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, May 10, 1966, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Bopp
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Hickman
Mr. Irons
Mr. Maisel
Mr. Mitchell
Mr. 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, and Tow, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Cardon, Legislative Counsel, Board of Governors
Mr. Fauver, Assistant to the Board, Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Hersey, Adviser, Division of International Finance, Board of Governors

Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Mr. Forrestal, Senior Attorney, Legal Division, Board of Governors
Mr. Furth, Consultant, Board of Governors

Messrs. MacDonald and Kimbrel, First Vice Presidents of the Federal Reserve Banks of Cleveland and Atlanta, respectively
Messrs. Eisenmenger, Parthemos, Baughman, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Chicago, St. Louis, and San Francisco, respectively
Mr. Deming, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Duprey, Economist, Federal Reserve Bank of Minneapolis.

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on April 12, 1966, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period April 12 through May 4, 1966, and a supplemental report for May 5 through 9, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that a reduction of perhaps $75 or $100 million in the Treasury gold stock probably could not be delayed much longer. The Stabilization Fund had only $39 million of gold on hand and there was a prospective order from the French approaching $90 million.

The London gold market had been quiet recently, Mr. Coombs remarked, with the price ranging around $35.11. The very tight money situation prevailing in all European markets appeared to be having pronounced effects on the gold market. High short-term interest rates were not only discouraging new purchases of gold but might even be stimulating dishoarding in some volume. A number of European commercial banks and industrial corporations usually kept some part of their cash in gold, and with the tight money conditions individual concerns tended to reduce their holdings somewhat from time to time. The effect, of course, was not a lasting one; but for the moment, at least, it was keeping the market under a minimum of pressure. There still were no signs of Russian gold sales despite the fact that the Russians now were in process of buying a substantial volume of wheat from Canada. At the same time, there was no evidence that the mainland Chinese were buying gold.

Sterling continued to be the main focal point on the exchange markets, Mr. Coombs continued. In April, Britain experienced a genuine reduction in its reserves of $53 million which was reflected in the published figures. In addition, $150 million of short-term central bank debt fell due at the end of the month. That debt was covered by borrowings of $50 million from the Bundesbank, $50 million from the U.S. Treasury, and $50 million from the Federal Reserve under the standby swap line. The borrowings from the Bundesbank and the U.S. Treasury were virtually over-night arrangements, and had already been paid off. The $50 million from the Federal Reserve was on the customary three-month basis but might be paid off before maturity.

Mr. Coombs went on to say that the initial market reactions to the British budget announcement on May 3 were unfavorable, and there was a risk that sterling might drop sharply. The New York Reserve Bank bought two million pounds for Treasury account, and that seemed to put a floor under the price of sterling. Subsequently another two million were bought for Bank of England account, pushing the sterling rate up somewhat. Those operations seemed to have a stabilizing effect on expectations, and bridged the few hours required for the market to digest the real significance of the budget. As the details became understood--particularly with respect to the payroll tax--the market stabilized on its own.

It was Mr. Coombs' impression that the British budget did provide for a rather strong restrictive effect on the economy, particularly in the first year, although there were a good many unknowns regarding the manner in which it would be administered. Perhaps the most hopeful sign was that the Bank of England people seemed reasonably satisfied; as the Committee would recall, they had been acutely dissatisfied with last year's budget. However, there still remained the key problem of price and wage stabilization, which had been the quid pro quo for the package of international assistance of last September.

Elsewhere in the exchange markets, Mr. Coombs said, the mark and guilder still remained under pressure. Both central banks concerned seemed determined to resist that pressure to their full ability, through tight money and other restrictive policies. Neither was making much progress in getting their Governments to take action in the fiscal area. The French franc and Italian lira continued strong. He had a feeling that the Italian surplus would gradually disappear, and that such an event might be hastened by political developments in Italy. At any rate, the surplus that the Italians had built up would prove to be a useful cushion against future adversities. The outlook in the case of the French franc was somewhat different. France's policy seemed to be geared to producing regular and substantial monthly surpluses, and there was no indication on their part of a willingness, such as was evidenced by other friendly countries, to engage in swap operations or other technical operations to cushion the impact of their surpluses. As long as the French continued that policy there would be attrition in the U.S. gold stock and pressure on the U.S. generally.

