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, December 14, 1965, at 9:30 a.m.

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

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

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

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

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

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

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 23, 1965, were approved.

Upon motion duly made and seconded, and by unanimous vote, the action taken by members of the Federal Open Market Committee on December 6, 1965, amending paragraph 1 (a) of the continuing authority directive to increase the aggregate amount by which System holdings of U.S. Government securities can be changed between meetings of the Committee by $500 million, from $1.5 to $2.0 billion, was ratified.

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 November 23 through December 8, 1965, and a supplemental report for December 9 through 13, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said the Treasury gold stock probably would remain unchanged again this week. The French seemed likely to buy about $70 million in gold from the Stabilization Fund, reflecting their November surplus.

That would just about exhaust the Stabilization Fund's gold holdings, and unless the Russians made sales in the market, it probably would be necessary to reduce the Treasury gold stock by $50 or $75 million before the year end. It was his impression that the heavy gold sales the Russians had made earlier in the fall--about $300 million--had left them in a relatively comfortable foreign exchange position. Thus, there might not be as much help from that source as had been hoped. The London gold market had been in reasonable balance recently, with the fixing price fluctuating in a $35.11-$35.13 range. The basic supply and demand situation in that market was not good, however, and there was a possibility that it would get worse rather than better during the coming year.

On the exchange markets, Mr. Coombs continued, there was a minimum of disturbance on Monday, December 6, following the System's discount rate action. Sterling declined on the news but quickly bottomed out. The Bank of England intervened to a limited extent--about $9 or $10 million--and the Federal Reserve put in a bid for sterling at the New York opening. Those actions were sufficient to stabilize the market. Since then sterling had moved up and the Bank of England had taken in dollars.

Mr. Coombs noted that the British trade figures for November, released this morning, showed relatively small increases in both

exports and imports and some minor narrowing of the trade gap. Those figures were likely to have little effect on market psychology. The total improvement in the British position since September now came to $1.4 billion, of which about $400 million had been added to reserves, $415 million used to repay short-term debt, and about $600 million used to liquidate maturing forward contracts. The British were now moving into what in the past had been a seasonally strong period running from January into May, and the seasonal increase in their earnings could be greatly accentuated by reversals of leads and lags.

As to the Euro-dollar market, Mr. Coombs continued, useful results were flowing from the Federal Reserve suggestion at the Basle meeting in October that central banks make a joint effort to control or offset window dressing operations by commercial banks. The Swiss commercial banks had already been doing a good deal of window dressing but, under an arrangement worked out by the Swiss National Bank and the Bank for International Settlements, money flowing to Zurich was being channeled back into the Euro-dollar market, thus limiting rate increases there. The Dutch and Germans also were being helpful in this connection, and he expected the Italians to take similar steps before the year end. As the Committee would recall, a number of the drawings the System had made on its swap lines last

year were required because of commercial bank window dressing. Insofar as European central banks could take care of the matter themselves it was all to the good.

In response to Mr. Balderston's question about the outlook for the U.S. gold stock during the coming year, Mr. Coombs replied that much would depend on the size of the French surplus, which this year was running even larger than last year--it probably would come to over $1 billion in 1965--and their policy with respect to it. If the French continued their present policy, there would be a one-to-one relationship--every dollar the French took in during 1966 would result in a drain on the U.S. gold stock. As far as the other European countries were concerned, there were not likely to be any serious drains, assuming that the U.S. balance of payments did not slip back into a heavy deficit. There would, of course, be shifts of dollars among the various countries, but if U.S. payments were close to balance the countries taking in dollars probably would feel under some obligation not to convert them into gold but rather to deal with the situation through such means as the swap network or the facilities of the International Monetary Fund. One other possibility of large gold drains was through the London market; as the Committee knew, the U.S. was responsible for covering 50 per cent of any sales in that market, and if there were difficulties there it was conceivable that the operations could be costly. On balance,

however, he would say that if the French did not run a large surplus or if they changed their policy the outlook for the U.S. gold stock for next year would be relatively good.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period November 23 through December 13, 1965, were approved, ratified, and confirmed.

Chairman Martin noted that Mr. Hayes had just returned from a BIS meeting in Basle, and invited him to comment.

Mr. Hayes reported that solid and enthusiastic approbation of the System's recent rate actions had been expressed at the meeting. Several of the participating central bankers had assured him that despite serious inflationary pressures in their own countries they did not intend to increase their discount rates further in the near future. They thought the System's actions would lend support to the effort to achieve equilibrium in the U.S. balance of payments, and they recognized the danger that prompt offsetting rate increases abroad would seriously weaken the effects of those actions.

Mr. Hayes said he might mention one other subject, of a highly confidential character, that had been discussed in Basle. For some months there had been a widespread view among central bankers that some effort should be made to analyze the problem posed for the United Kingdom by the existence of large sterling

balances abroad. Possible shifts in those balances continued to pose a threat to the stability of international financial markets, apart from the difficulties arising from U.K. deficits. They recognized the danger that information to the effect that the subject was under study might encourage speculative movements of funds, and the Bank of England had asked that any study be confined to the group of central banks represented at the meeting and to as small a number of individuals as possible. There had been some discussion of the matter at the special meetings of technical experts in Basle in October and November, and at the meeting of the Governors in October. However, the discussions at the earlier meetings as well as at that held during the past weekend had been confined entirely to procedural questions regarding when and by whom suggestions should be made as to possible courses of action.

Mr. Hayes was hopeful that if the matter was handled wisely some kind of British swap network, roughly comparable to the U.S. network, might be developed with the principal continental countries in due course. It was not clear at the moment how the U.S. would fit in. A British network of that kind was not imminent; presumably there would be further discussions at the monthly Basle meetings, and quite a few months might elapse before anything concrete was heard on the subject. Mr. Hayes concluded by stressing the confidentiality of the fact that such discussions were in progress.

Mr. Coombs then recommended renewal of the twelve-month, $250 million standby swap arrangement with the Bank of Canada, maturing on December 28, 1965, and three six-month, $150 million arrangements maturing on January 20, 1966. The latter included the standby arrangements with the Bank for International Settlements and the Swiss National Bank, under which the System could draw Swiss francs, and the standby arrangement with the BIS under which the System could draw other European currencies. At the moment there were no drawings outstanding on any of the four swap lines.

> Renewal of the four swap arrangements, as recommended by Mr. Coombs, was approved.

Mr. Coombs then noted that the Bank of England had $475 million currently outstanding on its swap line with the System, in addition to a debt of $200 million to the BIS. On December 30, 1965, a $275 million drawing on the System, which had been renewed once, would again mature. The Bank of England probably would want to request a second renewal of that drawing in view of the desirability of showing a reasonably good reserve position at the end of the month, during which there had been a number of disturbances, including those resulting from developments in Rhodesia.

On January 28, 1966, Mr. Coombs continued, the remaining $200 million of the $475 million outstanding would reach a six-month maturity, and the question would arise as to whether that drawing should be renewed. As he had mentioned earlier, the British were

heading into what had been a seasonally strong period in the past. Conceivably, they could repay all of their debts to the U.S. and the BIS out of their reserve gains, although in view of all the uncertainties in the world today that expectation might be somewhat optimistic. The question was whether the British should not make a special effort to clear up their debts in January or February by using part of the portfolio of U.S. securities that they had been progressively liquefying. He personally was persuaded that that would be a useful thing for them to do--for the sake not only of their own credit rating but also from the point of view of the integrity of the whole swap system. Otherwise, it was possible that the drawings in question would run on through the spring and summer months. Among other disadvantages, such a development might harden the position of those central banks that saw serious dangers of abuse of international credit facilities. Moreover, by repaying the System and the BIS within the next month or two, the British would greatly improve the chances of negotiating swap arrangements with some other countries, along the lines that Mr. Hayes had mentioned.

In sum, Mr. Coombs said, he saw many compelling arguments for the British to make a special effort to clear up the swaps in January or February of 1966. The question currently was being debated by the U.K. authorities. In accordance with his understanding

of the Committee's views he had taken the position that, while the Committee had a one-year limit on drawings under its swap lines, once any drawing extended beyond six months the Committee became concerned and assumed that the other central bank involved did also.

Mr. Coombs said he was bringing the matter to the Committee's attention in order to obtain guidance. In effect, he recommended that the Committee approve second renewals of the $275 million drawing maturing in December and of the $200 million drawing maturing in January if requested by the Bank of England, but with the hope expressed that the drawings would be cleared up as soon as possible.

Mr. Mitchell commented that repayment of the drawings appeared desirable not only for the reasons Mr. Coombs had mentioned but also because window dressing of central bank accounts made their true financial situation difficult to determine. There had been many discussions within the System of the need to make its own accounts fully reflect the true state of its affairs. Whether the Bank of England should engage in window dressing was for that Bank to decide, but the Committee should examine carefully any policy of its own that accommodated such actions by other central banks.

Mr. Coombs remarked that he shared Mr. Mitchell's concern. He would add, however, that the reasons for some of the British window dressing operations, such as that at the end of August,

were related to the extreme nature of the emergency then existing. If the British had revealed their true position at the end of August the joint action taken by central banks in September probably would have been unsuccessful. In effect, the window dressing of August provided the opportunity to turn the situation in September. Of course, that type of justification was one that could not be used often.

Mr. Hayes expressed sympathy with the comments of both Messrs. Mitchell and Coombs. While he assumed that there was no need for formal action on the subject, he thought it would be helpful to Mr. Coombs to know whether it was the general sense of the Committee that the British should be encouraged to clear up the swap lines soon.

Mr. Shepardson noted that he had raised questions on a number of occasions concerning drawings that appeared to be running on for extended periods. He concurred fully with Mr. Coombs' recommendation.

