedings for the sake of reaching some agreement.

Mr. Daane indicated that he shared Mr. Hayes' view.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period January 11 through 26, 1966, and a supplemental report for January 27 through February 7, 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 Treasury refunding of outstanding February maturities, in which owners of April, May, and August maturities were given a chance to prerefund their holdings, was the dominant feature of the period since the last meeting of the Committee. The Treasury's decision to make this more than a routine operation and to offer a 5 per cent note was a bold move, designed to ease the problems of debt management later in the year. And despite some uneasy moments while the books were open, the decision turned out to be a wise one. While attrition in the February and April issues was somewhat greater than expected, public subscription of $6.5 billion to the 5 per cent notes was substantially greater than the market anticipated at the time the books closed and has reduced the May and August refunding operations to routine proportions.

The Treasury announcement was initially very well received in the market, but the opening of the books on Monday, January 31, coincided with the resumption of bombing in North Vietnam and with accelerated discussion of the likelihood that monetary policy was apt to play the leading role in any effort to restrain inflationary pressures in the months ahead. In this atmosphere prices of some long-term Government bonds declined by as much as a full point during the three-day period while the books were open, and prices of rights and when-issued securities also declined, with the when-issued 5s closing the period at par bid compared with a premium of 7/64 immediately following the Treasury announcement. Dealer support of the refunding was minimal--with net positions in both new issues only $300 million--and with short positions in outstanding intermediate issues rising significantly during the financing. Dealer pessimism was not shared by holders of the issues eligible for exchange, however, as the results indicated. The notes appear to be in firm hands with little or no speculative activity and, as noted, there are no large dealer inventories overhanging the market. Since the books closed prices of the new issues moved up somewhat until yesterday when the 5s closed at par bid.

During the period since the Committee last met, the money market--at least as reflected in the Federal funds rate and member bank borrowing at the Reserve banks--has generally been relatively comfortable, as the extreme pressure on money center banks finally eased. A small net borrowed reserve figure has been maintained as System open market operations were generally directed towards maintaining an even keel surrounding the Treasury financing. A sizable proportion of the reserves provided involved repurchase agreements against rights. In contrast to the preceding period, there has been a general tendency since the last meeting of the Committee--at least until the past week--for reserve availability to exceed projections, as float stayed higher than anticipated and required reserves declined more than seasonally. Despite the absence of extreme pressures on the banking system, short-term interest rates moved irregularly higher over the period, with the three-month bill rate hitting an all-time high of 4.67 per cent in the auction on January 17, and with rates on three-month acceptances raised by dealers to 5 per cent bid on February 1. In yesterday's auction the 3- and 6-month bills were sold at average rates of about 4.65 and 4.77 per cent, respectively. Rates on long-term securities, which had been relatively stable since their initial adjustment to the discount rate change, rose by about 10-15 basis points.

While the market does not seem to have been at all impressed, the investor response to the Treasury refunding may hold some interesting implications about the attractiveness to investors of the historically high yield levels of intermediate- and long-term Government bonds. At the same time, at least some of the larger banks, many of which have been heavily dependent on borrowed funds, are taking a hard look at their lending policies. To the extent that this process results in greater reluctance to meet loan demands, some of the pressure may be removed from the Federal funds and CD markets. But it is not so clear what pressures would be shifted to other markets as corporations and others seek to meet their growing credit needs elsewhere.

In the meantime, the markets continue to be extremely sensitive to developments in Viet Nam, to price movements, and to demand pressures, both financial and real. Amidst it all, there appears to be a growing feeling that monetary policy will be forced to play the leading role in any anti-inflationary campaign. Some further tightening of monetary policy may well have already been discounted by the market and an unexpected settlement in Viet Nam could have a major impact on expectations. But the dominant mood continues to be one of anticipation of growing pressure on financial markets as the year progresses. At the moment the pressure appears to be focusing in the longer end of the market.

Mr. Swan referred to Mr. Holmes' observations that dealer participation in the refunding had been minimal and that the new securities appeared to be in firm hands. He asked what implications those facts had for the period over which an even keel policy would be required.

Mr. Holmes replied that he thought an even keel clearly should be maintained until the payment date for the refunding, February 15. While it was somewhat difficult to understand yesterday's decline in price of the new securities, dealers had been seeing a continuing moderate demand for those securities. On the whole, he saw no particular problems ahead in connection with the refunding, and he did not expect the process of distribution to be lengthy.

Mr. Daane asked what consequences for interest rates Mr. Holmes would envisage if net borrowed reserve figures were deepened from their recent levels. Was the rate impact likely to be minor since, as Mr. Holmes had reported, the market may already have discounted some further tightening of monetary policy?

Mr. Holmes remarked that, other things equal, a higher level of net borrowed reserves probably was already discounted by the market. While there was a great deal encompassed by the "other things equal" qualification, he doubted that somewhat deeper net borrowed reserves would act to push rates higher, particularly if some of the other upward pressures on rates diminished.

Mr. Hickman asked whether the identity of the sellers accounting for yesterday's decline in the price of the new securities was known. Mr. Holmes replied that there were some indications of sales by investors, but the decline appeared to be mainly due to professional activity, reflecting the reluctance of dealers to take a long position in the securities.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period January 11 through February 7, 1966 were approved, ratified, and confirmed.

Secretary's note: On February 1, 1966, the following message had been transmitted by Mr. Young to members of the Committee, by telegram to those outside of Washington:

The following message has been received from System Account Manager:

"Referring to current Treasury offering, System Account holds $2,232,950,000 of notes maturing February 15, 1966, about 47% of total outstanding. Account management proposes that Account exchange its entire holdings through subscription for $1,232,950,000 (about 55%) of the 4-7/8% notes maturing August 15, 1967 and $1 billion (about 45%) into the 5% notes maturing November 15, 1970. Principal reasons for the proposal are avoidance of excessively heavy System holdings of any single Treasury issue, ample holdings maturing in one and two years, and the relatively short maturity of the 5% notes offered by the Treasury.

"1. Assuming the public subscribes to $1,200 million 4-7/8% notes, if the System's entire holdings were exchanged into the 4-7/8% notes, it would represent 65% of the entire issue; under the proposed plan it will be 50% of the entire issue.

"2. Although it is difficult to assess at this moment how many fives there will be subscribed by the public (including prerefunding of May and August maturities) it appears unlikely that System holdings of the 5% notes would be excessive relative to public holdings.

"3. After the exchange, 55% of the total System Account would mature in one year and 84% in two years."

Please wire whether you would approve the Manager's proposal.

Advices subsequently were received from all available members of the Committee indicating that they approved the Manager's proposal.

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. Holland made the following statement on economic conditions:

I would like to focus my comments on price pressures this morning, for it seems likely to me that the next round of critical choices for stabilization policy, monetary and otherwise, will turn largely on the current and prospective performance of prices.

The over-all performance of our economy this past year has brought us very close to several of our domestic economic goals. Our level of output is high, and demand is broadly based and growing rapidly. Rates of resource utilization are correspondingly high, with manufacturing output running at better than 91 per cent of rated capacity and unemployment in January finally down to the 4 per cent milestone. But, partly for these very reasons, our price performance this past year has been less good than earlier. To be explicit, the index of wholesale prices of industrial commodities has been rising at around a 1-1/2 per cent annual rate throughout this past year and a quarter, after virtually no net change (+.3 per cent) earlier in this expansion.

From this point forward--absent an unlikely outbreak of peace in Viet Nam--the outlook seems to me to be for a further gradual step-up in the rate of price advance. This, in a nutshell, implies significantly more price rise this year than last, and more than has been projected by the Council of Economic Advisers and various other Administration officials.

Let me tick off briefly the reasons for this conclusion. The chief cause of this difference from the Council outlook is not hard to find: we project more demand than they do. Our latest green book[1/] projections through the first quarter of 1966 unfold along a track that runs roughly $5 billion higher than the Council's projection. Besides some variation in the timing of the build-up of Federal outlays, the biggest differences lie in our stronger figures for plant and equipment expenditures and inventory additions. Even these may strike us as too low, once the full implications of the sharp upward tilt of November-December inventory statistics are taken into account.

It may be that businesses are already acting in recognition of some of the market implications of these stronger demands. The surprisingly strong fourth-quarter inventory accumulation probably includes some buying to guard against longer delivery times, and also some stocking in anticipation of price advances. By January, the monthly purchasing agents' survey showed that more than three-fifths of the reporting firms were paying higher prices than a month earlier, a sharp rise from the two-fifths figure reported in December and the highest proportion in seven years.

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

Nonetheless, while price increases seem to be having a more pervasive effect, they are not yet omnipresent and the bulk of them still are not very large. This explains why the average price index for industrial commodities has not shown much acceleration to date. While a strong upward thrust has appeared in the latest over-all price indexes, it has stemmed chiefly from the further sharp rise in agricultural prices. These price increases did not attach to farm products that serve as industrial raw materials; rather, they have been confined mainly to foodstuffs, chiefly meat. Such price increases are not much of a direct addition to business costs outside the food processing industry. The consequent increases of retail food prices, however, are obvious to the average wage earner, and will undoubtedly stiffen demands in this year's labor negotiations. It is true that relatively few major labor contracts are up for negotiation until after midyear, and by then food costs may well be showing some declines. Nonetheless, in the interim, a great many less noticeable wage bargains inside and outside the unionized area are likely to be influenced both by limited manpower supplies and by the higher cost of living.

