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, April 12, 1966, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Bopp
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Hickman
Mr. Irons
Mr. Maisel
Mr. Mitchell
Mr. Shepardson

Messrs. Scanlon, Francis, and Swan, Alternate Members of the Federal Open Market Committee

Messrs. Ellis, Patterson, and Galusha, Presidents of the Federal Reserve Banks of Boston, Atlanta, and Minneapolis, respectively

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Eastburn, Green, Koch, Mann, Partee, Solomon, Tow, and Young, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Fauver, Assistant to the Board, Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, 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
Mr. Forrestal, Senior Attorney, Legal Division, Board of Governors

Mr. Heflin, First Vice President, Federal Reserve Bank of Richmond
Messrs. Eisenmenger, Link, Black, Brandt, Baughman, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, New York, Richmond, Atlanta, Chicago, St. Louis, and San Francisco, respectively
Messrs. Deming and Meek, Managers, 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 March 22, 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 March 22 through April 6, 1966, and a supplemental report for April 7 through 11, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that the Treasury gold stock would remain unchanged this week. The Stabilization Fund had about $100 million of gold currently on hand, but the French would probably be making a purchase of nearly $70 million before the end of the month. So a further sizable reduction in the gold stock would be required within the next few weeks unless sizable sales of gold were made by the Russians or by other central banks. The gold market continued to expect such Russian sales, and that--in combination with a heavier flow of new gold from South Africa and sales of $30 or $35 million by a still unidentified central bank--had managed to keep the London gold market in rough balance.

Sterling still remained a problem, Mr. Coombs reported. During March the Bank of England experienced reserve drains of $225 million, of which $150 million represented debt repayments to the Bank of Italy and the Bank for International Settlements,1/

At the month-end the U.S. Treasury provided a $150 million overnight swap, enabling the British to show a reserve reduction of only $75 million. For the month of April the British again faced the discouraging prospect of starting the month with an immediate deficit reflecting the $150 million repayment to the U.S. Treasury; and, mainly owing to money market pressures, they had subsequently lost another $50 million. He was hopeful that with the end of the Easter holidays sterling would show renewed strength this week as money market pressures reversed themselves. Also, there might be some sizable purchases

1/ Part of a sentence has been deleted at this point for one of the reasons cited in the preface. The deleted material referred to other operations by the Bank of England.

of sterling for oil company account which might significantly reduce the April deficit as the month progressed.

On balance, however, the position of sterling remained vulnerable, Mr. Coombs said. The problem was particularly worrisome because the present was a period in which sterling ordinarily was seasonally strong. In effect, the British elections had cut off the recovery of sterling that had been underway, and the question was how to get that recovery going again. The new British budget probably would have a decisive effect. The question of whether or not it would be restrictive enough to turn the market situation was important to the U.S. as well as to the U.K. It seemed clear to him that if the British allowed the present combination of overheating of the economy and a wage-price spiral to continue, sooner or later the sterling parity would be seriously undermined.

Mr. Ellis said he had thought the earlier strength of sterling had been due to a reversal of speculation against the pound, which was a one-time development. Was Mr. Coombs suggesting that the short positions still to be covered were large enough to be capitalized on?

Mr. Coombs replied that if the British had not held an election the return flow that developed in the period from September through January probably would have continued for another two or three months, although possibly at a diminishing rate; there was a good deal of pressure tending to push the sterling rate up. In addition, January through June normally was the time when British foreign exchange earnings were seasonally high. Finally, the U.K. had been making some progress in terms of more basic improvement in their balance of payments--exports rose about 7 per cent in 1965, while imports were up only 1 per cent. There had been a certain loss of momentum, and that was dangerous in a situation in which confidence was so vital a factor. New and more forceful measures were needed to recapture the earlier momentum.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period March 22 through April 11, 1966, were approved, ratified, and confirmed.

Mr. Coombs then recommended renewal for a further period of three months of the $100 million standby swap line with the Bank of France, which would come to the end of its three-month term on May 10.

> Renewal of the standby swap arrangement with the Bank of France, as recommended by Mr. Coombs, was approved.

In connection with a second recommendation, Mr. Coombs noted that the Account Management was authorized (under the

Committee's continuing authority directive for foreign currency operations) to buy, and to sell forward to the U.S. Treasury, up to $100 million of foreign currencies in which the Treasury had outstanding indebtedness. Such transactions were for the purpose of assisting the Treasury in financing payment of maturing bonds denominated in foreign currencies. As the Committee would recall, in late 1963 and early 1964 the Account had accumulated a total of nearly $100 million in Italian lire and had sold the lire forward to the Treasury which used them to pay off maturing bonds. In recent weeks, the Account had purchased $46 million of Swiss francs which the Treasury would use in the same way. At present there was an opportunity to acquire German marks, a currency in which the Treasury had about $450 million of indebtedness. After the Swiss franc purchases, the leeway remaining under the $100 million limit was $54 million, but it appeared likely that a larger sum could be usefully devoted to mark purchases. Accordingly, he recommended some increase in the limit, perhaps to $150 million. There was no risk to the System in operations of the type in question, and facilitating Treasury repayment of its foreign indebtedness was, of course, highly desirable.

In the ensuing discussion some members suggested that the limit might be removed entirely, or set at a level considerably higher than Mr. Coombs proposed, since the operations under discussion were riskless and helpful to the Treasury. Other members agreed that a limit of more than $150 million would be desirable. They saw some virtue, however, in keeping the figure within the range likely to prove necessary in the foreseeable future, noting that the Committee could raise it further at a later time if there were grounds for doing so. In this connection action to raise the limit to $200 million was proposed as a reasonable course.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the third paragraph of the continuing authority directive for System transactions in foreign currencies was amended to read as follows:

> The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $200 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates

Chairman Martin then referred to the Secretariat's memorandum transmitted on February 21, 1966, proposing a reorganization in the Committee's instruments governing foreign currecny operations; and to a memorandum by Mr. Baker of the Board's staff, entitled "Federal Reserve Operations in Foreign Currencies 1962-1965," that had been distributed on March 21, 1966. He also noted that Mr. Coombs today had distributed a memorandum dated April 8, 1966, commenting on Mr. Baker's paper.[1] The Chairman suggested that the Committee hold a preliminary discussion of these materials today and plan on pursuing the subject further at a later meeting, since the members had not yet had time to study Mr. Coombs' comments.

Mr. Heflin noted that language calling for certain reports by the Special Manager, contained in Section IX of the existing Authorization for foreign currency operations, had been deleted in the new Authorization proposed by the Secretariat. He recognized that no modification of present practice with respect to reporting was intended; rather, the language had been deleted to achieve consistency with the corresponding domestic instruments, in which the Committee did not consider it necessary to spell out the nature of reports to be made by the Account Management. In his judgment, however, the System's foreign currency operations were of a somewhat different character from its domestic operations; in particular, the Special Manager was given broader authority to act than was the domestic Manager. For that reason he thought there was some merit in having the record show that the Committee required reports from the Special Manager. Language as detailed

1/ A copy of Mr. Coombs' commentary, as well as copies of the other memorandums mentioned, have been placed in the Committee's files.

as that in the present Authorization did not seem necessary, but there might be a simple statement to the effect that the Special Manager was responsible for keeping the Committee informed on market conditions and on his operations, and for making such reports as the Committee might specify.

Secondly, Mr. Heflin said, it was not clear to him whether the language at two points in the proposed new foreign currency directive--paragraphs 1(D) and 2(B)--was intended to involve changes from present practice.

Mr. Young commented that a statement regarding reporting requirements could be included in the proposed new Authorization if the Committee thought that would be desirable. On the second point, he indicated that no departures from present practice were meant to be implied by the language of the directive paragraphs to which Mr. Heflin had referred.

Chairman Martin suggested that the staff might review the two directive paragraphs in question, and that Messrs. Young and Heflin might get together after today's meeting to draft language on reporting requirements for the Committee's consideration.

Mr. Young then remarked that he would recommend two changes in the proposed new instruments. The first affected the opening sentence of paragraph 3 of the proposed Authorization. Following the words "All transactions in foreign currencies undertaken under paragraph 1(A) above shall be at prevailing market rates" would be added, "and no attempt shall be made to establish rates that appear to be out of line with underlying market forces." Similar language was included in the Section 2 of the existing Guidelines, and it seemed desirable to retain it in the new instruments.

The second amendment, Mr. Young continued, related to paragraph 1(E) of the proposed new directive, which specified that one of the basic purposes of System operations in foreign currencies was "To facilitate growth in international liquidity in accordance with the needs of an expanding world economy, by providing for reciprocal holdings of currencies." It had been suggested that the final clause, following the comma, should be deleted. A similar coupling of reciprocal currency holdings with needs for international liquidity was made in the statement of the specific aims of operations in the existing Authorization, but when that language was written outright market transactions were expected to play a more important role than had proved to be the case. The fact that the great bulk of System operations involved swap drawings made the clause seem inappropriate.

Mr. Coombs commented that he thought it would be wise to delete the clause in question because it might be misinterpreted to imply that the System intended the swap network to be used for the purpose of inflating the foreign currency holdings of both parties to the arrangements.

Mr. Hayes observed that the proposed new instruments seemed to be a clear improvement over the existing ones. Noting that the Committee had postponed action on them earlier, he asked whether the kinds of questions that had been raised were sufficiently important to warrant again holding them over to a later meeting.

Chairman Martin remarked that no problem would be raised by delaying action; operations could be conducted under the existing instruments until some conclusion was reached on the proposed new ones. Mr. Coombs had distributed a new memorandum today, and it might be desirable for the Committee to consider the Secretariat's memorandum, as well as those by Mr. Baker and Mr. Coombs, at one time.

Mr. Hayes then said that he would make one observation on Mr. Baker's memorandum at this time. As the memorandum itself indicated, it tended to stress certain alleged limitations and shortcoming of System operations. Personally, he would have preferred a somewhat more balanced presentation. In his judgment the System's accomplishments in the foreign currency area had been great, and he hoped the members would not overlook those accomplishments in reviewing the memorandum. On the whole, he thought, the operations had been extremely useful. Moreover, all of Mr. Baker's criticisms were answered effectively in Mr. Coombs' memorandum.

Mr. Daane agreed that the operations had been highly useful. He added that they were so viewed not only within the System but at the Treasury and abroad as well.

Chairman Martin then suggested that the Committee plan on considering further the several memorandums on foreign currency operations at its next meeting.

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 March 22 through April 6, 1966, and a supplemental report for April 7 through 11, 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:

> System open market operations over the interval since the Committee last met kept bank reserve positions under pressure, and last week Federal funds traded for the first time at 4-7/8 per cent. On balance, outright holdings of Government securities rose by $526 million, including $56 million of coupon issues bought early in the period when Treasury bills were in scarce supply. Repurchase agreements against Governments were used to meet temporary reserve needs in the week ended April 6, but none were outstanding at the close of business last night. While net borrowed reserves were not much changed from earlier weeks, the money market came under increased pressure over the past week or so, reflecting continued strength in credit demands, particularly increased financing needs of

Government securities dealers. Market participants realize that the System is applying a fair degree of pressure and seem to believe that it is appropriate.

