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, March 1, 1966, at 9:30 a.m.

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

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

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

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

Mr. Fauver, Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Adviser, Division of International Finance, Board of Governors
Messrs. Axilrod and Gramley, Associate Advisers, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Mr. Strothman, First Vice President, Federal Reserve Bank of Minneapolis
Messrs. Willis, Ratchford, Brandt, Baughman, and Jones, Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, and St. Louis, respectively
Messrs. Nelson and Lynn, Directors of Research at the Federal Reserve Banks of Minneapolis and San Francisco, respectively
Mr. Meek, Manager, Securities Department, Federal Reserve Bank of New York

In the agenda for this meeting, the Secretary reported that advices had been received of the election by the Federal Reserve Banks of members and alternate members of the Federal Open Market Committee for the term of one year beginning March 1, 1966, and it appeared that such persons would be legally qualified to serve after they had executed their oaths of office.

The elected members and alternates were as follows:

Alfred Hayes, President of the Federal Reserve Bank of New York, with William F. Treiber, First Vice President of the Federal Reserve Bank of New York, as alternate;

Karl R. Bopp, President of the Federal Reserve Bank of Philadelphia, with Edward A. Wayne, President of the Federal Reserve Bank of Richmond, as alternate;

W. Braddock Hickman, President of the Federal Reserve Bank of Cleveland, with Charles J. Scanlon, President of the Federal Reserve Bank of Chicago, as alternate;

George H. Clay, President of the Federal Reserve Bank of Kansas City, with Eliot J. Swan, President of the Federal Reserve Bank of San Francisco, as alternate;

Watrous H. Irons, President of the Federal Reserve Bank of Dallas, with Darryl R. Francis, President of the Federal Reserve Bank of St. Louis, as alternate.

Upon motion duly made and seconded, and by unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after February 28, 1967, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, as the case might be, they would cease to have any official connection with the Federal Open Market Committee:

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| Wm. McC. Martin, Jr. | Chairman |
| Alfred Hayes | Vice Chairman |
| Robert C. Holland | Secretary |
| Merritt Sherman | Assistant Secretary |
| Kenneth A. Kenyon | Assistant Secretary |
| Arthur L. Broida | Assistant Secretary |
| Charles Molony | Assistant Secretary |
| Howard H. Hackley | General Counsel |
| David B. Hexter | Assistant General Counsel |
| Daniel H. Brill | Economist |
| David P. Eastburn, George Garvy, Ralph T. Green, Albert R. Koch, Maurice Mann, J. Charles Partee, Robert Solomon, Clarence W. Tow, and Ralph A. Young | Associate Economists |

Upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Federal Open Market Committee after February 28, 1967.

Upon motion duly made and seconded, and by unanimous vote, Alan R. Holmes and Charles A. Coombs were selected to serve at the pleasure of the Federal Open Market Committee as Manager of the System Open Market Account and as Special Manager for foreign currency operations for such Account, respectively, it being understood that their selection was subject to their being satisfactory to the Board of Directors of the Federal Reserve Bank of New York.

Secretary's note: Advice subsequently was received that Messrs. Holmes and Coombs were satisfactory to the Board of Directors of the Federal Reserve Bank of New York for service in the respective capacities indicated.

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on February 8, 1966, were approved.

Consideration then was given to the continuing authorizations of the Committee, according to the customary practice of reviewing such matters at the first meeting in March of every year, and the actions set forth hereinafter were taken.

With respect to the continuing authority directive relating to transactions in U.S. Government securities and bankers' acceptances, Chairman Martin noted that in a memorandum to the Committee dated February 24, 1966, the Manager had recommended a reduction from $2 billion to $1.5 billion in the dollar limit established in paragraph 1(a) on the aggregate amount by which System Account holdings of Government securities might be increased or decreased between meetings of the Committee. As indicated in the memorandum, a copy of which has been placed in the Committee's files, the higher limit had been established on December 6, 1965, because of certain circumstances which seemed to have passed.

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 Open Market Account in accordance with the following continuing authority directive relating to transactions in U.S. Government securities and bankers' acceptances:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $1.5 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed $125 million or 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York;

(c) To buy U.S. Government securities with maturities as indicated below, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market. U.S. Government securities bought under the provisions of this section shall have maturities of 24 months or less at the time of purchase, except that, during any period beginning with the day after the Treasury has announced a refunding operation and ending on the day designated as the settlement date for the exchange, the U.S. Government securities bought may be of any maturity.

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate 1/4 of 1 per cent below the discount rate of the Federal

Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $500 million.

Chairman Martin then noted that on February 21, 1966 Mr. Young had distributed to the Committee certain materials prepared by the Secretariat relating to a proposed reorganization of the Committee's instruments governing System foreign currency operations. (Copies of Mr. Young's memorandum and attachments have been placed in the Committee's files.) The Chairman invited Mr. Young to comment on the materials.

Mr. Young said that the members would recall that at the meeting of November 23, 1965 the Committee had asked the staff to review System operations in foreign currencies and to submit a report. Work on the report had progressed to an advanced stage but had not been completed. At the same time, the staff had made a study of the Committee's existing foreign currency instruments--the authorization, guidelines, and continuing authority directive--and had concluded that their essential content could be recast into simpler and clearer form in two new instruments--an authorization and a directive. Among the materials distributed were drafts of the proposed new instruments, an explanatory memorandum, and copies of the existing instruments with marginal notes indicating the disposition made of all passages in developing the proposed new instruments.

Mr. Young noted that the subject was a complex one and that the members had had relatively little time to study the documents distributed. For those reasons, and also because the staff report on foreign currency operations was not yet available, he thought the Committee might want to defer action regarding the recommendation that the three existing instruments be replaced by two new ones.

Chairman Martin suggested that the Committee reaffirm its existing foreign currency instruments today and plan on considering the proposed replacements at its next meeting, when all members would have had an opportunity to review them carefully. There was general agreement with this suggestion.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the Authorization Regarding Open Market Transactions in Foreign Currencies, as reaffirmed on March 2, 1965, was reaffirmed:

Pursuant to Section 12A of the Federal Reserve Act and in accordance with Section 214.5 of Regulation N (as amended) of the Board of Governors of the Federal Reserve System, the Federal Open Market Committee takes the following action governing open market operations incident to the opening and maintenance by the Federal Reserve Bank of New York (hereafter sometimes referred to as the New York Bank) of accounts with foreign central banks.

I. Role of Federal Reserve Bank of New York

The New York Bank shall execute all transactions pursuant to this authorization (hereafter sometimes referred to as transactions in foreign currencies) for the System Open Market Account, as defined in the Regulation of the Federal Open Market Committee.

## II. Basic Purposes of Operations

The basic purposes of System operations in and holdings of foreign currencies are:

(1) To help safeguard the value of the dollar in international exchange markets;
(2) To aid in making the existing system of international payments more efficient and in avoiding disorderly conditions in exchange markets;
(3) To further monetary cooperation with central banks of other countries maintaining convertible currencies, with the International Monetary Fund, and with other international payments institutions;
(4) Together with these banks and institutions, to help moderate temporary imbalances in international payments that may adversely affect monetary reserve positions; and
(5) In the long run, to make possible growth in the liquid assets available to international money markets in accordance with the needs of an expanding world economy.

## III. Specific Aims of Operations

Within the basic purposes set forth in Section II, the transactions shall be conducted with a view to the following specific aims:

(1) To offset or compensate, when appropriate, the effects on U.S. gold reserves or dollar liabilities of disequilibrating fluctuations in the international flow of payments to or from the United States, and especially those that are deemed to reflect temporary forces or transitional market unsettlement;
(2) To temper and smooth out abrupt changes in spot exchange rates and moderate forward

premiums and discounts judged to be disequilibrating;

(3) To supplement international exchange arrangements such as those made through the International Monetary Fund; and

(4) In the long run, to provide a means whereby reciprocal holdings of foreing currencies may contribute to meeting needs for international liquidity as required in terms of an expanding world economy.

## IV. Arrangements with Foreign Central Banks

In making operating arrangements with foreign central banks on System holdings of foreign currencies, the New York Bank shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee.

The Bank shall instruct foreign central banks regarding the investment of such holdings in excess of minimum working balances in accordance with Section 14(e) of the Federal Reserve Act.

The Bank shall consult with foreign central banks on coordination of exchange operations.

Any agreements or understandings concerning the administration of the accounts maintained by the New York Bank with the central banks designated by the Board of Governors under Section 214.5 of Regulation N (as amended) are to be referred for review and approval to the Committee, subject to the provision of Section VIII, paragraph 1, below.

## V. Authorized Currencies

The New York Bank is authorized to conduct transactions for System Account in such currencies and within the limits that the Federal Open Market Committee may from time to time specify.

## VI. Methods of Acquiring and Selling Foreign Currencies

The New York Bank is authorized to purchase and sell foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the Stabilization Fund of the Secretary of the Treasury established by Section 10 of the Gold Reserve Act of 1934 and with foreign monetary authorities.

Unless the Bank is otherwise authorized, all transactions shall be at prevailing market rates.

## VII. Participation of Federal Reserve Banks

All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G (1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

## VIII. Administrative Procedures

The Federal Open Market Committee authorizes a Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) to give instructions to the Special Manager, within the guidelines issued by the Committee, in cases in which it is necessary to reach a decision on operations before the Committee can be consulted.

All actions authorized under the preceding paragraph shall be promptly reported to the Committee.

The Committee authorizes the Chairman, and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors:

(1) With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;

(2) To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities;

(3) From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Problems.

## IX. Special Manager of the System Open Market Account

A Special Manager of the Open Market Account for foreign currency operations shall be selected in accordance with the established procedures of the Federal Open Market Committee for the selection of the Manager of the System Open Market Account.

The Special Manager shall direct that all transactions in foreign currencies and the amounts of all holdings in each authorized foreign currency be reported daily to designated staff officials of the Committee, and shall regularly consult with the designated staff officials of the Committee on current tendencies in the flow of international payments and on current developments in foreign exchange markets.

The Special Manager and the designated staff officials of the Committee shall arrange for the prompt transmittal to the Committee of all statistical and other information relating to the transactions in and the amounts of holdings of foreign currencies for review by the Committee as to conformity with its instructions.

The Special Manager shall include in his reports to the Committee a statement of bank balances and investments payable in foreign currencies, a statement of net profit or loss on transactions to date, and a summary of outstanding unmatured contracts in foreign currencies.

X. Transmittal of Information to Treasury Department

The staff officials of the Federal Open Market Committee shall transmit all pertinent information on System foreign currency transactions to designated officials of the Treasury Department.

XI. Amendment of Authorization

The Federal Open Market Committee may at any time amend or rescind this authorization.

Upon motion duly made and seconded, and by unanimous vote, the Guidelines for System Foreign Currency Operations as amended on November 23, 1965, were reaffirmed:

1. Holdings of Foreign Currencies

Until otherwise authorized, the System will limit its holdings of foreign currencies to that amount necessary to enable its operations to exert a market influence. Holdings of larger amounts will be authorized only when the U.S. balance of international payments attains a sufficient surplus to permit the ready accumulation of holdings of major convertible currencies.

Foreign currency holdings shall be invested as far as practicable in conformity with Section 14(e) of the Federal Reserve Act.

2. Exchange Transactions

System exchange transactions shall be geared to pressures of payments flows so as to cushion or moderate disequilibrating movements of funds and their destabilizing effects on U.S. and foreign official reserves and on exchange markets.

In general, these transactions shall be geared to pressures connected with movements that are expected to be reversed in the foreseeable future; when expressly authorized by the Federal Open Market Committee, they may also be geared on a short-term basis to pressures connected with other movements.

Subject to express authorization of the Committee, the Federal Reserve Bank of New York may enter into reciprocal arrangements with foreign central banks on exchange transactions ("swap" arrangements), which arrangements may be wholly or in part on a standby basis.

Drawings made by either party under a reciprocal arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

The New York Bank shall, as a usual practice, purchase and sell authorized currencies at prevailing market rates without trying to establish rates that appear to be out of line with underlying market forces.

If market offers to sell or buy intensify as System holdings increase or decline, this shall be regarded as a clear signal for a review of the System's evaluation of international payments flows.

It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions in order that System transactions do not conflict with those being undertaken by foreign monetary authorities.

3. Transactions in Spot Exchange

The guiding principle for transactions in spot exchange shall be that, in general, market movements in exchange rates, within the limits established in the International Monetary Fund Agreement or by central bank practices, index affirmatively the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public.

Temporary or transitional fluctuations in payments flows may be cushioned or moderated whenever they occasion market anxieties, or undesirable speculative activity in foreign exchange transactions, or excessive leads and lags in international payments.

Special factors making for exchange market instabilities include (i) responses to short-run increases in international political tension, (ii) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, or (iii) market rumors of a character likely to stimulate speculative transactions.

Whenever exchange market instability threatens to produce disorderly conditions, System transactions are appropriate if the Special Manager, in consultation with the Federal Open Market Committee, or in an emergency with the members of the Committee designated for that purpose, reaches a judgment that they may help to re-establish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified, curtailed, or eventually discontinued pending a reassessment by the Committee of supply and demand forces.

Insofar as is practicable, the New York Bank shall purchase a currency through spot transactions at or below its par value, and sell a currency through spot transactions at rates at or above its par value.

Spot transactions at rates other than those set forth in the preceding paragraph shall be specially authorized by the Committee or by the members of the Committee designated in Section VIII of the Authorization for Open Market Transactions in Foreign Currencies, except that purchases of exchange to meet System commitments may be executed without special authorization at rates above par when necessary.

4. Transactions in Forward Exchange

Transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken:

(1) When forward premiums or discounts are inconsistent with interest rate differentials and are giving rise to disequilibrating movements of short-term funds;

(2) When it is deemed appropriate to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders;

(3) To allow greater flexibility in covering System commitments, including those under swap arrangements;

(4) To facilitate the use of holdings of one currency for the settlement of commitments denominated in other currencies.

Forward sales of authorized currencies to the U.S. Stabilization Fund out of existing System holdings or in conjunction with spot purchases of such currencies also may be undertaken in order to allow greater flexibility in covering commitments of the U.S. Treasury.

In all other cases, proposals of the Special Manager to initiate forward operations shall be submitted to the Committee for advance approval.