Business production costs are also likely to be enlarged somewhat by nonwage increases in labor cost. Elasticity of the labor supply surprised many observers last year, but growth in the labor force was mainly among inexperienced youths and women. Skilled adult male labor is scarce. Recent trends suggest employers are hiring more inexperienced workers and perhaps are beginning some hoarding of labor. This will help make a dent in the toughest of the remaining unemployment problems--the inexperienced youngsters, the disadvantaged, the minority groups--but there will probably be a price to pay over the short run in the form of slower productivity gains and higher training costs. The combination of these influences, plus the higher Social Security taxes on employers, can easily push unit labor costs in manufacturing above the plateau maintained for most of this expansion, and add a small measure of cost-push to the demand-pull likely to be at work on prices as the year progresses.

What assurance do we have that the resultant price action will not develop rapidly into an old-fashioned inflationary outbreak? It is true that many individuals and businesses command the financial resources to finance a sudden price-boosting surge of spending if military or other developments were to deliver the necessary shock to expectations. But this prospect appears less likely to me than a fairly gradual demand-pull, cost-push, price advance. The major moderating influences are persisting forces often cited to this Committee: the rapid rate of expansion of plant capacity, the trend toward longer-run pricing policies on the part of business, still strong domestic interproduct competition, and vigorous competition for certain products supplied by foreign producers. (This latter is a mixed blessing, of course, as Mr. Hersey's report on recent import trends will show.) Reinforcing these factors will be the weight of the Administration "guideposts" and the President's own potent persuasion in headline cases of threatened price advances.

But, in my judgment, all these influences will not suffice to prevent the projected growth of public and private demands from provoking some increase in the rate of price rise, unless buttressed before long by a somewhat greater degree of fiscal and monetary restraint than has been observable up to now. Comments on how much further financial restraint may already be in train, and considerations as to the desirable composition and timing of any changes in the fiscal-monetary mix, I shall leave to my colleague, Mr. Koch, to illumine.

Mr. Koch made the following statement concerning financial developments:

With the most appropriate posture for monetary policy over the next couple of weeks likely to be of an even keel nature, at least until the payment date of the current Treasury refunding, and with recent developments adequately covered by the staff written materials and by Mr. Holmes' remarks, I should like to spend my few minutes this morning talking mainly about some of the more basic, longer-run, domestic financial developments that are facing us.

There was considerable discussion at our last meeting as to whether quantities of credit or liquid assets, or interest rates, should be our main target over the coming months. I don't think it is a question of "either-or." We have to keep both types of factors uppermost in our minds, continually watching their effects on each other, their effects on spending and investing, and the changing interactions among the real and financial variables.

Unfortunately, with our present state of knowledge, we do not know enough about the strength and the timing of financial restraint to be sure about either the volume of credit flows or the level of interest rates that would be consistent with a sustainable rate of growth of GNP given our current state of resource use.

Historical evidence does suggest, however, that under conditions of high resource use and expanding demands the pace of total credit growth can be large, and some increases in interest rates can occur, and still be consistent with sustainable economic growth without inflation. The job of monetary policy is to determine the increases in both financial variables that would be consistent with such a happy state of affairs.

There is evidence that the monetary restraint we have been seeking is having some effects. Both statistics and opinions obtained from the larger banks suggest that they are firming up their lending and investing practices. The weekly reporting banks have reduced their holdings of municipal and agency securities on balance in recent weeks and have made quite prompt redistribution of the new Treasury issues they acquired originally for tax and loan credit. Credit expansion at the nonweekly reporting banks, however, seems to have continued strong throughout January.

Also, in the last two months longer-term interest rates, even mortgage rates, have risen rather sharply for such a short period of time. Some feel that this is the main avenue through which monetary policy affects the real economy. The impact of this recent rise in longer-term interest rates on housing starts and other types of investment may not be visible for some months.

But even if monetary restraint is beginning to bite, there are reasons for expecting a fairly rapid total credit expansion to continue in the coming months. One reason lies in the business area. After economic expansions have gone on for several years, as this one has, business investment tends to grow sharply and available internal funds to level off. As a result, external financing demands jump. Last year, for example, business external financing increased 50 per cent over 1964. With the growth in internal funds likely to be slow this year, a further large increase in external financing will be required to finance a desired volume of investment.

The Federal Government will also add to, rather than subtract from, total credit demands in the coming months despite the apparently rosy look of the 1967 administrative and cash budgets. To assess the indirect as well as direct impacts of the Federal budget on financial markets, one has to translate the figures on spending and receipts in terms of their likely effects on the volume of the Federal debt held by the public and then to add such important influences as the projected speed-up of corporate taxes and the increased sale of financial assets. When one does this, the over-all demands on the financial markets stemming from Federal fiscal developments are likely to be considerably larger this year than in 1965, although it is very difficult to pinpoint the exact timing of the asset transactions. This conclusion is based on the volume of Federal spending projected in the Budget Document which, unless developments in Viet Nam improve greatly soon, will no doubt prove understated. Nondefense spending also may be underestimated.

Thus, if the projections of GNP that are currently prevalent prove to be true, in formulating monetary policy in the months ahead we will have to expect, and I feel should consider appropriate, further fairly rapid growth in the rate of over-all credit expansion as well as some additional increase in interest rates. Credit markets are in a sensitive state these days and recent events, such as the resumption of bombing in Viet Nam and the resultant increased talk of the likelihood of inflation and the need for a tighter monetary policy, have tended to make the interest rate outlook even more bearish. One near-term effect of this has been to keep the 3-month Treasury bill rate in the 4.60-4.65 per cent range and to put further upward pressure on bond yields.

I am less sure about likely future monetary expansion than total credit expansion, since it is not at all clear how much elasticity we still have in the existing monetary stock; that is, how much the likely increase in the demand for balances for transactions purposes will be offset by the decrease in the demand for money as a result of a further likely rise in interest rates on substitutes for money. The rate of expansion in bank credit, as contrasted to total credit, will likely decline even if money supply and demand deposit growth continue substantial for, with rising market rates of interest, banks will find time and savings funds more difficult and costly to obtain. The slackened growth in bank time and savings deposits recently, despite the changes in Regulation Q in early December, may already be reflecting this fact.

We are likely to have to support this course of domestic financial developments by further monetary restraint, but I would hope that the major share of any needed further restraint on the economy would come from fiscal policy.

Interest rates are already historically high. If they go much higher, it may be difficult to get some of the sticky ones down when economic conditions call for lower rates. High interest rates also have significant differential effects on the various sectors of the economy, tending to limit growth-inducting investment more than consumption. In the period ahead, restraint on consumption may prove to be the more appropriate policy goal. Of course, if adequate anti-inflationary fiscal measures are not taken promptly enough, it will put an added burden on the more flexible monetary policy instrument to help keep further economic expansion on a sustainable basis.

Mr. Hickman asked if there was any evidence that the Administration was planning to increase the degree of fiscal restraint beyond that outlined in the report of the Council of Economic Advisers.

Mr. Koch replied that, while he had no specific information on the subject, he assumed that the economists at the Council and Treasury were thinking about the possible need for further fiscal restraint.

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

One of the most striking pieces of economic intelligence to emerge in the past fortnight was the news that U.S. imports in the last three months of 1965 were even larger than in the preceding three months, with only a slight decline in steel imports. Commerce Department analysts are adjusting the Census figures down in the fourth quarter and up in the preceding quarter, to correct for statistical lags. Even so, they find a rise at a 10 per cent annual rate. In relation to GNP, fourth-quarter imports were at an almost unprecedented 3.30 per cent of total GNP expenditures. If these high and rising imports are a harbinger of what we have to expect in 1966, and if we cannot improve much on the fourth-quarter trade surplus, which was only a little over $5 billion at an annual rate, the outlook for achieving any significant reduction in our international payments deficit will be bleak indeed.

Imports in the fourth quarter were 17 per cent higher than those of the final quarter of 1964. The broad features of the upsurge that was occurring last year can be seen from corrected breakdowns available for the third quarter. First, imports of manufactures--that is, of consumer goods and capital equipment--have been rising at an accelerated pace. The trend has been steep for many years. In the mid-1950's these goods made up one-tenth of total imports. By 1964 they were nearly one-fourth of the total, having risen at a rate of 18 per cent a year, compounded. But now this rise has accelerated to about 25 per cent per annum. Second, imports of semimanufactured and crude materials--which constitute about two-fifths of the total--had a rising trend from the mid-1950's to 1962 of only 3 per cent a year, with large fluctuations of a cyclical character around this trend. From 1962 to the present the rise has been steadily accelerating. Data for October and November, corrected as well as we can, indicate an annual rise in imports of materials at least as great as the 18 per cent shown for the third quarter. Finally, imports of petroleum (under the quota system since 1959) have been rising very slowly in value terms, and the same has been true of our imports of foods.

Against this background, we must ask: is the rise of total imports going to continue in the 10-to-20 per cent range this year? Or, can we take reassurance from the standard forecasts, which have been projecting a smaller rise--in the 5-to-10 per cent range? For example, the National Foreign Trade Council projection implies a rise to the fourth quarter of 1966 of only 5 per cent, which is less than the 7 per cent average experienced in the past decade.

In the past, rapid increase in imports has tended to go with heavy inventory investment and with rapid increase in the materials and business equipment components of the industrial production index. The indications that inventory investment in the fourth quarter was large are wholly consistent with the recent import picture. Under current conditions I regard the NFTC projection as implausibly low. The problem of slowing the rise in imports now is closely linked with the problem of holding down the rate of inventory investment and damping capital outlays.

As I see it, the two big economic challenges that face the country are twin problems: how to end our balance of payments deficits soon, and how to make a smooth transition to stable growth at high employment. Excessive imports threaten our success on the balance of payments front; excessive inventory investments, along with excessively accelerated fixed capital investments, threaten the smooth passage we hope for in the economic life of the country.

The growing uneasiness about prices can aggravate both problems. Fears of price increases may already be a motive for stocking and ordering ahead, and excessive bunching of ordering may already be giving a push to the upward movement of domestic prices and encouraging greater importing.