Despite money market pressures and higher CD and finance company paper rates, the Treasury bill market was experiencing a life of its own until the very end of the period. Three weeks ago dealer inventories were unusually low. There was widespread demand for bills, including System buying and buying by public funds which are entering into a period of seasonal demand. For a time, indeed, the 3-month bill rate dipped below the discount rate. Moreover, there were anticipations of growing seasonal demands for Treasury bills, while the reflux of bills into the market following the quarterly bank statement and Cook County tax dates was only moderate. In this environment dealers were anxious to rebuild their inventories and received heavy awards in the April 4 auction. By this time other short-term money rates were more attractive relative to Treasury bill rates, and sharply increased dealer financing needs could be financed only at higher bank lending rates. In this environment, bill rates tended to back up. In yesterday's auction, bidding was cautious and scaled over a fairly wide range as dealers sought to protect themselves against further upward pressure on rates. Averaging issuing rates were set at 4.62 per cent and 4.76 per cent on the three- and six-month issues. The three-month rate was thus 4 basis points above the rate set in the auction just preceding the last meeting of the Committee and 8 basis points above a week ago.

Looking to the period immediately ahead, it appears that the banks have made careful preparation for the April tax date pressures and should have no special problems with CD maturities. Finance companies are expecting sizable maturities of their paper over the tax date, and may be forced to borrow from banks. Given the likely short-run credit demands on banks, dealer financing costs are apt to remain at the higher levels reached last week. Consequently, for the moment at least, the Treasury bill rate is probably more sensitive to pressures on bank reserve positions than it has been for some time. The Treasury bill, of course, is no longer the main instrument for bank reserve adjustments and the re-emergence of strong nonbank demand over the next few weeks could again isolate the bill rate from general money market pressures.

In the capital markets, the improved sentiment that was in evidence at the time of the last meeting of the Committee continued over much of the period, although there were fairly wide price fluctuations on a day-to-day basis. The Government market reacted strongly to the President's statement near the end of March that implied that tax action would be forthcoming if prices continued to rise. The corporate and municipal markets were also generally buoyant during most of the period. The large AT&T issue offered on March 29 sold out quickly, and yields on municipal bonds continued the decline that started in early March. By the close of the period, however, there were some signs that the pendulum had again swung too far. An A-rated corporate issue priced to yield investors only 5 per cent, compared with 5.35 per cent on a comparable issue in mid-March, was moving slowly. Prices of intermediate- and long-term Governments edged lower since last Wednesday, and a general note of caution appears to be coming back into the capital markets. While the forward calendar of offerings is not so heavy as in early March, a good volume of issues is scheduled for the current week and over-all capital demands are expected to continue strong. The markets remain sensitive and will be carefully assessing the prospects for a tax increase, while watching closely business response to the President's plea for moderation of capital spending.

The Treasury is currently going through a period of cash stringency, with its balance in the Reserve Banks falling as low as $46 million last Friday. The low level of Treasury balances has not been disturbing to System open market operations, and so far, at least, the Treasury has not had to use its temporary borrowing facilities. But it will be touch and go for the next week.

While the Treasury is not planning any cash borrowing for the rest of the fiscal year, various Government agencies will be raising sizable amounts of new money this month--aggregating perhaps $1 billion--in order to finance their own activities. In addition

> there is a possibility of further asset sales over the next month or so. These agency offerings will be applying continuing pressure to financial markets throughout the month.
>
> The Treasury will be meeting with its borrowing committees on April 26 and 27 to set the terms on its May 15 refunding of $9.3 billion outstanding bonds and notes, of which only $2-1/2 billion are held by the public. Last February's prerefunding by the Treasury has reduced the operation to routine proportions, and the market is generally expecting that the Treasury will come out with a short-term issue maturing in about 18 months. While no particular problems appear to be presented by the refunding at the moment, it will come in the midst of substantial agency financing and even keel considerations will be of some importance late this month.

Mr. Daane asked the Manager how he would expect the market to react if net borrowed reserves were deepened somewhat further.

Mr. Holmes said that such judgments were hard to make because other developments were likely to be affecting market attitudes at the same time. On the whole, however, he did not think that some further deepening of net borrowed reserves would be particularly disturbing to the market.

Mr. Ellis noted the Manager had said even keel considerations would be of "some" importance late in the month. How much attention did he feel would have to be paid to such considerations?

Mr. Holmes replied that the point he meant to emphasize was that the Treasury operation would be fairly routine, and that there would be less need than in connection with many other financings to insure that the markets were kept in good shape while it was underway. On the other hand, the financing would come at a time when a fair volume of agency issues was being sold, and it was hard to judge what pressures those sales would put on the markets. As to the timing of even keel considerations, the Treasury announcement probably would be made on April 27, the last day of a statement week and one day before reserve figures for that week were made available. Thus, some consideration might have to be given to the financing in that statement week.

Mr. Hickman noted that the blue book[1/] indicated that in the latter part of April there normally was a shift of funds toward money centers as well as seasonal demands for bills. He asked whether that suggested some downward pressures on bill rates after the tax date.

Mr. Holmes agreed that downward bill rate pressures might be expected under ordinary circumstances. Because of the agency issues in prospect, however, it was not clear that they would occur this year. On the whole, however, he did not think that even keel considerations would pose much of a problem.

Mr. Swan referred to Mr. Holmes' comment that banks should have no special problems with CD maturities over the tax date. Did he expect any problems as a result of borrowings for tax purposes?

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

Mr. Holmes replied that there was likely to be a significant volume of tax borrowing by corporations, as well as borrowing by finance companies with paper maturing on the tax date, as a result of which banks might well encounter some problems.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period March 22 through April 11, 1966, were approved, ratified, and confirmed.

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

Mr. Brill made the following statement on economic conditions:

> I haven't found a more succinct description of economic conditions and problems than the lead paragraph in the latest survey put out by the National Association of Purchasing Agents. The paragraph reads: "Prices are up; quality is down. Costs are up; profits are down. Lead time is long; labor is short. But business is very good."
>
> About all I can add are the statistics that confirm the statement. Business is certainly very good. Our production index for March, just off the computer, shows another one-and-a-half point gain, not bad for an economy pressing on capacity in many areas. The March rise brings the first-quarter average for the production index to a 13 per cent annual rate of gain over the fourth quarter.
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> And this output is not staying on the shelves very long. Retail sales are booming, a natural consequence of the acceleration in wage and salary disbursements. February sales figures were revised upward significantly, and the March preliminaries show a healthy rise on top of that, bringing first-quarter sales to a 13-1/2 per cent annual rate of gain.

This pace of advance in the economy is pressing on both plant capacity and the labor supply, with order backlogs rising in important durable goods lines. Utilization of plant capacity in manufacturing is up to a rate of between 92 and 93 per cent, with the rise limited in many key lines, such as machinery and other metal-using industries, by the shortage of skilled labor. We seem to have hit the bottom of the barrel some time ago for adult workers. The unemployment rate for this group is below 3 per cent, close to the low during the Korean war. And we have stretched the workweek pretty far. It was already at a postwar high in February, with hours in the machinery industries nearly back to World War II levels.

Further gains in output will increasingly depend on our ability to absorb and upgrade more of the young and the inexperienced in the labor force. But this has its consequences for productivity and costs. The productivity squeeze is already showing up in unit labor costs and prices. The rise in unit labor costs in January could be explained largely on the basis of the increase in social security taxes. But the rise in February, and there was probably another rise in March, is a much clearer reflection of labor hoarding, costs of training inexperienced labor, and the expenses of substantial overtime.

In this situation of strong demands, these rising costs are being carried through to industrial commodity prices, which advanced again in March. So far this year, the rise in industrial prices has been at about a 2-3/4 per cent annual rate, compared to the 1 to 1-1/2 per cent rate that prevailed over most of last year. And increases are becoming more pervasive through the list. In February, the latest date for which detail is available, almost three-fifths of the sub-groups in the index rose, as compared with less than half in the closing months of 1965.

Putting these output, sales, and price developments into aggregate terms, we are estimating gross national product in the first quarter at a rate of $712 billion, up $15 billion or 8-1/2 per cent from the fourth quarter in current dollars, and a little over 6 per cent in real terms. As best as we can see, the pace this current quarter is likely to be almost as fast. The driving forces, defense spending and business capital outlays, are not slackening. Although defense outlays in the first quarter were a little below Budget estimates, the President has indicated that the shortfall is expected to be made up this quarter. Business capital outlays, which may have exceeded earlier expectations in the first quarter, are also likely to stay strong, at a minimum to keep to the track marked out in the February anticipations survey. It is probably too early to expect to see any effects in this area of either monetary restraint or Presidential exhortations. Most other areas--except housing--are continuing strong, and a second-quarter rise in GNP at an annual rate of about 8 per cent, with prices accounting for about 2-1/2 percentage points of the rise, still seems likely.

There is general agreement that this is too fast a pace of advance to sustain, that increasingly more of the rise in GNP may reflect a larger price and a smaller real component unless something is done to retard it. But there is less agreement about what should be done, with controversy focusing around the need for a tax increase. To end any suspense, I will put myself forthrightly among the waverers. Over the past month I have argued myself all around the issue, but more often--and today--I come out on the side of favoring a tax increase.

My hesitancy in reaching this position rests first on the feeling that the restraint job that has to be done is relatively moderate, at least if it is done soon. It doesn't seem to me that very much has to be shaved off spending demands, as we now see them, to bring total outlays into better balance with growing resource availability. Second, I have faith in the efficacy of monetary restraint, and increasingly expect that the effect of the restraint imposed to date will be reflected in a moderation of spending. Third, I wouldn't be alarmed at the possible discriminatory effect of tighter monetary restraint, particularly if it whacked housing a little harder at a time when business and defense construction needs were rising. And finally, I don't think we have exhausted the potential of policy, not with borrowings from the Fed still fluctuating around only about half a billion dollars, and interest rates still well down from month-ago peaks.

But the arguments for fiscal restraint are more persuasive. Even as hardhearted a free market economist as I can't shrug off the plight of banks' competitors in the housing finance industry. And monetary restraint, short of a dramatic rise in the discount rate, is not likely to have as strong or as immediate effect in damping any emerging inflationary psychology as would the announcement of a request for a tax increase. Moreover, the possibility of a step-up in defense spending carries with it the danger of a real consumer and business buying spree. If for no other reason, we need the insurance of a prompt, moderate, but reversible tax increase.

This is not the Committee's decision to make, however; monetary policymakers have to live with whatever the Administration decides. And they have to live with the fact that even if the Administration does opt for a tax increase, there are weeks and probably months ahead before it would actually begin to absorb spendable incomes. In the interim, the only tools of restraint available are persuasion and monetary policy. The situation calls for the use of both. Now that financial markets have had a chance to catch their breath, after the hectic pace at which interest rates rose from December to February, it would seem appropriate to me to restore and maintain the pressure on financial markets in the near term, to restrict reserve availability further and, hopefully, to see these pressures transmitted through to long-term interest rates.

Mr. Holland made the following statement concerning financial developments:

The weeks since mid-March have been one of those confounding periods in which our measures of marginal reserve availability have proved remarkably stable around a new high plateau for this expansion, while other financial indicators have been charging off in all directions. We have had a major run-down in bill and bond rates, although the last few days suggest some turn-around of that move is in process. There has been an unexpectedly strong accretion of liquid funds to the money market banks, particularly the New York City banks. And there has developed a sharp bulge in bank loans and the money supply all around the country, although there are grounds for believing that some of that increase will prove temporary.