Upon motion duly made and seconded, and by unanimous vote, the following continuing authority directive to the Federal Reserve Bank of New York with respect to foreign currency operations was approved:

The Federal Reserve Bank of New York is authorized and directed to purchase and sell through spot transactions any or all of the following currencies in accordance with the Guidelines for System Foreign Currency Operations as reaffirmed March 1, 1966; provided that the aggregate amount of foreign currencies held under reciprocal currency arrangements shall not exceed $2.8 billion equivalent at any one time, and provided further that the aggregate amount of foreign currencies held as a result of outright purchases shall not exceed $150 million equivalent at any one time:

Pounds sterling
French francs
German marks
Italian lire
Netherlands guilders
Swiss francs
Belgian francs
Canadian dollars
Austrian schillings
Swedish kronor
Japanese yen

The Federal Reserve Bank of New York is also authorized and directed to operate in any or all of the foregoing currencies in accordance with the Guidelines and up to a combined total of $275 million equivalent, by means of:

(a) purchases through forward transactions, for the purpose of allowing greater flexibility in covering commitments under reciprocal currency agreements;

(b) purchases and sales through forward as well as spot transactions, for the purpose of utilizing its holdings of one currency for the settlement of commitments denominated in other currencies;

(c) purchases through spot transactions and concurrent sales through forward transactions, for the purpose of restraining short-term outflows of funds induced by arbitrage considerations; and

(d) sales through forward transactions for the purpose of influencing interest arbitrage flows of funds and of minimizing speculative disturbances.

The Federal Reserve Bank of New York is also authorized and directed to make purchases through spot transactions, including purchases from the U.S. Stabilization Fund, and concurrent sales through forward transactions to the U.S. Stabilization Fund, of any of the foregoing currencies in which the U.S. Treasury has outstanding indebtedness, in accordance with the Guidelines and up to a total of $100 million equivalent. Purchases may be at rates above par, and both purchases and sales are to be made at the same rates.

The Federal Reserve Bank of New York is also authorized and directed to make purchases of sterling on a covered or guaranteed basis in terms of the dollar up to a total of $200 million equivalent.

The Federal Reserve Bank of New York is also authorized and directed to assume commitments for forward sales of lire up to $500 million equivalent as a means of facilitating the retention of dollar holdings by private foreign holders.

Upon motion duly made and seconded, and by unanimous vote, the following procedures with respect to allocations of the System Open Market Account were approved without change:

1. Securities in the System Open Market Account shall be reallocated on the last business day of each month by means of adjustments proportionate to the adjustments that would have been required to equalize approximately the average reserve ratios of the 12 Federal Reserve Banks based on the most recent available five business days' reserve ratio figures.

2. The Board's staff shall calculate, in the morning of each business day, the reserve ratios of each Bank after allowing for the indicated effects of the settlement of the Interdistrict Settlement Fund for the preceding day. If these calculations should disclose a deficiency in the reserve ratio of any Bank, the Board's staff shall inform the Manager of the System Open Market Account, who shall make a special adjustment as of the previous day to restore the reserve ratio of that Bank

to the average of all the Banks. However, such adjustments shall not be made beyond the point where a deficiency would be created at any other Bank. Such adjustments shall be offset against the participation of the Bank or Banks best able to absorb the additional amount or, at the discretion of the Manager, against the participation of the Federal Reserve Bank of New York. The Board's staff and the Bank or Banks concerned shall then be notified of the amounts involved and the Interdistrict Settlement Fund shall be closed after giving effect to the adjustments as of the preceding business day.

3. Until the next reallocation the Account shall be apportioned on the basis of the ratios determined in paragraph 1, after allowing for any adjustments as provided for in paragraph 2.

4. Profits and losses on the sale of securities from the Account shall be allocated on the day of delivery of the securities sold on the basis of each Bank's current holdings at the opening of business on that day.

A proposed list for distribution of periodic reports prepared by the Federal Reserve Bank of New York for the Federal Open Market Committee was presented for consideration and approval.

Thereupon, upon motion duly made and seconded, and by unanimous vote, authorization was given for the following distribution:

1. The Members of the Board of Governors.
2. The Presidents of the twelve Federal Reserve Banks.
3. Officers of the Federal Open Market Committee.
*4. The Secretary of the Treasury.
*5. The Under Secretary of the Treasury for Monetary Affairs and the Deputy Under Secretary for Monetary Affairs.

*Weekly reports of open market operations only.

*6. The Assistant to the Secretary of the Treasury working on debt management problems.
*7. The Fiscal Assistant Secretary of the Treasury.
8. The Director of the Division of Bank Operations of the Board of Governors.
9. The officer in charge of research at each of the Federal Reserve Banks not represented by its President on the Federal Open Market Committee.
10. The alternate member of the Federal Open Market Committee from the Federal Reserve Bank of New York; the Assistant Vice Presidents of the Federal Reserve Bank of New York working under the Manager of the System Account; the Managers of the Securities Department of the New York Bank; the Vice President of the Foreign Function having supervisory responsibility for operations; the Senior Foreign Exchange Officer of the Foreign Function; the Managers of the Foreign Department; the officer in charge, the Assistant Vice President, and the Adviser of the Research Department of the New York Bank; and the confidential files of the New York Bank as the Bank selected to execute transactions for the Federal Open Market Committee.
11. With the approval of a member of the Federal Open Market Committee or any other President of a Federal Reserve Bank, with notice to the Secretary, any other employee of the Board of Governors or a Federal Reserve Bank.

The Committee reaffirmed by unanimous vote the authorization, first given on March 1, 1951, for the Chairman to appoint a Federal Reserve Bank to operate the System Open Market Account temporarily in case the Federal Reserve Bank of New York is unable to function.

The following resolution to provide for the continued operation of the Federal Open Market Committee during an emergency was reaffirmed by unanimous vote:

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*Weekly reports of open market operations only.

In the event of war or defense emergency, if the Secretary or Assistant Secretary of the Federal Open Market Committee (or in the event of the unavailability of both of them, the Secretary or Acting Secretary of the Board of Governors of the Federal Reserve System) certifies that as a result of the emergency the available number of regular members and regular alternates of the Federal Open Market Committee is less than seven, all powers and functions of the said Committee shall be performed and exercised by, and authority to exercise such powers and functions is hereby delegated to, an Interim Committee, subject to the following terms and conditions:

Such Interim Committee shall consist of seven members, comprising each regular member and regular alternate of the Federal Open Market Committee then available, together with an additional number, sufficient to make a total of seven, which shall be made up in the following order of priority from those available: (1) each alternate at large (as defined below); (2) each President of a Federal Reserve Bank not then either a regular member or an alternate; (3) each First Vice President of a Federal Reserve Bank; provided that (a) within each of the groups referred to in clauses (1), (2), and (3) priority of selection shall be in numerical order according to the numbers of Federal Reserve Districts, (b) the President and the First Vice President of the same Federal Reserve Bank shall not serve at the same time as members of the Interim Committee, and (c) whenever a regular member or regular alternate of the Federal Open Market Committee or a person having a higher priority as indicated in clauses (1), (2), and (3) becomes available he shall become a member of the Interim Committee in the place of the person then on the Interim Committee having the lowest priority. The Interim Committee is hereby authorized to take action by majority vote of those present whenever one or more members thereof are present, provided that an affirmative vote for the action taken is cast by at least one regular member, regular alternate, or President of a Federal Reserve Bank. The delegation of authority and other procedures set forth above shall be effective only during such period or periods as there are available less than a total of seven regular members and regular alternates of the Federal Open Market Committee.

As used herein the term "regular member" refers to a member of the Federal Open Market Committee duly appointed or elected in accordance with existing law; the term "regular alternate" refers to an alternate of the Committee duly elected in accordance with existing law and serving in the absence of the regular member for whom he was elected; and the term "alternate at large" refers to any other duly elected alternate of the Committee at a time when the member in whose absence he was elected to serve is available.

The following resolution authorizing certain actions by the Federal Reserve Banks during an emergency was reaffirmed by unanimous vote:

The Federal Open Market Committee hereby authorizes each Federal Reserve Bank to take any or all of the actions set forth below during war or defense emergency when such Federal Reserve Bank finds itself unable after reasonable efforts to be in communication with the Federal Open Market Committee (or with the Interim Committee acting in lieu of the Federal Open Market Committee) or when the Federal Open Market Committee (or such Interim Committee) is unable to function.

(1) Whenever it deems it necessary in the light of economic conditions and the general credit situation then prevailing (after taking into account the possibility of providing necessary credit through advances secured by direct obligations of the United States under the last paragraph of section 13 of the Federal Reserve Act), such Federal Reserve Bank may purchase and sell obligations of the United States for its own account, either outright or under repurchase agreement, from and to banks, dealers, or other holders of such obligations.

(2) In case any prospective seller of obligations of the United States to a Federal Reserve Bank is unable to tender the actual securities representing such obligations because of conditions resulting from the emergency, such Federal Reserve Bank may, in its discretion and subject to such safeguards as it deems necessary, accept from such seller, in lieu of the

actual securities, a "due bill" executed by the seller in form acceptable to such Federal Reserve Bank stating in substantial effect that the seller is the owner of the obligations which are the subject of the purchase, that ownership of such obligations is thereby transferred to the Federal Reserve Bank, and that the obligations themselves will be delivered to the Federal Reserve Bank as soon as possible.

(3) Such Federal Reserve Bank may in its discretion purchase special certificates of indebtedness directly from the United States in such amounts as may be needed to cover overdrafts in the general account of the Treasurer of the United States on the books of such Bank or for the temporary accommodation of the Treasury, but such Bank shall take all steps practicable at the time to insure as far as possible that the amount of obligations acquired directly from the United States and held by it, together with the amount of such obligations so acquired and held by all other Federal Reserve Banks, does not exceed $5 billion at any one time.

Authority to take the actions above set forth shall be effective only until such time as the Federal Reserve Bank is able again to establish communications with the Federal Open Market Committee (or the Interim Committee), and such Committee is then functioning.

By unanimous vote the Committee reaffirmed the authorization, first given at the meeting on December 16, 1958, providing for System personnel assigned to the Office of Emergency Planning, Special Facilities Branch, on a rotating basis to have access to the resolutions (1) providing for continued operation of the Committee during an emergency and (2) authorizing certain actions by the Federal Reserve Banks during an emergency.

There was unanimous agreement that no action should be taken to change the existing procedure, as called for by resolution adopted June 21, 1939, requesting the Board of Governors to cause its examining force to furnish the Secretary of the Federal Open Market Committee a report of each examination of the System Open Market Account.

Reference was made to the procedure authorized at the meeting of the Committee on March 2, 1955, and most recently reaffirmed on March 2, 1965, whereby, in addition to members and officers of the Committee and Reserve Bank Presidents not currently members of the Committee, minutes and other records could be made available to any other employee of the Board of Governors or of a Federal Reserve Bank with the approval of a member of the Committee or another Reserve Bank President, with notice to the Secretary.

It was stated that lists of currently authorized persons at the Board and at each Federal Reserve Bank (excluding secretaries and records and duplicating personnel) had recently been confirmed by the Secretary of the Committee. The current lists were reported to be in the custody of the Secretary, and it was noted that revisions could be sent to the Secretary at any time.

It was agreed unanimously that no action should be taken at this time to amend the procedure authorized on March 2, 1955.

This concluded the consideration of the continuing authorizations of the Open Market Committee, and the Committee turned to a review of operations during the period since the meeting of the Committee held on February 8, 1966.

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 February 8 through February 23, 1966, and a supplemental report for February 24 through 28, 1966. Copies of these reports have been placed in the files of the Committee.

Supplementing the written reports, Mr. Coombs stated that the Treasury gold stock would remain unchanged again this week. The Stabilization Fund opened the month with a gold balance of roughly $80 million, with prospective sales during the month of at least $34 million to the French, $19 million to settle the U.S. share of the Gold Pool deficit for February, and about $18 million for other scattered transactions. Those sales would just about clean out the Stabilization Fund's holdings. It was still hoped that the Russians would be compelled to sell as much as $200 million of gold to finance Canadian wheat imports during March and April, and that might enable the U.S. to fend off further reductions in the Treasury gold stock until April. If the Russian sales did not come through, the Treasury presumably would have to transfer $75 to $100 million from its stock to the Stabilization Fund before the end of this month.

Mr. Coombs reported that strong buying pressure had continued on the London gold market, and that the Pool had been forced to put in a total of $78 million worth of gold since the beginning of the year. It was hoped that sizable Russian gold sales would relieve the pressure on the Pool's resources during the next two months or so, but thereafter the Russians probably would stay out of the market. As he had mentioned on previous occasions, he did not think the outlook in the gold market was favorable. He was apprehensive that serious trouble might be encountered in that area before the year was over, with possible repercussions on other markets.

On the exchange markets, Mr. Coombs said, sterling had run into new troubles during the past two weeks. The Bank of England had had to give support to the rate each day last week, probably to a total of $50 million or so, and it was in the market again yesterday. However, yesterday the British authorities had let the rate slip below par. That involved some risk; whenever the rate moved below par there was the risk that selling pressures would cumulate. In his judgment, however, their decision to back away rather than to try to hold the rate was a wise one because market participants felt that with a British election in prospect a new element of uncertainty had been injected into the market. A number of factors seemed to be involved in the difficulties for sterling. The U.K. trade figures for January were disappointing, although that perhaps was fortuitous; more seriously, the trend of wages and prices remained inflationary; and the expectations of an election, now scheduled for March 31, had further unsettled the market. Also unsettling was the discussion of a suggestion by a group of European and American economists that the margins for exchange rate fluctuations might be widened. That suggestion was disturbing because of fears that sterling might move to the lower limit of the wider range, and that such a development might be a prelude to devaluation.