Mr. Galusha asked Mr. Coombs to amplify his comments regarding Russian purchases of wheat.

Mr. Coombs replied that the Russians were buying wheat, especially from Canada, as a result of the failure of the Russian wheat crop. The timing of the shipments was related to the opening of the ship canals; shipments in volume began in April and were scheduled to hit their peak in May. Since the Russians were paying cash, presumably there would be considerable inroads on their cash position during that period, and they might have to replenish their cash before long by selling gold. As he had mentioned, however, there still were no signs of such sales. At the time of the previous harvest failure the Russians had sold an amount of gold on the order of \$350 to \$400 million, and it was hoped that their current purchases would force the sale of an equivalent amount. Of course, gold sales would be required only if there was a net deficit in the over-all Russian balance of payments position, and no information was available on that subject.

In answer to a question by Mr. Ellis, Mr. Coombs said that the Communist Chinese had bought roughly \$150 million of gold in 1965. There was no evidence of current purchases, and while they might be buying secretly through Swiss banks, information on such transactions ordinarily leaked out.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period April 12 through May 9, 1966, were approved, ratified, and confirmed.

Mr. Coombs then recommended renewal of two standby swap arrangements that were scheduled to mature soon: the $750 million arrangement with the Bank of England, having a term of twelve months, and maturing on May 31, 1966; and the $100 million arrangement with the Netherlands Bank, having a term of three months, and maturing on June 15, 1966. He noted that a $50 million drawing by the Bank of England was presently outstanding, and that there were no drawings at present on the arrangement with the Netherlands Bank.

Renewal of the two swap arrangements for further periods of twelve and three months, respectively, was approved.

Mr. Coombs then noted that a so-called "third currency" swap with the Bank for International Settlements of sterling against Italian lira, in the amount of $50 million, had been made on February 25, 1966, and would mature on May 25, 1966. He recommended renewal of that swap for another three months, noting that it would be a first renewal.

In reply to Mr. Shepardson's question regarding the purpose of the transaction, Mr. Coombs said that it had been a means of clearing up swap drawings under the regular line with the Bank of Italy. The Account had acquired sterling on a guaranteed basis, and it appeared desirable to make multilateral use of that sterling by swapping it for another European currency with respect to which the dollar was clearly under pressure.

Mr. Shepardson noted that it was the intention of the Committee to have any swap drawings cleared up within a relatively limited time. He would be concerned if the transaction in question was a device to avoid clearing up a drawing by changing the form of the obligation to some other currency.

Mr. Coombs replied that he did not think the Committee should consider itself imprisoned in bilateral patterns; rather, if the System held a strong position in one currency it should use it to offset a deficit in another currency. Other countries accomplished the same result by transactions in dollars. While there was no single foreign currency in which the U.S. could repay debts to any of a number of other countries, the technique of third-currency swaps gave the System an equivalent flexibility. That technique had been employed successfully on a number of occasions and he considered it highly useful. Without it, the System would be handicapped in its foreign currency operations.

Mr. Mitchell asked whether the System had a contingent liability on the swap, and Mr. Coombs replied that since the sterling was guaranteed by the Bank of England the System would not suffer any loss in the event of a devaluation of sterling.

Renewal of the sterling-lira swap with the Bank for International Settlements for a further period of three months was noted without objection.