The reasons for all of this appear to be a blend of changing market expectations, shifting loan and investment policies of the larger banks, and heavy business cash needs over the March-April tax periods. These factors and their interrelationships have been amply described in the materials submitted for this meeting and in the comments of the Account Manager this morning, and I shall not belabor them.

The experience does emphasize again how accommodative of changes a net borrowed reserve target can be. It also has some implications for the proper stance of monetary policy in the weeks ahead. While there are good reasons for looking forward to some partial redress of the recent interest rate declines and bank credit increases, it seems to me that a question remains whether such market readjustments will themselves carry far enough to achieve the results desired, given our current policy stance.

Let me point particularly to the position of the banking system. The biggest banks--in New York City, especially--by dint of hard and costly efforts have managed to acquire some cushion of liquid funds in anticipation of expected strong credit demands just ahead. One result of these efforts is that the reserve pressures generated by System operations now bear most heavily upon other and smaller reserve city and country banks--banks that, by and large, are slower to undertake adjustments. In addition, the ways in which the pressures are now reaching these banks--poorer time deposit performance, and strong tax-associated credit demands in March and April--can easily be viewed by them as the kind of unexpected and temporary drains for which assistance can appropriately be sought under Regulation A. Consequently, we may be in a period when a given dollar of borrowed reserves will not represent quite as much restraint as before; or, to put it another way, when it would be in the spirit of current policy to let net borrowed reserves slide a bit deeper, with banks having to borrow a slightly larger fraction of the reserves needed to meet the remainder of the expected bulge in bank credit demand suggested in the green[1] and blue books. In the process, an extra degree of insurance will have been taken against any backsliding in the more restrictive lending policies being adopted by banks around the country. In other words, I would advocate a little further prudent tightening of reserve availability, to use the "phrase of art" employed in alternative B of the draft directives.[2]

Speaking of directives, the staff has been doing a good deal of study of directive language in the three weeks since the last meeting, reviewing minutes of the last few years in the process. It is striking how much corollary meaning can be drawn from the Committee's own comments to interpret its key operational phrases of art--two of them in particular. One, money market conditions, can now be fairly construed, I think, to imply more or less coordinate attention to free reserves, the 3-month bill rate, and the combination of cost and quantity of Federal funds transactions, cost and quantity of dealer financing, and the borrowing component of free reserves. A second phrase of art that has served the Committee well recently has been reserve availability. Comments at the last few meetings seem to be infusing this phrase with corollary meaning about as follows: primary attention to free reserves and borrowing, secondary consideration to the cost and availability of reserves in the Federal funds market, and probably also some modest allowance for changes in over-all reserve use, *e.g.*, a willingness to let net borrowed reserves slip a little deeper if required reserve or bank credit expansion should prove unduly strong. At the very last meeting, the Committee may have started to create a third operational phrase of art--pressure on bank reserve positions--and that phrase is preserved in alternative A of the directives drafted for your consideration this morning.

Mindful of the occasional criticism both from within and from outside the System that more explicit directive language is needed, the staff experimented

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

2/ Two alternative draft directives are appended to these minutes as Attachment A.

with being a little more specific this time; but the best we could come up with on this score was a combination target variable expressed as "maintaining about the same range of net reserve availability and related money market conditions as has prevailed since the last meeting of the Committee." We felt constrained by, among other things, the performance outlined in Mr. Bernard's memorandum 1/ distributed last week, showing that the staff projections of money market conditions as a group have proved reasonably accurate from one Committee meeting to the next, but up to now our ability to project broader financial aggregates has been distinctly mediocre. And, frankly, we felt that even this kind of language was a little more specific than the majority of the Committee would prefer.

In the absence of different directions from you, the staff would propose to push along resolutely in its current four-way approach to the directive: namely, continuing to serve up draft directives that speak essentially in the usual phrases of art; second, depending heavily upon comments at Committee meetings to interpret the shadings of those phrases, for purposes both of guiding operations and of phrasing the pertinent policy record entry; third, trying, in the contents of the green book, the blue book, and staff presentations, to go as far as practicable in suggesting the relevant measures and their interrelationships; and, finally, pushing research efforts to identify better the kinds of linkages that make up the monetary process and that might best be exploited in the conduct of System operations. A prime example of a subject for intensive study is the reserve target proposal put forth by Governor Robertson; it is planned that one or more memoranda on that proposal will be forwarded to the Committee before long by the Account Manager and perhaps othersof the Committee staff.

It should be recognized that all current efforts at any more explicit definition of Committee goals and instructions may soon be rendered obsolete; for both the Government securities market study and the discount

1/ A copy of this memorandum, dated March 31, 1966 and entitled "Staff quantification of FOMC directives since August 1964," has been placed in the Committee's files.

> study may lead to changes that could entail substantial revisions in System operating guides and procedures. But the subject of communicating the Committee's intentions may appear too important to wait until these basic studies are finished. Accordingly, the staff stands ready to proceed as noted, subject to all the guidance in this matter that the Committee members individually or collectively are moved to provide.

Mr. Ellis commented that he would urge the staff, instead of attempting to prejudge how far the Committee was prepared to go in accepting more explicit directive language, to advance any suggestions it had and let the Committee judge whether or not it was prepared to accept them.

Mr. Mitchell thought that the eloquence with which Mr. Holland described the present approach to the directive did the Committee an injustice. In his (Mr. Mitchell's) opinion the directives were basically inadequate. He had become discouraged about the possibilities of improving them, although he thought the staff should continue to work on the problem of developing more explicit language.

In his judgment, Mr. Mitchell continued, operations since the last meeting were unsatisfactory because the Committee had not given the Manager sufficiently good instructions; ground had been lost when it should have been gained. The Committee could not rely on fiscal policy, since no one could say whether a tax increase would be enacted. But one thing the Committee could do was to avoid letting up on monetary restraint at this time. Alternative A of the draft directives included a phrase about "continuing to exert pressure on bank reserve positions." Unless strong pressure of that kind was maintained it seemed to him that the Committee's whole program of monetary restraint would fail.

Chairman Martin said it was not clear to him that the Committee had lost ground since the preceding meeting. He asked Mr. Mitchell what measure he had used in reaching that conclusion.

Mr. Mitchell said he had based his judgment on the recent performance of the capital markets and the change in trend of long-term interest rates.

Mr. Hayes said it was his impression that some of the ground which Mr. Mitchell thought had been lost in capital markets actually was a natural reaction to the earlier excessive adjustment in interest rates. The market often displayed a pendulum-like pattern, with rates moving too far in one direction and then coming back part way. From his observations he concluded that banks still felt they were under considerable pressure. He hoped that was true, and he shared the view that it was desirable to maintain the pressure.

Mr. Mitchell agreed that bankers felt under pressure. His concern was with recent capital market developments, which he thought had not been desirable. He did not know whether monetary policy could have stemmed the decline in interest rates, but an attempt should have been made to do so.

Mr. Holmes commented that the market had indeed acted like a pendulum. The earlier rise in long-term rates probably would have occurred even if the System had moved toward greater ease. Subsequently there was a backwash, reflecting a basic change in expectations with regard to the likelihood of a tax increase. It was possible that the pendulum would now swing back the other way.

In reply to Mr. Mitchell's question as to whether a deepening of net borrowed reserves of perhaps $100 million would have stopped the recent decline in long rates, Mr. Holmes said it might have slowed the decline but he did not think it would have stopped it.

Mr. Maisel said he shared Mr. Mitchell's position. He would stress that during the recent period the System supplied too large a volume of reserves, permitting bank credit to grow at a much more rapid rate than earlier. He agreed that expectational factors affected the trend of long-term interest rates, but the movement in the variable the Committee could control--bank reserves--had been inconsistent with what he thought had been intended. It was clear from that experience that the Committee's directive was formulated improperly. The outcome would have been better if the Committee, rather than relying on a marginal reserve target, had given the Manager instructions along the lines Mr. Robertson had proposed at several recent meetings.

Mr. Holmes observed that there often were large swings in required reserves of a temporary nature that were hard to distinguish in the short run from more basic changes. For that reason it was extremely difficult to make operating decisions from week to week in terms of the broader reserve measures in which the Committee was interested.

Mr. Daane commented that while he sympathized with the view that the Committee did not want to lose ground, he thought it was necessary to gauge the degree of pressure that was being exerted in broader terms than the movements in reserves and bank credit.

Chairman Martin then asked Mr. Holmes if he thought the Committee had lost ground recently. Mr. Holmes replied he did not think so, in terms either of market developments or the views of market participants regarding the posture of policy. To use a phrase the Committee had employed in the past, the Desk recently had been "resolving doubts on the side of tightness." For example, last Wednesday, April 6, dealers had large financing needs and were inquiring about repurchase agreements. The Desk had responded negatively, and the dealers were forced into the banks. Nor, in his judgment, had ground been lost in terms of bank loan policies. The banks had tried to get more liquid and to put themselves in a position to meet some of the loan demands they saw ahead. While they were in pretty good shape to meet those demands, that did not mean that they were not turning down some customers, particularly new ones. In general, it had become harder for banks to get funds.

Mr. Hayes noted that one of the banks in the New York City area had begun to compile figures on loans that it was turning down, and found that the total already was quite large.

Chairman Martin commented that the question of whether ground had been lost obviously was a matter of judgment. It had been useful, he thought, to hear the views on that subject around the table.

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

> Recent balance of payments figures are in some ways reassuring. The first-quarter deficit on the liquidity basis now appears to have been below the $1-1/2 billion annual rate given in the green book. And the deficit on the basis of official reserve transactions was apparently very small indeed, less than $1/2 billion at a seasonally adjusted annual rate, in marked contrast to the very large deficit on this basis in the fourth quarter. In the latest quarter, U.S. banks succeeded in attracting large Euro-dollar deposits through their foreign branches, aided by the renewed weakness of sterling and by the fact that Italian commercial banks placed abroad again the funds they had pulled back late last year. This second measure of the deficit has fluctuated very widely from quarter to quarter, and should for most analytical purposes be averaged over a longer period, as I shall do presently.
>
> So far, we know of four other large changes in international transactions between the fourth quarter of 1965 and the first quarter of this year. On the favorable side, the reflow of bank credit swelled from an already large $1 billion annual rate in the fourth quarter to a rate of nearly $2 billion in January-February. A second change, also favorable, was that there was no U.K. debt service payment to be waived in the latest quarter. On the adverse side, the merchandise trade surplus shrank from its earlier annual rate of $5 billion to only $4 billion in January-February. And there was a sharp increase in the rate of

capital outflow into foreign securities, as new Canadian issues earlier postponed came to market.

These four changes by themselves would have increased the liquidity deficit. But apparently their net adverse effect was more than offset by favorable changes in other transactions not yet identified or measured.