Mr. Coombs went on to say that the Bank of England began the month of February with net outpayments of close to $400 million, of which $290 million represented debt payments to the System and to the U.S. Treasury. During February, more than $300 million of forward contracts also fell due and, with the adverse shift in the market atmosphere, a number of those contracts were apparently settled by running down existing sterling balances rather than buying the sterling needed with dollars. Despite the fact that the Bank of England's reserves benefited during the month to the extent of $100 million by operations undertaken by the Federal Reserve Bank of New York and by the Bank of Italy, they approached the month end with a prospective deficit of somewhat more than $250 million. Today Chancellor Callaghan was expected to announce that the British Government had taken into the reserves nearly $900 million of the British Government's portfolio of U.S. securities which had been progressively liquefied during the past year or so. That would serve not only to cover the February deficit, but would also add about $630 million to British official reserves. At the same time, the British Government would announce that the $750 million swap line with the Federal Reserve had been completely repaid.

Mr. Coombs said that he would like to bring the Committee up to date on the progress being made at the Bank for International Settlements meetings in negotiating a new international credit package designed to deal with the sterling balance problem. As Mr. Hayes, Mr. MacLaury, and he had mentioned at previous Committee meetings, the general objective was to put together an over-all package of roughly $1 billion, of which the U.S. share would be $315 million, to supersede the credit package provided last September to the Bank of England. The credit lines that had been granted by most of the continental central banks were due to reach the end of their six months' terms about the middle of March. At the last BIS meeting, further progress was made in shaping up a draft which would probably be technically acceptable to most of the European central banks concerned. Two of the European central banks, however, insisted that they could not participate in any new package until the British Government negotiated a backstop arrangement of medium-term credit from the International Monetary Fund or other sources, which would provide refinancing of central bank credits if the Bank of England should be unable to repay them at their final maturity.

Meanwhile, Mr. Coombs continued, it was informally agreed that on March 15 the European parties to the September credit package would extend their credit lines for another three months, but for the limited purpose of offsetting reserve drains occasioned by liquidation of the sterling balances. In his opinion it was unfortunate that the new credit authorizations would be subjected to a more restrictive use than those of September. However, there might not be too much difference in substance because any future speculative attack on sterling would, in all probability, be accompanied by a substantial running down of the sterling balances. He was inclined to think, therefore, that no serious damage would be done if the Federal Reserve and the U.S. Treasury were to pursue a roughly parallel course by informally restricting part of their combined credit lines to the Bank of England to use in financing liquidation of sterling balances. At the present moment, the unused portion of those lines amounted to $1,070 million, comprised of the Federal Reserve swap line of $750 million, a Treasury authorization of $200 million established last September, and the $120 million remaining under a Federal Reserve authorization for $200 million, also provided last September. He suggested that $400 million of the $1,070 million temporarily be earmarked for the specific purpose of offsetting drains on British reserves arising out of liquidation of the sterling balances. If and when the BIS proposal for a new credit package should become effective, the U.S. share of such credit assistance directed to the sterling balance problem would decline from $400 million to $315 million.

Mr. Coombs said he suggested that the Committee proceed informally in the matter because the negotiations on the new credit package were still in process. It was not as yet clear whether the Basle decision to restrict use of the temporary new credit lines could be maintained. With British elections ahead, and with the possibility existing of a new run on sterling, the continental Europeans might find it necessary to take a less restrictive attitude. By acting informally, the System could accommodate itself to the present fluid situation without endangering its own position or that of the Bank of England.

Mr. Daane commented that his personal inclination would be to keep the U.S. credit arrangements with the British as flexible as possible and not to take the more restrictive attitude.

However, he supposed that if the U.S. joined with other countries in a package that involved restrictions it would have to go along with them.

Mr. Coombs remarked that if more restrictive terms were adopted and if the British wanted to draw on the credit lines, the Europeans probably would insist that their credits not be drawn on unless there was a pro rata drawing on the U.S. for the same purpose. Thus the initiative could be left with the British; even if the Committee were to place no restrictions on the use of System credits, the Bank of England would be compelled to restrict its use of them in order to draw on the European central banks. Mr. Coombs added that that circumstance provided an excellent example of the way in which the U.S. could find itself locked into situations by application of the principle of multilateral surveillance, which gave enormous bargaining power to small countries that might be inclined to take extremely conservative positions.

Chairman Martin commented that the matter Mr. Coombs had raised was an extremely important one, and that it would be desirable for all members of the Committee to follow developments with respect to sterling closely over the coming weeks.

Mr. Daane remarked that it was desirable, in his judgment, for the Committee to allow the Special Manager the maximum possible degree of flexibility to deal with the situation.

In reply to questions by Mr. Mitchell, Mr. Coombs said that the Bank of England's total use of its swap line with the System probably had amounted to about $2 billion. The Bank had twice drawn the full amount available and it had made a number of additional drawings of a few days each around month-ends. Of the $200 million authorized in September for System covered purchases of sterling, $80 million had been used. Last fall $30 million had been employed in direct support of the sterling rate. The remainder had been used last week, when the System bought $50 million of sterling from the Bank of England against dollars. Since the System had swapped the sterling with the BIS for lire, and had used the lire as part of the repayment of its swap drawing on the Bank of Italy, last week's transaction served the interests of both the System and the Bank of England. There was no risk exposure to the System in using the authorization in question, because the sterling acquired under it was fully guaranteed by the Bank of England. The authorization for covered sterling purchases did not specify any time limit but it was, of course, subject to review and modification by the Committee. The System held somewhat less than $25 million of uncovered sterling in its working balances, but he planned to reduce that amount to about $20 million in the next week or so.

In response to other questions, Mr. Coombs noted that the September credit package had totaled roughly $930 million. The

U.S. share, divided equally between the System and the Treasury, was $400 million, or somewhat over 40 per cent; other central banks, not including the Bank of France, participated to the extent of about $530 million. The new package under discussion totaled slightly more than $1 billion, of which the U.S. share of $315 million would be a little over 30 per cent; and the Bank of France might possibly participate. The terms being considered allowed for 3-month credits renewable for periods of up to nine or twelve months. Thus, they would be consistent with the Committee's one-year outside limit on swap drawings, although they might call for a somewhat more generous interpretation of renewal possibilities within that limit. If the arrangements were completed, the System and the Treasury might reduce their authorizations for covered sterling purchases from the present combined level of $400 million to $315 million. Alternatively, the authorizations might be continued at $400 million, with $315 million earmarked for the more restrictive purpose. The matter remained to be negotiated with the Treasury.

Mr. Daane said he thought the latter course--continuing the $400 million authorization--would be preferable. Mr. Coombs agreed. To pursue the former course, he said, would amount to cutting back U.S. credit facilities to the Bank of England at the instigation of a small group of European countries. That, in his judgment, would be an unfortunate precedent, which might be followed by efforts to get other countries to reduce their lines of credit to the U.S.

Mr. Swan asked whether the informal earmarking Mr. Coombs had suggested earlier would be for British drawings under the swap line or for U.S. covered purchases of sterling under the September authorizations. Mr. Coombs replied that to retain the greatest flexibility it might be best to relate the earmarking to the overall total of available U.S. credit lines to Britain--including the System's $750 million swap arrangement with the Bank of England, which was now wholly on a standby basis; the Treasury's $200 million authorization for covered sterling purchases, which was not now in use; and the $120 million remaining under the Committee's $200 million authorization for covered sterling purchases. From the technical point of view, however, he was anxious to keep available for market intervention for general purposes the authorization for covered purchases of sterling, since that could be done at the System's initiative. Under certain circumstances the Bank of England might be hesitant about drawing on the swap line, and in any case such drawings gave the general impression of defensive operations. Operations by the New York Bank in the market were likely to be far more effective; they could be an extremely powerful tool.

Mr. Mitchell asked whether an increase in the size of the swap arrangement with the Bank of England might be desirable. Mr. Coombs replied that he would prefer to see the size of some of the other swap lines increased first, because the line with the British was on the high side relative to others. In general, he thought the System's network, taken as a whole, was too small, considering the continuing growth of international trade and payments. It would be desirable to increase it by $1 billion or so.

In reply to questions by Mr. Wayne, Mr. Coombs said he was not sure that an increase in the swap line with the Bank of England would have an adverse effect on the willingness of other central banks to extend credit to the British. It was true that some European central bankers thought the U.S. had been overly lenient in its dealings with the British and that it should have taken a firmer line. His own feeling was that a much more serious situation would have resulted had the U.S. followed such advice. He did not think the attitude of particular countries, such as France or the Netherlands, would seriously damage the chances of negotiating increases in the System's swap lines because the United States had a great deal of bargaining power. One general difficulty at the moment was that the whole international financial system was being subjected to formal review; many approaches were being considered, of which swap arrangements were only one, and there was some tendency for action to be frozen pending the outcome of those discussions. Also, at present the U.S. was mainly focusing its bargaining power on the negotiations for increasing international liquidity through a collective reserve unit and expanded IMF facilities.

Mr. Hayes commented that he thought it reasonable to draw a distinction between the size of the standby facilities the System extended to the Bank of England, which was a matter of public record, and the maximum amount of assistance the U.S. might be prepared to extend to the British under emergency conditions. He could conceive of circumstances in which the U.S. would be willing to provide additional credits on an _ad hoc_ basis but not through an enlarged swap arrangement.

Mr. Hickman asked whether there was any evidence that market participants were beginning to take short positions in sterling and, if so, whether it would be desirable for the System to intervene in the market to buy pounds.

Mr. Coombs replied that there was some indication that people who had maturing forward contracts were using existing holdings of sterling to settle them rather than buying spot sterling for that purpose. He recently had indicated to the Bank of England that the System was prepared to buy sterling on a covered basis, but the Bank had felt such action was not desirable at present. In his judgment their position was correct; the market was convinced that a sterling rate above par would not be realistic now, although no one could be sure what the equilibrium rate was. If the sterling rate began to slide, however, the System could step in.

Chairman Martin noted that any further liquefication of the British portfolio of U.S. securities would involve an additional drain on the U.S. balance of payments. Mr. Wayne then asked whether the step Mr. Coombs had noted the British would announce today--taking about $900 million of their U.S. holdings into their reserves--would have much impact on the U.S. balance of payments. Mr. Coombs replied that about 85 per cent of the impact had already been felt on the U.S. payments balance; $500 million had shown up in the second and third quarters of 1965 alone.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period February 8 through 28, 1966, were approved, ratified, and confirmed.

Mr. Coombs then noted that the System's $100 million standby swap arrangement with the Netherlands Bank would mature on March 15, 1966, and he requested the Committee's approval of its renewal for another three months. No drawings were outstanding on this arrangement; indeed, for the first time in a long time no drawings by either party were outstanding on any of the System's swap lines.

> Renewal of the standby swap arrangement with the Netherlands Bank for a further period of three months was approved.

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 February 8 through 23, 1966, and a supplemental report for February 24 through 28, 1966. Copies of these reports have been placed in the files of the Committee.

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

> A further sharp rise in long-term interest rates was the main feature of the period since the last meeting of the Committee and market participants appear convinced that more of the same lies ahead. Against the background of vigorous economic expansion and growing inflationary fears, a heavy calendar of corporate, municipal, and Government agency issues met generally with a cautious investor response. Anticipation of higher yields and lesser availability of funds later on in the year has tended to bring borrowers into the market ahead of need, while making investors--who seem periodically on the verge of succumbing to the temptations of the historically high yields now prevailing in many sectors of the market--inclined to wait and see.
>
> Government agency issues encountered some difficulties during the period. The poor response to the Export-Import participation certificates, and an

announcement of a $410 million FNMA issue scheduled for mid-March, reminded the market of the substantial extent to which the 1967 budget relies on agency asset sales. The poor response to the Export-Import Bank financing--$360 million placed out of a $700 million offering, despite a 5-1/2 per cent coupon--was not a true reflection of the state of the agency market. The Export-Import Bank participation certificate had few attractive features in present market conditions. The 18-month call feature made it unattractive for long-term investors, and the lack of marketability made it unattractive to corporations and others with liquid funds to invest. Given their tight money positions, commercial banks were understandably anxious to reserve lendable funds to serve customer relationships, rather than purchase a beneficial interest in loans made by the Export-Import Bank. System action to make the certificates eligible at the discount window was apparently not rated an important inducement.

The FNMA participation certificates, on the other hand, will provide a more meaningful test for the market. There already appears to be a substantial interest in the longer maturities to be offered--provided the price is right--but pricing of the intermediate maturities may be a problem. Other recent routine agency issues--a $340 million 9-month FICB issue, and a $506 million 8-month FHLB issue--met with only a lukewarm response despite a 5.15 per cent coupon. And a $250 million 14-month FNMA issue--priced to yield 5.38 per cent--was a real success only because of large--and unexpected--demand from an international institution at the last minute. The contrast of this most recent experience with the earlier ease of placing agency issues is a warning that serious rethinking of the general approach to agency financing may be required in the months ahead.

In the Government securities market, yields in the 5-10 year area rose by 1/4 per cent or more in the past three weeks, extending the "hump" in the yield curve and bringing yields to over 5 per cent on issues for maturities out to 1974. With Governments in the 20-year maturity area yielding around 4-3/4 per cent, yields in the long end of the Government list are well above 1960 peaks, while new corporate issues are now close to their previous postwar highs. Dealers have been extremely cautious, keeping their net positions in coupon issues close to zero or short and seeking to find a price level that will bring in buyers. There has been some bank selling, and some investors have made modest purchases as prices declined. While the market has been under pressure at times, most of it appears to have been professionally generated, and it has not been accompanied by panicky or urgent investor selling in any size. Thus, while rates have moved rapidly at times, the market has not been disorderly. While most market participants feel that the adjustment has further to go, the technical position of the market is strong. Favorable developments in the shape of a determined move in the fiscal policy area, or good news from Viet Nam, could still have a pronounced steadying effect on the Government bond market.

The short-term area of the market has been somewhat steadier, although CD rates have inched higher, the three-month Treasury bill has touched 4.70 on several occasions, and the one-year bill auctioned six days ago went at an average of 4.95 per cent--1/4 per cent higher than a month ago and equivalent to 5.21 per cent on a bond yield basis. Despite a strong demand for short-dated Treasury bills from public funds and from the temporary investment of money either raised in the capital markets or awaiting investment there, dealers have been very cautious and have been working with minimal trading positions in bills. As a result, dealer financing needs have been reduced, and this has tended to reduce the strain on the money market banks and on other short-term markets generally. At the same time, however, Federal funds rates have been consistently at a premium, with the likelihood that continued pressure on bank reserve positions may result in an effective rate of 4-3/4 per cent on funds from time to time in the near future.