Can we accept these conditions as necessary and inevitable, and hope to ride through them without fear either of a subsequent letdown in the domestic economy or of critical developments in the balance of payments?

I won't try to deal with the domestic side of the question. For the balance of payments, after we get beyond the seasonally favorable first quarter the next several months may be extraordinarily critical ones. It is not only the import bill that is at stake. Excessive domestic demand can suck back potential exports as well as suck in imports. Export prospects look reasonably favorable now, but there is no guaranty that sales will increase as much as we would like. If the trade balance fails to improve in the next few months, probably the balance of payments as a whole will worsen, for the adverse balance of capital movements and Government payments is likely to be somewhat larger in coming months than it was in the fourth quarter of 1965. And if the idea gains ground among investors and businessmen that the only hope the Government has for handling the balance of payments is instituting a set of controls more permanent and less voluntary than those we have now, capital outflows may well begin to accelerate again. Eventually our problems with the dollar could begin to resemble Britain's with sterling.

The Administration has held out great hopes--most recently in the President's Economic Report--that "we intend to complete the job (of moving toward payments balance) this year." The question is, how is this to be done?

I would like to quote, in conclusion, what seems to me a relevant part of a paragraph in the Economic Report, in which the President states that he will look to the Federal Reserve System for help in . . . "preventing excessive credit flows that could carry the pace of expansion beyond prudent speed limits."

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:

Now that we are one month into the new year, we have not only statistical evidence of a stronger economy in December than we believed it to be at our last meeting, but also clear signs that the rapid pace of the expansion is continuing. This year we see no sign of the "winter doldrums" that used to be a normal seasonal phenomenon early in the calendar year. Moreover, the outlook for 1966 is very strong. In the private sector, besides the stimulus of vigorous consumer demand and record business outlays on plant and equipment, accelerated inventory accumulation may be becoming a significant additional factor.

Of course the Viet Nam war is a major factor affecting all prospective economic and financial developments. The rising scale of military operations has clearly contributed to the strong business outlook, has generated skepticism as to the realism of the Federal budget, and has been a major cause of continuing upward pressure on interest rates of all maturities. We must have in mind this dominant uncertainty, with its possibility for bringing unexpected changes in the economic picture in either direction.

Notwithstanding the Administration's strenous efforts to produce a budget that would not add to inflationary pressures, the general atmosphere remains one of apprehension that excessive demands are building up. Our analysis suggests that although the budget as presented should be much less stimulative than the extraordinarily stimulative 1966 budget, it will still make a considerable expansionary contribution. All indications are that rising expenditures all along the line will increasingly press against available resources of labor and plant capacity. These pressures are likely to be especially noticeable in the area of manpower; and since the ranks of the unemployed consist, to a much greater degree than a year ago, of untrained workers, their absorption into employment could exert a strong initial drag on productivity. The changes of continuing stability in unit labor costs appear dim. While the increase in industrial wholesale prices remained relatively moderate in 1965, with no signs of acceleration in the over-all index, the price advances were quite pervasive and indeed increasingly so as the year went by. The outlook for prices in 1966 is clearly disturbing; and the performance of the stock market this year, especially with respect to low-priced issues, has been just one more sign of growing inflationary psychology.

Fragmentary balance of payments statistics, suggesting a deficit for the month of January, are not useful as a measure of the outlook for the year as a whole, because of the bunching last month of large Canadian issues originally scheduled for placement in November and December, besides unusually large tax and royalty payments to Venezuela and the Middle East. However, recent estimates of our prospective international transactions for 1966, made by a Governmental committee in Washington, are not encouraging. The benefits of an anticipated $900 million improvement in our trade surplus, together with a decline in direct investment, increased investment income, and the absence of large sales of British official portfolio securities, may well be fully offset by increases in military and aid expenditures, in bank credit to foreigners, and in travel expenditures. And even the hoped-for improvement in our trade surplus seems a bit optimistic in view of the prospect for continued rapid expansion in the domestic economy and accompanying cost and price pressures.

In the credit area, preliminary January figures suggest that the pace of the advance of the credit and liquidity indicators has moderated since December, although the gains were still rapid. Bank loan demand remains extremely active even at the higher interest rates charged since early December. This latter impression is verified by New York bankers who foresee no let-up in loan demand. Such factors as the upward drift of rates in the corporate bond market and the prospective speed-up in corporate tax payments are providing additional stimulus to loan demands, besides the general influence of the strong business outlook. Whereas reduced bank liquidity last year was not a major deterrent to the granting of all reasonable loan requests, there is now growing evidence of efforts by the New York banks to curb loan expansion. For one thing, I am glad to note an apparent increasing reluctance to finance transactions they consider more appropriate for the bond or equity markets, especially mergers and acquisitions.

Despite some continued uneasiness, I think there are some signs that the tensions characterizing the short-term financial markets in December and part of January are gradually receding. The success of the Treasury's refunding operation should be a constructive influence. At the same time, however, the long bond markets have come under increased pressure, with no real assurance of stabilization as yet. Earlier yield adjustments in the long area had been relatively moderate, but the growing corporate calendar, the prospective large asset sales by Government agencies, and the already heavily committed position of insurance companies and other institutional investors are major factors currently affecting market sentiment.

Turning to policy, I am impressed by the clear and present danger of inflation and by the fact that present fiscal policy plans do not provide any very significant restraint. It is impossible to estimate as yet whether the combination of a very high level of credit demand and a somewhat more stringent supply will result in a moderation of the financial expansion without further restrictive steps. Restraint in the rate of credit expansion seems highly desirable for purely domestic reasons, apart from the important contribution such a move might make to our balance of payments.

The nervous state of the money and capital markets during the last two months of adjustment to the higher discount rate and higher Regulation Q ceilings has made it difficult to keep reserves under sufficient pressure to encourage a slowing of credit expansion without excessive rate effects. The recent large Treasury refunding also required an especially solicitous attitude toward the state of the money and capital markets. Now that it is virtually completed, I would hope that net borrowed reserves could soon be restored to a range centering around something like $150 million, such as prevailed for sometime before last December's discount rate increase; and I would also hope that this would be consistent with other money market conditions similar to those prevailing in recent weeks. While I lean toward moving even a little further in the direction of reduced reserve availability, perhaps toward a target of $200 million or more net borrowed reserves, I think this decision might well be delayed until the next meeting, when we should have a better idea of the effects on credit expansion of our moves to date.

With respect to Mr. Robertson's interesting memorandum,[1/] I sympathize with his objective of more prompt counter-cyclical influence by open market operations, as well as with his goal of wider swings in net borrowed reserves that would have the effect of diminishing

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1/ Entitled "A Free Reserve Proposal," and distributed to the Committee on January 27, 1966. A copy has been placed in the Committee's files.

the present public overemphasis on a given reserve figure. However, I wonder whether we can rely on required reserves as a valid short-run measure of the forces of credit expansion. It seems to me that we have a hard enough time interpreting credit and liquidity developments on even a monthly basis, let alone relying on an automatic reserve interpretation on a day-to-day basis. Insofar as a net borrowed reserve target is involved, I would much prefer, as a general rule, to wait three weeks or a month until the next meeting and then make a conscious judgment that the target should be higher, lower, or unchanged.

The draft directive as proposed by the staff[1/] is entirely satisfactory.

One possibility which the Board might wish to consider is an increase in margin requirements, in the light of the sharp rise in customer credit over the last five months, and particularly in December.

Mr. Francis reported that economic activity in the Eighth District had continued to advance during the fall and early winter, but the growth rate probably had not equaled the rapid national increase. Employment in the District had risen since August, though at less than the national rate. Unemployment had declined in most of the area's major labor markets. In only two of the eight metropolitan areas of the District was the latest seasonally adjusted unemployment rate as much as 3 per cent. One of the areas was Fort Smith, Arkansas, where the Fort Chaffee military installation was closed.

1/ Appended to these minutes as Attachment A.

McDonnell Aircraft, the region's largest employer, had received Defense Department contracts to step up production of the Phantom fighter plane, Mr. Francis said. In addition, the company was beginning to build versions of the Phantom for the British. The company planned to increase its employment between now and next fall by 4,000, to about 40,000. Other major companies in the District which had recently received contracts for military goods included Wagner Electric, General Steel Industries, Universal Match Corporation, and Olin Mathieson Chemical Corporation. Each of those companies planned to increase its employment in the near future. Also, RCA commenced construction in December on a TV receiver manufacturing plant in the Memphis area; the plant was expected ultimately to employ about 7,500.

Since August, Mr. Francis continued, manufacturing output in the District had risen moderately, following a rapid expansion in late 1964 and early 1965. Spending, as indicated by the volume of bank debits, had risen at a 12 per cent annual rate in the same period. Personal income, reflecting the higher level of employment and greater activity, had been about 9 per cent higher in recent months than it was a year earlier. Gross farm receipts were up 3 per cent from the fourth quarter 1964 to the fourth quarter 1965. Returns from livestock jumped considerably, but were partially offset by reduced crop receipts. For the year 1965, income per farm was up about 5 per cent on both a gross and a net basis.

Total credit at large District banks had risen moderately since August, Mr. Francis said. Increases in total loans, particularly on real estate and to consumers, more than offset net sales of securities. Business loans had risen less than seasonally since August, following an unusually sharp rise last spring. Both demand and time deposits had gone up. Nevertheless, banks had been pinched for funds, and borrowings--both from the Federal Reserve Bank and from others--had been at higher average levels in the past three months than at any other time in over five years.

In summary, Mr. Francis observed, economic activity appeared to be vigorous in the District. He based that conclusion on both the statistics and the optimism of those with whom he had talked. From a review of the national data, it appeared that the national scene was as strong or stronger than that of the District. Aggregate demand might be excessive, as evidenced by price rises, labor shortages, and the increased concern about guideposts.