Chairman Martin then noted that at its preceding meeting the Committee had held a preliminary discussion of the new foreign currency instruments that had been proposed by the Secretariat, and of the memorandum by Mr. Baker, of the Board's staff, reviewing System foreign currency operations in the period 1962-65. A memorandum by Mr. Coombs, commenting on Mr. Baker's paper, had been distributed at that meeting, and subsequently the discussion had been continued in a memorandum by Mr. Furth dated April 27, 1966. Also, on April 28, 1966, the Secretariat had distributed revised drafts of the proposed new instruments, taking account of suggestions advanced at the April 12 meeting of the Committee; and today a memorandum noting certain suggestions by Mr. Mitchell for substantive revisions in the proposed new foreign currency directive had been distributed.1/ In the Chairman's judgment the various documents represented much useful work, and the Committee was indebted to Mr. Maisel for his original suggestion, at the meeting of November 23, 1965, that the staff undertake an examination of the foreign exchange operations. Chairman Martin then invited Mr. Maisel to open the discussion.

Mr. Maisel said he agreed that the several recent papers constituted a useful review of the System's foreign exchange

1/ Copies of the documents referred to have been placed in the Committee's files.

operations. He personally had no changes to suggest in the proposed new authorization and directive, and he was prepared to vote to approve them in the form submitted by the staff. He hoped the dialogue begun in the recent memorandums would be continued; in discussions with members of the Committee and staff he found a good deal of uncertainty with regard to the Committee's position on some issues. For example, the Committee had both long-run and short-run objectives, but its foreign currency instruments tended to be formulated in terms of the latter and it was not clear how they were related to the longer-run objectives. The uncertainty on that issue was evident at several points in the staff papers.

Chairman Martin then invited Mr. Mitchell to comment on the substantive revisions in the proposed new directive that he had suggested.

Mr. Mitchell said that his suggestions were not very complicated. First, he proposed that a paragraph be added at the end of the directive for the purpose of making explicit a position that had been implicit in the Committee's operations. The paragraph was as follows:

> 5. The Committee, in authorizing the foregoing operations, does not seek to conceal or distort the real effects of underlying economic forces on the currency of any country. When the magnitude or duration of operations are presumptive evidence to

> the contrary the full extent of support shall be made known promptly.

Secondly, Mr. Mitchell continued, he would strike the reference to foreign official reserves in paragraph 2(A) of the directive; in his judgment cushioning operations should be authorized only if payments flows had potentially destabilizing effects on U.S. official reserves. With the deletion, the paragraph would read as follows:

> A. To cushion or moderate fluctuations in the flows of international payments, if such fluctuations (1) are deemed to reflect transitional market unsettlement or other temporary forces and therefore are expected to be reversed in the foreseeable future; and (2) are deemed to be disequilibrating or otherwise to have potentially destabilizing effects on U.S. ~~or foreign~~ official reserves or on exchange markets, for example, by occasioning market anxieties, undesirable speculative activity, or excessive leads and lags in international payments;

Mr. Mitchell's third suggestion reflected a conclusion he drew from Mr. Baker's memorandum; namely, that there was a risk that operations undertaken to deal with situations originally considered to be temporary might be permitted to persist for undesirably long periods. He suggested rephrasing paragraph 2(B) of the directive as follows:

> B. To temper and smooth out abrupt changes in spot exchange rates, and to moderate forward premiums and discounts judged to be disequilibrating. Whenever supply or demand persits in influencing exchange rates in one direction FOR A PERIOD OF THREE MONTHS, System transactions should be modified~~,~~ OR curtailed, ~~or~~

> ~~eventually-discontinued-pending-a~~ UNLESS UPON REVIEW AND reassessment OF THE SITUATION ~~by~~ the Committee ~~of supply-and-demand-forces~~ DIRECTS OTHERWISE;

In Mr. Mitchell's judgment the proposed new language for paragraph 2(B) was consistent with the Committee's present practice. He thought, however, that the burden of proof that a development persisting for more than three months was still appropriately considered temporary should be placed on the Special Manager, and his objective was to make that point explicit.

Finally, Mr. Mitchell said, he would amend paragraph 2(C) by inserting "short-term" before the reference to interest rate differentials, as follows:

> C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2) differences in phasing of international economic activity that give rise to unusually large SHORT-TERM interest rate differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions . . .

The language of the affected clause had always been somewhat obscure to him, Mr. Mitchell said, but if the interest rate differentials mentioned related to long-term rates he thought the statement would be fundamentally inconsistent with the Committee's announced intention of dealing only with short-term fluctuations.

In response to Chairman Martin's request for comments on Mr. Mitchell's proposed changes, Mr. Coombs noted that he had not yet had an opportunity to study them carefully, but could give his initial reactions. He though that if the proposed new paragraph 5 was given a liberal interpretation it would not pose a problem most of the time. Under certain circumstances, however, it might prove extremely restrictive. For example, along with the U.S. Treasury and other central banks, the System had rendered substantial assistance in support of sterling over an extended period, in an effort to counter strong underlying forces. If the proposed language had been in effect it could have been interpreted to require making known the full extent of that support promptly. But it had been deemed necessary to keep details of the support secret for a time, because prompt disclosure might well have defeated the whole purpose of the assistance given. Similar emergencies could arise in the future, in connection not only with sterling but with other currencies as well, and perhaps the dollar; and the language might be considered to call for prompt public disclosures of a type that would be undesirable. Accordingly, he would not recommend adding the paragraph.

The suggestion to delete the reference to foreign official reserves from paragraph 2(A), Mr. Coombs continued, raised a question of principle: were the System's arrangements with foreign central banks intended to be reciprocal, or were they unilateral? In his view the arrangements would work only on a reciprocal basis; the

System had to be willing to cooperate with its partners to the arrangements if it was to expect cooperation from them.

As to the suggested revision of paragraph 2(B), Mr. Coombs thought that three months often would prove to be a rather short period in which to determine whether a problem was of a long-run nature. As Mr. Mitchell had recognized, drawings on the swap lines were reviewed by the Committee every three months, at which times the Special Manager presented his judgments on the prospects for clearing them up. Such judgments were necessarily rough since it was not possible to forecast accurately the balance of payments positions of both the other country and of the U.S., and since international flows were strongly influenced by national policies that were subject to change. He did not think it would be fruitful to impose an additional "burden of proof" on the Special Manager, since the Committee now got his best judgment on the prospects for reversals of drawings. He continued to think that the Committee's best insurance lay in the fact that, despite the many unknowns in each situation, the record showed that swap drawings had not been allowed to run on for extended periods. The risk existed, of course; but it was always in the thinking of the Account Management, and when the duration of drawings began to approach the one-year mark some other mode of financing had always been arranged. Further insurance was provided by the fact that the view of the swap network as providing only short-term facilities was shared by the other parties to the arrangements.

Mr. Coombs saw no problem with Mr. Mitchell's suggested amendment to paragraph 2(C). The description of the interest rate differentials referred to in that paragraph as "short-term" was consistent with the interpretation he had been placing on the passage.

Chairman Martin commented that the changes Mr. Mitchell had suggested appeared in large part to involve matters of language only.

Mr. Wayne said he did not feel that was the case with respect to the proposed new paragraph 5. On first reading the statement seemed to serve a useful purpose, but on reflection he was not sanguine that the Committee would be able to hold to it in a true emergency affecting some major foreign currency or the dollar. If that judgment was correct he would question the desirability of including the paragraph.

Mr. Daane agreed with Mr. Wayne regarding the proposed new paragraph. Nor did he favor the proposed revision of paragraph 2(B). The question of what constituted a "temporary" situation was a difficult one to answer, and he thought it was easy to ask too much of the Special Manager in the way of forecasts of developments. In his judgment that criticism could be applied to Mr. Baker's memorandum and to some of the other documents that had been distributed. It was recognized, not only in the Federal Reserve but at the Treasury and at other central banks as well, that the System's foreign exchange operations had made a useful contribution to the international monetary system. To impose an arbitrary three-month time limit would run counter to the spirit of the operations and would reduce their usefulness. Emphasis should be placed on purposes, and the Special Manager should be given maximum flexibility to achieve the stated purposes. He had no strong objection to adding the phrase "short-term" to paragraph 2(C), but he saw no real need for doing so, particularly after Mr. Coombs had indicated that he so interpreted the present language. Moreover, the Committee had assured its foreign partners both by word and by deed that it had no intention of using the swap arrangements to meet long-run problems. In sum, he would leave the directive in the form in which it was drafted by the staff.