These recent developments do not seem to call for any broad revision of earlier projections for the year 1966 as a whole. It still seems likely that with good management, by which I mean adequate restraint of domestic inflationary pressures, the liquidity deficit may be held close to last year's rate despite the larger balance of payments costs of Vietnam, and the deficit on the basis of official reserve transactions may be a little smaller. However, no substantial improvement over last year seems likely and there would almost certainly be a deterioration if domestic inflation and anticipations thereof should become more intense.

This morning I should like to comment on some longer-term trends in the balance of payments. It seems to me that the over-all figures for the latest three quarters, since mid-1965, give a good indication of the trend-level of the payments deficit. For this 3-quarter period, the deficit was at an annual rate of $1.6 billion on the liquidity basis and $1.4 billion on the official reserve transactions basis, i.e., about $1-1/2 billion on either basis of calculation. The deficit was held down by a number of special factors, including debt prepayments, military prepayments, and the voluntary restraint programs. On the other hand, there were also a number of special factors tending to increase the deficit in this period, including the U.K. debt waiver already mentioned, liquefication by the U.K. Treasury of its security portfolio, and a strike-related bulge in U.S. imports of steel. These two sets of special factors may be very roughly regarded as cancelling each other out. So also may the twin payments influences of our domestic boom, which has made credit unusually tight but import demand unusually strong. Obviously any quantitative weighing of all these factors must be exceedingly rough. But after allowance for them, it seems reasonable to think of the recent size of our payments problem as about $1-1/2 billion a year.

This represents a significant improvement from a trend rate of deficit of about $3-1/2 billion in

1959-60--a little higher on the liquidity basis, a little lower on official settlements. The fact that our progress has not been exactly breathtaking should not be allowed to obscure the fact that it has been substantial--substantial even after one discounts that part of it that can be attributed to the voluntary programs.

A key element has been the improvement in the relative price-cost position of this country. Appropriate indicators are hard to come by, but consumer price indexes give some rough ideas of magnitudes. From the year 1960 to the year 1965, the U.S. consumer price index rose by only 7 per cent. In the same period, similar indexes for Britain, France, Germany, and the Netherlands rose by about 20 per cent, and the increases were even larger in Italy and Japan.

Thus, inflation abroad has permitted us to achieve an important degree of international adjustment merely by avoiding inflation at home. But there is nothing automatic about such an adjustment--nothing inherent in the system that guarantees its continuation. If therefore we wish it to continue, at a time when other leading countries are experiencing price advances of 3 or 4 per cent a year but are attempting to slow them down, it is crucial that we not acquiesce in domestic price advances of similar proportions.

Against this setting, how should prospective payments developments in 1966 be viewed? In particular, if there should be little change in the liquidity deficit in 1966 as compared with 1965, and only a modest reduction in the official settlements deficit, would that mean that the slow-working, favorable underlying trends of the past five years has ceased to operate? I do not think so. If military expenditures abroad in connection with hostilities in Vietnam were to increase by more than \$1/2 billion this year, as seems probable, while the deficit on all other transactions were to diminish by more than \$1/2 billion, it seems to me that this outcome could reasonably be interpreted as further progress towards equilibrium.

Whether the market, or European central bankers, would so interpret it would depend partly on the clarity and candor of the official explanations, and even more, I should think, on U.S. economic developments other than those directly reflected in the balance of payments accounts.

What would profoundly justify a new round of pessimism about the U.S. payments position would be a clear acceleration

> of price-cost advances in this country. If that should be allowed to happen, it seems to me that pessimism would be justified even if the adverse payments effects of inflationary developments were to be offset for a time by ad hoc programs or controls aimed at restraining particular types of international transactions. Inflation here would close one of the main avenues of adjustment that has been open to us in a world of fixed exchange rates.
>
> In short, the balance of payments outlook--both short-run and long-run continues to indicate to me that the paramount economic policy objective now must be to moderate domestic inflationary pressures, rather than to operate ad hoc on particular international flows.

Chairman Martin then called for the go-around of comments and view on economic conditions and monetary policy, beginning with Mr. Hayes.

Mr. Hayes said he would first like to commend the three members of the staff on the high quality of their presentations today. His own analysis of the business situation followed Mr. Brill's quite closely. And, with Mr. Reynolds he would emphasize the great importance of avoiding an acceleration of price-cost advances.

Mr. Hayes then made the following statement:

> The economy's current performance and the economic outlook are both extremely strong. Unemployment has been dropping very rapidly at a time when a relatively moderate rate of absorption of the remaining unemployed would be preferable; and the capacity utilization rate in manufacturing is higher than at any time since late 1955. These conditions are resulting in undue upward pressure on costs and prices. There is an undertone of inflationary expectations, even though there has been no outbreak of inflationary fever. Recently there has

been some leveling tendency in the farm and food price area. But industrial wholesale prices rose again in March, bringing the rate of increase thus far this year to about double that experienced in 1965. Price rises have been increasingly pervasive in the last few months. While it is encouraging to note that the recent appeals of the Administration for restraint constitute recognition of this inflationary threat, the effectiveness of this method of combatting cost and price pressures may be open to doubt. Among businessmen in our District, there seems to be a good deal of skepticism as to the effect of the President's appeal in restraining plant equipment expenditures, though some businessmen concede that it might have some modest influence.

After several months of relatively favorable performance, the balance of payments is becoming again a cause for serious concern. The annual rate of deficit in the first quarter, after seasonal adjustment, seems about in line with that of 1965 as a whole. But we face a very real danger of further deterioration, primarily because imports are likely to rise steeply under present boom conditions. The demand for exports is decidedly favorable but our export performance over the next few months may well depend largely on the extent to which domestic demand pre-empts available output. Thus an improvement in the trade balance in 1966, which had seemed likely a few months ago, now appears doubtful. Our tighter monetary policy is proving helpful on the side of capital flows. However, the projected reduction in direct investment abroad may turn out to be overoptimistic in view of growing difficulties in placing offshore issues in Europe. With imports and military and tourist outlays burgeoning, it seems very probable that the Administration's solemn assurances of near-equilibrium in our 1966 balance of payments will not be fulfilled in the absence of intensified policy measures. And, in my judgment, our failure to come close to this goal could bring a renewal throughout the world of the serious doubts concerning the dollar that haunted us until a year or so ago.

The latest credit data are hard to evaluate, as usual, but there does seem to be some basis for concluding that a more restrictive monetary policy has brought some significant slowdown in bank credit expansion relative to last year. Business loan demand continues very strong, but selective lending policies appear to be growing in importance as a limiting factor in loan expansion. There may be some transfer of demand to the bond market in view of the sharp increase in the cost to prime borrowers of bank borrowing as compared with the sale of new bond issues. However, for the time being, there seems to be a considerably calmer tone in the capital markets than prevailed through much of March. Apparently part of the recent improvement in the tone of the financial markets has resulted from rising expectations of a tax increase to stem inflationary developments.

On both domestic and international counts, this would seem to be a time when general Government policies must work together in the direction of restraint. As far as international considerations are concerned, we are no longer in the situation of the last five years when we were trying to stem a payments deficit while stimulating the domestic economy. On the contrary, our prospective payments deficit may be regarded in some degree as of the "classical" type attributable to excessive demand in the economy. There seems to be persuasive evidence that the monetary and fiscal measures taken to date are insufficient to prevent excessive growth of aggregate demand. The most recent revisions to our measures of fiscal stimulus indicate that in the absence of a tax increase the Federal budget will continue to provide substantial economic push in the second half of this calendar year, despite an assumed slowdown in the growth of Federal spending. The needed degree of additional restraint is such that a tax increase is clearly warranted. In business circles there seems to be considerable reluctance to accept this necessity, largely because of a belief that the Government has not yet shown sufficient restraint on the expenditure side and might well dissipate much of a tax rise through further growth of expenditures. My own view is that since there is no likelihood that the necessary degree of restraint will be forthcoming from a reduction in expenditures, we must inevitably look to a tax increase, and the announcement thereof, to dampen current inflationary psychology. Furthermore, a decision must be reached very soon if the fiscal restraint is to be effected when it is needed, *i.e.*, during the coming six months or so.

If monetary policy is left to carry the burden alone, without fiscal support, I think we shall have to face some very unpleasant decisions later this year. Even with fiscal support, it seems quite possible that our policies will have to become somewhat more restrictive. Nevertheless, I would not suggest any appreciable change in policy at this time, mainly because such a move might be taken by the public as a signal that a tax increase is not likely to be forthcoming, and also it might even contribute to the fulfillment of that expectation. For the time being, I think the Committee should maintain about the present stance of policy, i.e., we should maintain a considerable degree of pressure on bank reserve positions in order to carry through with the slowdown in bank credit expansion which--subject to temporary deviations--may already be under way. We might well aim at maintaining net borrowed reserves in a \$200 to \$250 million range, with swings outside of this range on both sides, with borrowings ranging perhaps close to \$600 million and with the Federal funds rate consistently at a premium over the discount rate. Until we have had a little more time to evaluate the results of our policy to date and to reach a more accurate judgment on the probabilities of a fiscal policy move, I believe we should avoid any further dramatic action such as a discount rate increase. We might well bear in mind that in any case even keel considerations will probably prevent any policy move during the first three weeks of May.

With respect to the directive, I think that alternative A is quite satisfactory.

Mr. Ellis reported that business appeared to be running at just about full throttle in New England. Consumers were setting the pace with March department store sales substantially above year-ago levels and auto registrations in the most recent data also above 1965 levels. Manufacturers noted still expanding flows of new orders in March, and in February they boosted output to a

12-month rise of 11 per cent in the Reserve Bank's region-wide index. Manufacturing employment, in turn, showed a 6 per cent year-to-year gain, leading total nonfarm employment to successive new peaks and unemployment to a low of 3.6 per cent. At that level the outstanding characteristic of the labor market was a quite general shortage of trained or mature workers and greater willingness of workers to shop for better jobs, adding to so-called "frictional" unemployment.

In that atmosphere, Mr. Ellis said, District bankers had aggressively pursued one another into increasingly tighter, less liquid positions. Competition for deposits was intense and the commercial banks were more than holding their own. The weekly reporting member banks had increased their savings deposits by 12.6 per cent in 12 months, while their "all other time deposits" had expanded 33.7 per cent. Deposit balances at the regularly-reporting mutual savings banks showed a 6.4 per cent year-to-year growth in the February reports. Compared with a year ago, new deposits were up 17 per cent but withdrawals were up 29 per cent.

Even with substantial rates of deposit growth--both demand and time--commercial banks had shown no evidence of satisfying the demands for bank credit, Mr. Ellis continued. With business loans standing 20 per cent higher, with loans to other financial institutions (chiefly finance companies) standing 28 per cent higher, and with real estate loans standing 15 per cent higher than year-ago levels, the Boston banks had loan-deposit ratios that averaged 81 per cent in March. Those same banks had a growing uneasiness about their long-standing commitments to loan--when asked--to their customer savings banks.