Chairman Martin commented that the observations that had been made should prove helpful to Mr. Coombs, and the latter concurred.

> Possible renewal of the two swap drawings by the Bank of England was noted without objection.

Mr. Coombs' final recommendation related to the System's swap with the BIS of German marks against Swiss francs, in the

amount of $40 million. He recommended renewal of this swap, which matured on January 10, 1966, for another three months.

Renewal of the German mark-Swiss franc swap with the Bank for International Settlements for a further period of three months was noted without objection.

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 November 23 through December 8, 1965, and a supplemental report for December 9 through 13, 1965. Copies of both reports have been placed in the files of the Committee.

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

> The general reaction of the securities markets to the change in the discount rate announced on December 5 was one of relief that the air had been cleared by a decisive move indicating that market forces of supply and demand had been taken into account by official action. There was some surprise at the timing, a measure of concern over the inevitable loss that dealers incurred in their portfolios, and some fear that competitive factors might tend to put continuing upward pressure on short rates.
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> The initial rate reactions, which were swift and orderly, have been spelled out in the written reports. Government securities dealers marked prices 1/2 to 1 point lower in intermediate- and long-term securities on Monday morning after the change had been announced, with some modest improvement in prices over the remainder of that week. A sizable bulge in the yield curve developed with issues in the 2-5 year area rising to about 4-3/4 per cent (up about 20 basis points), tailing off to about 4-1/2

per cent (up about 6 basis points) in the longer area. The greater yield rise in the shorter area of coupon issues reflected the market's knowledge that the 4-1/4 per cent interest ceiling will force the Treasury to confine its financing within a maturity span of 5 years.

Treasury bill rates also reacted sharply, with most issues rising by 15-20 basis points. The timing of the discount rate announcement gave the market a chance to make its initial adjustment before the auction on Monday, December 6, when average rates of 4.34 and 4.47 per cent were established for 3- and 6-month bills, respectively. Subsequent trading was carried on close to these rates before the weekend, although some heaviness developed in the longer bill maturities.

In the corporate and municipal markets, prices also declined by about a point, raising yields by 7-10 basis points. At the new levels, new issues coming into the market met with good reception and distribution of older issues improved, with a moderate price recovery in process towards the end of the week. Rates on bankers' acceptances, commercial and financial paper, and certificates of deposit also were adjusted upward. At this juncture, it appears that most commercial banks are using their new-found freedom under Regulation Q with restraint, although there has been much speculation about the future course of CD rates. Most banks in New York City were paying about 4.40 to 4-1/2 per cent on 30-day CDs, 4-5/8 per cent on 3-month CDs and 4-3/4 per cent on 6-month or longer deposits. One large bank, however, has moved its 3-month rate to 4-3/4 per cent.

System operations after the discount rate change were directed first to the provision of ample reserves to facilitate the market adjustment and then to a cautious absorption of reserves in the general context of stable and orderly markets. At the opening of the market on Monday, December 6, the System bought $270 million Treasury bills in a market go-around, with purchases well distributed among the dealers. The reserves thus supplied subsequently led to a very comfortable tone in the money market; Federal funds, which initially traded at 4-1/2 per cent, moved to 1 per cent or below by Wednesday. With a steady atmosphere prevailing in the securities markets by then, and with a market scarcity of shorter-dated bills for which there was a good demand, the System sold $139

million December and January bills in a modified market go-around. In a similar operation on Thursday, an additional $100 million short bills were sold. Last week's free reserve figure of $9 million was interpreted by the market, as we expected, as reflecting only a temporary extra supply of reserves to cushion the market adjustment.

Thus, by last Friday the market seemed to have settled down substantially, and, based on our then current estimates, net borrowed reserves of over $100 million appeared likely for the statement week ending December 15.

Yesterday, however, a further professional reassessment of the rate structure took place, stemming, as far as we can gather, from market letters stressing the potential inflationary tendencies in the economy and from reports that led some market participants to believe that a further U.S. buildup in Vietnam would be necessary before our objectives there could be achieved. Prices of Government notes and bonds fell by 1/4 to 3/8 points, with yields in the 2-5 year area reaching as high as 4.80 per cent; prices of corporate bonds also moved lower. Treasury bill rates also moved higher, and bidding in yesterday's auctions was extremely cautious, with the three- and six-month bills averaging 4.39 and 4.55 per cent, respectively. A tighter tone also prevailed in the Federal funds market, while dealer lending rates at New York banks moved higher, after demonstrating surprising stability before the weekend.

Before the market reaction set in, wire reports had indicated that reserve availability on Friday had been some $300 million in excess of expectations, and that, as a consequence, about $50 million free reserves were now being projected for the current statement week. Despite this, we felt it desirable to supply the market with about $180 million in reserves through over-night repurchase agreements as market tightness began to contribute to the deterioration in atmosphere before the Treasury bill auctions. In the auction itself System tenders were submitted, as noted in the supplementary report, at marginal prices to guard against an unusually sharp rate adjustment. In the event, the System was awarded $112 million Treasury bills, while $145 million were redeemed. I would hope that the new reserve figures that became available today, together with market developments as the day progresses, will permit a more satisfactory assessment of the situation than now seems possible. Further

adjustments may be necessary before market participants regain confidence in the tenability of rate levels. On the other hand, a technical reaction that would move rates lower cannot be ruled out.

To leave an immediate perplexing period and return to an earlier one, I should confess that my colleagues and I at the Trading Desk were somewhat apprehensive on Sunday and Monday a week ago about the reserve absorption job that lay immediately ahead. At that time projections indicated that we would have to absorb about $600 million in reserves by the week ending December 22 in order to get back to a net borrowed reserve position of $100 million. With the extent of the market reaction still uncertain, we had some doubt about its ability to absorb outright sales of bills in that magnitude without producing substantial additional upward pressure on rates, and we did some intensive thinking about possible modification of operating techniques that might be useful in carrying out System objectives. In the event no innovation has yet proved necessary; the sales last week already noted, plus the runoff of $145 million bills in yesterday's auction, have accomplished much of the job to be done. Nevertheless, it seems worthwhile to give further study to possible changes in System operating techniques that could prove useful in such special situations. With this in mind we are preparing a paper to be discussed with the Committee staff and eventually submitted to the Open Market Committee if this appears desirable after further analysis.

We are, of course, moving into a period of active Treasury cash financing. It appears likely that the Treasury will announce the broad outline of its plans to raise new money within a week to ten days, with the first stage--probably an additional issue of June tax bills--under way before the year end. Market developments will determine whether there can be a note offering in addition to the tax bill offering and an increase in the regular Treasury bill cycle.

In response to a question by Mr. Swan, Mr. Holmes said that the Treasury's tax bill offering probably would be in the neighborhood of $1 billion. The market had been on notice that there would be an

additional offering of tax bills. The various offerings would probably be for payment in January, but the first stage would be announced before the end of the year.

In reply to Mr. Mitchell's question as to what kind of directive might be appropriate in the current unsettled state of the market, Mr. Holmes remarked that it was necessary to recognize that the relations among the various money market measures were in a state of flux, and that further experience was necessary before patterns of consistent relations could be discovered. Mr. Mitchell then commented that he did not understand from Mr. Holmes' earlier statement how a directive could best be formulated. If he understood Mr. Holmes correctly, after the discount rate action the bill rate initially settled down at about 4.35 per cent, and that situation persisted for a week. Now, however, a new situation of an unclear nature was developing. Presumably a bill rate in, say, the 4.35-4.40 range would no longer be an appropriate guideline. At the same time he gathered that a net borrowed reserve target of, say, $100 million also would not be reasonable now.

Mr. Holmes said he hoped that some better clues as to where the market was going would be available before today was over. In his judgment the bill rate guideline that Mr. Mitchell had mentioned probably would be too narrow at present, while the market was still

in process of finding its way. His personal view was that a combination of the factors used in measuring market conditions, including rates, should be taken into account. Thus, if bill rates were tending higher, there would be a move toward greater reserve availability; if bill rates were tending down, reserve availability would be reduced.

Mr. Hickman asked whether a succession of net free reserve figures in the next few weeks might not confuse the market with respect to the Committee's intentions. Mr. Holmes replied that such a risk would exist unless there was continuing upward pressure on short-term rates. If bills continued to press higher the market probably would not be misled by free reserve figures.

Mr. Maisel commented that in the study Mr. Holmes had mentioned he hoped there would be some consideration of the relations between money market variables and developments with respect to bank credit and money. He recognized that in its day-to-day operations the Desk had to concern itself with such variables as marginal reserves and bill rates, but it was important that the relations between these operating variables and the Committee's more fundamental objectives be clarified.

Mr. Holmes agreed that such analyses were highly desirable, but as the Committee knew it was difficult to assess credit developments on a month-to-month basis, and far more difficult on a shorter-term basis.

Mr. Hayes remarked it often might take several months to determine the existing relations between conditions in the money market and developments with respect to money and credit.

Mr. Mitchell then asked how Mr. Holmes would interpret the second paragraph of the proposed directive drafted by the staff.[1] Specifically, would he view it as calling for operations to "moderate further adjustments" in either direction? Mr. Holmes replied in the affirmative, saying that he would interpret the draft as calling for reducing reserve availability if rates were going down and increasing reserve availability if rates were tending higher.

In response to a question Mr. Holmes said that at the moment the Desk estimated free reserves of about $70 million for the statement week ending tomorrow(December 15), assuming no further operations. The figure, of course, was subject to revision.

Mr. Hickman said he thought that publication of such a figure would be bound to have a psychological effect that might be viewed as unfortunate later on.

Chairman Martin commented that he thought the situation would change after seasonal pressures ebbed later in the month. The period immediately ahead was the difficult one.

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[1] Appended to these minutes as Attachment A.