Mr. Francis said that he preferred not to make detailed comments on policy at this, his first, Committee meeting. However, with most measures of the banking system--bank reserves, loans, bank credit, time deposits, demand deposits, and money--expanding rapidly during the past two months, with the current stimulative fiscal situation, and with the strong upward momentum in the economy, it would appear that insofar as the Committee's responsibility to the Treasury permitted some firming in monetary policy was indicated.

Mr. Patterson reported that economic developments in the Sixth District continued to provide a base for strong credit demands, and the latest banking figures confirmed that conclusion. Loans at banks at leading cities in the District declined less in January this year than in 1965. District bankers were looking forward to continued loan expansion during 1966 although there were differences of opinion about its strength.

A new round in the competition for time deposits might possibly be developing, Mr. Patterson said. Until recently, most bankers had adopted a "wait-and-see" attitude with respect to their rates on time deposits, and any increases in rates that were made were modest. Two weeks ago one of the large Atlanta banks launched an extensive advertising campaign, offering to pay 4-3/4 per cent on savings certificates for as short a time as 90 days and for as small amounts as $25. A newly opened nonmember bank in New Orleans was offering 5 per cent on savings certificates held for one year in amounts of $25 and over. So far, no reaction had been noted from the other banks or savings institutions. Negotiable certificates of deposit declined during

January at practically all the banks in leading Sixth District cities, the major exception being a bank that had aggressively competed on the basis of rates.

For some time, Mr. Patterson observed, the Committee had been hoping that the dust would settle so that it could identify the forces that were responsible for the rate and loan behavior following the discount rate changes. That cloud of dust seemed to be very persistent. Even now, the Committee could not sort out clearly the technical, expectational, and real factors, and that seemed also to be the case for persons outside the System. Nevertheless, more and more of them were commenting on the apparently inconsistent behavior of rates and reserves. As was usual, they had been advising the System that something ought to be done. But, contrary to most occasions, they had not told the System how to go about controlling the expansion of reserves and the money supply without pushing up rates.

When a dust cloud persisted for as long as this one had, Mr. Patterson continued, one was tempted to just rush in to do something, and hope for the best. On the other hand, if the Committee waited for the dust to settle completely, it might find that it had permitted undesirable developments that could not be changed after visibility had improved. There was, however, the possibility of adopting a policy that gently probed toward the desired goal with the understanding that that course of action might have to be altered at any time.

Mr. Patterson commented that during recent weeks the Committee's operations had been primarily directed toward keeping the short-term Treasury bill rate within bounds, at the same time hoping that implementing that policy would not create too large a volume of reserves. It seemed appropriate after the Treasury refunding was completed to reverse the emphasis and to carry out a probing operation aimed at getting a tighter control of reserves. He did not think that the Committee should delay that type of action until after the short-term bill rate fell below the discount rate.

Possibly some tightening of member bank reserve positions would result in a further increase in the bill rate, Mr. Patterson said. However, he was not sure that that would be the case. To the extent that the present bill rate structure resulted from a maldistribution of reserves and special credit demands, pressures on the short end of the market might be reduced in the future. But even the Treasury bill rate's remaining above the discount rate would not inevitably call for an immediate further increase in the discount rate as had sometimes been suggested. Member banks at present showed no disposition to take advantage of the differential between the bill and the discount rates. Should that develop, of course, the System's policy would have to be reconsidered.

The Committee could not begin the probing operation until after the Treasury refunding program had been completed in mid-February, Mr. Patterson said. After that, he would like to see System operations so conducted as to reduce the availability of reserves, by moving toward a net borrowed reserve figure of around $200 million, as suggested by Mr. Hayes.

Mr. Bopp remarked that, with the President's budget message having been made public, it appeared clearer than ever to him that the economy was poised to move strongly ahead in coming months and that price pressures were likely to mount and become more pervasive. The strength of demand showed up in the trend of fixed investment, the fast pace of inventory accumulation, burgeoning new orders and unfilled orders for durable goods, and an operating rate in the manufacturing sector now within a hair's breadth of the preferred rate.

Earlier, Mr. Bopp said, when the margin of unutilized resources was larger, it had seemed reasonable to him to wait for actual price increases before taking additional restrictive action. The margin of unutilized resources was much narrower now and, although industrial prices had been fairly quiet recently, the stage was set for major increases in prices. In that environment, such increases could lead to speculative inventory building and other anticipatory actions, creating upward pressures which fed on themselves.

Also, in that kind of environment uncertainties over the Federal budget became more crucial. As Mr. Bopp saw it, there were four principal areas of uncertainty, and all of them appeared to veer in an expansionary direction. First, with respect to spending: Viet Nam needs were unpredictable and spending estimates were very possibly on the conservative side. Moreover, it was uncertain whether and to what extent Congress would be successful in cutting domestic spending. Second, on timing: If, as some forecasted, the largest expansion in Government spending occurred in the second half of fiscal 1966 and early in fiscal 1967, such a "bunching up" of expenditures could prove quite stimulative even if total spending did not exceed the amount budgeted by the President. Third, on revenues: While a burgeoning economy might well generate the increased receipts envisaged by the President, and while his proposed tax changes probably would be passed, the question still remained of whether and to what extent the tax measures would restrain private spending during the current calendar year. Finally, as to additional fiscal restraint: Even if the President should move very quickly to recommend added taxes or reduced spending in the event of further inflationary pressures, those recommendations would have to be appraised and acted upon by Congress.

In short, with strong pressures from private demand and the many uncertainties in the fiscal outlook, it seemed to Mr. Bopp that action should be taken to damp current rates of flow of money and credit. However, with the Treasury refunding in progress, there was a question of whether to wait until the next meeting of the Committee before imposing additional restraint. He would be inclined to move initially to tighten reserve availability as soon after February 15 as the Manager judged was appropriate in view of the refunding.

The move, however, should be a moderate and gradual one, Mr. Bopp said. It might be necessary, among other things, to relieve some pressures on commercial banks, should they have strong credit demands at the same time they were experiencing trouble replacing CDs. He would rely mainly on the discount window to relieve any excessive pressure from those and other sources. The staff's draft directive appeared appropriate to him.

Mr. Hickman remarked that the impact of fiscal policy on the economy this year seemed to be even less predictable than usual. The figures for Federal spending in the national income and "high-employment" budgets, which measured the impact of budget policy on the economy, probably would be on the low side, particularly in the area of defense--although the situation was subject to change almost on a daily basis. Despite the general uncertainty about the budget, it now appeared that fiscal policy would be stimulative, at a time when aggregate demand was pressing on the nation's capacity to produce. Under those circumstances, higher taxes than were now contemplated seemed indicated. Until such plans emerged, he thought the Committee should rely on reduced credit availability and on tighter money.

Such a course of action was also indicated by current developments in the economy, Mr. Hickman said. As the staff had pointed out in the green book, GNP in the first quarter would probably increase by at least as much as in the fourth quarter of last year. Industrial production through December exceeded the most optimistic expectations. All major price indexes continued to move up, with the resurgence of farm and food prices at wholesale presaging further increases at retail.

Mr. Hickman thought recent price developments were not surprising in view of the kinds of pressures now impinging upon resource utilization. The Cleveland Reserve Bank's informal survey in late January of manufacturing firms in the Fourth District indicated widespread manpower shortages, especially for firms in the machinery and fabricated metals industries, where the work week was currently ranging from 50 to 60 hours. In some cases, pressures were also developing on plant capacity because new facilities were not coming on stream rapidly enough to offset rising order backlogs. Moreover, several important industries in the District emphasized limitations imposed by streched-out delivery dates for machinery. Many firms were already operating above preferred utilization rates and would have difficulty handling any further increase in orders. The backlog of defense orders was already large, and another surge of orders would simply intensify problems of capacity and priorities.

On the financial front, Mr. Hickman continued, increases in nonborrowed reserves, money supply, and time deposits apparently had slowed to a less frenetic pace in recent weeks. Nevertheless, over-all rates of increase in those variables since the discount rate action had been excessive and inconsistent with his view of appropriate monetary policy.

Because of the massive Treasury refunding, Mr. Hickman said, there was little that the Committee could do now of a constructive nature, particularly in view of the unsettled state of the bond market and the probable churning in the after-market. Nevertheless, some moderate corrective action might be possible later this month, if the bond market settled down. In the past four weeks, the net reserve position of banks had averaged slightly above zero, and bank borrowings had averaged about $400 million, which created slightly easier conditions than Mr. Hickman thought the Committee had intended, even during a period of even keel. He hoped that it would soon be possible for the Manager to move net reserve positions back to levels prevailing before the last discount action. Once the Treasury refunding was out of the way, he would prefer a still deeper level of net borrowed reserves and correspondingly higher bank borrowings.

For reasons already indicated, Mr. Hickman did not agree with the second paragraph of the staff's draft directive. It seemed to him that it was time for the Committee now to begin to reduce credit availability, which would mean higher interest rates rather than stable rates, given the current strength of loan demand. That approach would involve less tampering with the economy than would any system of credit rationing based on vague distinctions as to what are and are not productive uses of credit.

Mr. Maisel thought that if the Committee examined the Economic Report it could derive certain assumptions as to where monetary policy was expected to aid stabilization in the current situation. Monetary policy was expected to aid in containing the expansion of fixed investment and to cut back on inventory investment. In addition, it appeared as if a decrease in the net export balance would aid the fight against inflation.

With respect to the latter point, Mr. Maisel thought the Committee should give more consideration to the question of whether it now had a contradiction in the directive. Could it expect monetary policy to help in restraining inflationary pressures and at the same time aid in achieving balance in the country's international payments? If the Committee was to fight inflation, shouldn't the net export balance decrease? Could it expect the current account to carry as much foreign investment as it had in the past?