Dealers appear to be in a relatively good position to go into the March tax and dividend period, but heavy runoffs of CD maturities at banks will intensify the seasonal pressures and some strain on short-term rates is a likely prospect in the next few weeks.

Even keel considerations posed no handicap to open market operations over the past three weeks. Dealers had managed to dispose of the bulk of the modest amounts of the new issues they had acquired in the February refunding by the payment date on February 15, although some buying of the new 5's by Treasury trust accounts was necessary to slow the decline of prices below par. During the last two weeks, both the new 4-7/8 per cent 18-month notes and the longer 5 per cent notes have performed well, with the latter up 2/32 over the period, in sharp contrast to the performance of the rest of the market.

While the settlement of the February refunding posed no problems, operations were handicapped by a persistent tendency for reserve availability to exceed projections as float ran unusually high and required reserves fell short of seasonal expectations. Consequently, in the weeks ending February 16 and February 23 action taken to supply reserves before the weekend had to be reversed later on. On one occasion reserve objectives had to be temporarily sidetracked to take account of the unsettled state of the market. During the period, the System purchased short-dated Treasury coupon issues for the first time since last September. Purchases of such issues had not been made since that time because of a succession of circumstances--including a desire to avoid action at a time where strong market feelings of developing upward rate pressures were being confounded by various official statements about interest rate objectives. Recently we have been seeking an opportunity to provide some portion of reserve needs by undramatic purchases of available coupon issues. Such an opportunity arose on February 17 when we had a substantial amount of reserves to supply at a time when there was a scarcity of Treasury bills available in the market. Our purchases, confined to 1966 and 1967 maturities, made some dealers think twice about their short positions and induced some temporary short-covering, but otherwise had no effect on the bond market. In the future we plan to purchase additional modest amounts of coupon issues from time to time when supplying reserves, while trying to avoid an impression that special significance attaches to our purchases.

In conclusion, a few words may be in order about the Treasury's cash position in the weeks ahead. Given the heavy cash drains anticipated before mid-March and again before mid-April, there is a possibility that the Treasury may want to take advantage of its temporary borrowing facilities at the Reserve Banks. At the moment, there is some uncertainty about the outlook, which is partly dependent on how much various agency asset sales may raise in the coming months. All in all, it appears that the Treasury's cash position is developing at least as satisfactorily as had been anticipated earlier. Given the pre-refunding of part of May maturities, direct Treasury financing problems do not at this moment appear troublesome over the balance of the fiscal year.

Mr. Scanlon asked whether the Manager thought he had accomplished the firming action the Committee had decided on at its previous meeting. Mr. Holmes replied that a good start had been made, but he would consider the action to be still in process.

Mr. Maisel noted that in his statement the Manager had referred several times to problems associated with Federal agency issues. Developments with respect to agency issues might dominate the Government securities market over coming months, since the Treasury was depending on them to build up its cash balance. Accordingly, there might be advantages if the System traded in agency issues. Perhaps the continuing authority directive ought to be reviewed to consider whether it should be revised to authorize such transactions. He did not know enough about the subject to hold a firm opinion at the moment, but felt that consideration should be given to that possibility. More generally, he thought it would be useful for the staff to examine the question of the appropriate relationship between the System and the market for agency issues, and for the Committee to plan on discussing the subject at a future meeting.

Mr. Hayes agreed that the subject of agency issues was important, and noted that the Treasury was studying it now. However, while the System might be able to offer the Treasury some advice on debt management aspects, he could see nothing to indicate that it would be desirable for the System to trade in those securities.

Mr. Daane felt that exploration of the fundamentals of the subject would be worthwhile. But he agreed with Mr. Hayes that the System should not enter the agency issue market, particularly in view of the budgetary implications.

Chairman Martin observed that the question Mr. Maisel had raised might well be considered in the study of the Government securities market that the System and the Treasury jointly were about to launch. There was general agreement with that suggestion.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period February 8 through 28, 1966, were approved, ratified, and confirmed.

The staff economic and financial report at this meeting was in the form of a visual-auditory presentation. (Copies of the charts have been placed in the files of the Committee.)

The introductory portion of the review, presented by Mr. Brill, was as follows:

The time of year has come again for the staff to present to the Committee an annual exercise in which we dissect the economic model underlying the Budget and explore the financial implications of the projected spending and income flows. The purpose of these exercises is to gauge the pressures in financial markets one might expect to encounter in pitting a particular monetary policy against the pattern and level of demands for goods and services projected by the Administration.

Today, however, our presentation must take a somewhat different tack. The economic world has been moving swiftly since early January, when the final touches were being put on the Council's model. Moreover, data now available for late 1965 reveal a surge in activity barely evident in the economic information available at that time. It would hardly profit to ignore these new data and new developments in setting forth to explore the financial outlook. We have, therefore, modified the CEA model, revising--in most cases upward--the projected spending and income estimates. It is this revised model that serves as the basis for our analysis of the financial outlook.

First, however, we will review briefly the salient elements of the CEA model.

Mr. Koch commented as follows:

The Administration GNP projection for 1966 is centered on $722 billion, give or take $5 billion. In current dollars, the increase for the year is $46 billion, about the same as in 1965. With the GNP price deflator projected to rise about 1.8 per cent, the increase in constant dollars amounts to 5.0 per cent, compared with 5.5 per cent in 1965. Projected growth is fairly uniform throughout the year, with the fourth quarter projected at $739 billion.

In the CEA model, the main expansionary forces are Federal spending for defense and business spending for fixed capital. Federal purchases of goods and services rise $7 billion between 1965 and 1966, mostly for defense. But with GNP rising rapidly, the proportion of GNP devoted to defense increases little.

Transfer payments are expected to advance almost $5 billion, with Medicare coming in at a $2 billion annual rate at midyear and rising rapidly thereafter.

Grants-in-aid to State and local governments, included in transfers and other payments, also show a considerably larger rise than during 1965.

Thus, in addition to the direct contribution to GNP from rising purchases of goods and services, scheduled increases in other Federal payments would support rising private demands.

This expansion of Federal expenditures is just about matched by the growth of tax receipts. The first quarter bulge in receipts reflects increased social security taxes. Thereafter growth in receipts stems mainly from increased personal and corporate income.

Consequently, the Federal deficit, as measured in the national income accounts, is estimated to remain not far from the level of late 1965 throughout most of 1966.

The other major expansionary force in the Council model, business fixed investment, is projected to rise 10 per cent for the year, compared with 15 per cent in 1965. Increases in spending after midyear are quite moderate. At year end, fixed capital investment accounts for 10.6 per cent of GNP, little different from the share in late 1965.

Over all, developments projected for 1966 in the CEA model are not far from a replica of those in 1965. The increase in defense spending is larger than last year, but this is about offset by a smaller rise in business fixed investment. The steady growth in State and local spending continues. Disposable income rises about as much as in 1965, and with the consumer spending rate remaining unchanged, consumption increases about the same amount as last year.

With substantial growth in total demands, further pressure is exerted on available resources, particularly manpower. But the projected rise in the GNP deflator is about the same as in 1965, with declining food prices helping to offset a somewhat faster rise in industrial prices. The unemployment rate is calculated to decline to an average of 3-3/4 per cent for the year, compared with 4.6 per cent in 1965.

As Mr. Brill noted earlier, the CEA projection was constructed in late 1965; new data and new developments since then suggest the need for a new perspective on the outlook. The revised GNP data for the fourth quarter alone suggest greater strength in demands than was evident earlier.

The staff's reassessment raises expenditures moderately in several key categories, and the over-all effect of this implies significant differences in the degree of resource utilization. Basically, we look for more business investment spending and larger State and local purchases. The effects of this on income also raise consumer outlays.

We have not, however, departed from the CEA projection of defense expenditures. Like everyone else, we are aware of the uncertainty attaching to the ultimate magnitude and time pattern of the defense effort, but military clairvoyance is not our forte.

The staff's projection of State and local purchases is significantly larger than the Council's. Pressures are strong for expansion of spending on a host of community services--from education to waste disposal. A sizable volume of these increased services will be financed through the scheduled increase in Federal grants-in-aid. Federal purchases are also shown as increasing strongly, in line with the Budget message.

Available evidence suggests a marked increase in business fixed investment this year. In about a week, we shall have a new reading on business spending plans; pending this we have assumed continuation throughout the year of the expansion rate indicated in the earlier survey for the first half. Indeed, on the basis of a recently released private survey, our own estimate may prove too low. Projecting a slowdown after midyear, as in the CEA model, hardly does justice to the very expansive psychology now pervading the economy, nor to the underlying determinants of this type of spending. Sales are rising rapidly, and profits are projected to rise faster than GNP, although not as much as last year. Manufacturing capacity is currently harder pressed than at any time since late 1955, and new orders for machinery and equipment are still mounting, as are unfilled orders. Thus, we expect that by the fourth quarter, nearly 11 per cent of GNP will be accounted for by business spending on fixed capital.

Inventory investment rose sharply late in 1965, despite rapid liquidation of steel stocks. Continued strong demands for inventory are likely, in a setting of rapid expansion in final sales and growing prospects of supply shortages, delivery delays, and price increases.

In absolute terms, projected inventory accumulation may appear high. Nevertheless, the stock-sales ratio is expected to remain at the 1965 level.

Unlike other types of economic activity, prospects for housing starts are for some further decline. For the single-family component of private starts, underlying demographic factors will continue relatively neutral, and upgrading may be limited by further increases in building costs. The already higher level of borrowing costs will also be a factor whose effect may be felt increasingly as the year progresses. In the case of multi-family starts, which accounted for all of the year-to-year drop in 1965, a further downward adjustment is indicated.

U.S. exports of goods and services are expected to increase rapidly this year, with demand conditions abroad generally buoyant. However, U.S. imports will also be rising rapidly, and net exports may thus be only moderately larger. An improvement of $800 million is projected, but the margin of uncertainty is large. Imports of goods and services include military expenditures abroad; these are expected to increase about $1/2 billion this year.

Merchandise imports are not expected to rise as fast this year as last, mainly because steel imports should not increase further from the high 1965 level. Nevertheless, total merchandise imports are projected to rise as fast as GNP, and hence, as in 1965, to remain higher in relation to GNP than in any other year since the Korean War.

Increases projected for government spending and investment outlays would generate a large rise in consumers' after-tax income. Disposable personal income is expected to rise rapidly, and the projected increase for the year is more than in 1965. Gains in employment and wage and salary disbursements are projected at the rapid rate of late 1965, and government transfer payments will rise sharply.

With this growth of income, total consumer spending is projected to show a larger dollar rise than last year, but about the same percentage increase.

The consumer spending rate advanced last year from the reduced 1964 level. But in 1966 a slight decline appears likely, in part because a much smaller rise is anticipated this year in expenditures for autos and hence in total consumer spending on durable goods.

After 4 years of sharp increases, sustained high auto demand, rather than a large further increase, seems the more likely prospect. This assumption is consistent with the findings of the latest Census survey of intentions to buy. Spending on nondurable goods and services, on the other hand, is expected to increase in step with disposable income, and the decline in the over-all spending rate for 1966 would therefore be small.

Summarizing the expenditure changes, the staff projection for the year is a GNP in current dollars of about $731 billion, 8 per cent above 1965, with a fourth quarter GNP close to $750 billion. Allowing for an increase of 2.2 per cent in the deflator, the increase in real GNP would be 5.9 per cent, almost a full point more than the CEA projection, and the largest increase of recent years.

Mr. Partee continued the discussion, focusing on the implications for resource use and prices, as follows:

With GNP growing rapidly, manpower demands will intensify this year. The supply of trained workers is already diminished, and substantial additions of younger workers and women to the labor force will be required.

Bringing into employment many inexperienced workers will tend to offset the gains in output per manhour arising from the enlarging volume of new plant capacity. Thus, we would expect productivity growth to slow somewhat further from last year's reduced pace. The length of the workweek in the private economy, which is already high, should show little change.

On these assumptions, civilian employment would have to increase by 2.2 million from fourth quarter to fourth quarter, in order to produce the projected GNP. And the build-up of the armed forces is scheduled to absorb an additional 300,000 men.

To meet these very strong demands for manpower, the total labor force may expand by 1.9 million, about 600,000 more than the long-term trend would suggest. Unemployment would fall throughout the year, with the unemployment rate dropping to 3.3 per cent for the fourth quarter, nearly a full percentage point below the fourth quarter 1965 rate.

In recent months, wage rate increases have accelerated in many industries, as available supplies of labor have been reduced. Consequently, increases in average hourly earnings during 1965 were larger than from 1960 to 1964 and were generally above the guidepost. The largest gains occurred in such industries as retail trade and services, where average wage rates are low and excess labor supplies until recently had acted to limit wage advances. Increases in minimum wage rates were also a factor in raising wages in some of these industries in 1965.

In manufacturing, wage gains generally have continued to be moderate and close to the guidepost. Here too, however, there has been some tendency for average wage increases to accelerate, reflecting higher overtime costs, selective upgrading of jobs and pay scales to reduce the incidence of voluntary quits, and more rapidly rising wages in the non-union sectors of manufacturing.

The prolonged stability in unit labor costs in manufacturing since 1959 thus seems likely to give way, as direct and indirect wage costs come under pressure from intensive utilization of manpower resources and slower productivity growth. In the immediate months ahead, the degree of acceleration in the advance of wage rates should be moderate, because few major contracts can be reopened this year. Nevertheless, any increase in the advance of wage rates would tend to steepen the rise in industrial commodity prices already underway.

Manufacturing capacity also is likely to be under sustained pressure. In January, the capacity utilization rate was about 92 per cent. This year, capacity is estimated to grow by 7.0 to 7.5 per cent--much more than last year. But manufacturing output is projected to rise almost as much, so that the capacity utilization rate would remain around 92 per cent. In the 1955-57 boom, a 92 per cent rate was reached in only one quarter--in late 1955.

The projected environment of further rapid expansion in demands and strong pressures on labor, capacity, and materials should be conducive to somewhat larger and more widespread price increases this year. But unless increases in costs are larger and more pervasive than now seems likely, or unless Vietnam developments inspire buying sprees, the acceleration in the rise of industrial prices should be moderate. As a rough estimate, we would expect industrial prices to rise on average about 2.5 per cent this year, compared with the 1.5 per cent increase of the past 12 months.