Mr. Hickman said he would be inclined to let rates move up during the period of seasonal pressures since free reserve figures were bound to cause comment. Mr. Hayes observed that excessive fluctuations in the bill rate might lead to exaggerated views of what the Committee was attempting to do

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period November 23 through December 13, 1965, were approved, ratified, and confirmed.

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

Mr. Holland made the following statement on economic conditions:

> The key business statistics becoming available since the last meeting of the Committee can be divided into two chief groups: (a) those historical numbers that indicate the economy has been growing more vigorously than previously thought this fall; and (b) projected numbers that also imply a more expansive course for the economy in the months ahead.
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> The first group has to be called noninflationary, for they show mainly that, given the credit and price performance to date, a somewhat larger amount of real production, investment, and employment was taking place than had previously been surmised. Three developments are particularly noteworthy. First is November's widely spread increase in nonfarm employment, which amounted to the biggest net creation of jobs of any month in 1965. Second is the striking increase in the

industrial production index in November to a level of 145.5. This number, confidential until tomorrow, is more than a point higher than the revised October level, which has in turn been marked up nearly 1 point above the preliminary October estimate. Third is the upward revision in the estimated level of business plant and equipment expenditures, amounting to $1.5 billion in the third quarter just past and carrying through in somewhat larger dimension into the current quarter. Clearly we have managed to employ more resources, add more to our capacity, and turn out more product that we thought we were doing earlier.

In the price arena, meanwhile, the most significant single index, that for wholesale prices of industrial commodities, has continued to edge up through November at about the rate prevailing since midyear. Small and selective increases continue to be the principal ingredients in the advance in this price index.

The focus of concern has been shifting, however, from how prices have performed thus far to how they might perform in the future. This shift reflects the impact of the second grouping of business statistics released in recent weeks--those showing strong business, consumer, and Federal Government spending intentions over the months ahead.

The new Commerce-SEC survey shows business plant and equipment expenditures moving on up from current levels (that were themselves revised upward) at a 13.5 per cent annual rate in the first quarter of next year and a 15.2 per cent rate in the second quarter. Even assuming no further increase after mid-1966, these numbers imply rates of expenditure significantly higher than the McGraw-Hill survey taken one month earlier. The just-released Commerce estimates for next year's construction outlays show plant construction figures that seem broadly consistent with these stronger expectations as to capital outlays.

The other major area of spending prospects on which attention should be focused this morning is the Federal budget for the remainder of fiscal 1966. Spending, particularly military spending, is headed higher, and the only question is how much. The Administration's release of a global estimate of budget expenditures in the $105-$107 billion range galvanized analysts everywhere into agonizing reappraisals; for expenditures thus far this year seemed to be running so far below such a level that the implicit step-up in spending for the remainder of the year appeared incredible. Our own Government finance analysts dutifully

(but skeptically) built a $105 billion assumption into the table following page III-15 in your "green book,"[1] but we stubbornly held to an implicitly lower rate of increase in the GNP projections shown on page II-3.

At the moment, the latter approach seems to run closest to what might be called the "maximum likelihood" estimate within the Government as to the level of Federal activity over the next two quarters. Such estimates currently might imply total budget expenditures for fiscal 1966 of just under $104 billion, a net cash deficit to be financed of $4 billion, and--perhaps most significantly from an expansionary point of view--a full employment surplus over the next half year of around $1 billion, little changed from the second half of calendar 1965 and $2.5 billion more stimulative than that portrayed only three weeks ago in the green book and the chart show.

Insofar as timing is concerned, higher Social Security taxes effective January 1 will introduce a transitory degree of fiscal restraint, but before the first quarter is over that effect will be more than counterbalanced by rising Federal purchases. Moreover, some further enhancement of this fiscal stimulus cannot be ruled out, either from further escalation in outlays for Viet Nam, or failure to realize some hoped-for slowdowns of the Great Society programs--all this despite possibly greater resort to financial asset sales that could serve to reduce the deficit on paper but in fact would only change the form of its financing.

I have dwelled on the possible future shape of the Federal budget and business capital outlays this morning because of their special significance for the future. In our chart show three weeks ago, we concluded, ". . . new price pressures could develop if military activities increase substantially or investment spending rises much faster than is now indicated." The evidence received in the ensuing weeks would seem to suggest that, in both these crucial categories, projections are now straining and very possibly exceeding the tolerances of that earlier model. Avoidance of enhanced upward price pressures as 1966 progresses would seem, from this viewpoint, to depend upon either or both of two factors: (1) more success

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

> by Administration deficit-cutters than I, for one, now expect, and/or (2) a gentle but pervasive moderating influence on spending growing out of the higher credit costs that have evolved this fall, capped by the reaction to the discount rate increase.
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> Immediate spending patterns seem to me to be such as to give policymakers a little time to appraise the interaction of these two moderating influences; but only time can tell whether they will prove sufficient to the task.

In the discussion following his statement, Mr. Holland said that the $104 billion figure for Federal budget expenditures for fiscal 1966, to which he had referred, was believed to be the current "maximum likelihood" estimate by technical experts within the Government. The Board's staff concurred in this estimate although, of couse, it contained a large element of conjecture. Mr. Brill noted that the figure of $105 billion implied an increase in the estimate of Federal spending for the second calendar quarter of 1966 of nearly $3 billion. In further discussion Mr. Holland indicated that the results of the recent Commerce-SEC plant and equipment survey would imply upward revisions in the GNP figures for the third and fourth quarters of 1965 of about $1 billion, but those revisions had not yet been made in the official figures.

Mr. Brill made the following statement concerning financial developments:

> The initial responses in financial markets to the discount rate and Regulation Q changes last week have been ably described in the Manager's report to the Committee, and I have nothing to add. Further, it would seem premature to offer any predictions now as to what may ultimately be a more permanent equilibrium level for credit flows

and interest rates. Certainly we can't assume that we're over the hump of market reactions. Participants are still exegetically examining our statements, particularly the commitment for ". . . the continued provision of additional reserves to the banking system in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy without promoting inflationary excesses. . . ."

The first week's rise in marginal reserves to a small net positive figure was apparently accepted for what it was--a partly accidental result of attempts to cushion the immediate impact of the official rate and ceiling actions. The market certainly doesn't expect a string of positive numbers for this variable. But what isn't clear to the market is how far back into the negative marginal reserves may slip or, for that matter, what any given marginal reserve measure will mean under the new rules of the game.

The market is not alone in this confusion, because it's not evident to me that we're all in accord on how the usual policy variables ought to behave under a policy of higher ceiling rates and somewhat increased monetary restraint. Since I've nothing to add to the review of the recent past, and have little basis for predicting the near-term future, I thought it might be helpful to explore the general subject ofpolicy guides this morning.

Let's begin with aggregate flows and, in particular, bank credit. I have argued often that bank credit changes are imperfect guides to, or targets of, policy under regulatory conditions which foster bank competition for savings flows. The Board's actions last week make the bank credit total more difficult than ever to interpret for policy assessment. If banks do take advantage of the flexibility under Regulation Q to bid more aggressively for corporate and consumer saving, some acceleration in bank credit growth is likely, but this could well be entirely consistent with the System's effort to increase monetary restraint. A diversion of saving flows from other intermediaries into banks is not *per se* inflationary. In fact, depending upon the composition of credit demands and on System attitudes toward the provision of reserves, it can prove to be quite restrictive. Therefore, if one has to look at some credit flow measures as gauges of policy, one had better include total credit flows, not just the bank component. If we focus on slowing the expansion in *bank* credit, while at the same time encouraging banks to become more important credit intermediaries, we'll really see interest rates soar.

I must confess that, while I expect some acceleration in time deposit growth, I don't expect a rise on the order of that which followed earlier increases in Regulation Q ceilings, when banks responded fairly promptly and the public responded to the banks. For one thing, corporate liquidity is much lower, and business needs for funds to finance real investment are growing rapidly. Banks may find it rather expensive to add significantly to their negotiable CD totals. They may also be reluctant to push harder in the competition for consumer saving. Banks have been doing very well against their competitors, even under existing pass book ceiling rates which weren't raised last week. And the devices available to apply the new higher ceilings to consumer saving--savings bonds and savings certificates--usually carry long-term commitments to pay these higher rates, commitments which may cause more prudent bankers to reflect a bit before joining in the competition. But whether banks do or do not go after a larger share of the savings flow--or whether or not they are sucessful--is more a matter of supervisory concern than a test of the effectiveness of monetary policy. Credit diverted through, rather than created by, the banking system is no cause for inflationary alarm.

Turning to another of the commonly used policy variables, I wouldn't expect that, in the short run, changes in the money supply would be useful in assessing the effectiveness of the recent policy moves. Previous experience with Regulation Q ceiling changes suggest that the initial reaction of savers bears on their holdings of demand deposits as well as on market instruments and on the obligations of other intermediaries. It would not be surprising to experience a sharply lower growth rate in money balances after the turn of the year, perhaps persisting for two or three months. This development alone would not signal to me an exceptional degree of restraint. Despite the rise in recent years in income and transactions velocity, I would hesitate to assume that the economy has already achieved maximum economization of cash balances and, therefore, some spurt in velocity would not surprise or alarm me. If it showed no sign of abating after two or three months, however, I'd get suspicious, but by then, market rates of interest would probably have given all the indication we'd need of the effectiveness of our restraint.

The uncertainties that attach to interpretations of changes in the rate of aggregate bank credit and deposit

flows also limit the usefulness of aggregate reserve targets in the months ahead, even abstracting from the effects of Treasury financing and cash management on reserve needs. Total reserve needs will be boosted by banks' success in capturing "outside" saving flows, but moderated to the extent that there is some switching or diversion from demand balances to CDs or other time accounts. Until we get a clearer picture of the response of banks and savers to the new Q ceilings, it will be difficult to interpret the changes in aggregate reserves.