Looking ahead, Mr. Ellis said, the virtually universal expectation in New England was for continued and even expanding loan requests. Contract awards during the past three months had averaged 17 per cent above year-ago levels, paced by unusually high nonresidential building awards. The Boston Bank's spring survey of manufacturers' capital expenditure plans for 1966 kept indicating higher and higher goals as more reports were tabulated. In response to Mr. Holland's query,1/ the Boston Reserve Bank surveyed eight of the largest respondents who accounted for a fifth of manufacturing employment in the region. None had made any recent revisions. Three indicated they might review their plans later in the year. Since some 10 per cent of this year's planned expenditures were carryovers of 1965 plans that could

1/ On April 4, pursuant to a suggestion by the Board of Governors, Mr. Holland had sent the following telegram to the Presidents of all Reserve Banks: "In connection with your presentation at Open Market meeting on April 12, it will be appreciated if you will report such information as may come to your attention regarding changes (particularly downward revisions) since the end of March in business plans for plant and equipment expenditures, and reasons for such changes."

not be accomplished because of delayed deliveries and so forth, there was some expectation that, if some companies did cut back on expenditures, that would simply enable others to fulfill their programs.

At the national level also Mr. Ellis would describe the economy as "cruising at full throttle." He said "cruising" because he believed--and hoped--it was not running out of control; "full throttle" because virtually all labor and capital resources were in production. The critical question for monetary policy was whether that condition had been achieved or was being maintained through a credit creation process that was itself appropriate and sustainable. In retrospect, on the negative side, Mr. Ellis would suggest that as of early December, when the Federal Reserve raised the discount rate, it was not expecting or seeking acceleration to an 8 per cent rate of growth in total reserves (on average) in the succeeding four months. It remained true, however, that the present economy included that financial event in its recent history.

On the positive side, Mr. Ellis continued, it was equally true that the rate of increase in total reserves had fallen each month since December to an estimated March annual rate of 2.6 per cent. It was also true that by gradual tightening of reserve availability the Committee had even more dramatically reduced the rate of providing nonborrowed reserves. Unhappily, however, experience suggested that that time span was too short and the numbers too tentative to support a full-blown conclusion that the bite of policy had been fully realized and that the Committee could rest on its oars. The staff projection for April suggested a reversal; that the proxy variable for bank credit (total member bank deposits) would expand sharply and that total reserves would again increase at a 7 or 8 per cent annual rate. The first paragraph of both the present and proposed directives set out the objective of "moderating the growth in the reserve base," an objective which he favored.

Mr. Ellis' own inclination, looking ahead to the next four weeks, was to continue the policy of gradual tightening commenced on February 8. He found it impossible to accept the philosophy that the Committee should not use monetary policy for fear that such a course would reduce the chances of a tax increase, because he feared that any tax increase would come too late. To be specific, he urged the Manager to accept a target of net borrowed reserves centered at $250 million. Borrowings probably would range near $600 million, bill rates would be expected to rise slightly from their present levels near 4.58 per cent, and Federal funds would usually trade at premiums of 1/4 per cent or more. He found alternative B of the directive drafts more closely expressed that policy choice, but he would have liked to have had an opportunity to study the other language Mr. Holland had mentioned.

Mr. Irons commented that business conditions in the Eleventh District paralleled those in the nation. Industrial production was quite strong; manufacturers' output was 11 per cent above a year ago, with strength in both durable and nondurable goods sectors, and petroleum production was very high. The employment situation continued to tighten--unemployment was negligible and there was a real scarcity of skilled workers. District retail sales, as measured by data for department stores, were rising about in line with national sales. Automobile registrations were continuing to run at high levels. The agricultural outlook was quite promising; the indications were that this year would be better than last, which in itself was not a bad year.

Turning to financial developments, Mr. Irons noted that there had been little change in the positions of banks, which remained tight. There was no appreciable borrowing from the Reserve Bank but purchases of Federal funds remained heavy. Bank loans continued to expand moderately. Bankers still reported very strong loan demands, and they saw no relaxation of pressures in the months ahead. In recent weeks several bankers had noted in the course of informal conversations that they were making loan decisions in a manner that approached rationing. They said they were reducing anticipatory borrowing to a minimum, cutting back excessive loan requests of firms that overstated their needs in an effort to "play it safe," and denying loans to firms with banking connections in other parts of the country that were now seeking funds in the west. Also, they were requiring substantial compensating balances. In general, they felt that credit availability had to be lessened in view of existing economic conditions, and that it was necessary to take actions of a type they did not like and ordinarily would not take.

With respect to Mr. Holland's question concerning cutbacks in business plans for capital spending, Mr. Irons had little of a definite nature to report that could not be found in the press, such as the announcements that had been made by some large national companies with operations in the District. There were indications of a re-examination of plans by several companies. As one firm had put it, they were looking at their planned capital expenditures from the standpoints of essentiality, desirability, and deferrability. They hoped to cut back some expenditures that fell in the desirable but deferrable category, even though that meant taking a less economic approach in the strict sense. But those indications were highly indefinite and they applied only to a few of the large concerns. It was the opinion of many bankers and businessmen in the District that companies considering cutbacks in their plans were primarily concerned about rising wage rates and costs of operations, and were beginning to think about the consequences if the volume of activity should slip. At the same time, he had not heard any significant criticism of the System or of the Government; the causes of the current situation were simply being accepted as facts. Insofar as there was any criticism, it was directed to fiscal policy, and reflected the position that if it was proper for private industry to re-examine its expenditures it was proper for the Federal Government to do so also.

As to national economic conditions, Mr. Irons said it was unnecessary to repeat what was said so well in the green book. It was clear that the economy was operating at full strength.

On policy, Mr. Irons aligned himself with those who would not seek any appreciable further firming at the moment. He favored net borrowed reserves in the \$200-\$250 million range, about where they had been recently, and he noted that the difference between such a target and one of around \$250 million was fairly small. He hoped member bank borrowings would run around \$600 million, and he would expect Federal funds to trade at 4-3/4 or 4-7/8 per cent. The bill rate might run somewhat above the discount rate and perhaps up to the 4.70 per cent area.

Mr. Irons favored alternative A for the directive. However, he thought the Committee's objective with respect to growth in the reserve base, bank credit, and the money supply was accurately described by the word "restricting." Accordingly, in the final sentence of the first paragraph he would suggest using that word rather than "moderating," which struck him as having a weaker connotation. He did not feel strongly about the matter, and could accept the directive as drafted.

Mr. Swan reported that the Twelfth District continued to share in the national expansion despite the lack of strength still apparent in residential construction and retail sales, particularly automobiles. Year-to-year comparisons in consumer expenditures were considerably less favorable for the District than for the U.S. as a whole. As he had noted at the previous meeting, District banks as a group were not under particularly severe reserve pressure and had not been for some weeks, despite their concern over the strength of loan demands. They had been substantial sellers of Federal funds for some time now and had been supplying funds to Government securities dealers, although the totals were influenced substantially by the operations of one bank that had worked itself into a more liquid position. Borrowings at the Reserve Bank had remained low through the week ended April 6, and the increase in loans at weekly reporting banks in the three-week period through March 30 was well under the increase in the comparable period of 1965.

At the same time, Mr. Swan said, District banks had intensified their efforts to attract savings funds. Savings certificates were now being offered to individuals at a 5 per cent rate by most of the banks in California, compared with a 4-3/4 per cent rate three weeks ago. Moreover, for the first time one or two large banks outside of Los Angeles and San Francisco had joined the few small banks that were offering a 5-1/2 per cent savings certificate. It was difficult to assess the impact of the higher rates partly because interest earnings were credited to savings accounts in the period since the rate increases began. However, there appeared to have been a substantial shift at banks from passbook savings to savings certificates, although total time deposits also rose rather substantially in the three weeks ending March 30.

Most of the savings and loan associations reacted by offering 6-month savings certificates at 5 per cent, Mr. Swan remarked, although a number of them had now raised their regular savings rate to 5 per cent. No figures were yet available to indicate what the consequences of the rate changes were for the distribution of the flow of funds between savings and loan associations and banks. Officials of the Federal Home Loan Bank recently had said their impression was that there had been a considerable outflow of funds from the savings and loan associations starting in late March. It was a little difficult to understand, however, why 5 per cent on savings certificates at banks should result in a substantial outflow from regular accounts in savings and loan associations paying 4.85 per cent.

On the question of business plans for plant and equipment investment, Mr. Swan continued, the information that had come to the attention of the Reserve Bank could be fairly summarized by the statement that it included no reports of revisions in plans. While no direct inquiries had been made of companies in defense-related industries, it was quite unlikely that they would make any cutbacks. The attitude of some of the utilities perhaps was represented by the comment of an officer of one such firm that their investment plans were based on their estimates of the needs of their customers and they saw no basis in those estimates for cutbacks. The reaction of another major company was somewhat similar to one cited by Mr. Irons. Their treasurer indicated they were taking a long look at their planned capital expenditures, but intimated that the examination was pretty much in terms of profitability and had been prompted more by questions concerning the cost and availability of funds than by any other recent developments. Again, that company had no downward revisions to report at this point.

Mr. Swan agreed with the comments already made about national economic conditions. It seemed to him that, with the tax date and the Treasury financing ahead and with due regard to recent developments, the Committee should maintain about the same degree of pressure that it had, perhaps with some very gradual further tightening--and he would emphasize the word "gradual." He would go along with a net borrowed reserve target in the $250 million range. However, he did think it was increasingly important to look behind the net borrowed reserve figures to the extent possible, to consider what was happening to required reserves and also to time deposits. He noticed there had been a substantial increase in the rate of time deposit growth in the past few weeks, and if that should continue it obviously meant a greater expansion potential with respect to the reserve base. However, time deposit growth might slacken after the April tax date.

Mr. Swan said he could accept either alternative for the directive but, on balance, would prefer alternative A. He would encourage the staff to attempt to develop somewhat more specific language in its draft directives; the present situation was an ideal illustration of the need for more specific language. He had one other comment on the directive, relating to the statement in the first paragraph that "our international payments continue in deficit." As the green book indicated, there was a surplus in March and approximate balance in January-February before seasonal adjustment. In the interest of accuracy, it might be better to revise the statement to refer to the over-all payments position in the first quarter.

Mr. Galusha commented he did not as yet have any "hard" information on how the Ninth District economy performed during March, but suspected that it did very well. All the statistical series indicated that January and February were exceptionally prosperous months, that the historically high growth rate established in the fourth quarter of last year was maintained in the first two months of 1966. And in the Bank's most recent round of conversations with District businessmen there was no hint of a slowdown in the pace of economic advance.

On short notice, Mr. Galusha said, he had not been able to determine for sure whether there had been any trend of downward revision of investment plans by District firms. His suspicion, for what it might be worth, was that a few already had and that quite a few more would be soon. The Reserve Bank had been getting reports, not only of the difficulties of borrowing money, but of shortages of engineering personnel and construction labor and of rapidly rising construction costs. One of the largest manufacturers had reported recently that they had asked a dozen construction firms to bid on a proposed plant and got only three submissions, all of which were, to quote the manufacturer, "ridiculously high." On the basis of informed gossip he had heard, he thought the odds favored no upward revision in plant and equipment spending estimates later this year.

Mr. Galusha went on to say that Reserve Bank's most recent agricultural credit survey, completed only last week, indicated that even though country bankers did not see themselves as short of funds they nevertheless had increased their loan rates. Few respondents reported having to turn down loan applications because of a shortage of funds, or being no longer interested in new loan accounts. But the vast majority reported higher short-term and long-term loan rates.