In contrast, prices of foodstuffs--up 10 per cent over the past year--are likely to turn down before year end, barring very unfavorable weather. The high hog prices of the past six months are stimulating recovery in production, and prices of hogs and pork could begin to fall as early as this spring. These prospective developments should limit the rise in the total wholesale price index, perhaps to about one-half the 4 per cent increase of the past 12 months.

In terms of consumer prices, foods should reverse direction this spring or summer. Any decline in prices of foodstuffs, however, will be more than offset by further and larger increases this year in the nonfood categories.

Prices of nondurable goods and services are expected to rise more in this year's stronger markets. And consumer durables prices are likely to rise somewhat, in contrast with last year's declines, which reflected mainly reductions in excise taxes.

Turning now to financial implications, it seems clear that the increased spending contemplated in the staff's GNP model--a gain of 8 per cent in current dollars--could not occur without a significant increase in credit demands. Our financial projection seeks to assess the potential dimensions of the resulting credit flows, in order to gain some insight into the pressures that might develop in financial markets.

The financial projection is to be interpreted in the light of two principal assumptions that underlie it. First, it is assumed that the expansion in GNP shown here can be realized despite mounting pressures in markets for credit portrayed in the projection. To the extent that spending plans would be revised in response to the financial developments portrayed, the financial flows and market pressures would themselves be affected.

Second, with respect to monetary policy, we postulate a somewhat more restrictive posture than in 1965--in terms of growth in reserves and bank deposits--because the GNP model suggests heightened price pressures. Without prejudging how restrictive policy should be, we have assumed that growth of total reserves would be about 4 per cent--compared with a bit over 5 per cent last year.

Consistent with that reserve expansion, and given other aspects of the projection, we would expect a reduction in growth of the money stock to about a 3 per cent annual rate, the lowest since 1962, as the influence of rising interest rates partly offsets the public's growing demand for transactions balances. Growth in time deposits also is assumed to decline, with a less rapid expansion in negotiable CD's held by corporations the principal factor. Bank credit expansion, consequently, would slow to about 8 per cent for the year, compared with 10 per cent in 1965.

Mr. Gramley continued the discussion, focusing on the implications of the policy assumption, together with the GNP model, for developments in markets for credit, as follows:

With these assumptions in mind, we turn now to the credit flows consistent with the GNP model. Total funds raised are seen as rising nearly 13 per cent, to $81 billion in 1966, with most of the increase coming from Federal borrowing. Total Federal borrowing may be more than $9 billion this year, when planned sales of loan participation certificates and Federal agency issues are added to Treasury financing. Private borrowing--already large last year--is expected to rise, but only moderately further.

In fact, the ratio of private borrowing to private spending would decline slightly in 1966. This is attributable partly to a slight decline projected for State and local borrowing, reflecting a larger increase in receipts than in expenditures. Also, consumer credit is expected to rise at about last year's rate--despite a sharp increase in total consumer spending--since auto purchases are projected to increase less rapidly than last year.

The projected expansion of total funds raised is, by the way, only moderately larger than what the Administration's GNP model would have implied. In that model, a less rapid growth of private spending would have resulted in a smaller expansion of private credit, but Federal borrowing would have been somewhat higher--because of lower tax receipts. On balance, total funds raised might have risen about 10 per cent, as opposed to 13 per cent in our projection.

Corporate demands for credit are projected to rise substantially further this year, even though total private credit flows increase only moderately. The increase projected for corporate fixed investment and inventories is sharp, almost twice the expected increase in gross retained earnings. Consequently, external borrowing rises further from last year's already high level.

This increase in corporate borrowing may take the form principally of an expansion in bond issues. Given the difficulties likely to be faced by banks in supplying funds to meet all loan demands, growth in corporate bank loans could scarcely be accommodated at a pace much faster than last year's. Consequently, we are projecting corporate bank loan expansion at no more than the high 1965 pace, with nearly all of the 1966 increase in borrowing hitting the security markets. The corporate bond market, as a result, is expected to be a major focal point of pressures in credit markets as the year progresses.

The securities markets during 1966 must also absorb sharply increased marketings of Federal securities, including participation certificates. As a result, the projected growth in total funds raised is concentrated largely in security issues rather than in loans. The projection calls for a slight decline in mortgage borrowing, and for little change in other loans from the exceptionally high 1965 pace.

The banking system, nonetheless, will face heightened pressures on available resources this year. As noted earlier, growth in total bank credit is projected to slow down. But expansion in bank loans other than mortgages is expected to be as much, or a bit more, than last year, leaving little room for expansion in other earning assets.

Consequently, we expect banks to cut back sharply on their acquisitions of municipal securities, and to liquidate Federal securities in somewhat larger volume than last year. They might also acquire mortgages at a somewhat slower pace.

This projection of changes in bank earning assets implies a significant further increase in the ratio of bank loans to deposits, and banks would thus be likely to tighten their lending policies substantially further over the course of the year.

The bank share of total funds supplied is projected to decline significantly in 1966, reflecting both the reduced growth rate of bank credit and the expansion in total credit flows. The share falls below that of the past 5 years, but banks would be supplying a much larger portion of total funds than during earlier postwar expansions, when inflows of time deposits to banks were small.

The share of funds supplied by nonbank intermediaries, meanwhile, also is projected to decline in 1966. Inflows of savings to mutual savings banks and savings and loan associations may decline slightly further, under the pressure of competition from commercial banks and rising market rates of interest.

To fill the gap, there would have to be a jump in the portion of funds supplied directly to credit markets by the nonfinancial public--that is, by businesses, State and local governments, and especially households. In the past, it has taken a substantial boost in interest rates to bring these investors into security markets in volume.

Evidence from past periods of monetary restraint provides clues as to the orders of magnitude that might be involved in such an adjustment of interest rates. Given the credit flows indicated and the policy assumed in the projection, it seems plausible that late in 1966 rates on 3-month Treasury bills may be 50 basis points or so above current levels. At these rates, banks would once again encounter difficulties in attracting CD's under present Regulation Q ceilings.

Yields on 3-5 year Governments might rise a little faster than those on bills, especially if the Treasury seeks to prevent too much debt shortening by offering intermediate-term issues, and continues to be inhibited from issuing long-term securities by the 4-1/4 per cent ceiling.

Long-term rates of interest would likely be under continuing upward pressure. Mortgage rates probably would adjust upward gradually, given the heavy commitment of institutional lenders to the mortgage market, although other mortgage terms would undoubtedly become significantly more restrictive. Municipal yields, however, could move up substantially in response to reduced bank demand.

Yields on corporates would also rise sharply in response to a swelling volume of flotations, and sometime during the year we might see 6 per cent rates even for top quality issues. At these rates, corporations would be forced to reconsider the desirability of financing investment through capital market issues--as opposed to other sources of finance--and also to reconsider investment programs.

Outflows of private capital should be held down this year by tighter domestic credit conditions, working hand-in-hand with voluntary restraints. But the net outflow of U.S. private capital was cut back very sharply last year, partly as the result of a repatriation of liquid funds that is unlikely to be repeated. Consequently, no further cut back in net outflows is projected--instead, some increase seems likely.

Direct investment outflows this year are likely to be held below last year's level by the Commerce Department's voluntary program, but they will be at a higher rate than in the second half of 1965. A year-to-year reduction of about $300 million is projected; this would be consistent with a $700 million cut in terms of the Commerce program, which employs a somewhat different measure of direct investment abroad.

Other outflows of U.S. capital--including bank lending, transactions in foreign securities, and movements of liquid funds--are projected at about the same rate as in the second half of 1965, somewhat above the average for all of last year.

The concluding part of the staff presentation was given by Mr. Brill, as follows:

Before turning to the policy implications of the foregoing analysis, let me stress again the uncertainties involved in projections, particularly at a time when the economy is moving as rapidly as ours has been in the past few months. The growth projected in GNP is substantial, but we could be underestimating the expansion ahead by a margin that is significant for policy purposes.

Given the pressure on available resources suggested by the projection, we could also be underestimating the strength of factors pushing on prices. Certainly, our projection suggests stronger upward pressure on prices this year. But barring a wave of scare buying by consumers and businesses, or further escalation in Vietnam, the potential price rise doesn't appear to be of 1955-56 proportions.

What appears more likely is some moderate acceleration of the rise in the industrial commodities index, perhaps to a rate of about 2-1/2 per cent, as against 1-1/2 per cent over the past 12 months. The index for all commodities would increase less, because of the expected drop in food prices. The equivalent, in terms of the GNP deflator, would be a rise of somewhat less than 2-1/2 per cent.

But for international reasons particularly, any increased pressures on industrial prices would be unfortunate. Merchandise imports already are very high, and military spending abroad is increasing. Outflows of capital for direct investment, though projected to decline in 1966, will remain large. Altogether, our balance of payments position seems likely to remain troublesome.

Would the degree of restraint postulated in our financial projection be sufficient to check the advance of spending and prices? Given the present state of knowledge, we must still rely heavily on intuitive judgments as to the strength and timing of responses to monetary policy. My own judgment is that a constraint on reserve growth this year to 4 per cent would raise interest rates high enough to begin cutting deeply into private demands. In fact, if additional fiscal policy actions were taken to slow the expansion in private spending, the projected degree of monetary restraint might even prove over time to be excessive.

How rapidly should this degree of restraint be achieved? There are advocates of a rapid and dramatic monetary action, one that might bite quickly into spending plans and might, at the same time, unblock fund-flows by assuring investors that interest rates had attained peak levels. Recognizing merits to this argument, I still find myself favoring gradual intensification of restraint.

First, the pace at which long-term interest rates have been rising in recent weeks borders on the precipitous. Financial markets are taut--indeed, unsettled. It might be well to pause a bit and see how the economy adjusts to so sharp and extensive a change in borrowing costs and asset values. Second, investor attitudes are now strongly shaped by Vietnam uncertainties, and these attitudes would not necessarily be modified by a dramatic monetary action, whatever explanation accompanied it. These factors, plus our inability to pinpoint the desirable degree of restraint, argue to me for a series of cautious moves, rather than for a large, rapid or dramatic action.

Translating this general policy stance to specific operating targets, we may note first that total reserve growth thus far in 1966 has been somewhat above the 4 per cent figure for the year assumed in the projection--principally because of an increase in reserves to support growth in Treasury balances. The money stock in January and February together grew only a little faster than the projected 3 per cent rate, although some increase in the expansion rate of money may occur in the weeks ahead, since Treasury deposits are projected to decline. Thus far, time deposit growth has been much slower than the projection given here.

To stay on the course of reserve growth assumed in the projection would seem to indicate the need to move somewhat further in the direction of lessened reserve availability, perhaps to a range around $200 million for net borrowed reserves. Over the next few weeks, pressures on bill rates resulting from that course of action might arise, but probably would not be severe, because dealer inventory positions are relatively low and investors still seem to be disposed to keep their portfolio maturities short. The 3-month bill might thus move in a range between 4.70 and 4.80 per cent.

But interest rates in bond markets are already moving up sharply, and tighter bank reserve positions would accentuate that movement, particularly in light of the burgeoning calendar of new corporate and municipal offerings.

Given the present unsettled condition of the bond markets, postponing a significant deepening of the net borrowed reserve target for three weeks or more may be more appropriate. Even with net borrowed reserves averaging near $150 million, continued upward pressure on long-term rates can be expected, but Treasury bill rates probably would show only a moderate further adjustment.

Mr. Ellis asked if Mr. Brill would explain the background for the staff's projection of inventory developments.

Mr. Brill said that the staff estimated that the first-quarter rise in inventories was likely to be at a rate close to that of the fourth quarter. The large fourth-quarter increase had been a surprise to everyone, particularly since steel stocks were being liquidated rapidly then. Moreover, the increase now shown in the published figures for the fourth quarter was likely to be revised upward again by a significant margin. In this context the increase projected for the first quarter might be considered moderate, given the turnaround in steel, the general ebullience in the economy, and the probable increase in the price component of the figures. Some of the efforts to build stocks might fail, but the short-fall was not likely to be great.

Mr. Daane asked whether the staff thought an Administration announcement of further fiscal action would have a substantial effect in quieting present expectations.

Mr. Brill remarked that the effect would depend on the type of fiscal action announced. A modification of the investment tax credit, for example, might have a bigger impact on the forces that were providing the main upward thrust to the economy than would a general tax increase.

Mr. Holmes agreed. He added that in his judgment any steps toward a firmer fiscal policy would have a large impact on expectations in financial markets. Fiscal policy was an area of great concern to market participants, who were focusing on the projected demands on capital markets.

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

> The business situation and outlook remain very strong, with the Vietnam buildup a major contributing factor. The most disturbing feature of the economy at present is the growing evidence of inflationary pressures. As recognition of these pressures and worry over inflation are becoming more widespread, additional pressures are being generated. The high rate of inventory accumulation in the fourth quarter of 1965 was a danger sign, and this accumulation is probably continuing. We can hardly view with equanimity the 3.6 per cent rise in the wholesale price index over the past year, or the 5.8 per cent annual rate of increase in the three months through the end of January. While the rate of increase in industrial wholesale prices has been less, it does show signs of acceleration. The entire price picture is disturbing.
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> Balance of payments statitstics during most recent weeks have made better reading than for some time past. Nevertheless, the outlook for the year as a whole is decidedly cloudy. On the one hand export prospects appear to be reasonably good, as long as supply bottlenecks and price pressures do not undermine our competitive position. But much higher imports, military outlays, and tourist expenditures are also in the offing. In the capital area, new foreign security issues have been running at a high level; fortunately, banks have kept well below their lending limits under the voluntary restraint program, at least in part because of heavy domestic credit demands. The rise in U.S. interest rate levels has decreased the spread between domestic and foreign rates, with beneficial effects on private holdings of dollars. Balances held by overseas branches of U.S. banks in their head offices reached a record total of $1,776 million on February 19, up $450 million since the year end.