Nor can we assume that the marginal reserve measures have the same import now as they did three weeks ago. Because the discount rate has been raised relative to short-term market rates, we should expect to find bank reluctance to obtain reserves through the discount window reinforced; increased elbow room in the CD market should also reduce the needs for borrowing. At the same time, the cost of carrying excess reserves has been raised. All in all, therefore, it would seem that a given level of net borrowed reserves may carry a more restrictive connotation now than before the recent policy action.

The question is how much more, and the answer is we really don't know. In the "blue book"1/ distributed Friday, the staff presented a guess that over the next several weeks a target of $100 million net borrowed reserves--not far from the average of the previous five weeks--would likely be associated with some further upward adjustment in bill rates, but not much change in longer rates. Yesterday, the whole rate structure moved up significantly even though projected marginal reserves were still net positive, and even though the Desk put in a substantial volume of RPs.

The point is that during periods of peak seasonal pressure, and when a new structure of rate relationships and new market attitudes are evolving, marginal reserve measures are exceptionally difficult to predict. It may be that a target of $100 million net borrowed reserves will prove too restrictive for Committee aims. Given all the uncertainties extant--as to how banks are going to respond to both the new Q ceilings and the new discount rate, as to whether the higher prime rate will tend to force some bank borrowers into the capital market, and as to the likely longer-term outlook for Treasury financing needs--it would probably be most

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

appropriate at this juncture for the Committee to stipulate how large and how rapid an adjustment in money market rates it is willing to tolerate, and let the marginal reserve measures fall out of this decision.

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

It occurs to me that it might be useful to stage a minor rebellion against the tyranny of the calendar, throw away the score card for the calendar year 1965, half of which is by now pretty ancient history, and take a look this morning at the record and prospects of the balance of payments in the July-to-June year.

The first full statement for the July-to-September quarter will be published two weeks from now. You may recall my saying six weeks ago that no one knew yet whether the direct investment outflow in that 3-month period would be nearer a billion dollars, as it had averaged in the first half of 1965, or half a billion as in most of 1964. We have now been informed that the returns are in, and that the figure is encouragingly low: only $515 million, after seasonal adjustment. (I must ask that this figure be treated as confidential until published.)

The July-to-September deficit on regular transactions, seasonally adjusted, was about $650 million. Without the U.K. security liquidations it would apparently have been around $450 million. Six weeks ago it was difficult to explain so large a deficit unless the direct investment outflow had been large. As it turns out, the mystery of the large deficit has an entirely different explanation, which is that U.S. imports were a great deal larger than the monthly statistics were telling us. What had seemed an encouraging leveling off of imports was not really happening--at least not yet then.

The story is a complicated one. It starts with an effort to speed up the compilation of accurate import statistics from last June onwards. But there seem to have been some monumental failures in carrying out the new procedures. Trouble was suspected when unexplainably low figures came out for coffee imports in August and September. The Census Bureau then made

a special tabulation of all documents processed for the October statistics that referred to shipments that actually came in at any time before October. The upshot now is that the balance of payments statistics for the third quarter to be published in a fortnight will show imports much larger than the monthly Census Bureau figures indicated--larger by more than $300 million, or 6 per cent. Compared with the third quarter a year ago, the corrected figure is up 17 per cent, a very large rise.

The import figure for October recently published by Census shows what looks like an alarming jump over the preceding months, but the true October import figure, excluding pre-October imports, was probably below the true third-quarter level; we will not know for sure until another special tabulation is made to see how many October imports will have been included in the forthcoming statistics for November. Ironically, the speed-up effort has only delayed our getting an accurate knowledge of the facts.

Thus far in the fourth quarter the balance of payments seems to have remained in deficit, despite some improvement. On the "official settlements" basis, weekly indicators suggest a repetition in November of the October deficit of about $100 million. On the "liquidity" basis, the October deficitof about $300 million may have been followed by a surplus in November--or if not, by a quite small deficit, and the weekly figures would then imply that December got off to a good start. But these figures are all seasonally unadjusted, and experience in past years suggests that within the fourth quarter October is usually a poor month, November a good one. Moreover, it is worth noting that $75 million of the November improvement this year was due to a special transaction: an Italian prepayment for military equipment. Evidently, taking October and November together, regular transactions have been more favorable than in the third quarter, but it is too soon to speak of surpluses on any but the very shortest time scale of a couple of weeks.

Now, if we look ahead a few months, can anything be said as to whether the average level of the deficit for December through next June will be appreciably lower than it was in July through November?

I believe we can discern three or four adverse factors, and on the other hand at least three favorable factors. But I am unable to weigh these against each other quantitatively.

On the unfavorable side, at the year-end the seasonally adjusted accounts will be adversely affected if the U.K. defers its debt payment. Second, bank credit outflows may begin to resume, since the banks are well below their aggregate ceiling, and since they now know what the program is for 1966. Third, we can hardly hope that direct investment outflows next year will hold to the relatively low $2 billion annual rate recorded for the July-to-September quarter.

Despite all efforts of persuasion by the Government, capital expenditures by foreign affiliates in 1966 will be far above the 1964 level. Their capital expenditures in 1964 were accompanied by financing outflows that year of $2.4 billion from parent companies in the United States, and in the absence of the voluntary program the 1966 figure would tend to be much higher than that. What a sizable number of companies are now doing to comply with the Government's request for cooperation is to set up special subsidiaries to borrow at long term in Europe, often with the parent corporation's guaranty. It may be that several hundred million dollars can be raised in this way over and above the very considerable amounts that would be borrowed for working capital in the usual course of events. But the greater the demands made in this way on European capital markets, the longer the present high interest rates in Europe will stay high, and the stronger the forces making for leakage of capital from the United States will be. For example, foreign investors holding U.S. domestic bonds may switch to high-rate U.S. bonds newly issued in Europe; they may sell the domestic bonds to U.S. residents, since the I.E.T. would not apply on these.

These are some of the adverse factors one can foresee. Another is likely to be a rise in military expenditures abroad. On the favorable side, we may assume that the U.K. Treasury has now stopped liquefying its security holdings. Secondly, U.S. investment income receipts will undoubtedly continue to rise. Thirdly, it seems reasonable to count on some increase in the U.S. trade surplus from its

recent level of $5-1/2 billion a year. It is hardly necessary to say to this Committee that the lower U.S. prices remain, the better the chances of an upward trend in the trade surplus.

Finally, some encouragement may be drawn from the prospect that U.S. interest rates will be higher rather than lower. However, as we have already seen last week, rates in closely related markets, as in Canada or in the Euro-dollar market, are quick to change when rates change here. Any net impact of Federal Reserve actions on private capital movements of various sorts may well depend more on what happens to the growth of U.S. bank credit in the aggregate, domestic and foreign, and on the basic ease or tightness of U.S. financial markets in general, than on interest rate changes *per se*.

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

The rise in discount rates and the revision of Regulation Q ceilings have demonstrated that the Federal Reserve can still act when the situation warrants action, and should have a salutary effect in removing some of the uncertainties which have hung over financial markets in recent months. I have no doubt that these measures will prove valuable both in extending the duration of the present business upswing and in bolstering the international position of the dollar. Today I think we must explore the extent to which open market policy should be used to back up recent official rate action. In an economy as buoyant as this one, the influence of higher interest rates alone could turn out to be entirely inadequate, if availability considerations were neglected.

The domestic economy is, I think, stronger both currently and prospectively than when we met last. First, the apparent strong rise in industrial production in November should remove any lurking worries concerning the short-term adverse effect of steel inventory liquidation on the economy. Second, the sharp upgrading in both actual and planned capital

spending leads me to feel that next year this sector of the economy may turn out to be even stronger than in 1965; nor do I believe that the interest rate advances that have already occurred will in themselves significantly change the implications of the most recent capital spending survey. Third, it seems to me that developments in Vietnam, and the guesses concerning the budget estimates publicized since our last meeting, have added to the already buoyant psychology of the business community. Residential construction is the one questionable area. But consumer spending generally continues to look as strong, or stronger, than earlier. All of this adds up to a prospective rise in total output that is likely to equal, and may even exceed, the advance of the past year.

Such an outlook--in the context of both the rapid rise in resource utilization and the current high level of resource use--suggests that further pressures on prices are likely and might well lead to price increases exceeding those of the past year.

So far at least, unit labor costs in manufacturing have been relatively stable. But the outlook suggests that a continuation of such stability is now very questionable. It is hard to see how productivity can, at best, do more than maintain its recent rate of growth. Yet it seems clear that wage increases have been larger so far this year than earlier. Add to this the upward push that will be exerted by the increase in social security taxes, and the prospects for continued cost stability seem doubtful--especially in an environment where unemployment is declining and the over-all unemployment rate is approaching 4 per cent.

Any threat to reasonable price stability also has serious implications for our balance of payments deficit. For the past, as against the future, the latest balance of payments figures appear to show a sizable surplus in November. The liquidity deficit for the fourth quarter may turn out to be at an annual rate of about $1.1 billion, down from $1.9 billion in the third quarter. However, this apparent improvement is more than accounted for by the deferral of payment dates into 1966 on a substantial volume of new Canadian bond issues and by the issue of a $75 million

nonmarketable, nonconvertible bond to Italy. For the year as a whole, this would imply a deficit on the old regular transactions basis of $1.6 billion, or a liquidity deficit of about $1.2 billion--with each figure $0.5 billion less if the influence of the liquidations of official British long-term portfolio holdings is removed. This is progress as compared with 1964, but it reflects primarily the short-term effectiveness of the restraint program, and could easily be wiped out if the prospects for a rising export surplus were erased by accelerated price increases in this country.