Mr. Maisel agreed with the previous statements around the table that tighter fiscal policy at this time might be proper. He would doubt, however, that tighter fiscal policy would be tried until monetary policy had had its chance to decrease demand. As a result he believed that the rate of expansion of total credit had to be cut back at least to where it was in the Committee's previous policy period.

The Desk should put more emphasis on the rate of expansion of nonborrowed reserves, Mr. Maisel said. That rate of expansion should be reduced to prior levels, even if that caused somewhat higher interest rates. The proposal in Mr. Robertson's memorandum might be a way of achieving the cut in the expansion of nonborrowed reserves and, therefore, it should go into effect as soon as possible. He thought the Committee also should be concerned with the question of how much of market action and disturbances resulted from rumors without proper knowledge of what the System was attempting to do. Specificially, he asked whether the market would operate better if it knew that the Federal Reserve was willing to operate at a much higher level of borrowed reserves without resorting to another increase in the discount rate.

Mr. Daane said he confessed to being a bit gloomy about the outlook after listening to, and agreeing with, the people who had spoken thus far. He noted particularly Mr. Holland's expectation of a continued price upcreep; the statement by Mr. Hersey, whose pessimism regarding the balance of payments was, he thought, well founded; and the excellent analytical case Mr. Koch had made for further fiscal restraint, about which Mr. Daane was not sanguine at this point. While he shared Mr. Koch's distaste for higher interest rates he thought that, were it not for the necessity of maintaining an even keel during the current large Treasury financing, the Committee should be trying to restore a somewhat deeper level of net borrowed reserves. He would favor such a course as soon as it was feasible and to the extent that it could be accomplished without racheting interest rates upward. Because he felt somewhat skittish on the latter score, he would go along with a target of $150 million for net borrowed reserves; otherwise he would have been inclined to accept a somewhat deeper target. The staff's draft directive appeared appropriate to him.

Mr. Daane was sympathetic with the goals of Mr. Robertson's memorandum. However, he recalled the occasion, a number of years ago, when he had tried to disabuse the Committee of the view that free reserves were an appropriate guide for policy, and had received a letter from Woodlief Thomas saying that free reserves were the only serviceable policy benchmark available to the Committee. His own views had come full circle. He shared Mr. Robertson's opinion that the free reserve figures should not be closely pinpointed, and he would like to see the market rely less on those figures as indicators of policy--as he believed it was already doing. He was skeptical, however, that the Committee could abandon free reserve figures for target purposes; and he was even more skeptical that it could use required reserves as a policy guide in the manner Mr. Robertson had suggested. While he shared all of Mr. Robertson's reservations about free reserves, he thought they still were the most useful benchmark to indicate the nature of the thinking around the table. Recently, the net borrowed reserve figures had been showing relatively wide fluctuations so, in effect, the Committee was accomplishing one of Mr. Robertson's objectives. In Mr. Daane's judgment those wider swings were appropriate; but he hoped that the Committee would not try to put greater emphasis on aggregate magnitudes and quantities in its instructions to the Desk.

Mr. Mitchell remarked that many of those speaking today, including the staff, seemed to be saying that there was something wrong with the budget submitted to Congress by the Administration. He did not think it really needed defense--and yet, perhaps, something should be said in its favor. In his judgment the budget represented a plan that encompassed the possibilities of both peace and war; it straddled that question, and necessarily so.

What was the Committee's role when confronted with that type of budget? Mr. Mitchell thought the answer lay in the Committee's flexibility to fill in during the interim. The Committee prided itself on its flexibility but, at the same time, it could not pinpoint the effects of its actions because it did not have the necessary selective controls. If it were able, the Committee might well be trying to do something about the inventory situation, which in his judgment was an element not of strength in the economy but of great weakness.

The Committee did have controls over the banking system, Mr. Mitchell said, through which it could put some pressure on bank reserves, although not without some interest rate effects. Another step could be taken immediately--to advise banks coming to the discount window to repay their borrowings more quickly and to adjust their liquidity positions. The System attempted to discourage continuous borrowing under the terms of Regulation A, but there was no hard and fast rule as to what "continuous borrowing" was, and banks were able to maintain an illiquid position by shifting between the window and the Federal funds market. System discount officers could be of some help in contributing to the Committee's over-all objective of restraining borrowing.

As to policy, Mr. Mitchell said he agreed that at this point the Committee should not interfere with the Treasury financing. However, he favored moving toward greater firmness as soon as the Manager judged that the financing was no longer an important consideration; and increasing the degree of firmness over time if present circumstances persisted. As long as there was a belief that the country faced developments such as were associated with the Korean war, such a policy would be desirable to help reduce inflamed expectations.

Mr. Shepardson commented that all of the opinions expressed thus far today seemed to be consistent with the statement in the first paragraph of the staff's draft directive that the economy was expanding vigorously. Pressures seemed to be building in almost every facet of the economy, and developments since the Budget Message suggested that Federal expenditures would be higher than estimated in that document, implying still greater pressures ahead. It was important that efforts be made by any available means to keep the pressures from mounting and, accordingly, there was merit in the idea of fiscal restraint to curb demand. But such restraint did not seem to be in immediate prospect. In his opinion the Committee should be exerting more restraint; it should be supporting the December discount rate increase by acting to reduce reserve availability.

Recently, Mr. Shepardson said, he had been studying the possibilities of developing a better target for operations than free or net borrowed reserve targets. As everyone knew, there had been periods when the Committee had maintained negative reserve targets but had not achieved its objectives for bank credit because of rising credit demands. He had discussed the possibility of using some other measure, such as total reserves, with members of the staff, but thus far had not found a satisfactory approach. For lack of a better suggestion at this time, he recommended working back toward the level of net borrowed reserves that had prevailed before the discount rate action, and perhaps to higher level. He recognized the Treasury financing situation but, if he correctly interpreted the statements made today on that subject, the financing had been generally successful and the problem of digestion of the new issues was a relatively small one. Moreover, the need for maintaining an even keel would become progressively less over the coming period.

With those circumstances in mind, Mr. Shepardson said, he would change the second paragraph of the draft directive to read: "In light of the successful Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to moving toward somewhat firmer conditions in the money market." With such an instruction, he would expect the level of net borrowed reserves to be moved toward the $200 million level--not immediately, but before the next meeting of the Committee.

Mr. Mitchell suggested that the Manager indicate how long he thought even keel conditions should be maintained.

Mr. Holmes replied that in his opinion it certainly would be desirable to maintain an even keel through the payment date, February 15. As to the subsequent period, while he could not be certain, it appeared that even keel considerations were likely to be less important than usual at that stage of a refunding. As he had noted, the underwriters' positions in the new issues were rather minimal and it was conceivable that they would be even more minimal a week from now. He did see one problem with Mr. Shepardson's proposal for the directive, connected with the description of the Treasury financing as "successful." Certainly it had been successful in achieving the objective of extending the average maturity of the debt. From the point of view of market developments, however, it had been somewhat less successful; it was quite unusual to see the price of a new security move down to par at this point.

Mr. Shepardson agreed that there might be some problem with the word "successful," but it was the best word he could find. He thought it definitely was desirable to start moving toward deeper net borrowed reserves; since the distribution of the new securities already was fairly well accomplished, it would be unfortunate, in his judgment, to wait three weeks before doing so. The objective at first might be to restore the earlier target level of $150 million net borrowed reserves. To his recollection the Committee had not changed that target--the figures had slipped away in the course of recent developments--and its restoration could be considered to be consistent with maintaining an even keel. As he had indicated, however, he favored going a little further than that before the next meeting.

Mr. Daane suggested that Mr. Shepardson's objective might be accomplished by having the directive call for moving toward firmer conditions "as soon as the current Treasury financing permits."

Mr. Young then proposed the following language: "In the light of the imminent conclusion of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining in the first part of the period about the same conditions in the money market as have prevailed in recent weeks, and in the latter part of the period moving toward firmer conditions."

Mr. Daane remarked he could live with that language but it seemed a little cumbersome. He would prefer a formulation along the lines of his own suggestion.

In response to a question by Chairman Martin, Mr. Holmes said the intent of the members of the Committee who had spoken thus far was clear; they favored moving to firmer conditions after the Treasury financing.

The economic go-around then resumed with the following statement by Mr. Robertson:

> The round-up of evidence suggests that a strong business advance is still under way. With demands already beginning to press hard upon our narrow remaining margin of available resources, this situation possesses all the ingredients for an outbreak of an inflationary public psychology. The latest readings on the price indexes are up somewhat, even though chiefly because of higher agricultural prices. Other signs of a possible developing ebullient attitude are exemplified by the apparent inclination of businesses to commence some hoarding of both materials and labor, and--in some cases--to borrow now before interest rates rise further and lendable funds become harder to locate. There also is the possibility that Viet Nam developments will do more to aggravate than to calm these inflationary expectations in the weeks and months ahead.

This is the kind of situation in which we must be alert to the signs of an inflationary outbreak and be prepared to adopt a firm counter-inflationary stand by a wise combination of fiscal and monetary policy. We have the new budget figures now, even though it is generally recognized that the visissitudes of the war effort render the figures more than ordinarily uncertain. While the analysts are still arguing over the fine points of the budget's impact, I am inclined to regard it as just a shade more stimulative than in the second half of 1965. The additional money-raising actions of the Government may be almost but not quite enough to offset the expansive effect of the step-up in Federal spending. But no matter how you shade it--either a little more stimulative or about the same--the Federal budget will do little, if anything, to help restrain any upthrust of private demands. This means that monetary policy must bear the brunt of dampening excessive demands if they actually develop.