As for credit developments, the growth in bank credit and in a number of related liquidity indicators appears to be moderating in February, after an exceptionally rapid advance in January. While loan demand continues very strong, it is possible that the banks are now coming under sufficient liquidity pressure to have tightened loan policies to the point at which the actual rate of bank credit growth is responding. Loan-deposit ratios since late 1965 have not been advancing as fast as before, and bankers may now feel that they are close to some limit which it would be unsafe to exceed. Also, many bankers report that their holdings of U.S. Government securities are about as low as they would like to see them go, given their liquidity requirements and their needs for collateral on public deposits. Liquidation of municipals is inhibited by reluctance to incur significant capital losses. Finally, the banks are finding it very hard indeed to attract additional CD money, in spite of an advance in CD rates that has moved much faster than in the periods following earlier changes in Regulation Q. Apparently this difficulty in attracting time deposits may be attributed to the rapid growth of the economy, with the implied need for transactions balances, plus the rise in capital outlays relative to corporate cash flows and liquidity.

In any event, a special survey (made at the Board's request) of lending policies and bank resources at selected Second District banks showed virtually all banks embarked upon some sort of program to restrain loans in the face of above average-to-unusually strong demand; and this restraint has been stepped up in some banks in the last few weeks. Yet we cannot be sure that the current degree of monetary policy restraint will produce an adequate slowdown in bank credit growth. Several large New York banks have indicated that they believe the prime rate should be raised to assist in their rationing process; but for the time being they are restrained by fears of political reactions.

It seems to me that, with inflation a real and present danger, a coordinated Government program is needed to preserve the integrity of the dollar for domestic as well as international reasons. This would involve holding the line on the wages and cost front and a close coordination of fiscal and monetary policy. Unfortunately there seems to be much uncertainty as to whether, and how soon, fiscal policy will play a significantly restraining role; but since it is clearly undesirable to place too much of the burden on monetary restraint alone, we are probably justified in moving rather cautiously in the hope that the Administration will decide on more restrictive tax and spending policies. Certainly the important role assigned to the sale of assets in the 1966 and 1967 fiscal-year Federal budgets is placing a much greater strain on interest rates than the size of the deficits alone would suggest. A second reason for our moving slowly is to give a little more time to evaluate the effect of previous policy moves on the rate of bank credit expansion and to try to sort out exaggerated expectations from the prospective balance of demand and supply factors. Under these conditions, it would seem to me unwise to contemplate a further rise in the discount rate or in Regulation Q ceilings at this juncture, and by the same token we should avoid for the time being such a sharp increase in open market pressures as to make a higher discount rate virtually inevitable. The time may perhaps be approaching when strong overt moves will be needed in the areas of both fiscal policy and general monetary policy. We should not rule out the possibility--particularly if fiscal policy moves are not forthcoming--that a supplemental voluntary domestic credit restraint program may be required. However, there are many undesirable features in the last-named type of approach, and it should not, I believe, be adopted until other more normal measures have been fully utilized.

For the near term, I should think the Manager should be instructed to continue the policy agreed upon at our last meeting, i.e., to seek a gradual reduction in reserve availability. To me this might point to net borrowed reserves centering in the $150 to $200 million range, if this can be accomplished without too rapid additional rate adjustments. Actually, it seems likely that the market has already discounted such a move, and thus it would not in itself necessarily lead to significant upward pressures on the Treasury bill rate--although there will be seasonal pressures on short rates in the weeks ahead. The proposed policy on reserves could push the Federal funds rate up more frequently to 4-3/4 per cent, but this would not be a cause for concern.

> Since I am really advocating continuation of the gradual reduction in reserve availability which was sought at the last meeting but not completely achieved to date, only a modest change in the wording of the directive is required, and the staff's proposed alternative B seems quite appropriate.[1/]

Mr. Ellis observed that one of the embarrassments of prosperity was the danger of having to forego the benefits and privileges of special programs designed to assist distressed areas. New England was just about to be designated as eligible for a Regional Action Planning Commission, under the terms of the Economic Development Act. Such designation had been threatened, however, by the disturbing prevalence of prosperity. New England unemployment (seasonally adjusted) fell to 3.6 per cent in January compared to the 4 per cent national average. Declines occured in all six States, reaching a low of 2.1 per cent in New Hampshire. Apparently the designation was based more on long-term data, however, so New England was to have the advantage of being classified along with Appalachia, the Ozarks, and upper Michigan in qualifying for the program. Extensive Federal funds were to be available to support economic development research and planning at the community, area, and regional levels.

The leading indicators covering New England business prospects suggested continued expansion, Mr. Ellis reported.

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1/ Alternative draft directives suggested by the staff are appended to these minutes as Attachment A.

Initial returns from the Boston Reserve Bank's capital expenditures survey were very bullish. Construction contract awards during the most recent three months averaged 4 per cent ahead of last year. Purchasing agents continued to report a two-to-one preponderance of upward trends in new orders to manufacturers.

District banks reported a continued high level of loan demand, in excess of normal seasonal patterns, Mr. Ellis continued. For the first time some of the banks reported that they were rejecting acquisition loans and many reported that they were taking a posture of being less-eager lenders. Their attitude toward continued active participation in the home mortgage market was viewed as an important factor in determining whether mortgage rates would rise further in New England. A sharp inflow of time and savings deposits in the past year and currently had encouraged the weekly reporting member banks to increase their real estate lending in the month by 17 per cent. At reporting Boston mutual savings banks withdrawals exceeded new deposits during January, but interest credited resulted in a new deposit increase. Withdrawals in January exceeded last year's experience by one-third. As a consequence, virtually no money was flowing out of State from the large mutuals. Only five of the ten largest Boston mutuals had raised their rates since December 6, and only two of those five paid as much as 4-1/2 per cent on special savings.

Mr. Ellis thought that both the green book[1] and chart presentation documented the prevalent consensus that the major threat to a sustained prosperous economy was the strengthening of inflationary pressures. To the expanding demands from government, business, and consumers, must now be added the incremental effects of inventory demands. It was necessary to anticipate that decisions by all of those consuming groups would be increasingly affected by changed price expectations. To the extent that the wage guidelines were exceeded, those demand pressures would be supplemented in their inflationary impact by wage-cost pressures.

Despite the widespread recognition of strengthening inflationary pressures, Mr. Ellis said, there did not seem to be a matching determination to reverse the thrust of fiscal policy. Present programs seemed to call mainly for a lessened expansionary posture. At the same time, there was a general consensus that monetary policy must and would do its part in fighting inflation. But, while some people feared the System would act too abruptly and bring the economy to a halt and downturn, others feared it would be too timid. Quite obviously the search had to be for a "middle course."

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

In Mr. Ellis' judgment, the Committee had launched a middle course at its previous meeting by deciding to moderate growth in the reserve base, bank credit, and the money supply by seeking a gradual reduction in reserve availability. The results had appeared tentatively in slightly higher money rates, member bank borrowings, and net borrowed reserves but, as the Manager had reported, the move was still in process. With the Committee having embarked on that policy course, the critical question became one of how to define and execute a gradual movement. One way was to consider a longer time interval and time the increments of action accordingly. For example, the Committee might take, as a June 1 target, a net borrowed reserve position averaging $300 million, plus or minus $50 million, to be achieved by lifting the target $50 million per month for three months. Depending on conditions and expectations, that action could be expected to yield a higher level of borrowings and interest rates. Such a development might then be confirmed by a discount rate increase of 1/4 per cent, thereby reaffirming an intention to rely on gradual and incremental moves at this sensitive stage in the economy's evolution.

Taking such a course of action as his objective, Mr. Ellis found the present directive quite appropriate, with exclusion of the reference to Treasury financing; operations should continue to be conducted "with a view toward a gradual reduction in reserve availability." He would classify alternative B of the staff drafts as calling for no change in a policy which was in process of firming.

Mr. Irons reported that conditions in the Eleventh District reflected the same sort of expansion and inflationary pressures in almost all areas that were seen in the national economy. Employment continued to rise and labor shortages were becoming increasingly apparent; the problem was immediate, and not in the future. The unemployment rate was about at the minimum, ranging between 3 and 3.5 per cent. District industrial production continued to expand, with nondurable manufactures up and durables showing relatively little change, and with a rise in minerals output reflecting increased production of petroleum. Sales of new automobiles were strong, as were department store sales, which were up 9 per cent from a year ago. Agricultural conditions were particularly favorable at this time.

Mr. Irons found that District financial figures continued to reflect the strength of credit demands and the relatively illiquid position of banks. District banks had been very large users of Federal funds during the past four weeks, with net purchases running up to almost $1 billion in one recent week.

Bankers were trying to be restrictive in their loan policies, especially on loans that did not relate to the production of goods. But they still found loan demand extremely strong.

Mr. Irons commented that the national economic situation had been covered adequately in the chart presentation and there was no need to review it in detail again. Briefly, it was evident that aggregate demands had become excessive; increases in defense spending, business fixed investment, inventories, State and local government spending, and consumer outlays were all putting pressure on markets for goods and on financial markets.

The most desirable means of cutting back aggregate demands at present, in Mr. Irons' judgment, would be a positive, strong fiscal policy move in the form of a tax increase of some type. He was not sure that monetary and credit action could bring about the desired results without the assistance of fiscal policy. Nevertheless, in the absence of fiscal action it was up to the Committee to do what it could.

Mr. Irons agreed with the comments made earlier that the Desk was still moving toward the objective decided upon at the previous meeting, and he favored continuing the policy adopted then. In the coming period net borrowed reserves might be deepened gradually to the $150-$200 million range, with an attempt made to avoid any operations that might stimulate sharp, appreciable further increases in interest rates. He would very much hope that short-term rates would not increase so much relative to the discount rate that the System would be almost compelled to raise the discount rate again. With a gradual movement of net borrowed reserves to that range the bill rate might go to 4.70 per cent or a few points higher, and the rate on Federal funds might frequently be at 4-3/4 per cent. He hoped rates would not move beyond those levels. He also hoped that fiscal policy actions that would have a more direct effect on the demand situation would be taken. He did not consider the present to be a time for dramatic monetary policy action; there were too many uncertainties in the picture. Nor would he want to make a monetary policy recommendation that involved projections for several months into the future. The existing uncertainties suggested that judgments on appropriate monetary policy should be made on a short-run basis for the time being.

Mr. Swan reported that except for residential construction the various sectors of the Twelfth District economy continued to reflect strength. January employment trends were, if anything, somewhat stronger in the Pacific Coast States than in the country as a whole, with the unemployment rate declining three-tenths of a percentage point to 5.1 per cent. There was another substantial addition to aerospace employment in the month, although it was a little less than the December gain. Estimates of future labor requirements by major firms in the District indicated further significant employment increases ahead if the firms were able to find the workers.

The District banking picture was much the same as elsewhere in the country, Mr. Swan said. In the three weeks ending February 16, the increase in loans at weekly reporting banks was more than offset by reductions in securities holdings. Commercial and industrial loans expanded, but by less than in the comparable period of last year. Savings deposits continue to decline, as they had fairly consistently thus far in 1966. However, other time deposits increased further. District banks continued to be net buyers of Federal funds on a rather substantial scale.

With respect to policy for the next three weeks, Mr. Swan said he was in complete agreement with Messrs. Hayes and Irons as to the desirability of a very gradual further implementation of the decision made at the previous meeting, and he favored a net borrowed reserve target somewhere in the $150-$200 million area. As Mr. Brill had pointed out, to maintain some reasonable rates of increase in total and nonborrowed reserves, it probably would be necessary to move slowly to a somewhat lesser degree of reserve availability. He was encouraged by the reduction in the growth rates of aggregate reserves in February, even though so far it was only a one-month development and he did not know the nature of the lags involved. Finally, he agreed that this was not the time for an overt or major action, either in terms of reserve availability or a change in the discount rate.

Mr. Galusha commented that recent economic statistics for the Ninth District paralled those of the nation. It was important to note that every indication was for the continuation of livestock prices at present high levels. Numbers of cattle had remained relatively constant, which would assure continued price pressures.

The present national economic outlook appeared to require some slight tightening of monetary conditions, Mr. Galusha continued. Possibly, further increases in interest rates and further firming of credit terms could be achieved without a change in the level of net borrowed reserves. If so, fine; but, if not, then some modest change should be effected. He would, however, stress the word "modest." Now did not seem to be the time for a dramatic, well-publicized change in monetary policy.

Mr. Galusha had several reasons for that belief. First, the current flow of economic intelligence was not monotonously and overwhelmingly bullish. Quite obviously, too much should not be made of the latest retail and auto sales figures, nor of the latest survey of consumer buying intentions. But perhaps those bits of information should give the Committee slight pause, modestly corroborated as they were by the reappearance for the first time in months of precautionary statements, however discreetly expressed, by a few business leaders. Secondly, there had been a good deal of concern expressed about the condition of financial markets. Although he did not fully understand the bases of that concern he was willing to defer to those with greater experience in the ways of financial markets and to regard the concern as another reason for the wisdom of making haste slowly. To a comparative newcomer, the market appeared to be still beset by a number of disruptive forces which seemed unpredictable both in timing and scope. The present would appear to be one of those times when the Committee had to be reactive rather than active.

Mr. Galusha's final reason for wanting to avoid a dramatic change in policy at the present time was also, in his opinion, the most important. It was simply that such a change could sharply reduce chances for a tax increase later this year. Yet it was very much in the interest of world economy, the U.S., and, indeed, the Federal Reserve itself, that aggregate demand be curbed to the extent necessary not by further monetary restraint but by an increase in tax rates. It was not reasonable to assume that whatever the near-term future brought there would be no new Administration tax bill, or that a tax increase could not be got through Congress. The Committee could, he thought, be more confident than was possible a few weeks ago that a tax bill, if needed, would be forthcoming.

Mr. Galusha felt he could not be as specific as Mr. Ellis had been regarding the appropriate course of action over the next few months. Perhaps the Committee should be giving some thought as to how it should act if, a few weeks hence, the future promised a GNP level for 1966 of, say, $735 billion and contained insufficient hint of a tax increase. It might be useful to speculate whether, with such an outlook, a gradual tightening of monetary conditions--the use of open market operations to push interest rates up gradually--would be best. It might be better at that time to run certain obvious political risks and follow a more dramatic course, possibly increasing discount rates again ahead of the market or increasing reserve requirements. Actually, the near future might present an excellent opportunity both to alter the structure of reserve requirements, which cried for attention in his District, and to tighten monetary conditions in a dramatic way.