It is in the context of a very strong domestic economy and a continuing need to achieve balance in our payments position that I turn to the policy questions before us.

In analyzing the question of where we go from here, I think it is useful to draw a distinction between underlying policy objectives and the temporary posture that may be necessary in the weeks immediately ahead.

Let me start by considering the question of underlying policy objectives. (Parenthetically, I should note that we are presumably all against sin: that is, in favor of a growing economy that will absorb a growing labor force into active employment, without price increases that would make such progress unsustainable. Rather, when I speak of underlying policy objectives, I am referring to what are sometimes called "intermediate" objectives.) It seems to me that we have at least three choices before us. First, we might continue a policy of providing sufficient reserves to support a continued growth in credit at the same rapid pace as in the recent past. Second, we might adopt a policy that would attempt to moderate whatever demands for credit do develop, which would in effect leave open the question as to what change in pace, if any, as compared with the recent past was being sought. Finally, we could deliberately attempt to reduce the rate of growth of credit from what it has been in the recent past.

As to the first of these possible policies, it seems to me that, once the inflationary potential

in the economic outlook is recognized, it is necessary to back up recent rate adjustments with a more positive open market policy. If we continue to permit credit to grow at the rapid rate so far chalked up this year, we would be doing less than is necessary. We could also be subject to the criticism that the System has acted only to raise interest rates and has done nothing to affect the availability of credit.

The second possible policy, that of merely moderating the pace of credit advances from what would otherwise have been the case, runs up against the difficulty that the objective is unclear. We would in fact never find out whether anything at all had been done to back up the rate changes already made. On the one hand, the rise in interest rates that has already occurred might be expected to reduce somewhat the demands for credit. On the other hand, the apparent growing strength in the economy could more than offset this effect. Merely moderating the demands that might otherwise occur could actually result in a stepped-up rate of growth of credit.

As you can see, I am in favor of third alternative policy objective--that which would deliberately attempt to reduce the rate of growth of credit from the rapid pace of the past year. For several years I have been critical of a rate of growth of bank credit that was running around 8 per cent. This year, however, the pace has mounted to almost 10 per cent. I would not want to set any precise figure on the magnitude of growth that is warranted and sustainable in the present economic situation. But I would argue strongly that recent growth rates have been excessive, particularly in the context of cumulatively large increases in previous years. Parenthetically, I might add that in making these comments I have fully taken into account data with respect to total credit flows.

If the forthcoming weeks had no special and unusual characteristics, an underlying objective of reducing the rate of growth of credit could be implemented in a straightforward manner by putting the banking system under somewhat greater pressure. This might mean a movement in net borrowed reserves to over $200 million as a definite signal that open market policy was not out of step with discount rate policy My only caveat would be that such a move should be undertaken in a cautious and flexible fashion. It would be undesirable,

for example, to see the Treasury bill rate move so close to the 4-1/2 per cent discount rate as to set off speculation as to a further hike in the discount rate.

In fact, however, the forthcoming weeks will see a convergence of a number of factors that may make it difficult to achieve the underlying objective that I favor. In particular, it is still uncertain to what extent financial markets have fully adjusted to discount rate changes and the revision of Regulation Q ceilings. There is still considerable uncertainty as to what may happen in the CD area, where there is a risk that competitive pressures may push up CD rates to an inordinate degree and, as a consequence, exert undue upward pressures on other rates. Moreover, there are the usual end-of-the-year money market pressures and uncertainties to contend with; and, in addition, a forthcoming Treasury financing which will reintroduce even keel considerations.

In view of these factors, it seems to me important that the Account Manager have more than usual latitude over the next few weeks. In particular, net borrowed reserve figures will be difficult to interpret, but I would hope that we would not show positive free reserves. I believe that our chief focus should be on money market tone and short-term rates. A three-month bill rate ranging between 4.30 per cent and 4.45 per cent, combined with a firm money market tone, would seem to be about right. If, in this context, it is possible to move net borrowed reserves to over $200 million, I would consider it highly desirable as a means of achieving the underlying objective that I favor. The suggested directive is acceptable.

Mr. Shuford reported that in the Eighth District economic activity had continued to expand at a rapid pace since early summer. During the past five months, payroll employment in the District had risen at a 4 per cent annual rate, slightly faster than for the nation as a whole. District manufacturing activity had been very strong in the last half of the year. Since June, employment by

manufacturing firms had risen at a 5.4 per cent rate, markedly higher than in the first half. Manufacturing output in the District's metropolitan areas had increased 6 per cent over the past twelve months, the same as for the nation. Unemployment as a per cent of the labor force had decreased significantly since the end of last year in all of the District's States and in most of its major labor markets.

Business loans at District banks had continued to rise at a rapid rate, Mr. Shuford said. Deposit growth had been strong, with virtually all of the growth centering in time deposits.

While only a few days had passed since the discount rate and Regulation Q maximums were raised, Mr. Shuford continued, it was evident that the economy had taken those developments in stride. Sentiment appeared optimistic, the stock market had remained strong, and money market movements had been reasonable. Interest rates had risen, but when viewed within the context of the past five months the rise was not unusual in light of both seasonal and cyclical pressures.

New data since the Committee's last meeting indicated continuing growth in economic activity, with some strengthening, Mr. Shuford remarked. Total civilian employment rose at a 5.6 per cent annual rate from September to November, twice as fast as over the past twelve months. Weekly data for November indicated

that industrial production was continuing to expand. Retail sales also appeared to have been strong in November. Labor resources had come under added pressure since September. The unemployment rate was below the level recorded at the peak of the previous business expansion and was near the level reached in the 1957 expansion. Further price rises had accompanied the expansion in business activity since the Committee's last meeting, as weekly wholesale industrial prices had continued to advance.

With respect to policy, Mr. Shuford said, money market conditions had firmed over the last week but not more than might have been expected. On the other hand, for the next four weeks he would not like to see any additional firming, especially in view of the prospective Treasury financing. That would call for maintaining essentially the same conditions in the money market as had come to prevail during the last several days but moderating any further upward adjustments for the time being.

Mr. Shuford felt the Desk had to have considerable latitude during the coming period. He was glad that Mr. Brill's remarks and Mr. Mitchell's questions had pointed up the difficulty in trying to establish guidelines under present circumstances. He had never been satisfied with attempts to quantify the Committee's directive and the problems of doing so would be particularly great at present. For purposes of general guidance, however, he

was inclined to agree with Mr. Brill that in the main the Committee should think in terms of rates rather than free reserves or other measures. He also concurred with the suggestions by the staff and Mr. Hayes of a 4.30-4.45 per cent range for the 90-day bill rate. He would not like to see the bill rate go over 4.45 per cent, and he certainly would not want it to go above the discount rate. He would hope and expect that the Federal funds rate would be around the discount rate and, to the extent possible, he would like to see it under the discount rate--although he was aware that in one or two instances it had already moved above that rate. He was not sure what such objectives would imply for marginal reserves but he did not believe that the latter could be relied on for target purposes during the next few weeks.

Mr. Patterson reported that in the Sixth District, as he was sure had been the case in other Districts, the changes in the discount rate and Regulation Q had generated a tremendous amount of interest and comment. Many persons outside the financial community seemed to be bewildered, possibly because of the newspaper stories that came out prior to the official Board release. The question he most often got from laymen was, "What effect will the Federal Reserve 'order' raising interest rates have on the cost of buying an ice box or TV set?"

Among the more informed, Mr. Patterson commented, there had been a mixed reaction to the Federal Reserve's action. Most of the large banks had endorsed the move, and an informal survey of a group of about 25 officers of the largest business firms in Alabama, made by the Chairman of the Board of the Birmingham Branch, indicated that all of them also approved the move and many thought it long overdue. Last Wednesday the large city banks in Atlanta announced an increase in their prime rate, and the large banks in the District's other cities had made similar moves. Although one of the larger banks in Atlanta had announced a slight upward adjustment in its CD rate, he did not as yet have information about what the banks in general expected to do. Some officers of the smaller banks, however, feared that, as the result of the increase in the Regulation Q ceiling, it might become more difficult for them to retain their time deposits without raising the rates paid, a step they were reluctant to take. As to contemplating changes, the smaller banks and the savings and loan associations apparently were postponing any action until they saw what happened.

It was even more difficult to determine whether or not the general economic conditions had been or would be affected, Mr. Patterson said. Certainly, the most recent statistics for the District indicated an expansion strong enough to weather a

slightly higher cost of credit. In practically every category, the record for the District during 1965 would be better than that of the nation generally.

Until the dust had settled, Mr. Patterson continued, the Committee could not tell very well to what extent the new interest rate structure reflected expectational factors. The problem of judgment would be compounded as the economy entered the period when pressures on bank reserves were reduced because of seasonal factors. Meanwhile, the Committee might be hemmed in by having to maintain an even keel because of Treasury financing.

Under those conditions, it seemed best to Mr. Patterson to allow the Desk to be guided chiefly by the behavior of rates even if, because of expectational and other forces, the Committee ended up with a somewhat lower net borrowed reserve position than prevailed prior to the discount rate increase. He would not like to see the rate structure move upward but neither did he think the Committee should attempt to offset all tendencies toward softening that might develop because of seasonal influences. By the next meeting the Committee might be able to determine more precisely the level of reserves needed to support the appropriate rate of credit expansion. The staff draft directive was satisfactory to Mr. Patterson.

Mr. Bopp remarked that now that the discount rate action had been taken, additional reserves should be supplied to the banking system, as the Board phrased it in its December 5 press release, "in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy. . . ." Looking further ahead, the rate at which money and bank credit would be allowed to grow should depend on the degree to which the economy became subject to the stresses and strains accompanying near full-employment levels of activity. One measure of those would be the extent of pressure in the labor market. As noted in the green book, prospective increases in real GNP early in 1966 and expansion in the armed forces rendered further tightening in the labor market very likely, despite gains from the anti-poverty program.