With farm prices so much in the news, Mr. Galusha said, the Reserve Bank had lately given some thought to the outlook for the agricultural sector. Its current guess was that the general level of agricultural commodity prices would remain pretty much unchanged over the next few months and then would decline somewhat over the second half of the year. He was therefore apparently in agreement with the authors of the green book and the Secretary of Agriculture. But he was not sure what the implications of that prospective decline were. Possibly the decline, if it materialized, would moderate future money wage demands, but that seemed rank optimism.

But why the Secretary of Agriculture should have seemed so joyous when he announced his bearish outlook for agricultural prices was rather hard to understand, Mr. Galusha observed. That one could now be more confident than a while back about a decline in agricultural commodity prices would not seem to have altered the demands the economy was making on economic policy-makers or, more particularly, on the Committee. In determining open market policy, the Committee should focus not on the outlook for agricultural prices nor even on the outlook for the prices of basic raw materials, which incidentally affected the developed trading countries pretty much alike. The Committee should focus, at least in the first instance, on the outlook for other prices and especially on the prices of those manufactured products which bulked importantly in the export total. And that outlook was not at all reassuring.

That, briefly, was why Mr. Galusha would favor a modest increase in monetary restraint at this time, with a slight increase--to somewhere around $300 million--in net borrowed reserves. The only misgiving he had about greater monetary restraint at present was its likely effect on nonbank financial institutions and--although their problem seemed less severe--on smaller commercial banks. Lately he had been hearing reports, not only from Ninth District institutions but from others around the country as well, of savings and loan associations and savings banks being in what was described as a "bad way." One must of course discount those reports somewhat, but it would be foolish, it seemed to him, to treat them as nothing more than expressions of grasping self-interest. The Committee could, however, keep a careful watch on the situation and, at the same time, move toward slightly greater monetary restraint.

However, Mr. Galusha added, instead of consideration of a higher target for net borrowed reserves, he would prefer a change in reserve requirements--an increase in the average requirement and, more importantly, a reform of the structure which would give advantage to the smallest member banks. He continued to be concerned about the situation of those banks and, equally to the point, how they felt about System membership. There were sharp indications of a deterioration in the relationship. The implications were hardly precise but in a world ruled by emotion--not reason--that was hardly a comforting change in the environment in which the Federal Reserve System had to operate.

Mr. Scanlon reported that no abatement of the pressures of demand on available resources was evident in the Seventh District. Labor shortages had intensified, and price increases in the industrial sector had been increasingly frequent. He thought the passage Mr. Brill had quoted from the Purchasing Agents' report would also serve pretty well as a summary of basic economic conditions in the District so he would not comment further on that subject.

As to changes in business plans for plant and equipment spending, Mr. Scanlon had no evidence of "voluntary" cutbacks in the District, although admittedly the Reserve Bank's inquiries had not been extensive. If anything, sights had been raised further. A factory-locating service headquartered in Chicago reported an acceleration during the past month in an already high volume of proposed work. Some construction projects, both business and municipal, had been postponed or scaled down because of unexpectedly high bids, inability to obtain firm bids, difficulties in arranging financing, delays in architectural and engineering work, and delays in deliveries. He knew of no private projects postponed primarily because of the President's statement on capital expenditures.

Bank loans in the Seventh District gave no indication of any slowing in credit demands, Mr. Scanlon said. Business loans expanded in March somewhat less rapidly than last year but still much faster than usual. Outstandings to finance companies remained at a relatively high level. District weekly reporting banks continued to add to their holdings of real estate loans and municipal securities. In his judgment, the reserve positions of the weekly reporting banks in the District had not shown evidence of severe pressure. The large Chicago banks appeared to have weathered the April 1 personal property assessment date with less difficulty than usual. To some extent, however, the relatively light reserve pressure reflected their continued sales of CD's at high rates. Loan increases at smaller District banks also appeared quite strong through the mid-March period and their borrowings at the discount window remained relatively high.

As to policy, Mr. Scanlon agreed with those who favored continued gradual firming, with due consideration, of course, for the Treasury financing. He favored alternative B for the directive.

Mr. Clay reported that telephone calls were made to the heads of three large national industrial corporations with headquarters in the Tenth District in order to develop some indication of revisions in business capital outlay plans since the end of March. All three indicated that their firms were reviewing their capital outlay plans, although none had completed the review. One was confident that his company would be able to make some downward revisions whose implementation would begin to show in four months or so after the review was completed. The second said that his firm's review could not produce any capital outlays cutback for at least a year. While his company had a large capital program, there was no practical way of cutting back on the projects under way. The only possibility for capital outlay reductions involved programs that were still in the planning stage.

The head of the third company also indicated that it would not be economically feasible to cut back projects already under way, Mr. Clay continued. In that connection, the company head mentioned a $36 million project scheduled for completion in February 1967 and for which all needed materials had been provided. On the other hand, he referred to a $40 million project that he thought would be deferred. While the deferral would coincide with President Johnson's cutback drive, he indicated that it actually would be because of shortages of materials. In that case, a substantial amount of fabricated materials and electrical machinery were required in which copper was a component, and it was particularly that type of material that would cause the deferral.

Looking toward the formulation of monetary policy, Mr. Clay said the Federal Reserve was faced with an economy in which the pressures on resources did not appear to be lessening. While news stories over the week end underscored the favorable showing in the latest monthly wholesale price index release, it actually did not involve any significant change or improvement in the forces at work in the nonagricultural sector of the economy. The impact of the Administration's appeal to businessmen for cutbacks in capital outlays was difficult to judge. There was reason to wonder whether the principal cutbacks would not be in projects only in the planning stage and whether any significant impact on the economy might not be many months away. It still was to be hoped that fiscal policy action would be taken.

Mr. Clay thought that monetary policy should continue to apply pressure on the financial sector of the economy, and that the Committee should avoid any retrogression in the progress toward monetary restraint achieved since the discount rate increase late last year. Recognizing that Treasury bill yield movements had differed from other short-term rates in recent weeks, money market conditions in the period ahead should be maintained generally in line with those in the interval since the last meeting of the Committee. Presumably the Federal funds rate would be mostly at 4-3/4 per cent. Upward movements in Treasury bill yields from recent levels need not be a matter of concern unless they threatened to make the present discount rate untenable. Gradual reduction in reserve availability should continue to be the Committee's aim, with the net borrowed reserve target set at $250 million. Open market operations would need to be adapted to the varying conditions that might prevail in the money markets during and following the April tax payment period. The draft economic policy directive with alternative B as the second paragraph was satisfactory to him.

Mr. Heflin commented that whether one found himself agreeing with Mr. Mitchell that the Committee had lost ground or with Mr. Hayes that capital markets recently had acted like a pendulum, it was apparent from the situation in the Fifth District that the task of moderating--or, as Mr. Irons would say, restricting--the expansion would not be easy. The Richmond Bank's latest business survey suggested that business activity in the District was expanding at the fastest pace in the past four years. There were no reports of declines in wages, prices, or hours worked except in textiles, where one of eight respondents reported small declines. New orders and shipments were strong in all manufacturing industries, but especially so among producers of durable goods. Additional evidence could be found in several recent developments in the textile business, the furniture industry, and bituminous coal mining, and in the growing pressures on banks.

Almost no evidence of any significant reduction or postponement in plans for capital spending had been found in the District, Mr. Heflin said, until Friday afternoon when one such report was received from North Carolina, and yesterday when another case was reported from southwest Virginia. In Virginia 97 new plants and expansions were announced in the first quarter, compared with 60 in the first quarter of 1965. Informal interviews with a few leaders in the textile, metals, electrical equipment, and furniture industries yielded remarkably uniform replies. The respondents, as Mr. Clay had reported was the case in his District, contended that their programs were too far advanced to permit any significant reductions this year. They said they urgently needed additional capacity, and that they had no assurance that their competitors would practice restraint. With respect to plans for the more distant future, several of the respondents said that they were reviewing their long-range plans in the light of one or more of three possible restraints. The first was the higher cost of capital funds. The second, and possibly more important, was the lack of certainty that funds would be available at any cost. A final limiting factor in some cases was the availability of equipment within any reasonable time. Incidentally, one manufacturer called attention to another problem created by inflation and tight money. He would have to raise several million dollars of additional working capital because many of his customers were short of funds and were not taking the cash discount.

In the national economy, Mr. Heflin said, there seemed to be growing signs of stress. The report on employment for March was especially significant in that respect, showing a larger than seasonal increase in employment and a further rise in the already high figure for weekly overtime in manufacturing. As employers dug deeper into the ranks of the less qualified and less experienced workers there was likely to be a fall in productivity and an increase in unit labor costs. Despite the appeal of the President, it was unlikely that there would be any reduction in capital spending large enough to be significant in the next few months. In the same way, it was doubtful that any change in fiscal policy could be expected which would be effective in the immediate future. Each new report, and especially each revision of preliminary data, showed that inventories and unfilled orders continued to mount, probably reflecting rising speculative expectations.

Such conditions would normally be accompanied by a distinct upward trend in prices, Mr. Heflin continued. The large number of price increases publicly announced and the very small number of price reductions, as well as reports from manufacturers, purchasing agents, and others all indicated that such a trend now existed. At the moment the country might be experiencing a pause in the upward movement, with a shift from price increases caused by demand-pull and scarcities of farm products and metals to increases caused by cost-push as producers passed on higher labor and materials costs.

In that situation, it seemed advisable to Mr. Heflin that the Committee step up its effort to reduce reserve availability in the hope of slowing down the rate of expansion in bank credit and the money supply. He found himself aligned with those who favored alternative B for the directive; if the Committee was going to make progress, it would have to apply more pressure.

Mr. Shepardson commented that there was no need to elaborate on the reports that had already been given indicating generally strong economic activity. Whether the apparent relaxation in security markets in recent weeks was an actual relaxation or simply a swing of the pendulum, the indications as noted by the staff were for further rapid expansion in the weeks ahead in both bank credit and the money supply. That pointed to the need for further restraint at this time.

Mr. Shepardson then said that he would like to make one point with respect to the interpretation of recent changes in agricultural prices. Earlier, when prices of farm products and foods were rising rather rapidly, it had been observed repeatedly that the effect on the total wholesale price index should be discounted because agricultural prices were not subject to the same forces as other prices and because adjustments would occur as increased supplies, particularly of meat, came onto the market. Now publicity was being given to the decreases that had occurred and could be anticipated, which would have effects on both the wholesale and consumer price indexes. But if it was proper to discount the effects when farm and food prices were rising, by the same token too much should not be made of declines. In any case, nonagricultural prices, which monetary policy could influence more than farm and food prices, were continuing to advance.

As he had indicated, Mr. Shepardson said, he thought that the Committee should exert greater pressure. In his judgment that should be reflected in a net borrowed reserve target ranging from $250 million upward rather than from that level downward. He would expect some increase in bill rates, and a Federal funds rate in the present neighborhood or possibly somewhat higher. The policy he favored was indicated by alternative B of the draft directives, which called for some further gradual reduction in reserve availability.

Mr. Mitchell remarked that he favored as much firming as possible within the confines of the existing discount rate and Regulation Q ceilings. He was not sure just how restrictive that would be. However, it was at least as restrictive as called for by alternative B of the draft directives, for which he would opt.