Perhaps fortunately, however, the issue of whether to move gradually or dramatically was for the future, Mr. Galusha said.

At the moment, it would seem, prudence dictated a decidedly gradual tightening of monetary conditions. Accordingly, he favored alternative B of the staff's draft directives.

Mr. Scanlon observed that businessmen and bankers in the Seventh District were convinced that manpower and productive facilities were being utilized at practical capacity. Demand for most types of goods, especially durables, was strengthening further. Demand for steel from all user categories continued to rise. Auto inventories were the highest relative to current sales since early 1961, and there had been more than seasonal weakness in used car prices; nevertheless, confidence was high among industry leaders that output and sales of both cars and trucks would equal or exceed last year's records. Recent evidence suggested that loan demand had continued to be basically very strong in most parts of the District and was expected to remain so.

As to policy, Mr. Scanlon would like to see the Manager continue the policy adopted at the Committee's last meeting but not yet completed. He would favor alternative B of the draft directives. However, he would change the word "emergence" to "strengthening" in the first-paragraph reference to inflationary pressures, thus making the phrase read, "to resist the strengthening of inflationary pressures."

Mr. Clay commented that the basic question before the Committee was the ability of the national economy to meet the demands being made upon it without creating a serious price inflation problem. While the price record of this business upswing generally had been very good, particularly when weighed against the economic growth achieved, the present situation was a much more precarious one. With military expenditures imposed upon civilian spending, the pace of expansion was very rapid at a time when the room for growth had become more limited. In addition, expectational factors appeared to have become of considerable importance in accelerating demands for goods, such as in business inventory accumulation. Upward price movement had increased somewhat more than earlier. In the tighter situation now prevailing in the economy, further price pressures appeared highly probable.

Under those circumstances, Mr. Clay said, monetary policy should make me its contribution toward restraining the growth in aggregate demand to the output of goods and services that was attainable without creating a price inflation problem. On the other hand, that also meant that monetary policy should provide reserves in sufficient volume to finance the national economy's growth. Just what program of action would lead to that result was not so readily determinable. Accepting the need for further restraint, the proper course at this time would appear to be a reduction in the degree of reserve availability, approached cautiously so as not to create avoidable disturbances in the money and capital markets.

Although tightening of reserve availability would put upward pressure on interest rates, Mr. Clay felt this should not be the aim of further monetary restraint. Particularly, it would seem desirable to avoid such upward pressure on interest rates as would call for another increase in the Federal Reserve discount rate at this time--granting that the pursuit of that policy might justifiably lead to a discount rate change later. Carrying out the program in that way would provide further opportunity for evaluating the economy's performance as well as additional knowledge of the course of fiscal policy.

In Mr. Clay's opinion the net borrowed reserve target might be set at $200 million, with recognition that the Manager might not find it feasible to attain that goal within the constraints already mentioned. The money and capital markets continued very sensitive to further upward movement in yields. The impact of such open market operations would be increased by the reduced liquidity of business firms and commercial banks at this stage of the business upswing. Moreover, the mid-March seasonal pressures would need to be taken into account. It also remained to be seen what would be the effect of further reductions in reserve availability upon market expectations.

The draft economic policy directive, with alternative B as its second paragraph, appeared satisfactory to Mr. Clay.

Mr. Wayne said that the productive facilities of principal Fifth District industries apparently were being utilized about as fully as the availability of labor and materials would permit. The resulting pressures were reflected in reports of price and wage increases, which were reaching the Richmond Bank with increasing frequency. Furthermore, unfilled orders, which had been unusually large for many months, continued to rise. Upward pressures were particularly strong in textiles, where recent trade reports had attributed maintenance of a considerable measure of price stability to "industrial statesmanship." In the Reserve Bank's latest survey, business optimism appeared to be rising again from an already high level, and manufacturers on balance reported further increases in orders, employment, wages, and prices. A spokesman for an aluminum company which had headquarters in the District and recently announced a substantial program of expansion, said that the national supply might increase by some six per cent this year but not until the second half. Meanwhile, orders were already at new highs, requiring temporary use of some mild form of nonprice rationing. Among the District's weekly reporting banks, business loans rose more than seasonally in the four weeks ended February 16 and were considerably stronger than in the nation as a whole.

On the national front, Mr. Wayne was in general agreement with the analysis of the staff as presented in the green book and in the chart show this morning.

In the present situation, it seemed to Mr. Wayne that it would be appropriate to continue the policy the Committee adopted at its last meeting of a gradual reduction in the level of reserve availability. Reserve projections for the next few weeks indicated that that could be accomplished by reducing the rate at which reserves were supplied without the necessity of any actual absorption of reserves. He would be reluctant to try to project policy beyond the next three weeks. Alternative B of the draft directives represented, as he saw it, a continuation of the policy objective adopted at the Committee's last meeting and was acceptable to him.

Mr. Robertson then made the following statement:

> Both the reports of current developments and the staff's projection of the future convey the picture of a business expansion under more and more upward pressure. Investment in inventories and fixed capital is moving up at what appears to be an unsustainable rate, price increases are becoming more pervasive, and our vulnerability to a substantial degree of price inflation is mounting.

This picture could be altered sharply, of course, for example by a major de-escalation of the war in Vietnam and a change in public psychology. But this eventuality seems too uncertain to count on. Consequently, we need appropriate stabilization policies to deal with the more likely alternative of growing rather than declining pressures upon prices and resources from this source. To be explicit, absent any new stage of fiscal restraint, monetary conditions will probably have to be tightened further.

Just how far and how fast monetary firming might appropriately proceed at this stage can be a matter of debate. The evidence reported for this meeting suggests that a good bit of monetary tightening is already well under way. And I suspect some people will soon be raising questions as to how much more pressure the banks and the money and capital markets can stand without starting to become disorganized. Nonetheless, I would not want to hang our policy on market rates and terms alone--or even primarily.

Given these circumstances, and considering the tax and dividend date strains lying just ahead, I think it would be wise to continue, slowly and cautiously, the gradual tightening of reserve availability. This I would like to see accomplished by slowly deepening the net borrowed reserve target, thereby forcing banks to borrow somewhat more at the discount window or to curtail the expansion of credit. A change in the discount rate is not called for at this time.

To make my policy intent clear, let me say that I would like to see net borrowed reserves averaging around $150 million. At the same time, I would like again to suggest that net borrowed reserves be permitted to range up to as much as $100 million on either side of $150 million, depending upon the accompanying strength of bank deposit expansion. This would mean dropping toward $250 million, if required reserves turn out to be much stronger than expected, or, alternatively, moving back down toward as little as $50 million net borrowed reserves if credit demands are less than expected.

Mr. Robertson added that he favored alternative B for the directive. He agreed with Mr. Scanlon's objective in proposing a rephrasing of the reference to inflationary pressures in the first paragraph. He thought, however, that the objective might be better attained simply by deleting the words "the emergence of"; the phrase would then read, "to resist inflationary pressures."

Mr. Shepardson said that both the staff presentation and the comments around the table thus far seemed to be in agreement on the high level of activity and the pressures existing in the economy at present. The uncertainties with respect to developments in Vietnam also had been noted; but in his judgment the probability of any immediate easing in that situation was smaller than that of further escalation. He shared the view that fiscal action would be a desirable means of attempting to curb some of the excess demands that seemed to be developing. But he was skeptical that fiscal action would be taken soon and he was concerned about how far conditions might get out of hand before such action was taken.

Mr. Shepardson did not think this was the time for a drastic change in monetary policy and he agreed that there should be a continuing gradual reduction in reserve availability. He was concerned, however, about the interpretation of the word "gradual." It seemed to him that too often a decision in favor of a gradual approach was implemented in an overly gradual manner and the System found itself arriving "too late with too little."

He did not advocate eliminating the word from the directive but he would like to see continued movement toward the objective agreed upon. Net borrowed reserves of $200 million appeared to be an appropriate target, and he hoped it would be reached in the period before the next meeting.

Mr. Shepardson said that alternative B of the draft directives was acceptable to him, and he agreed with Mr. Robertson's suggestion with respect to the first paragraph.

Mr. Mitchell thought the staff's policy analysis was correct except in one respect--he believed too much emphasis was placed on interest rates and not enough on availability. In the present situation, he thought, the Committee should have less implicit and explicit concern with the rate structure and more concern with availability.

Mr. Mitchell went on to say that several members had expressed the view today that fiscal policy could do a better job than monetary policy in curbing excess demands at present. He agreed with that view; but he also agreed that it was not useful for the Committee simply to confine itself to making that statement. The problem for the Committee was to decide what it could and could not do. He saw no possible way by which the Committee could relieve the anxieties in the capital markets. But there were problems the Committee could do something about, and it should focus its attention on them. In particular, it seemed to him that the banking system was not doing all that it could to restrain the exuberance of its customers. That was because bankers were not sure just how far the Committee would go in permitting them to accommodate loan demands. In some way the Committee should make it clear that it was not going to make it possible for banks to meet all of the demands placed on them. It was in this sense that he considered it important to focus on availability.

Although the Manager had reported that on one occasion he had had to sidetrack reserve objectives, Mr. Mitchell said, for most of the recent period the Desk had been able to work toward reduced reserve availability. But open market operations were not the System's only tool; the Reserve Banks also could make a contribution through the manner in which they administered their discount windows. They might be a little firmer in defining continuous borrowing, and they could make it clear to banks borrowing continuously that adjustments had to be made in their asset positions.

As to the directive, Mr. Mitchell thought the first paragraph probably was adequate, and that the Committee might dispense with the second paragraph entirely.

Mr. Daane said he had little to add to the discussion. He shared the hope several members had expressed that the Administration would move on the fiscal front, calling for a tax increase of some type with a view to curbing aggregate demand. That curbing seemed to him clearly required by current circumstances, and he feared that too great a burden would be placed on monetary policy to achieve it. In his judgment an attempt by the Committee to implement such a monetary policy--and he would not shirk the responsibility if the need arose--would result in interest rate levels well beyond those projected by the staff.

While continuing to hope for fiscal action, Mr. Daane remarked, he would favor the course others had suggested of trying to achieve the gradual reduction of reserve availability decided on at the previous meeting. His own target for net borrowed reserves would be in the neighborhood of $200 million. But he would like to emphasize one point--he hoped the Committee would not ask for nor expect too much precision in moving to such a target. During a recent visit to the Desk he had been particularly impressed with the difficulties the Manager faced in meeting targets because of such factors as widely divergent reserve projections.

Mr. Daane agreed with much of what Mr. Mitchell had to say about the role the Reserve Banks might play. He was disturbed by the seeming unwillingness of commercial bankers to act on their own initiative in curbing their customers' demands. That was highlighted a few weeks ago at the Board's meeting with the Federal Advisory Council, when several members had indicated that banks would welcome advice from the supervisory agencies on the subject. Although he was not sure how it might best be done, he would be sympathetic to any steps the System could take to help stiffen the attitude of bankers and lead them to exercise more prudence and restraint.

Mr. Daane favored alternative B of the draft directives, and would accept Mr. Robertson's proposed amendment to the first paragraph.

Mr. Maisel thought there was little disagreement on the present situation or need for monetary constraint. He, therefore, would discuss only the proposed directive which, particularly in light of prior discussion around the table, seemed to him unusually unclear.

In comparing the changes in reserves, bank credit, and the money supply for the past three months, one found very sharp differences. Rates of growth were high in December, moderate in January, and small in February. Because of the sharp differences among those months, Mr. Maisel found a good deal of difficulty in interpreting the proposed directive. Depending upon which period was used, the directive could be interpreted in very different ways. Since to be useful one must designate the comparison period, he would suggest that the changes so far this year be used as the proper base.

In accordance with his previous suggestions, Mr. Maisel believed that for the period ahead the Committee should attempt to set its goals in terms of the basic underlying monetary variables rather than in terms of interest rates or net borrowed reserves. With that in mind, he would suggest replacing the words "moderating the growth" near the end of the first paragraph with the words "by maintaining reduced growth." That suggestion was based on the assumption that the preliminary reported growth rates of 3.6 per cent for nonborrowed reserves and 6.7 per cent for bank credit were correct. Similarly, he suggested that alternative A of the second paragraph, which he supported, be revised to read "maintaining the present rate of growth in reserve availability," rather than "maintaining the present degree of reserve availability"; it was unclear to him whether the word "degree" applied to an existing total or an existing rate of change. Around the table today it had appeared as if the directives could be interpreted as a maintenance of existing amounts of reserves, a cut in reserves, or a cut in the rate of growth. His point clearly applied equally to alternative B; it was not clear there either whether "reduction in availability" meant in amount or rate of growth in reserves.

As he had also indicated previously, Mr. Maisel was concerned that the Committee attempt to communicate more information to the public to avoid speculation on Committee action. Thus, he would support the idea that free reserves be allowed to vary more, depending upon what was happening in the reserve base and in required reserves. Under that policy in the latest period the Committee might not have been as concerned with reacting to unforeseen changes in required reserves. He also thought that it would be proper to indicate to the market that in attempting to moderate credit expansion for the next quarter or half year, the Committee would be less concerned than in the past by changes in the amount of discounting or by deviations between the discount and money market rates. He especially felt that the System should make it clear that movements in the prime rate were a function of the commercial banks. It would be most unfortunate if discount rate policy were used primarily to set prices for banks. The System should try to make it clear that it did not plan to use the discount rate for that purpose.

Mr. Maisel added that because he thought the Committee should be concerned with the rate of growth in total reserves he did not agree with Messrs. Mitchell and Daane; he felt that borrowings at the discount window should be offset through sales in the open market. If borrowings of reserves rose, holdings of nonborrowed reserves should fall. The Committee should set its goals in terms of a cut in the growth of total reserves to a rate between that experienced in January and February.

Mr. Hickman observed that business activity continued to speed ahead. Evidence mounted that the type of policy prescribed by the Committee at the previous meeting was appropriate for the next three weeks.

It was now known that inventory accumulation had been proceeding at a faster pace and in larger amounts than originally estimated, Mr. Hickman noted. The buildup of business inventories in the fourth quarter, when steel inventories were being reduced, was apparently associated with widespread anticipations of future shortages and further price increases. Those conditions were continuing and a further large expansion of inventories was expected.