During the past week, Mr. Bopp continued, the Philadelphia Bank had looked into the data to get a better feel of pressures in the labor market and had discussed the situation with personnel departments of several large industrial and governmental units in the Third District and with some of the larger employment agencies. From the data, he got the impression that some cushion existed over-all, but that pressures were considerable in certain skills and areas, especially durable manufacturing. On an over-all basis he found that, compared with the similar

phase of most other postwar business upturns, the labor force presently was expanding at a relatively rapid rate, which should help offset pressures to some extent. In addition, participation rates were lower than in other postwar expansions, suggesting that there was more leeway for a further rise in the labor force. Finally, the over-all unemployment rate and that in most subgroupings by age, sex, and so on, now provided a greater cushion than in the Korean War period and about the same leeway as in the similar phase of the 1953-1957 business upswing.

Focusing on the manufacturing sector, Mr. Bopp remarked, pressures on the labor force became more evident. The average workweek in manufacturing had now exceeded the highs of 1953-1957 and 1958-1960 and was near the highest level of the Korean War period. Overtime in manufacturing was much higher than in 1956-1957 or 1958-1960 (there were no data for the Korean War period) with pressure particularly severe in durable goods manufacturing.

The Reserve Bank's survey of the Third District labor market bore out what was found in the national data, Mr. Bopp said. In durable manufacturing industries, most firms were feeling definite shortages of skilled machinists and technical and professional help. Several firms in Philadelphia and Wilmington had had to send out recruiting teams or advertise elsewhere for engineers, machinists, and technicians. Nondurable and nonmanufacturing industries were split about half and half between

those reporting conditions no tighter than usual for this time of the year and those saying that definite shortages existed in most occupations.

Labor pressures in the manufacturing sector had particular implications for the behavior of unit labor costs, Mr. Bopp observed. Not only was there likely to be some upward pressure on wage rates next year, but the kinds of pressures now being felt--reaching near the bottom of the skilled labor barrel for generally less efficient workers and extending overtime hours and the workweek--had an important bearing on efficiency, tending to raise unit labor costs. Meanwhile, if public policy was successful in holding down prices, any rise in unit labor costs would tend to eat into profits. Past behavior would suggest in turn, that when unit labor costs rose faster than prices, the economy was entering a cyclical danger period.

What all that added up to was pressure building in specific areas, Mr. Bopp said, particularly durable goods manufacturing, but some cushion in the over-all labor market.

As to monetary policy, Mr. Bopp thought the draft directive was appropriate.

Mr. Hickman remarked that a basic justification for the recent discount rate action was to prevent excessive additions to the money supply and to moderate demands for bank credit, thus

reducing the risk of inflation. On the basis of information now available, continuation of the recent rate of increase in bank credit would not appear to be consistent with that aim, assuming that the response of savings flows to the change in Regulation Q was not great. Following that line of reasoning, the Committee should supply less, not more, reserve availability. Looking ahead a bit, it should validate the discount rate change by forcing the banks to the discount window, thus making the new rate effective.

Since a Treasury financing was imminent, and since the markets were in the midst of the heavy tax and dividend period, even-keel considerations seemed to Mr. Hickman to be dominant at the moment. There was, of course, some problem of defining just what "even keel" meant in view of the recent gyrations of the reserve figures. He suggested net borrowed reserves of about $100 million as a rough target during the period of Treasury financing, shifting to a somewhat deeper level--say, $200 to $250 million--when the financial markets settled down after the turn of the year. To avoid misleading the market he would try to avoid, if at all possible, positive free reserve figures during the next few weeks.

Mr. Maisel said that the concluding statement of the draft directive, calling for operations with a view to "moderating

further adjustments of money and credit market conditions in a period of widely fluctuating seasonal pressures," seemed proper to him. He felt that as a result of the statements in the Board's press release at the time of the discount rate change it was evident to the market that an objective of letting things settle down would dominate the Committee's thoughts. As a result the level of the marginal reserve figures was comparatively unimportant. Between now and the next meeting the question of market conditions should be dominant; at the next meeting the Committee would have a better picture of the nature of underlying supply and demand forces and would be able to work out its longer run objectives. He favored adoption of the directive as drafted by the staff.

Mr. Mitchell commented that having been in the minority position on the discount rate question, he found it difficult to adjust his thinking to the present situation. He would say, however, that he thought there was a tendency to underestimate the amount of restraint that had come about in the past several months, not only in terms of interest rates but also in terms of credit availability. Also, the weekly money supply figures had shown little growth in the past two months, which meant that something had happened; he was more inclined to agree with Mr. Shuford's general position on that subject than with that of Mr. Brill. Total bank credit had expanded at a 12 per cent annual rate

in the first quarter, but at only a 5 per cent rate in the third quarter. The growth rate so far in the fourth quarter was above the third, but as far as loan demand in October and November was concerned, to quote from Mr. Eckert's remarks at the Board briefing last Friday, "Excluding security loans, total loans increased only a little over half the average monthly rate for the first three quarters. Recent slackening from earlier growth rates occurred in business, real estate, and nonbank financial loans. Business loans rose somewhat more in November than the small October advance. But for the two months combined, the annual rate of growth was about 11 per cent, a little less than the much reduced third quarter rate."

The figures indicated that there had been evidence of restraint in the money supply, interest rates, and credit availability, Mr. Mitchell said, and now there also had been a direct signal in the form of the discount rate increase. In his judgment that was enough for the time being. He knew the Desk would face difficulties in getting through the rest of December. As to the directive, he found that he could not improve on the staff's draft and would accept it.

Mr. Shuford commented that he agreed the money supply had shown little change in the recent period. That probably was a short-run development, and he would hope the money supply

would soon begin to rise again, preferably at an annual rate in the 2-4 per cent range.

Mr. Shepardson said he did not think it was necessary to make extensive comments on the economic situation; apparently all of the indicators pointed to continued rising activity. At this season of the year the situation in financial markets usually was a difficult one, and this year the problems were compounded by the recent discount rate action. For that reason it would seem to him that the proposed directive, as he understood it, would be appropriate for the coming period. He hoped that in implementing the directive there would be no attempt to roll back the rate changes that had developed. The general guides that had been suggested appeared appropriate to him, and he shared the hope that free reserve figures would not result.

Mr. Robertson then made the following statement:

> With all the events that have been jammed into the three weeks since this Committee last met, I expect it will be some time before we can see either the recent developments or their future implications in clear and dispassionate perspective.
>
> I think it is a good idea at this juncture to distinguish between what actually <u>has</u> happened and what is projected. The latest statistics on what <u>has</u> happened (mostly in November) are gratifying. They show a further small reduction in unemployment, a vigorous increase in production, a price performance still confined to small and selective advances, and a balance of payments position that is appreciably improved, even if part of that improvement may prove temporary. No pressing call for a tighter policy emerges from these facts concerning developments to date.

Future prospects, however, must now be regarded as stronger, in view of the latest surveys of business capital expenditures and the announcements as to the future rates of Government spending. Were they to be taken at face value, these spending rates could seem high enough so that they might be expected to begin generating some real inflationary pressures in the country. But there are two big uncertainties as to these prospects. First, the Federal Government is now trying to hold spending well below the tentative estimates for 1966 first released. Second, the climate of significantly higher costs of credit resulting from the discount rate increase may very well serve to dampen some of the more optimistic spending intentions.

As these uncertainties begin to be resolved, we should be able to decide with some greater degree of assurance whether the next turn of open market policy should be toward further tightness or toward some relaxation of pressures. In the meantime, a policy of maintaining relatively steady money market conditions seems to me to be in order.

A steady course for policy is also desirable for two technical reasons--the onset of peak seasonal pressures in the money market and the schedule of Treasury financing activity between now and the next meeting of this Committee. Recognizing that some churning in the markets is probably inevitable over this period, I would be satisfied if the Manager could maintain money market rates within the ranges mentioned in the blue book (4.30-4.45 per cent three-month bill rate, Federal funds around 4-1/2 per cent). I assume this may necessitate a somewhat lower level of member bank borrowing, and if the result is a few fairly small net borrowed reserve figures--or even small net free reserves for some individual weeks- I would not object. I would vote in favor of the draft directive distributed by the staff.

Mr. Wayne reported that the orderly advance of Fifth District business continued. In manufacturing generally, backlogs remained heavy and the volume of new orders was still rising. The textile industry had been operating close to capacity all year in an

effort to keep pace with expanding demand, and now new defense orders were putting even more pressure on production facilities. Reports from all around the area indicated that the already tight labor markets were becoming tighter and that wages had risen in a number of industries. In the agricultural sector, less over-all strength was evident, although livestock was experiencing strong demand and rising prices.

In the national economy, Mr. Wayne said, there was not much news except more of the same as business activity moved ahead with sustained momentum. New and revised data which had become available in recent weeks showed a continuing buildup of inflationary pressures as reflected in higher consumer and wholesale prices, increasing labor shortages, higher wage rates and hourly earnings, a faster growth in personal income, accelerated capital spending, sharp increases in new and unfilled orders for durable goods, and a considerable increase in the deficit in the cash budget. The expected extension of the budget deficit into the early part of next year despite a sharp increase in payroll taxes meant that it would not be possible to use fiscal policy to counter inflationary pressures.