It seemed to Mr. Mitchell that everyone who had spoken thus far agreed that the staff reports today accurately described the existing situation, and that the Committee had to be as aggressively inclined against inflation as possible now. Short of a discount rate increase, for which he was not prepared at present, he thought the Committee ought to be putting more pressure on the banking system. Several of the Reserve Bank Presidents had reported that banks in their District were in a reasonably comfortable position. There had not been much comment on the money supply thus far in the discussion but its recent growth rate was high for a period of restraint.

Mr. Mitchell observed that if there was to be additional fiscal restraint it would not occur before mid-year, and its main effects would not be felt until another half-year had passed. The Committee did not have much time left in which to operate against an expansion rate that all agreed was unsustainable; given the lags in monetary policy, major effects on spending of monetary actions taken in the second quarter probably would not be felt until at least the third quarter. He believed, therefore, that the Committee should adopt a policy at least as restrictive as that indicated by alternative B.

Mr. Daane said that the strength of the boom clearly called for dampening aggregate demands by the methods within the power of the Committee. With Mr. Mitchell he felt that, whether the Committee liked it or not, monetary policy had to carry the burden for the foreseeable future. The Committee could hardly look for much help from fiscal policy for the balance of the year even if a tax increase were enacted. Certainly the Committee should not let up on the degree of monetary restraint.

The real question, Mr. Daane continued, was when and how to apply more pressure. He would be a little reluctant to press too hard at this particular juncture. He thought Mr. Mitchell had put the matter well when he called for maximum firming within the confines of the existing discount rate and Regulation Q ceilings. For the moment, taking into consideration the Treasury financing and the fact that a bite of undetermined proportions was being achieved with the existing degree of restraint, he would align himself with those who favored a net borrowed reserve target of $250 million, ranging upward. He would remind the Committee that for the past three weeks net borrowed reserves had averaged about $230 million; an increase of a few million from that level could hardly be considered a very significant change.

Mr. Daane said he had no firm convictions as to which of the draft directives should be adopted. If, in the language of alternative A, operations were conducted with a view to "maintaining firm conditions in the money market and continuing to exert pressure on bank reserve positions," the results probably would be about the same as under alternative B.

Mr. Maisel observed that, as had been made clear in previous discussion, there were two questions which the Committee had to answer in determining a proper policy for the next period. First, had there been a sufficient change in the underlying economic situation to call for a current change in monetary policy? Secondly, what was the relationship between the recent movements in the monetary aggregates and the Committee's existing policy stance? In that respect, he recognized the difficulty of interpreting short-run movements, and also that there seemed to be some differences around the table in the interpretation of the data.

It seemed to Mr. Maisel that there was insufficient evidence of any change in the underlying situation to require currently an alteration in monetary policy. Demand was still heavy. Current projections showed a fine balance between demand and supply. There remained considerable probabilities that demand could be met only with further increases in the prices of industrial commodities. He concluded that a proper monetary policy for the System still was to attempt to restrict the growth of bank credit and total credit to a level at least one-third less than the rate of expansion of last year. On the other hand, he believed it important that the Committee no longer delay in adjusting reserves to a reduced expansion level which was consistent with a policy aiming at lowering real investment. Because of the lags in the system any further delays in reducing the reserve expansion rate increased the danger that the real policy shift might have been delayed too long and that it would become effective in a contra-productive period.

When the actual results of current monetary policy were examined, Mr. Maisel continued, a major divergence between the record for the past six weeks and the prior six weeks was noted. While the marginal reserve measures showed a sharp increase in net borrowed reserves as well as in borrowings, the changes at the margin had not succeeded in restraining the aggregates to a desirable rate of advance.

In fact, Mr. Maisel pointed out, even as net borrowed reserves had increased, total reserves, the money supply, and the bank credit proxy all had exhibited an accelerated rate of expansion. At the same time, as had been noted, a sharp fall occurred in interest rates. While the Committee might believe it had brought about a changed monetary policy--and clearly the atmosphere and some rates had changed--if one considered either the entire period since December 1 or the past six weeks, one found that the basic policy indicators (with the exception of the money market) showed an expansionary rate of increase over the period prior to December 1.

It seemed to Mr. Maisel, therefore--consistent with his views at the past several meetings--that the Committee ought to put less stress on the marginal measures. He agreed with the Secretary's interpretation of the directive, but felt that it was not a proper policy directive. In place of what was primarily a money market instruction, the Committee should make certain that its directive was interpreted in terms of a desirable rate of expansion in total reserves and in bank credit. Between now and the Committee's next meeting, an attempt should be made to restrict the rate of expansion in total reserves even if that required a somewhat larger increase in the level of net borrowed reserves. He would support alternative B for the directive.

In contrast to the purely net borrowed reserve criterion, Mr. Maisel would interpret "reduction in reserve availability" to mean that the rate of increase in reserves and bank credit should be cut back from the recent five-week expansion at an annual rate of nearly 16 per cent to an annual rate of 5 per cent or less. The amount of net borrowed reserves and money market rates should be allowed to move considerably higher if necessary to bring about that slower rate of expansion in total reserves. However, during that time, it would be useful to continue to make it clear that changes in the discount rate and Regulation Q would be avoided if at all possible.

Mr. Brimmer commented that staff reports in the course of recent Board briefings indicated that corporations were likely to be back in the market for funds, substantially increasing either their bank loan requests or their capital market flotations. That prospect suggested the need to move toward some further tightening at this time. It appeared that at the end of the first quarter corporate liquidity was much lower than had been anticipated, which in itself might result in more security floations. It also might insure that the recent sharp bulge in bank credit, which the blue book described as apparently largely temporary, might turn out to be somewhat less temporary than expected. That again pointed to the need for some further tightening.

Mr. Brimmer thought that the Committee should not rely on an expected tax increase to achieve the necessary degree of restraint. According to estimates by the Board's staff a tax increase on the order of $5 billion--the magnitude suggested by recent press stories--put into effect at mid-year would cut only about $3 billion from GNP in the third quarter (in terms of annual rates) and about $7 billion in the fourth quarter. In the interim, monetary policy would still have quite a bit of work to do. He felt that alternative B of the second paragraph of the draft directives was a reasonably accurate summary of what the Committee's objective should be at this time, and accordingly he subscribed to that alternative.

Mr. Hickman said that the marked rise in nonfarm employment in March and further increases in orders, backlogs, inventories, and overtime pay were disquieting developments against the background of an extremely tight labor market and bottlenecks in materials, equipment, and plant capacity. The most recent monthly reports on unit labor costs in manufacturing now showed clearly the shift towards increased costs that had been feared for so long.

Prices were, of course, the most bothersome element in the situation so far, and would remain so until demand leveled off, Mr. Hickman continued. The wholesale price index was stable in March, as a rise in industrial prices was offset by declines in farm and food prices. He remained concerned about the unrelenting rise in industrial prices caused by the pressure of output on available resources.

As to the possible moderation of capital spending by business firms, Mr. Hickman said, it was still much too early to evaluate the effects of monetary policy, resource bottlenecks, and the President's latest exhortations. As he had reported at the last meeting, some firms in the Fourth District had taken a second look at capital spending plans, because of tighter money, higher costs of materials, and limited supply of labor. The President's request was unlikely to interrupt spending plans already under way, but might deter some corporations from starting planned projects.

A number of firms reported to the Cleveland Reserve Bank that they were re-evaluating their capital spending plans. For reasons unknown to Mr. Hickman, many of those companies were centered in the Pittsburgh area--for example, Westinghouse, Alcoa, Pittsburgh Plate Glass, Koppers, and Heinz. In the case of Koppers, it was known that a substantial cutback was already in process before the President's request. He had also just been informed, on a confidential basis, by executives of Goodyear Tire & Rubber and Armco Steel, that, although they would be unable to cut projects already under way, they would take a hard look at projects not yet started because of short supplies of money, materials, and labor, plus the President's exhortations.

Unlike typical experience during business expansions, Mr. Hickman observed, actual capital spending in 1966 might not exceed by much, and perhaps might even fall short of, spending anticipated in early surveys. Monetary policy had to be given credit for at least a marginal influence in moderating capital spending, but he was not able to quantify the effects and to disentangle them from others. Since only starts would be affected, there would be a lagged delay which, while desirable today, could cumulate into unwanted slack tomorrow.

Fiscal policy remained the main hope for alleviating the present difficulties, Mr. Hickman said, but he was rapidly losing confidence that it would be used at the right time and in the right amount. The Administration was vacillating on taxes, and Congress seemed determined to outspend the Administration, as evidenced by the new G.I. Bill, the House bill for higher Civil Service salaries, and the upgrading of other popular programs.

Monetary policy in the past three weeks had followed the last directive as he interpreted it, Mr. Hickman continued, but the money and capital markets had had a slightly easier tone than he now thought desirable, given today's inflationary political and economic environment. In the absence of a decision about taxes, and with Federal spending pointing higher than original budget estimates, he believed the Committee should continue to tighten cautiously and gradually. With credit demands still strong, he favored letting net borrowed reserves rise slowly against that demand, from the present target of about $200 million to $250 million, or perhaps even to $300 million if market conditions eased towards the latter part of April, as the staff suggested in the blue book. He assumed that that target could be achieved without the 91-day bill rate piercing the 4.75 per cent level, which he believed would trigger discount rate action. He would not favor the latter at this time. For the reasons indicated, he supported alternative B of the staff's draft directives.

Mr. Bopp remarked that almost every sector and every indicator at which he had looked in the past three weeks confirmed the pressure on the economy and provided little suggestion that a letup might be in sight. Of course, capital spending remained a pivotal sector of economic activity, and from the Reserve Bank's sounding of business attitudes in the Third District, the President's recent call for a re-examination of capital outlays bore little promise for a timely amelioration of pressures. Capital spending plans had been discussed with top executives from 37 large firms whose business ranged from textiles and apparel to paper, chemicals, primary and fabricated metals, machinery, transportation equipment, and instruments. Of those 37 firms, only 3 had so far re-examined plans, and they had done so in the ordinary course of business and had decided to increase not decrease spending. When asked if spending plans would be re-examined in the very near future, 11 of the firms replied affirmatively, and 8 of those mentioned as one of the reasons a desire to cooperate with the President. However, it was also pointed out that any decisions which might be made to reduce spending would not be felt in the economy for many months because of firm commitments over the near term.

Turning to policy, Mr. Bopp said that while he would not let up on existing pressure, he would be reluctant to move toward further restraint at this time for three reasons. First of all, the full impact of earlier actions still had not been fully transmitted either to financial markets or to markets for goods and services. He would be reluctant to impose additional restraint until the results of past actions were known with greater certainty.

Second, Mr. Bopp continued, the degree of restraint associated with any given level of borrowing and net borrowed reserves was probably greater now than in the 1950's. That point was made at the last meeting of the Committee and was supported by evidence from the most recent survey of Federal funds activity in the Third District. At the present time, almost half of the country banks in the District were active in the Federal funds market, compared with a little over one-third last year at this time. Moreover, of the banks currently active in the market, almost 90 per cent had entered after 1960.