We are now in a period of "even keel" that probably has to stretch over a good part of the time between now and the next meeting of the Committee, although the relatively smaller dealer awards of the new 5's suggest that we might not have to hold very much beyond payment date. Nevertheless, I would agree that any significant further firming in our policy must wait until at least the March 1 meeting.

In the interim, however, there are two operational considerations we could have in mind that might make our next policy change easier to accomplish. One is to define our current "even keel" with the same qualifications the Manager attached to the term three weeks ago, namely, that market responses to basic military, economic, and budgeting developments should only be moderated and not completely offset. The second adaptation I would suggest is to permit a somewhat greater range of movement in net borrowed reserves, along the lines of the memorandum I circulated to the Committee ten days ago. I will not take the time to reiterate here all the arguments put forth in that document, but will simply suggest that net borrowed reserves be centered on $100 million, but permitted to range between $0 and $200 million as my memorandum suggests. That would mean dropping toward $200 million if required reserves are larger than

> expected, and rising toward zero if credit demands are less than expected. This would not do violence to the "even keel" principle but would give us a better basis for maneuver come the first of March.
>
> With this interpretation, I would be willing to vote in favor of the draft current directive distributed by the staff.

Mr. Robertson added that he also would concur in a revision of the directive such as had been suggested, calling for firming after the payment date. He was grateful for the sympathetic comments made with respect to his memorandum, and he would simply note that he hoped further consideration would eliminate skepticism. Since the members were aware of the need to get away from fixed targets he would suggest that the staffs of the Board and the Reserve Banks be requested to give consideration to the problem; if his suggestion was not the best, the staff might be able to offer a better suggestion.

Mr. Hickman commented that the Committee might want to plan on discussing Mr. Robertson's proposal in depth, perhaps at a time several months from now.

Chairman Martin agreed that the staff should consider the subject and that at some time the Committee might hold a discussion not only of Mr. Robertson's paper but of any others that were prepared. It would be desirable, he thought, for other members who were so inclined to present papers to the Committee.

Mr. Wayne then reported on Fifth District business conditions, noting that they continued to follow a strong upward course. December increases in nonfarm employment and factory man-hours were even stronger in the District than in the nation as a whole. Manufacturers reported that they felt the pinch of tight labor markets in the higher costs incurred to find and train the workers needed to meet existing commitments. Furniture producers complained of the limited supply and rising cost of labor, and some were unable to promise deliveries of popular lines in less than four months. The textile industry was beset by other problems in addition to labor shortages. Leaders of the industry said they could meet Defense Department needs only by reducing production and delaying deliveries to civilian customers in some product lines. They felt, however, that the resulting upward pressure on prices could be controlled by their determination to hold the line. Textilemen were also concerned lest domestic shortages lead to increased imports, a development that would concern the Committee as well because of its implications for the balance of payments.

On the national scene, Mr. Wayne continued, the long-sustained business expansion showed increasingly disturbing signs of becoming a classical boom. Gains in business activity in December were outstandingly broad and strong and there were no signs of slackening in January. Pervasive upward pressure on prices continued, with wholesale prices rising by 1 per cent from October to December and by 3.4 per cent for the year. Labor markets were progressively tighter, and optimal rates of capacity utilization had been passed in a number of industries. Order backlogs continued to grow steadily, with an especially large rise in December. Unfilled orders for durable goods had risen every month for two years, but they rose about as much in the last four months of 1965 as in the first eight months of the year. Business generally seemed under growing pressure to step up investment in both plant and inventories. Business expectations were increasingly buoyant and credit demands continued unusually heavy despite sharply higher interest rates. The budget presented two weeks ago had apparently made no contribution toward reducing inflationary sentiments or settling the money and capital markets.

Against that background of the economy's exuberant advance, Mr. Wayne said, the growth of reserves, bank credit, and the money supply in recent weeks had not been consistent with the rationale of the policy change made in December. From December 29 to January 26 weekly reporting banks showed smaller declines than in comparable periods of the previous two years in investments, total bank credit, demand deposits, and total reserves. The money supply apparently grew more in January than was normal for the month. He was aware that it had been necessary for the Committee to make a strong effort to provide stability and order in credit markets and that the recent rapid growth rates in money and credit had been a by-product of that effort. But if the Committee was not to negate the December action, it must now move to slow the growth of reserves, credit, and the money stock. The low level of bank borrowing in the past three weeks suggested that the Committee might have been supplying reserves somewhat more freely than might be consistent with the December rate action.

Credit demands had increased greatly in the past two months, Mr. Wayne observed, and the sharp rate increases over the period clearly had not exerted any appreciable restraint on credit and money growth. In the past ten days those demands had extended to the long end of the capital market and, along with military developments and the Treasury refunding, had raised yields on long-term Governments by as much as ten points. The heavier demand appeared to be associated in part with expectational factors that could pose a progressively more serious problem unless it was made clear that prompt and effective action would be taken to contain the boom which seemed to be developing.

An unequivocal move toward a lower level of reserve availability seemed to Mr. Wayne to be necessary and also consistent with recent Administration evaluations of the situation, especially those of Secretary Fowler last week. Such a move manifestly involved risks, as a sudden turnabout in the market's assessment of the policy posture could produce serious market disorders. The increased reliance of bankers on the money market also could contribute to an over-reaction of money market rates to diminished reserve availability. Nonetheless, he was convinced that those risks would have to be assumed at some early stage if monetary policy was to make its proper contribution toward restraint. He would favor a move toward a lower level of reserve availability, and adoption of a directive which would contemplate that before the next meeting of the Committee.

Mr. Clay remarked that once again the Committee was faced with a Treasury financing that tended to dominate policy considerations for the interval between meetings. It was essential, nevertheless, to evaluate the economic and financial situation apart from Treasury financing. So far as economic activity was concerned, the statistical measurements continued their upward revisions both as to what the economy had been doing and what it was doing now, and indeed as to what it probably would do. Accordingly, the relationship between resource availability and prices became of more crucial importance month by month. That was apparent also in the Tenth District where economic growth had been much slower than in the nation. Nevertheless, there was a growing scarcity of skilled workers in the region, with up-grading and salary adjustments becoming more noticeable. As a consequence, many firms were conducting training programs for production workers, and also were endeavoring to attract workers from outlying communities and rural areas.

Looking beyond the immediate interval between meetings, Mr. Clay continued, consideration would need to be given to the possible application of further monetary restraint. That view was underscored by the fact that the Federal budget appeared to carry expansionary implications for the economy, even if Federal outlays were confined to the budget projections. What should be involved in such a policy change would be difficult to perceive, however. A judgment would need to be made as to the rate at which the economy's accelerating credit demands could be met without price inflationary developments. In making provision for the growth of the credit base, the changing mix of demand and time deposits would have to be taken into account. The problem would be further complicated by the marked movement of interest rates that had taken place since the monetary policy actions of early December and the apparent sensitivity of interest rates to further increase under current conditions, so that only limited restrictions on reserve availability might prove to be compatible with the current discount rate.

As he had already indicated, Mr. Clay said, even keel considerations would need to prevail in the period ahead because of the Treasury financing. The draft economic policy directive appeared satisfactory to him.

Mr. Scanlon observed that developments in January in the Seventh District provided further confirmation that the business upswing was continuing. Most District labor markets continued to tighten, backlogs of unfilled orders continued to rise, delivery schedules were lengthening, orders were being placed earlier, and reports of higher prices paid for components and raw materials were heard more frequently. Retail sales remained strong. Debits to demand deposits at District member banks were up 17 per cent from a year earlier in December, compared to a 12 per cent gain from 1964 for the year 1965 as a whole.

Mr. Scanlon now saw some evidence that the domestic capital spending boom might have an adverse effect upon the balance of payments in 1966 while contributing to domestic inflationary pressures. Machine tool orders placed by domestic users in the fourth quarter rose sharply from the year-earlier level while foreign orders, discouraged by lengthening lead times, were down substantially.

After allowance for seasonal forces, credit demands still appeared very strong, Mr. Scanlon continued. Loan liquidation in January was relatively larger in the District than in the nation as a whole, but to a large extent that reflected pay-downs--especially by machinery and other hard goods manufacturers--on the very large borrowings over the December tax and dividend period. He had seen no indication of any diminution in the underlying strength of credit demands. Despite the seasonal reduction in loan volume, the major Chicago banks had moved to a deeper deficit position over the past month as their holdings of Governments rose and deposits declined.

Like others, Mr. Scanlon said, he was pleased to receive Mr. Robertson's memorandum of January 27, since he thought it desirable that the Committee give further consideration to the form and content of its directive. He would not take time today to indicate the points on which he agreed or disagreed, but would merely state that Mr. Robertson had given the Committee something to work from, and that the Committee should pursue and not dismiss the matter.

As to the current situation, Mr. Scanlon remarked, System policy appeared to be lending support to the rising pace of business activity. He believed that the System should undertake to moderate further the rapid pace of monetary expansion as soon after the current Treasury financing as was feasible in the judgment of the Manager. He would concur in any directive that so specified.

Mr. Galusha reported that the Ninth District continued to do exceedingly well economically. As noted in the green book, it was benefiting especially from higher farm prices. District cash farm income reached an all-time high in the fourth quarter of 1965; the quarterly total was up a full 10 per cent from a year ago. And of course the outlook was bright--for farmers, if not consumers. Indeed, the recent and prospective behavior of farm prices might well seriously affect the future course of money wages, as Mr. Holland had observed. There appeared to be nothing in the District's agricultural situation to suggest that prices to consumers would break at all in the next twelve months.