The System had now made a decisive and perhaps historic move, Mr. Wayne said, and there should be no turning back at this point. The question now was how to implement the new policy

and what pattern of money market rates would be consistent with the new level of the discount rate. The Committee was committed to supply sufficient reserves to meet seasonal pressures and the needs of an expanding economy. The generous supply of reserves made available in the past week was probably necessary and desirable in facilitating the transition to the new level of rates. But the peak of seasonal pressures would pass within the next two weeks and immediately thereafter open market policy should change to validate the change in the discount rate. Otherwise, the move which had been made would be nullified. As yet very little was known about the relationship that would prevail between the level of free or net borrowed reserves and money market rates under the higher discount rate. In those circumstances, Mr. Wayne suggested that for the period ahead the Committee place primary emphasis on the bill rate and attempt to hold it within a range of 4.25 to 4.40 per cent. In view of the great uncertainty which prevailed and the large seasonal movements which would occur, the Manager should have somewhat more discretion than usual. The draft directive was acceptable to him.

Mr. Clay commented that both the current and the prospective performance of the domestic economy were strongly expansionary. With the national economy functioning at high levels and at

substantially reduced margins of unutilized resources, it became increasingly evident that Federal Government expenditures, notably defense outlays, were the key to the forthcoming pattern of economic events. Those Federal outlays carried not only a direct impact upon economic activity but also indirectly influenced private demand sectors such as the stepped-up rate of business capital investment. Thus, that growth in aggregate demand relative to the expansion in the resource base also was the key to future price developments and would determine whether the recent pattern of selective price increases became more general. Despite budget data recently released it appeared, however, that there was not a clear picture yet of the magnitude and time pattern of those expenditures.

The monetary policy decision to be made today, Mr. Clay said, was one of planning the accommodation of open market operations to the actions already taken in raising the discount rate and modifying Regulation Q. The initial adjustment of the money and capital markets had taken place in an environment of substantial cushioning action through open market operations. There was no way of knowing how much additional adjustment would take place in the weeks ahead. There were so many uncertainties in the financial picture over the next several weeks that it was difficult to foresee the various financial

relationships that would develop and to determine System policy targets. It would appear appropriate to provide sufficient reserves to meet the credit needs for orderly economic growth, to stand ready to avoid any credit stringencies that might develop, such as in connection with the runoff of CD's, and to temper further adjustments in the money and credit markets. The draft economic policy directive appeared satisfactory to him.

Mr. Scanlon reported that conditions in the Seventh Federal Reserve District remained excellent with indications that both consumers and businessmen were very optimistic. Labor markets were exceptionally tight--in part, of course, because of the seasonal demand for labor. One automobile manufacturer had recently announced a cutback in production to balance dealer inventories. But that development had been expected and did not appear to indicate any weakening of over-all demand for automobiles.

Recent conditions in the money and capital markets had been dominated by the increase in discount rates, Mr. Scanlon commented. The rate increase unleashed a host of expectational and other forces and the immediate impact might prove to be an over-adjustment. Because of the uncertain relation between money market conditions and aggregate supply measures at the present time, and the evidence of the slowing in growth of total reserves

and money in the past few months, care should be exercised to assure that total reserves did not fail to increase at least seasonally.

It seemed to Mr. Scanlon that it was imperative that the Committee follow a policy that would reinforce the language in the release made by the Board at the time of the announcement of the discount rate change. He believed a 4.25-4.40 per cent range for short-term bill rates was consistent with that policy. If the draft directive accomplished that, he favored it. Like others, he believed the Manager should have ample latitude to moderate any market adjustments during the coming period.

Mr. Galusha reported that all indications were that the Ninth District had continued to enjoy a remarkable prosperity in recent weeks, and the outlook for coming months was bright. There were signs of some slow-down in the pace of economic advance. Thus, retail sales increased at a lower rate in the third quarter than over the first half of the year; and District measures of real output for October, while still well above year-ago levels, suggested a slight decline from those for the third quarter. Despite this objective evidence, business sentiment by all accounts remained bullish. The optimism might be due in part to the outlook for agriculture, which was quite rosy, and to the visible impact the Vietnam escalation was having

on the District economy. Certain depressed areas in the District were now getting military contracts and only a few days ago plans were announced for re-opening a Twin Cities area arsenal and putting on 1,000 employees.

Mr. Galusha said that District bank credit growth was considerable in November, far greater than seasonal. Non-weekly reporting banks showed the usual increase, but weekly reporting banks showed a much larger than seasonal gain--which could be traced to an increase in business loans beyond anything past Novembers would have led one to expect. The reason for that large increase in business loans was not altogether clear.

The heads of the largest District banks were reporting--on the basis of their own experience and conversations with colleagues in other areas--that CD money was getting hard to come by, Mr. Galusha continued. Evidently corporations, and particularly those with ambitious investment programs under way, were finding less and less cash to lend out. Rates were generally 4.5 per cent for 30 days, 4.6 per cent for 60 days, and 4.7 per cent plus for 90 days. One major savings and loan association had moved to 4-1/2 per cent on passbook savings.

Mr. Galusha remarked that he had nothing to add to what had already been said on the issue of monetary policy. He did not understand the draft directive. Perhaps the best the Committee

could do today would be to give the Desk a vote of confidence and let it go at that until there had been a re-establishment of a pattern of relationship among customary target variables. He thought the Committee was faced with the necessity of framing an objective in qualitative terms of tone, color, and feel.

Mr. Galusha added that he would like to compliment the authors of the green book again; he had found the explicit discussion of likely future developments most helpful. He hoped that the Board's staff could now be coaxed into sticking its collective neck out not one but two quarters into the future.

Mr. Swan said he had no significant changes in recent business trends in the Twelfth District to report. Loan demand at banks continued strong and bank credit expanded sharply in the last three weeks of November. However, banks had not been substantial borrowers from the Reserve Bank, even during the four days when the San Francisco discount rate was lower than in some other Districts. Last Thursday, however, some major banks with which he had checked indicated that in the current week they expected to be quite heavy borrowers in the Federal funds market, and he understood that that had developed.

As to responses to the change in Regulation Q, Mr. Swan continued, major banks in the San Francisco and Los Angeles

areas had indicated that they were planning some upward adjustment in CD rates. They all emphasized that the new rates--which were 4-1/4 per cent for 30 day money, 4-1/2 per cent for 90 day money, and 4-5/8 per cent for deposits of 6 months or more--were still tentative; they had not been announced publicly, and were subject to modification. In the other three reserve cities of the District--Seattle, Portland, and Salt Lake--none of the banks reported plans to raise rates but they had not made final decisions on the subject.

The savings and loan associations had, of course, expressed concern about the effects of the Regulation Q change on their situation, Mr. Swan said. However, the District's major banks had not been pushing savings certificates for individuals and it seemed to him unlikely that they would change their attitude in that regard. Mr. Brill's point that commercial banks generally were doing well this year in attracting ordinary savings deposits certainly applied in the Twelfth District. Despite the rather wide margin between their rates and those of around 4.85 per cent [illegible] by savings and loan associations, savings accounts at weekly reporting banks increased 8 per cent in the first ten months of 1965, as compared with a 6.4 per cent rise at savings and loan associations.

In the same period in 1964 the rise was 4-1/2 per cent at banks and 13-1/2 per cent at savings and loan associations.

In terms of policy, Mr. Swan agreed generally with the comments that had already been made. He was not inclined to argue with what had been said regarding the relationships that were likely to prevail, but he would come back to what he thought was the Manager's original point, that adjustments in market conditions should be moderated so that they did not feed on themselves. He favored a bill rate in the 4.25-4.40 per cent range, with possible swings in the net reserve figures. He felt, however, that the first and second paragraphs of the directive were somewhat inconsistent. In his judgment the directive could be made a little more straightforward by deleting the word "current" in the last sentence of the first paragraph, and by replacing the second paragraph with language along the following lines:

> However, taking into account the forthcoming Treasury financing activity and widely fluctuating seasonal pressures at this time of the year in addition to the recent increase in Reserve Bank discount rates, System open market operations shall be directed to moderating any further adjustments in money and credit markets that may develop.

In response to Mr. Robertson's question as to whether the import of Mr. Swan's suggestion was any different from that of the staff's draft, Mr. Swan said he thought the two came out at the same point but that the language he proposed was somewhat clearer; it made more evident the nature of the problem in the period immediately

ahead. The Committee's underlying policy was to "complement other recent measures," as the first paragraph said, but the instruction given in the second paragraph to "moderate further adjustments" was not intended to implement that underlying policy. Rather, it was related to the forthcoming Treasury financing, year-end seasonal pressures, and the fact that the discount rate had just been changed.

Mr. Mitchell commented that if yesterday's market deterioration had not occurred one would have assumed that it was developments of that type that were to be "moderated." He asked Mr. Holmes whether he would interpret yesterday's events as "further adjustments" to be moderated, or whether he would start with the situation as of the close of business yesterday.

Mr. Holmes said that he assumed the Committee would intend the latter interpretation, and Mr. Swan commented that he had proposed the words, "any further adjustments . . . that may develop" to clarify that point.

Chairman Martin commented that perhaps Mr. Swan's proposal involved some grammatical improvement over the staff's draft, but to his mind it did not differ in substance.

The go-around then resumed with remarks by Mr. Irons.

Mr. Irons reported that business activity in the Eleventh District was very strong and seemed to be gaining in strength. There was a marked undertone of confidence, and there were references at

times to elements of speculative activity in the picture. The outlook was viewed bullishly, especially with the Vietnam war and the likelihood of further increases in Government spending. Practically all of the District's major indexes were showing increases and the probability of further increases. Employment had grown further; the District was almost in a state of full employment, with the unemployment rate a little over 3 per cent in the District as a whole and at 2-1/2 per cent in some of the larger cities. Auto sales, and retail trade generally, were strong, and retailers were expecting heavy seasonal buying. Despite some concern earlier, it looked as though agricultural conditions this year, with respect to both volume and prices, would be the most favorable in some time. Also, the crude oil outlook was good.