With new orders and backlogs still rising, particularly in durable goods, the industrial sector remained under serious pressure, Mr. Hickman said. The steel companies that reported regularly to the Cleveland Reserve Bank indicated that unadjusted new orders in February, a seasonally weak month, were the same as in January, which in turn represented the highest level since last March. He had also been informed by one of the Bank's directors, on a confidential basis, that lead times of suppliers to the machine tool industry were more critical than at any time since the Korean War.

Reflecting pressures in the industrial sector, Mr. Hickman continued, prices of industrial commodities were still moving up. Spot prices of raw materials had risen sharply since the Committee's previous meeting. Farm and food prices had also climbed sharply, but the Cleveland Reserve Bank's analysts believed that wholesale prices of foodstuffs probably were now at or near their peak. Higher food prices at retail were still indicated, which would inflate the consumer price index, wage demands, and price expectations in general. With newspapers and other periodicals full of accounts of rising prices, the country was faced with the type of inflationary psychology that characterized the mid-1950's; that in turn would make it all the more difficult to hold back prices and wages.

Mr. Hickman said that the latest data on the financial front suggested that System policy was finally beginning to bite. The Manager was to be complimented on his contributions to that result. In February, increases in nonborrwed reserves, bank credit, and the money supply appeared to have been considerably smaller than in the preceding two months. The rise in long-term bond yields had taken some of the steam out of the stock market, which in turn should help to restrain capital spending.

Mr. Hickman went on to say that the Committee thus appeared to be in a fairly good position to take whatever further steps might be needed to help control the excessive pace of economic activity. It would, of course, be helpful if fiscal policy complemented monetary policy in the period ahead. Lacking such help, he believed the Committee should move very gradually and cautiously towards further monetary restraint. He would underscore the words "cautiously" and "gradually" partly because monetary policy was already beginning to bite, and also because more time would be needed to formulate appropriate fiscal policy.

Mr. Hickman therefore recommended that the Committee move gradually and cautiously towards a deeper level of net borrowed reserves over the next three weeks, say a range of $175 to $200 million. If credit demands, as reflected in the behavior of required reserves, turned out to be as strong or stronger than recently, he would favor Mr. Robertson's proposal to allow net borrowed reserves to go even deeper. Conversely, if credit demands slackened, he would be satisfied with slightly shallower net borrowed reserves. For the reasons indicated, he would prefer alternative B of the draft directives.

With regard to Mr. Mitchell's suggestion, Mr. Hickman said that the Cleveland Reserve Bank administered its discount window in a firm fashion at all times. He thought the figures would support the statement that it was clear to banks in the Fourth District that they were expected to repay their borrowings as soon as possible.

Mr. Bopp remarked that a decision as to whether to take further restrictive action today hinged primarily on an assessment, first, of the strength of inflationary pressures and, second, whether steps already taken were sufficient to contain them. While industrial prices had not increased much more rapidly recently, they were still rising, and pressures for further increases--possibly much faster increases--were clearly present. One new bit of information bearing on the problem was the Wharton School's index of capacity utilization, just released. The index showed that the rate of industrial utilization was now at 94.2 per cent of capacity, higher than at any time in the past fifteen years with the exception of the Korean War period.

One of the most disturbing evidences of pressure, Mr. Bopp said, was the rapid buildup of new and unfilled orders and of inventories. As a straw in the wind, a discussion with executives of several large industrial firms in the Philadelphia area revealed that at least part of the spurt in orders and inventories was motivated by anticipations of price increases, lengthening delivery schedules, and scarcities. Pressures from those sources did not pervade all industry groups; where they existed, they were not regarded as being exceptionally severe.

At this point, Mr. Bopp continued, like everyone else he felt far from complacent about prices and saw many signs of possibly serious price pressures in the near future. But he would not now recommend drastic steps to meet that possibility.

A second question was the extent to which restraint had already been effective, Mr. Bopp said. The Philadelphia Reserve Bank's survey of loan and deposit experience of commercial banks in the Third District produced results that were difficult to evaluate. On the one hand, the tone of replies was clearly that banks felt tight and expected stronger pressures in the future. To a certain extent, the data bore them out; loan-deposit ratios were high and cash assets were at a low ebb. On the other hand, there was some reason to believe banks might not be so tight as they might indicate. The seasonal slack in loan demand had been slightly more pronounced this year than last and the banks had been selling Federal funds. Moreover, there had been little selling of securities to meet loan demand,

and the Philadelphia banks had not been so aggressive in the CD market as banks in other areas. The degree to which banks had instituted policies of vigorous credit rationing was questionable. On balance, it seemed to him that while the banks were girding for an expected squeeze, it had not yet appeared to any pronounced degree compared to other periods of restraint or to the situation confronting banks in the New York City area.

The short time interval which had elapsed since the February 15 refunding provided scant evidence of the effect of action already taken, Mr. Bopp observed, and thus afforded little in the way of guidance to determine whether additional policy moves should be made at this time. Given the current sensitive condition of financial markets, any sudden and substantial move toward more restraint now would likely reflect itself quickly in substantial upward movements in rates. He would, therefore, continue the more moderate and gradual course adopted at the last meeting of the Committee.

Mr. Bopp said he had serious qualms about a directive expressed in terms of a single variable, particularly one over which the Manager had no direct and immediate control. Nevertheless, in the light of many discussions of the problem, alternative B of the draft directives reflected his general judgment of appropriate policy for the immediate future, with the deletion of "the emergence of" from the first paragraph.

Mr. Patterson thought that the Committee, having altered its policy only three weeks ago, wanted to be sure that economic and financial conditions had really changed before deciding on a different course of action. Certainly, no developments in the Sixth District indicated a dramatic change. The vigorous pace of consumer spending in the Southeast appeared to have carried over into 1966, and the banks had contributed to that expansion through further increases in consumer and other loans.

Many banks in the District were not yet under much restraint, Mr. Patterson said. Only 194 out of 521 member banks found it necessary to liquidate Government securities this past year to keep up with their lending. Most of the banks surveyed by the Atlanta Reserve Bank recently confirmed that they still had some leeway in unpledged securities to accommodate future loan demands.

How much room commercial banks had in meeting prospective demands was something monetary policy should take into account, Mr. Patterson continued. By the same token, the Committee could not overlook the fact that the demand for credit from other than commercial bank channels had been very heavy and was likely to rise even further. Therefore, it was not surprising that interest rates had continued to increase. Even higher rates were in prospect if savings slowed down significantly, and that would have the further effect of aggravating the inflationary pressures present in the economy.

In that atmosphere, Mr. Patterson thought, the policy shift formulated at the previous meeting was sound. That course of action had not been in effect long enough to be responsible for the recent slowing down in reserves and deposits. But those developments were certainly consistent with the direction of our operations. He would not think that a policy change every three or four weeks was advisable. Thus, unless the Committee felt the change of three weeks ago was in error, it should continue such a policy.

At the last meeting, Mr. Patterson noted, he had suggested that the Committee carry out a probing operation aimed at getting a tighter control of reserves. That still struck him as an appropriate objective today. Such a program would not make the Committee especially popular either with those who saw no need for restraint or with those eager to apply the brakes in earnest. Thus, in allowing credit to expand at the fastest sustainable rate, the Committee might be walking something of a tightrope. Yet, that type of action was perhaps the best it could hope for and one to be tested in the months to come. He believed that net borrowed reserves somewhere between $150 and $200 million over the next three weeks would probably come close to meeting that objective. He favored alternative B of the draft directives.

Mr. Francis commented that aggregate demand for goods and services had been rising rapidly. As one indication of total demand, retail sales had risen at a 13 per cent annual rate since October compared with a 4-1/2 per cent trend rate from 1953 to 1965. Both employment and output had gone up at an advanced rate. Yet, production had not been able to keep pace with the huge demand, and prices had increased. In contrast to the 1958 to 1964 period in which there was little net change, wholesale prices had risen at a 4.7 per cent annual rate since September, double the rate during the previous year.

The Government's fiscal actions appeared to Mr. Francis to be expansionary. The "high employment budget" apparently would show a deficit in the current six-month period as against a small surplus in the last half of 1965. More important, the Government was stimulating the private sector by increasing sharply its orders for military goods. Those orders did not all show up as outlays in the current budget, but the economy got the stimulus as industry began production. Then, too, Government debt had continued to become more liquid, despite some lengthening of average maturity in the February refunding. With the 4-1/4 per cent interest rate limitation on bonds, the average maturity of the debt was likely to continue to shorten in the near future.

With private demand rising with such great momentum and with the Government acting in so stimulative a way, Mr. Francis said, the Committee needed to do all it reasonably could to restrict total demand to reasonable proportions. It was desirable that potential borrowers not get all the credit they wanted. If, in a time of excessive total demand, potential borrowers received all the credit they wanted, that would contribute further to excessive demand, resulting in further acceleration in price rises.

As for policy, it seemed desirable to Mr. Francis to keep the growth rates of total reserves and money to very modest proportions. The less expansionary developments regarding Federal Reserve holdings of Government securities, total reserves, and money since late December seemed to him to be quite satisfactory. He would like to see those trends continued in the near future. If such actions should motivate banks to reduce their excess reserves or to increase their borrowings from Reserve Banks, Federal Reserve holdings of Governments should be correspondingly less in order to control total reserves, credit, and money.

Mr. Francis said he would not be concerned if, in the face of such policy, interest rates continued to rise. High rates were probably the most efficient method of rationing appropriately the available credit supplies among the competing demands and would tend to reduce the rate of expansion in aggregate demand. He would not raise the discount rate at this time, since he believed that for the time being the Committee could accomplish what was necessary through open market operations. He favored alternative B of the draft directives.

Chairman Martin commented that there was a high degree of agreement on policy today, although the Committee still had a problem with respect to its choice of target variables--a problem that Mr. Maisel had pointed up very well. The Chairman also was sympathetic with Mr. Mitchell's remarks. As to policy, he thought the Committee was moving in the right direction and he, too, favored the gradual approach.

Chairman Martin then noted that recently he and Secretary of the Treasury Fowler had discussed the possibility of having the three Federal bank supervisory agencies issue a joint statement calling for restraint in extensions of credit. He personally was somewhat dubious about the proposal; it seemed to him that it amounted to a program of voluntary domestic credit restraint without detailed guidelines, and was likely to lead to difficulties.

However, the Chairman continued, there was an alternative possibility that he would like to raise for consideration, in which all Reserve Bank Presidents would hold informal discussions with individual bankers in their Districts, as some were already doing. It could be pointed out in those discussions that restraint on credit extensions was required at present, that it was not desirable to meet all demands for credit, and that the System did not intend to supply the reserves that would be needed to do so. It would be important to avoid any suggestion that the discount windows were to be closed. At the same time, it was incumbent on the Reserve Banks to do a good job in administering their discount windows, and if there were any instances in which insufficiently rigorous standards were being applied they should be corrected.

The Chairman said he recognized the difficulties of such an approach and the problems that would arise in implementing it, but he thought it would be preferable to a formal statement by the supervisory agencies. There was no better organization than the System, with its twelve regional Banks, for pointing out the nature of the current problem to commercial banks.

In the ensuing discussion a number of members expressed agreement with the Chairman's view that a joint statement on the subject of credit restraint by the supervisory agencies would be undesirable. Among the objections seen to such a statement were that it would be a misuse of supervisory authority, and that it might be interpreted as implying a lack of willingness to employ the usual tools of stabilization policy--both fiscal and monetary--in curbing excessive demands.

A number of problems likely to arise in the suggested informal discussions with bankers also were noted. Among these were the difficulties of setting priorities among various kinds of bank credit, and the possibility that individual bankers would ask the Reserve Banks to establish a system of priorities for them to follow. Several members expressed the view that it would be undesirable for the Reserve Bank Presidents to indicate priorities; such judgments, they thought, should be made by the bankers themselves. Some members thought the best course might be for the System to confine itself to the question of the aggregate volume of reserves to be supplied, but others indicated that the bankers would find conversations of the type suggested useful in subsequent discussions with their loan officers and with customers. The diversity in attitudes of individual bankers and the consequent need for varying the approach taken with them was noted, as was the desirability of talking both with bankers that were frequent borrowers at the discount window and with those that were not. Also touched on was the desirability of avoiding any implication that the System was attempting to promote rationing over interest rate changes as a device for allocating bank credit, by remaining neutral on the subject of interest rates.

At the conclusion of the discussion Chairman Martin commented that he thought it was fair to say that a number of members of the Committee were opposed to the suggested joint statement by the supervisory agencies, and that there was considerable sympathy with the thought that the System should do what it could through conversations with bankers. It was important that these conversations be informal and held on an individual basis, and that they not be viewed as an alternative to the usual instruments of monetary policy. He was not particularly concerned about the possibility that the press would exaggerate their implications; there already had been press stories to the effect that some Reserve Bank Presidents had been discussing the problems of credit restraint with bankers, and keeping in continual touch with bankers on such problems was part of the System's job.

Returning to the subject of today's policy decision, Chairman Martin noted that the majority of the Committee appeared to favor alternative B of the draft directives, and that several had agreed with Mr. Robertson's suggested deletion of the words "the emergence of" from the reference to inflationary pressures in the first paragraph. Mr. Maisel, however, had expressed a preference for a different formulation.

Mr. Maisel commented that he could accept alternative B. He hoped, however, that the Desk would interpret the language calling for a "gradual reduction in reserve availability" as meaning a gradual reduction in the rate of growth of aggregate reserves.

Mr. Hayes said he thought the language of the first and second paragraphs of the directive taken together made that point quite clear.

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

The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with prices continuing to creep up and credit demands remaining strong. Our international payments continue in deficit. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by moderating the growth in the reserve base, bank credit, and the money supply.

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

It was agreed that the next meeting of the Committee would be held on Tuesday, March 22, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

February 28, 1966

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on March 1, 1966

## First Paragraph

The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with prices continuing to creep up and credit demands remaining strong. Our international payments continue in deficit. In this situation, it is the Federal Open Market Committee's policy to resist the emergence of inflationary pressures and to help restore reasonable equilibrium in the country's balance of payments, by moderating the growth in the reserve base, bank credit, and the money supply.

## Second Paragraph

Alternative A (No change in policy):

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the present degree of reserve availability.

Alternative B (Moderate firming):

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