Mr. Galusha noted that the Reserve Bank's examination reports for 1965 recently had been analyzed. Of 123 banks, 19 were eliminated because they consistently had low loan volumes and seldom had any criticized loans. The remainder fell into two groups--the consistent problem banks, numbering ten in all, and the remaining 94, comprising the great majority. The latter group had increased their loan ratios slightly--from 48 per cent in both 1963 and 1964 to 50 per cent in 1965. Their classified loans had dropped from 3.2 per cent in 1963 to 2.5 per cent in 1964 and then to 2.2 per cent in 1965. The conclusion might be drawn that the strong loan demand in the period had enabled the banks with reasonably good management to upgrade the quality of their loan portfolios. Conversely, the problem banks had slipped slightly. Classified ratios for them rose to 7.7 per cent in 1965, from 6.8 per cent in 1963 and 4.8 per cent in 1964.

Mr. Galusha said that he would omit the other comments he had prepared on District developments because they were largely reiterative of statements already made. As to open market policy, an even keel seemed to be indicated, at least for the next week and possibly beyond. He would favor holding money market conditions unchanged for the whole period until the Committee's next meeting; in his judgment it would be unwise to decide today on a change in policy that could not be put into effect until very near the time of the next meeting.

Mr. Galusha added that he was unhappy about phrases like "holding money market conditions unchanged," or "maintaining about the same conditions in the money market," because those phrases connoted a qualitative and quantitative appraisal that had been and would continue to be illusory. He hoped the day would soon come when the Committee could take positive action to curb sharply the growth of credit and inflation. As to the latter, the signs were showing up in the business community of the Ninth District with distressing and alarming frequency.

Mr. Galusha concluded with an expression of gratitude to Mr. Holland for his letter of January 18, 1966, explaining the proposal he made at the preceding meeting.[1/] In his judgment both Mr. Holland's proposal and that made by Mr. Robertson warranted the Committee's fullest consideration; they went to the heart of the Committee's operating procedure.

Mr. Swan reported that business conditions in the Twelfth District continued to show considerable strength. Despite reports of tight labor markets, the aerospece industries reported a surprisingly large employment gain in December. They added almost 9,000 employees in that month, bringing their total increase since the low of March 1965 to 48,000. Their employment level in December was 594,000, still about 40,000 below the peak of December 1962.

As elsewhere, Mr. Swan said, in the Twelfth District banks seemed to be facing a strong loan demand. They had been substantial buyers of Federal funds throughout January and early February. At weekly reporting banks savings deposits declined in January and negotiable CDs and other time deposits rose considerably less than a year ago. Still, at the moment at least, there was much less

1/ Copies of this letter, addressed to Mr. Galusha, were sent to all members of the Committee and a copy has been placed in the Committee's files.

concern than some weeks ago about the possibilities of excessive rates or destructive competition in seeking deposits of individuals through the use of savings certificates in various forms. That situation seemed to have settled down somewhat.

Mr. Swan agreed with what had been said about the strength of the business and financial situation generally and about the desirability of moving toward a more restrictive credit policy. He favored slowing somewhat the rate at which reserves were being provided, and setting a somewhat deeper net borrowed reserves figure as the short-run target of operations after the payment date for the Treasury refunding. His only qualification was that the implications of the refunding for policy might have been understated somewhat in the discussion thus far. Despite the small participation of dealers, there was a question in his mind as to how firmly some of the new securities were held. Thus, while he would favor moving in the direction of a somewhat tighter policy after the payment date, he hoped the Manager was right in thinking that the market might already have discounted such a step. The move would have to be cautious and probing, given the sensitivity of the market and the price behavior of the new securities thus far. He agreed with those who questioned whether the Committee could, in fact, make a significant move before its next meeting.

For the directive Mr. Swan would accept either the staff's draft or one referring to the possibility of firming. If the Committee favored the latter, he would much rather put it in some such terms as "when conditions surrounding the Treasury financing permit" than "after the payment date," or "in the latter part of the period," because the Committee would have to rely on the Manager's judgment of the state of the market.

Mr. Irons reported that Eleventh District economic conditions were strong in all of the major areas--production, employment, unemployment, retail trade as reflected by department store figures, and so forth. Weather conditions had been good in the District recently and, generally speaking, the agricultural picture was quite favorable with respect to both production and prices. Much of what Mr. Galusha had said about the farm situation in the Ninth District applied to the Eleventh District also.

On the financial side, Mr. Irons said, bank loans in all major categories had declined in the District in the first four weeks of the year. Investments rose because of gains in holdings of Governments; holdings of non-Governments were down. Demand deposits showed seasonal declines, and time deposits continued to grow. The liquidity position of banks was reflected in part in their demand for Federal funds, which on a net basis had been running at about $400 million for the past two weeks. Borrowing from the Reserve Bank was negligible; apparently the large banks were using non-Federal Reserve facilities and the smaller banks in need of funds were borrowing from city correspondents. The situation with respect to Regulation Q had quieted down reasonably well. A number of bankers were negotiating rate increases when necessary, but they were not advertising higher rates and in general were trying to hold rates at reasonable levels.

The general expectation in the District, Mr. Irons observed, was for continued over-all expansion, with capital expenditures rising further. There was an underlying concern about inflation; people found it hard to believe that the Administration could accomplish everything it planned domestically and in connection with Viet Nam.

As to policy, Mr. Irons thought the point had been reached at which the Committee should work toward a deepening of net borrowed reserves. It would be desirable, in his judgment, to move as soon as possible from the average level of under $50 million of the last three weeks up to the $100-$150 million range prevailing before the discount rate change.

Mr. Irons believed that the second paragraph of the staff's draft directive was inconsistent with a policy decision calling for greater firmness during the coming period; it would be appropriate only if the decision was to maintain about the same conditions as in recent weeks. He had attempted an alternative formulation, as follows: "After settlement of the impact of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted so as to tighten further the conditions in the money market that have prevailed in recent weeks." He held no particular brief for that specific wording, but he would not want to refer to specific dates or parts of the period; such a procedure would set an undesirable precedent.

Mr. Ellis commented that in a period when the economy of New England was reflecting a general surge of rising activity, there tended to be a sameness about the glowing reports from each segment. That fact lead him to mention just two points--the deposit record of savings banks and the pressures on member banks in the First District.

Deposit balances at regularly reporting mutual savings banks continued to grow, Mr. Ellis said, but at a slower pace. The December expansion was 0.8 per cent. Compared with a year ago, new deposits during December were 9 per cent higher, but withdrawals were up 15 per cent. The twelve-month net growth in deposit balances narrowed to 7 per cent from growth rates 2 points higher a year ago.

However, Mr. Ellis continued, savings deposits at the weekly reporting member banks showed a 17 per cent year-to-year gain, compared with 10 per cent for the U.S., and they continued to grow in the three weeks ending January 26. All other time deposits registered a 27 per cent twelve-month gain, one-tenth greater than the U.S. pattern. Those deposit inflows, coupled with a year-to-year increase in demand deposits of 6.5 per cent, helped reduce loan-deposit ratios from the regional average of 74 per cent in November and December to 72.3 per cent in January.

The leading money market banks in Boston continued to lean heavily on borrowed funds in meeting their reserve positions, Mr. Ellis said. Through CDs, Federal funds, short-term notes, or borrowings from the Federal Reserve, they had borrowed an average of 176 per cent of their required reserves during the past 20 weeks, compared with 186 per cent for the eight New York City money market banks. Those Boston banks were still holding to a posture of meeting all their customers' requests--at least those of established customers.

Mr. Ellis noted that Mr. Hersey had concluded his remarks with a quotation from the President's Economic Report on what the President requested of the System. He (Mr. Ellis) had planned to begin his remarks on monetary policy with a fuller version of the same quotation. On hearing Mr. Hersey, he was struck by the fact that the statement consisted of two parts, the first of which, "meeting the credit needs of a vigorous and growing economy," reflected a point made by Mr. Koch today. The second part, relating to the prevention of "excessive credit flows that could carry the pace of expansion beyond prudent speed limits," had been cited by Mr. Hersey and reflected a point the latter had emphasized.

Retrospectively, Mr. Ellis continued, while the System's rate action in December had usefully allowed more realistic rates in relation to credit demands, the Committee's action in temporarily de-emphasizing reserve targets had facilitated a sharp expansion of reserves and credit in magnitudes that certainly strained the concept of "prudent speed limits."

Looking ahead, Mr. Ellis said, some of the path was marked by the economic message and the budget. From the monetary viewpoint, one of the most important decisions was to forego tax rate increases in favor of accelerating tax payments. To the extent that such acceleration would have any restraining effect on total spending, it had to influence the taxpayers, both individuals and corporations, to forego spending they would otherwise have undertaken. While individuals might well reduce their takings by amounts roughly equivalent to the accelerated payments, corporations might well seek to hold to pre-established plans by borrowing funds to replace tax-drained cash positions. That alternative means of financing

Federal outlays clearly threw additional burdens onto monetary policy. It involved an increment of borrowing in an economy that apparently was already being stimulated by a budget more stimulative this calendar year than last. In sum, fiscal restraint seemed more of a goal than a present likelihood.

Clearly, Mr. Ellis observed, the need to distribute the new securities issued in the recent Treasury refunding suggested no immediate shift in monetary policy. But once the new issues had been distributed the market would be watching closely to identify the emerging posture of policy. As he listened to Mr. Holmes' report today, he got the impression that the market was waiting for the other shoe to fall. It appeared appropriate to delay no longer than absolutely necessary in recovering to at least the posture the Committee held before December, as a basis for future moves.