Mr. Irons remarked that the System's recent actions on the discount rate and Regulation Q appeared to have been well taken in the District. The comments he had received generally reflected favorable reactions except, perhaps, on the part of savings and loan associations. He hoped that banks would not let competitive considerations cause them to increase rates on CD's and other time deposits unduly. There were no reports so far of such developments in the Eleventh District, although two small country banks were raising the question of the need to raise their rates on grounds of competition.

Bank credit had increased further, Mr. Irons continued, and District banks were fairly fully loaned up. Demand deposits had risen quite sharply. On the other hand, there had been some slipping off of time deposits and CD's. Larger banks in the District were net buyers of Federal funds, averaging about $200 million. There had been little borrowing from the Reserve Bank.

It was not necessary to comment in detail on the pattern of national developments, Mr. Irons said He noted that the Commerce-SEC survey of capital spending and other recent data had led to higher estimates of activity in the period ahead.

Mr. Irons remarked that he recognized the framework within which policy would have to be carried out in the coming month. The adjustments so far to the recent rate actions had been satisfactory, but further adjustments probably lay ahead. With strong seasonal demands and with the need to provide for normal growth, and with the Treasury also in the picture, market conditions would be uncertain and difficult to deal with. In general, he would like to have the discount rate viewed as a ceiling for the bill rate and the Federal funds rate for the time being. It might be necessary later to take steps to validate the new discount rate, but he would not favor them in the next month. He would be satisfied to see the Federal funds rate around 4-1/4 to 4-1/2 per cent, and the Treasury bill rate ranging from a low of 4.25-4.30 per cent to a high of 4.45 per cent.

Certainly, Mr. Irons said, the Manager had to be given considerable latitude during a period such as lay ahead. He would not favor setting a target in terms of net borrowed or free reserves; he would accept the marginal reserve figure that developed from an effort to keep the rate structure in line with the discount rate. And he would not want to see any reluctance in meeting seasonal and other needs for reserves. He did not advocate a policy of ease, but as the Board had implied in its recent press release, reserve availability should be adequate to meet requirements. He would accept the draft directive as written.

Mr Ellis said that business in New England continued to warrant the "ebullient" label. Manufacturing production and employment were rising and upward trends in new orders continued. Construction contracting had paused in total but was feeling the impact of sharp surges in highway building. Unemployment declines continued and evidence of labor shortage had widened. Consumer spending slowed its increase in November but department store sales were running 3 per cent better than in the pre-Christmas season last year.

Mr. Ellis remarked that he had been watching the District's weekly reporting member banks for signs of any trouble in meeting their needs in December, when 30 per cent of their CD's matured--as compared with 21 per cent for the U.S. So far, the evidence suggested they were making the switch smoothly. To be specific,

they had not had to reach out and match the rates announced by Chase Manhattan last Friday (December 10). Nor had they resorted to expansion of negotiable notes. As of last Friday rates quoted on negotiable notes matched CD rates up to 90-day maturity and then shaded below the CD rates by 5 and 10 basis points out to one-year maturity.

Mr. Ellis welcomed Mr. Brill's discussion of guideline interpretation, and agreed that it was necessary to start with consideration of total credit flows. He therefore expected the next green book to reflect the results of such analysis. The green book was good but could be better.

Since the last meeting of the Committee, Mr. Ellis said, the weight of evidence seemed to have supported the judgments reached then. The Federal budget outlook had turned toward deeper deficits and stepped-up outlays; the balance of payments news emphasized the need for further action to achieve a solution; manufacturing output had increased vigorously and defense orders were helping to bolster it; capital spending and its outlook had strengthened; the labor supply had tightened; and price trends continued to show an upward tilt.

As expected, Mr. Ellis continued, the discount rate action had drawn out many vocal reactions. In Boston the Reserve Bank kept a finger to the academic pulse as a matter of practice. He

was a little surprised by the intensity of disapproval voiced by some academicians. The sting of their lashes was tempered somewhat by the more balanced views of others, who concluded that it was a close decision that could be tipped either way by personal judgment. The latter offered the view that one salutory result of the action would be to force public attention to the problem of financing the expected added costs of the Vietnam conflict and the Great Society program without simple and automatic resort to higher deficits.

In his basic position on policy, Mr. Ellis found himself in agreement with the statement by Mr. Hickman that the Committee should establish and preserve an even keel through the year end. Since the discount rate increase the markets had been so influenced by the ease in reserve availability that it was hazardous to attempt an identification of compatible intermediate goals of policy. Perhaps because he had been participating in the daily telephone conference call since the Committee's previous meeting, he believed that the Manager should be provided with some goals of policy in addition to an indication to preserve orderly conditions in the market as it adjusted to new rates. He would recommend dealing with the difficult alternatives by picking a likely combination of intermediate goals--one that had some prospect of being compatible--and then suggesting to the Manager some priorities within that package to be followed if choice was forced upon him.

To be specific, Mr. Ellis said, he was prepared to accept the staff estimates as a starting point. He believed that a bill rate in the range of 4.30-4.45 per cent might well prove compatible with net borrowed reserves averaging around $100 million, borrowings holding around $550 million, and a Federal funds rate generally at 4-1/2 per cent. It struck him that such a pattern would be acceptable to the market as not being a further turn of the reserve availability screw, recognizing the positive free reserve figure of last week as temporary. He would direct the Manager to seek such intermediate targets unless short-term bill rates unexpectedly tended to move above 4.45 per cent, in which case he would want him to abandon temporarily the reserve target in favor of holding rates below 4.45 per cent. On the other hand, he would not expect the Manager to seek higher levels of net borrowed reserves in order to hold bill rates up to any level the Committee might establish today. The underlying objective, of course, was to allow markets to find their own new level.

In view of the Committee's disposition not to specify intermediate goals of policy, Mr. Ellis continued, he was prepared to accept the staff's draft directive with the understanding that the Committee was not establishing a single rate objective as the principal goal of policy. However, he liked Mr. Swan's proposed rewording of that draft; he shared the view that there was some inconsistency in the staff draft.

Mr. Balderston said he would divide the four weeks between this meeting and the next into two parts. As the Committee knew, bill rates tended to be seasonally high during the Christmas period and then to decline. He would hope the Desk would dampen any bill rate increases during the first two weeks and then, if necessary, support bill rates in the two weeks remaining before the Committee met again. For both intervals he would use the 4.30-4.45 per cent range suggested by the staff as a guide. The staff had indicated that a net borrowed reserve figure of $100 million might be consistent with such a bill rate objective over the next four weeks as a whole, and he was merely suggesting that the Desk might need to treat the two parts of the period separately. In any case, it now appeared that there would be net free reserves for a second successive week, and he would hope that such figures could be avoided in the future. Otherwise the public might well be confused with respect to the System's intentions in raising the discount rate.

Chairman Martin said he had little to add to what already had been said. He thought the discussion today provided good evidence of the futility of trying to project developments under the circumstances of the moment. In due course the storm was likely to be followed by a calm in which the Committee could remold its policy. He had always found the year end a particularly difficult time to assess conditions.

The Chairman said he thought that the members of both the majority and minority had conducted themselves well through the recent period, and that the System had played a constructive role in 1965. Of course, no one could be absolutely certain that his judgments were correct in every detail.

Chairman Martin then turned to the question of the directive. As he had indicated earlier, to him Mr. Swan's proposal did not differ in substance from the staff's draft, but that was a matter of judgment. In any case, he saw no objection to the proposal and he suggested that the Committee vote on it.

Mr. Galusha asked whether the Manager thought the proposed directive gave him room to deal with all of the changes that could occur in the period until the next meeting, including the possible shift in the direction of seasonal pressures. Mr. Holmes replied that seasonal pressures might well ebb during the interval and the Desk would certainly have that possibility in mind. The period ahead was a highly uncertain one, however, and he did not think that all possible developments could be anticipated. Mr. Galusha then noted that as he understood the general consensus there would be no attempt through open market operations to reverse the impact of the discount rate change, and Mr. Holmes replied that was clear in the proposed directive.

In the course of further discussion the Committee agreed to some language revisions in the directive proposed by Mr. Swan.

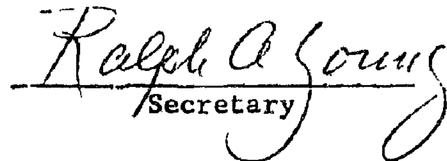
> Thereupon, upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

> The economic and financial developments reviewed at this meeting indicate that domestic economic expansion is gaining in strength in a climate of optimistic business sentiment, with continuing active demands for credit and some further upward creep in prices. Although there appears to have been some recent improvement in our international payments, the need for further progress remains. In this situation, it is the Federal Open Market Committee's policy to complement other recent measures taken to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

> Until the next meeting of the Committee, and taking into account the forthcoming Treasury financing activity and widely fluctuating seasonal pressures at this time of year in addition to the recent increase in Reserve Bank discount rates, System open market operations shall be directed to moderating any further adjustments in money and credit markets that may develop.

It was agreed that the next meeting of the Committee would be held on Tuesday, January 11, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

Attachment A

CONFIDENTIAL (FR) December 13, 1965

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on December 14, 1965

The economic and financial developments reviewed at this meeting indicate that domestic economic expansion is gaining in strength in a climate of optimistic business sentiment, with continuing active demands for credit and some further upward creep in prices. Although there appears to have been some recent improvement in our international payments, the need for further progress remains. In this situation, it is the Federal Open Market Committee's current policy to complement other recent measures taken to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, and taking into account the recent increases in Federal Reserve Bank discount rates and forthcoming Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to moderating further adjustments of money and credit market conditions in a period of widely fluctuating seasonal pressures.