Mr. Swan commented that he also did not favor revising paragraph 2(B) to specify a three-month time period. He would, however, eliminate the word "eventually" in the phrase in that paragraph that read ". . . System transactions should be modified, curtailed, or eventually discontinued pending a reassessment by the Committee of supply and demand forces." In his judgment that word carried implications that were not consistent with the Committee's intentions.

Mr. Hayes said he agreed fully with Mr. Daane. He also concurred in Mr. Coombs' view that the record showed the System had done remarkably well in clearing up drawings within a short time. The Committee, in effect, had been experimenting on the question of what constituted the best interpretation of "short-term"; whether it was three, six, or nine months in a particular case seemed to him to depend on the facts of that case, and he favored a more flexible interpretation than three months. He also agreed that the suggested paragraph 5 could be very damaging in major crises. There had been two or three crises in the past few years and there might well be others.

While he, too, felt the dialogue had been highly useful, Mr. Hayes continued, he would repeat the point he had made at the preceding meeting--he hoped the Committee would not overlook the extremely useful character of the operations to date. In his judgment the Committee could be proud of its foreign currency operations.

Mr. Mitchell commented that if there was any question on the point he wanted to make clear that he had not intended to imply any criticism of the Special Manager. On the contrary, he had felt that his suggestions were in line with the policies the Special Manager had been pursuing and had been recommending. He was concerned with the possibility that the Committee might eventually come under attack from critics charging that it was distorting market conditions and concealing facts. If the directive contained language of the sort he had suggested for paragraph 5, it would strengthen the Committee's position in meeting such charges. He had no particular pride of authorship in the specific wording and was not wedded to it, but the substance seemed to him to be consistent with the way in which the Committee was trying to operate.

Mr. Wayne agreed with Mr. Mitchell's observation, but thought that the purpose would be served by including the first of the two sentences. He would omit the second sentence, which was where the problem lay.

Chairman Martin then suggested that the Committee defer action on the proposed new instruments until the next meeting, to give the members more time to consider Mr. Mitchell's suggestions and the various points raised in the discussion today. He thought that discussion had been valuable, and that further consideration would be constructive from the viewpoints of both internal operations and the System's public posture.

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 April 12 through May 4, 1966, and a supplemental report for May 5 through 9, 1966. Copies of both reports have been placed in the files of the Committee.

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

The period since the Committee last met has been highlighted by generally firmer money market conditions, by rising interest rates in the face of strong credit demand, and by an exceptionally apathetic reception to a--fortunately--routine Treasury refunding operation. Over much of the period, market participants tended towards a consensus that the chances for a tax increase had diminished. But there was still a general element of uncertainty, fed in part by events in the stock market. At the moment both the bond and equity markets appear to be trying to sort out conflicting public statements, and their implications for the possible future course of fiscal and monetary policy. While markets appear to be discounting some further gradual tightening of monetary policy, expectations as to the future course of long-term interest rates are still in a state of flux, and will be strongly influenced by developments in the stock market and by specific developments in the fiscal policy debate.