Mr. Ellis thought that the most critical long-range policy choice facing the Committee was in deciding how much emphasis to place on alternative short-term targets of policy--money market conditions, interest rates, or reserve growth. Experience suggested that the Committee never completely abandoned any one of the three; but it often elevated one to greater relative importance, and in the past few months it had placed relatively greater emphasis on rates. In the present context, he believed interest rates should not be accepted as a principal object of policy. Changed and changing price expectations--from an expectation of a 2 per cent annual rate of increase to one of perhaps 2.5 or 3 per cent--coupled with foreseeable expansion in credit demands, suggested that the 1/2 point rise in short-term rates since November might not represent a completed adjustment to the new situation and outlook. However important interest rate objectives might properly become at some points in time, at present they did not serve as adequate substitutes for direct attention to the pace at which reserves were being created in relation to the economy's need for credit expansion. In his judgment, the Committee should move to restore "moderated reserve growth" as a prime target to guide the Manager's operations.

In that context, Mr. Ellis found helpful the suggestions in both Mr. Robertson's recent memorandum and Mr. Holland's letter to Mr. Galusha. Both proposals started with the objective of improving the use of the net borrowed reserves concept as a target of policy. However much the Committee might challenge its present technical capacity to determine the "expected demand for required reserves and deposits" on a weekly basis, it remained true that in times of rising demands the Account Manager was required to seek--within other constraints of rate trends and money market conditions--

to meet in full all demands in excess of such expectations for reserve expansion, in order to achieve on average a target range of net borrowed reserves.

As one alternative, Mr. Ellis commented, Mr. Robertson suggested that initially, at least, the Manager not meet any such demands for required reserves when they rise at a "faster than anticipated pace." Instead, he would allow net borrowed reserves to rise to the upper limit of a target range--$200 million at present, for example. Mr. Holland's approach would be to supply decreasing proportions of the desired reserves when their growth exceeded expected rates. Both approaches would (1) rely more on borrowed reserves; (2) allow more fluctuation in net borrowed reserves; (3) presumably result in somewhat greater fluctuations in bill rates; and (4) provide quicker responses to underlying shifts of trend. His personal preference would be for the Holland alternative, because it would apply to the whole range of reserve variations--not just the amount within a preselected range--and it might facilitate more gradual adjustment of the Committee's target. It would avoid simply shifting attention from a target figure to a target range.

Since the Committee obviously was not going to adopt either of the suggested alternatives today, Mr. Ellis said, he would urge that the Manager be directed to probe toward a deeper level of net borrowed reserves when the market settled down from the current refunding. His own choice of target would be net borrowed reserves of $150 million, with the expectation that variations around that target would fall within plus or minus $50 million, as had been true on average during 1965. The major objective of moderating the pace of reserve growth was clearly described in the first paragraph of the directive. In the second paragraph he would avoid any effort to specify subperiods, and he favored language along the lines of that suggested by Mr. Shepardson.

Mr. Balderston remarked that he was pleased by the unanimity of views on policy this morning, even though the circumstances from which it stemmed were not comforting. The economy was in a wartime boom and risking uncontrolled escalation unless restraint, both monetary and fiscal, was applied without delay. Many of the Committee members had noted that because plant and inventories were being built in the expectation of enlarged demand based upon the pyramiding of war orders and private buying, prices were tending to push steadily upward. In short, the economy was pressing hard against its resources--human and other--with the over-all unemployment rate about the same as in the expansion of 1956 and early 1957, and with the precentage of adult men unemployed at 2.3 per cent and of married men at 1.8 per cent. Farm land values continued to advance; the national average rose 6.6 per cent in the year ending November 1 last. There was no substitute for real restraint that bit, especially at a time when a portion of bank credit was being used for speculative purposes and for the promotion of such activities as mergers, take-overs, and similar ventures.

Reflecting current ebullience, Mr. Balderston said, January trading on the New York Stock Exchange stayed at the high level of last fall, with common stock prices rising further. The volume of daily transactions during the first three weeks of January was above the historic peak of 8.7 million shares reached in December. Since July 1965, net debit balances had risen $660 million; or 13-1/2 per cent, which about offset the decline in that form of stock market credit between the November 1963 change in margin requirements and July 1965. Not only had margin buying expanded but one could not help but suspect that credit for the buying of stocks was being obtained through bank loans and the resetting of mortgages. There was something reminiscent of American Founders in the exuberant reception accorded the Manhattan Fund. Its focus upon special situations reflected the mood of the moment.

Mr. Balderston went on to say that two types of increased efficiency in the use of bank credit and of the underlying reserves might tend to offset such braking of bank credit expansion as the System sought to apply between last spring and the December change in the discount rate. Since then, availability had not been curbed visibly, at least by the central bank. The two efficiencies were the increased turnover of demand deposits and the greater reliance on Federal funds. The turnover rates in 1965 were 12 per cent higher than in 1964 outside of New York City and 13.7 per cent higher within it. The second type of efficiency that influenced reserve utilization was resort to the Federal funds market. In addition, the use of reserves had been altered since earlier periods of bank credit restraint, such as those of 1957 and 1959, by changes in the deposit mix. Although total reserves rose last year at an annual rate of 5.2 per cent, time deposits--against which the reserves required were only 4 per cent--rose at an annual rate of 16.3 per cent. The mix of time and demand deposits had altered markedly since earlier periods when restraint was called for. That might explain why bank credit, as reflected by total member bank deposits, rose last year by 9.1 per cent and the money supply by 4.8 per cent while the System was intending to apply restraint.

It was clear to Mr. Balderston that the time had come to deepen the net borrowed reserve figure substantially as soon as feasible after the current financing. He would hope that well before the next Committee meeting the net borrowed reserve figure would rise above $150 million, with subsequent targets substantially larger. When resources were being used fully, as they were now, it was appropriate to force banks to get more of their reserves through borrowing at the Reserve Banks. He shared the view expressed so generally at this meeting that there was no time to lose; in fact, the bus might already have been missed.

Chairman Martin commented that in his judgment the System had performed quite well over the past few months. The Committee should not lose sight of the fact that economic pressures had been mounting steadily. Various impediments to the free flow of funds had had to be removed, and when the System took the rate actions of December it was clear that a difficult money market operation would be involved. All it all, the System had come through that operation quite well. Now some people were beginning to say not that the actions were wrong but that they should have gone further.

At present, the Chairman continued, the Committee ought to be reasonably cautious about keeping the flow of funds as orderly as possible. The experience with the current Treasury refunding was typical of the uncertainties of the current period. For a time--about the middle of last week--it appeared as if the refunding might be a failure; but it turned out to be substantially, although not overwhelmingly, successful, despite the fact that the subscription books happened to be opened on the day the President announced the resumption of bombing of North Viet Nam. Unfortunate coincidences of that kind were likely to reoccur for some time to come, and the more orderly the Committee could make any adjustments the better it would be. As to the directive, he would have read the staff's draft as giving the Manager sufficient latitude to accomplish that objective, but perhaps the language should be made more specific.

There followed a discussion of possible alternative wordings of the second paragraph of the directive, in the course of which Mr. Wayne suggested instructing the Account Management to move toward somewhat lessened reserve availability, rather than toward firmer money market conditions. Although he personally did not feel strongly about the matter, the former type of instruction would seem to reflect the sense of today's discussion better. Mr. Wayne also suggested that the move should be called for in the coming period "with appropriate regard for the current Treasury financing." A number of members concurred in Mr. Wayne's proposals, and there was a suggestion that the reduction in reserve availability to be sought should be described as "gradual."

Chairman Martin remarked that the present was a period in which operations based largely on the "color, tone, and feel" of the market would seem appropriate, although as a rule he did not particularly care for those terms. Under existing circumstances it might be difficult to achieve a gradual adjustment, but it would be desirable to make it as gradual as possible. He then asked Mr. Holmes if the Committee's intentions were clear.

Mr. Holmes replied affirmatively. As he understood it, when considerations relating to the Treasury financing permitted, the Committee would like to have net borrowed reserves move back gradually to about where they were before the December discount rate action, recognizing that the market atmosphere now was somewhat different. While the objective might be difficult to reach, the desired course was clear. He added that he would interpret the references to the conclusion of the Treasury financing to take into account the aftermarket.

Mr. Hickman asked whether the Manager would propose not to initiate a change until after any churning in the market had ended. Mr. Holmes replied that his course would depend on whether or not the churning was related to the refunding, as best as he could interpret it. If the churning appeared to be related to other developments he would not postpone firming action.

> 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 the domestic economy is expanding vigorously, with prices continuing to creep up and credit demands remaining strong. Our international payments continue in deficit. 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.
>
> To implement this policy, System open market operations until the next meeting of the Committee, with appropriate regard for the current Treasury financing, shall be conducted with a view toward a gradual reduction in reserve availability.

Mr. Shepardson commented that over the past several months some members had felt that the Committee should be moving toward reducing the rapid rate of credit expansion. Others had felt that no attempt to slow the expansion should be made until certain developments had occurred. Those developments had come to pass; and it seemed to him that the hesitancy to move earlier meant that now, when everyone recognized the existence of real pressures, the Committee might have to move less gradually than otherwise might have been possible. His own hope would be that since those pressures now were definitely apparent, the Committee would not act in too gradual a manner in meeting them. He recognized that the current Treasury financing had to be considered, but it would not constitute a constraint for long.

Mr. Mitchell agreed, except that he noted that conditions in the money market had been disorganized during the recent period and that the market even yet had not settled down.

Chairman Martin commented that it was desirable to get as smooth a flow of funds in the money markets as possible so that when an adjustment was made it would not prove disruptive. He hoped that in carrying out today's policy decision for a gradual move the Desk would maintain as much stability as it could. By the time of the next meeting the Committee would have more information on the basis of which it could decide whether a further policy change was indicated.

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

Thereupon the meeting adjourned.

Ralph A. Young
Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

February 7, 1966

Draft Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on February 8, 1966

The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with prices continuing to creep up and credit demands remaining strong. Our international payments continue in deficit. 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 current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.