Corresponding with the rapid increase in country bank participation in the Federal funds market, Mr. Bopp noted, had been a sharp reduction in borrowing at the discount window by District banks. The District's share of total borrowing at the discount window dropped from an average of about 5 per cent in 1959 to around 2.5 per cent last year. Although the development of the Federal funds market might have proceeded more rapidly in the Third District than in some other areas of the nation, it was reasonable to believe that a relatively heavier reliance on the Federal funds market was typical of other sections of the country as well. If that was so, a given level of borrowing and net borrowed reserves might be associated with greater restraint today than in the 1950's.

The third reason for which Mr. Bopp would hesitate to impose additional monetary restraint at this time was simply that, at present high levels of rates and given the heavy loan commitments of financial institutions and the potential problems inherent in rolling over CD's, significant further tightening could be particularly unsettling to financial markets. Given those problems, it would be most desirable for any additional restraint to come from the fiscal side of the monetary-fiscal policy mix. A significant shift in monetary policy now would make it all the more unlikely that timely and appropriate fiscal measures would be taken.

Mr. Bopp said that he favored alternative A of the draft directives on balance, but would be prepared to go along with alternative B if the latter was the choice of the rest of the members.

Mr. Patterson reported that the battle for time deposits in Atlanta that he predicted several weeks ago had broken out in earnest. On March 30, one large bank advertised it would offer 5 per cent on so-called investment certificates. The next day, the only Atlanta bank that previously had paid more than 4-1/2 per cent announced it was going to 5 per cent. And as one might have expected, the other two major banks quickly followed suit. The conditions under which the various institutions were paying that new rate varied, of course. But two of them were paying 5 per cent on denominations as low as $100 and $25, respectively, if held for 90 days.

The savings and loan associations had not yet changed their rates, Mr. Patterson noted. One was trying to hold on to its shares by advertising that it was paying the highest rate any Atlanta savings institution paid on equivalent passbook money. Several others stressed in their ads the premium offered on longer-term savings. Since mortgage rates in Atlanta were already well above 6 per cent, the savings and loan associations' decision to stand fast seemed to reflect a weakness in housing rather than competitive conditions.

The increase in time deposit rates of banks had been predictable from straws in the wind, some of which were not exclusive to the Atlanta area, Mr. Patterson continued. Bank loan demand in Atlanta had been very strong and unpredictably so, since large out-of-town corporate customers had begun to draw on credit lines for the first time in years. The corporate CD and passbook savings growth rate had slackened. A regional Federal funds market and a regional mortgage-gathering market were slower to develop than the decline in bank liquidity seemed to demand. Time deposits seemed to be the only major source left for the banks to exploit. The fact that the one bank which moved in that direction last year had been fairly successful in that endeavor, at least temporarily, was undoubtedly another factor influencing the decision.

Mr. Patterson reported that the latest available employment figures for the District were not quite as bullish as they had been. Only a large gain in Florida's employment had made it possible for the District to register a plus in February. In his estimation, those figures indicated only a slight slowing down from very high increases. Perhaps the same generalization could be made for some national economic series. However, in neither case was the Reserve Bank's staff prepared to attribute much of that change to higher interest rates or changed credit conditions. Certainly, one could expect the pace of the economy to slacken occasionally even in a period of rapid expansion.

In checking for changes in business plans for plant and equipment spending in the District, Mr. Patterson said, no single instance was discovered of a reduction in capital expansion plans; nor was there found a single postponement of a commercial or industrial construction project in the Atlanta area. Only in the residential housing field could evidence of disruptive markets be found. And, perhaps he should add, the District shared in some of the cancellations and postponements of security offerings of State and local governments.

The Committee was just beginning to realize what Mr. Patterson believed was its present goal, namely, a slackening in the growth rate of money and bank credit. For that reason alone, in his opinion, the Committee should hold to its present policy posture. Then, too, monetary policy although flexible was not so precise that the Committee could adjust its actions to the slight ebb and flow of the course of the economy. He also believed that the Committee, having changed policy not too long ago, needed to observe more closely what effects its actions were having before it turned to additional tightening. Finally, the status quo, which he interpreted to be a net borrowed reserve figure of around $200-$250 million, also made sense by reason of the Treasury mid-May refunding, even if that refunding was just routine. He favored alternative A of the draft directives.

Mr. Francis said that the St. Louis Reserve Bank had not learned of any recent cutbacks in capital spending plans in the Eighth District. From time to time they heard of a case in which a firm had been unable to obtain financing from its customary sources, but such firms generally succeeded in finding alternative sources of funds.

Mr. Francis then noted that since last June and continuing since November, monetary expansion had been at the very rapid rate of about 6 per cent a year. In the last half of December there had been a great jump in the money supply, and in January a partial elimination of the jump returned growth to the 6 per cent trend line of the past nine months. That rate of growth in money was the highest for any nine-month period since World War II. Total reserves and reserves available for demand deposits had followed a similarly rapid upward trend.

The rapid increase of the money supply had continued at the same time that the directive had called for only a moderate rate of increase of reserves and money, Mr. Francis noted. Apparently, the continued rapid increase of reserves and money supply had come about because net borrowed reserves, averaging about $150 million since last July, had not been restrictive.

In recent months, Mr. Francis said, fiscal actions of the Government had been the most stimulative in several years. While it would be desirable for the Government to adopt a more restrained fiscal position, such a move of a substantial or adequate magnitude did not appear to be forthcoming in the near future. In the absence of fiscal restraint, or until evidence of such restraint appeared, a risk might be run of further price rises of a significant nature unless the rate of monetary expansion was reduced considerably. Therefore, it seemed to him, the Committee should not be reluctant to apply the tools of monetary action at its disposal to limit growth in total demand for goods and services to the amount that could be accommodated without inflation.

With regard to policy, then, Mr. Francis suggested a reduction in the rate of increase in money. The proper rate could not be specified with certainty, but he suggested that the rate might properly be brought down gradually to as much as half the 6 per cent rise of recent periods. If the rate of increase in money were so reduced, loan funds would become more restricted than during the past nine months. He would view the likely resulting rise in interest rates as desirable from both domestic and balance of payments points of view. He would give major consideration to reserves and money supply in carrying out System actions in the immediate future.

Mr. Francis favored alternative B of the draft directives. He liked Mr. Irons' suggested revision in the first paragraph, replacing the word "moderating" with "restricting."

Chairman Martin commented that the differences in members' views on policy did not seem great today. His own thinking was similar to Mr. Mitchell's conclusion; he would like to see the pressure maintained as vigorously as possible without necessitating a change in the discount rate or an overt change in policy. As he had observed at the previous meeting of the Committee, monetary policy could not be formulated in terms of still pictures; the economy always was in motion and the Committee had to maintain pressure if it was to achieve its objectives. Whether alternative A or B of the suggested directives was adopted, it was clear that the Committee did not want to reduce the degree of pressure from that currently existing. Alternative B seemed to be favored by the majority, and if it was interpreted in the manner he had suggested perhaps the Committee could agree on it. He asked whether anyone would question that statement.

Mr. Maisel said he thought the discussion today reflected a basic difference in the interpretation of recent developments. A number of members believed there had been a relaxation while others, as well as the Manager, felt there had not. In his judgment it would be desirable to get some agreement on the nature of the existing situation before deciding how to proceed.

Chairman Martin agreed that there were differences in judgment regarding recent developments; he personally thought that, by and large, there had not been any relaxation, although some others disagreed. He did not know quite how to resolve that sort of difficulty. Certainly there had been no intention to relax; the developments in which members saw evidence of relaxation had come about because of other factors. Mr. Maisel's point was that if net borrowed reserves had been deepened the growth in aggregate reserves would have been less, but Mr. Holmes thought that such a course would at most have moderated the decline in interest rates.

Mr. Holmes said he felt that somewhat deeper net borrowed reserves certainly would not have forestalled the decline in long-term interest rates, which was caused mainly by a change in expectations.

Chairman Martin then said that however one might assess recent developments he thought it was clearly the Committee's intention to continue the process of cautiously and gradually increasing the degree of pressure over the coming period.

Mr. Shepardson noted that several members had expressed the opinion that the rate of increase in aggregate reserves should receive attention. The net borrowed reserve figures suggested that pressure was being applied, but the growth rate of total reserves was quite high. His own feeling was that that growth should be slowed down.

Mr. Hayes observed that, while earlier he had expressed a preference for alternative A, he was prepared to go along with the majority on the policy of continued gradual firming called for by alternative B. It seemed to him that the Chairman's summary of what the Committee would intend by adopting alternative B was clear, and he did not expect much difficulty in interpretation.

Chairman Martin then asked Mr. Maisel whether he thought his position had been taken into account adequately.

Mr. Maisel replied that to him the point Mr. Shepardson had made was the critical one. If there was agreement with Mr. Shepardson's point, then the Committee was agreed on the issue that had concerned him.

The Chairman noted that Mr. Shepardson's comment was to the effect that total reserves should be taken into consideration. He did not think that anyone would disagree with that; it was just a matter of the degree.

Mr. Hayes observed that, while the objective was clear, there was a question arising from the problems of implementing such an instruction, particularly within a short time period.

Mr. Hickman noted that there would be an interval of four weeks before the Committee's next meeting. He suggested that it might be desirable for the Committee to hold an interim meeting, perhaps by telephone conference, if there again was a divergence between developments in the market and the Committee's intentions such as he thought had occurred in the recent period.

Chairman Martin commented that it was always possible to call a meeting of the Committee if one was required. In general, however, he did not favor telephone conference meetings unless there was something of real importance to discuss.

Mr. Daane remarked that he agreed with the Manager's view that the recent decline in long-term rates was atrributable to developments in the market, particularly to the change in expectations regarding a tax increase. Expectations were always subject to change and such developments could have much more significant effects than an increase of, say, $25 or $50 million in net borrowed reserves.

Chairman Martin said that whatever change might occur in net borrowed reserves he would not want so much pressure to be put on the market as to force an increase in the discount rate. Several other members indicated that they concurred in that view. Mr. Swan, noting that the Federal funds rate recently had touched 4-7/8 per cent for the first time, expressed the opinion that on the basis the Chairman had mentioned it might not be possible to go much beyond the existing degree of pressure.

Chairman Martin then said he gathered that all of the members were prepared to vote for alternative B for the directive as it had been interpreted. As to Mr. Irons' suggestion that the word "moderating" be replaced by the word "restricting" in the last sentence of the first paragraph, he personally had no strong feeling.

Mr. Daane remarked that when the directives for the calendar year were published in the Committee's record of policy actions some readers might interpret the substitution as reflecting a significant change in policy when none was in fact intended. However, he had no real quarrel with either word.

Mr. Mitchell observed that if "restricting" was ever a proper word to use, it was the appropriate word now. Other members also indicated that they favored the change.

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 industrial 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 inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by restricting 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 shall be conducted with a view to attaining some further gradual reduction in reserve availability, while taking into account the forthcoming Treasury financing.

It was agreed the next meeting of the Committee would be held on Tuesday, May 10, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

April 11, 1966

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on April 12, 1966

First paragraph

The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with industrial 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 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.

Second paragraph

Alternative A (preserving about the current degree of firmness)

To implement this policy, while taking into account the forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market and continuing to exert pressure on bank reserve positions.

Alternative B (continued gradual firming)

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some further gradual reduction in reserve availability, while taking into account the forthcoming Treasury financing.