Day-to-day open market operations were complicated to some extent over the period by changing bank responses to the shifting pattern of reserve availability within individual statement weeks, and by the general problem of reducing net reserve availability just before a period of Treasury refunding. While I will not try to recount the day-by-day problems that emerged, I might note that an accumulation of reserve needs necessitated very heavy bank borrowing from the Reserve Banks on April 19 and 20--amounting to nearly $1.6 billion on the latter day, the last day of the statement week for reserve city banks. Dealers had a great deal of difficulty in meeting their financing needs on that day, and market participants generally interpreted the tight money conditions as further evidence that the Federal Reserve was keeping bank reserve positions on a taut rein. Partly as a result of this atmosphere, banks over-borrowed over the following weekend, and as the statement week ending April 27 progressed it became apparent that even with high net borrowed reserves the funds market was almost certainly bound to ease up as the excess reserves accumulated earlier came into the money market. As the money market did in fact begin to ease on Tuesday, April 26, a token sale of $100 million Treasury bills was made as a psychological reminder to the market that easy conditions would be resisted. On Wednesday, April 27, it was learned that there had been a substantial reserve shortfall on Tuesday, and that net borrowed reserves were estimated at $376 million for that statement week. Although even such a level of net borrowed reserves probably would have been consistent with a comfortable money market on that one day, the level was too high to be consistent with an even keel policy at the very time that the Treasury was announcing the terms of its refunding operation. Consequently, a substantial volume ($420 million) of reserves was injected that day--despite the easier money market. Borrowing was light early in the week ended last Wednesday, but the money market firmed substantially after the weekend with Federal funds trading at 5 per cent for the first time and dealer loan rates rising sharply. By last Friday the effective Federal funds rate reached 5 per cent and there had been some trading at 5-1/8 per cent.

I believe market participants have generally interpreted System open market operations during the period as designed to put as much pressure on bank reserve positions as possible in the context of even keel considerations. The very cautious attitude of both bank and nonbank dealers in the Treasury refunding reflected this interpretation. Market participants now appear to feel that they have a crystal clear reading of the System's views on fiscal policy, and while they would not be surprised to see some further reduction in reserve availability and some additional firming of interest rates, they would not expect any major monetary moves until it became virtually certain that no fiscal action would be forthcoming.

As everyone knows, the Treasury refunding operation met with an unusually apathetic response. It was indeed fortunate that the February advance refunding had reduced the public's holding of maturing issues to only $2-1/2 billion and that the Treasury's cash position is such that the attrition can be handled without strain. The issue was considered to be fairly priced in the market, and although prices of the when-issued securities dropped to below the Treasury offering price there were few repercussions on the market for outstanding issues. Dealers wound up with a net position of only $130 million in the new 4-7/8 per cent notes and, while they had been expecting a heavier than usual attrition, the actual 43 per cent of public holdings to be turned in for cash is without precedent. Nevertheless, the results were taken in stride in yesterday's trading, with market participants focusing on other factors affecting the demand for securities.

Despite substantial market demand for Treasury bills, rates moved higher over most of the period since the Committee last met, as did other rates on short-term instruments such as finance paper and bankers' acceptances. Selective increases in posted rates on negotiable CD's have also been reported during the interval, with banks in New York and Chicago finding it more difficult to roll over maturities, apparently largely because of increased competition from other instruments as well as from rates being paid on CD's by other banks. Demand for Treasury bills picked up appreciably over the past few business days, however, and was particularly strong yesterday. Dealers are anticipating making sizable sales of bills over the next several days as reinvestment demand appears from a recent secondary stock sale and from the funds obtained through attrition in the Treasury refunding. In this atmosphere bidding was quite aggressive in yesterday's auction, with average issuing rates set at about 4.63 per cent on the three-month bills and 4.82 per cent on the six-month issue, up 1 and 6 basis points, respectively, from the rates set in the auction just prior to the last meeting of the Committee.

Dealer loan rates at current levels, up about 1/4 to 3/8 per cent from four weeks ago, will, as the blue book1/ indicates, tend to work against any seasonal tendency for rates to decline. In fact, dealer financing could become a serious problem in the weeks ahead. As you know, several of the large money market banks have acted virtually as lenders of last resort at penalty rates relative to those paid by dealers on corporate RP's or to out-of-town banks. Given the pressure on the money center banks and their anxiety to avoid use of the discount window except in

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

rare emergencies, there is a risk that at some point they may decide to withdraw entirely from what has been an extremely useful market function. While an abrupt withdrawal may be unlikely, we shall have to be alert to avoid a panicky situation that could ensue if normal channels of dealer financing were to be disrupted.

In the Treasury bond market, rates also moved higher over most of the past four weeks, although the strength in the market over the past few days has reduced the net changes in yields over the period as a whole to small proportions. Activity in the market was unusually quiet during the period. Surprisingly little swap activity was generated by the Treasury's refunding, with day-to-day fluctuations in prices depending mainly on how the market interpreted the most current statement on fiscal policy. The sharp decline in stock prices following the series of cut-backs in automobile production was paralleled by a rally in Governments over the past several days with gains yesterday ranging up to half a point.

In the corporate market, a number of syndicates formed early in the period had to be terminated with concessions of 10-15 basis points in order to move securities, but later on new issues were priced more generously and were readily sold, leaving the market in a better technical position. The calendar is expected to grow, however, and we hear talk of a large number of private placements that are getting underway. Municipal bond yields have also risen, under the weight of dealer inventories, while the calendar remains quite large.

The Treasury has completed its financing activity for the 1966 fiscal year, but will be raising cash in July--presumably through an issue of tax anticipation bills--with an announcement likely in late June. However, a very heavy schedule of Government agency financing and asset sales before the end of June is apt to exert a great deal of pressure on the markets. New money needs have been swollen by the heavy secondary market mortgage activity of the Federal National Mortgage Association and by the build-up of saving and loan association borrowing from the Home Loan Banks--both of which are further evidence of the general pressure of credit demand and of bank competition in financial markets. The FNMA last night priced a new issue of 13-month notes carrying a coupon of 5.45 per cent, designed to raise $400 million new money, at a discount to yield about 5.50 per cent. Later this week the Export-Import Bank will be announcing an issue of $500 million 7-year participation certificates, expected to carry a 5-1/2 per cent coupon, which will be placed through a number of the larger banks throughout the country. While it is impossible to estimate precisely the total amount of agency issues to be brought to market before the end of the fiscal year, the new money need estimated in the blue book is apt to fall near or above the upper end of the range cited--that is, somewhere around $3 billion.

Mr. Ellis noted that all of the draft directives prepared by the staff[1/] included references to the "current Treasury financing" but in his report the Manager had indicated that the Treasury had completed its financing activity for this fiscal year. He asked whether Mr. Holmes thought the reference was needed in the directive.

Mr. Holmes replied that the Treasury would not make delivery on the new securities until May 16, and customarily the even-keel period was considered to include the date of delivery. The market reception of the current financing had been apathetic from the outset, however, and there certainly were no strong even-keel considerations at this point.

Mr. Scanlon asked whether the Manager interpreted "even keel" to mean relatively stable net borrowed reserve figures.

1/ Appended to these minutes as Attachment A.

Mr. Holmes replied that the reserve figures were not the only factor. However, the Account Management had to be alert to how the market would interpret the marginal reserve figures. The market might well have been seriously upset if net borrowed reserves of, say, $400 million had been published for the week ended April 27. Including the operations on that day, the Management had expected the figure to be about $315 million--which, in his view, was just about as high as was desirable.

Mr. Wayne asked whether the announced attrition rate of 43 per cent in the financing reflected operations by the Treasury trust accounts. Mr. Holmes replied that it did not. Taking account of such operations would have raised the figure for the attrition rate to about 50 per cent.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period April 12 through May 9, 1966, were approved, ratified, and confirmed.

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

Mr. Koch made the following statement on economic conditions:

There is somewhat more uncertainty about the likely course of domestic economic developments today than there was a month or six weeks ago. This is due to a number of factors, topped perhaps by the continuing doubt about the course of the war in Vietnam. Political unrest in that country plus the absense to date of additional requests for larger defense appropriations have given some support to the idea that the rise in military spending may taper off after mid-year.

In addition, there is a growing feeling that the recent sharp rate of recent economic expansion cannot be sustained. Both industrial production and retail sales, for example, rose at about a 12 per cent seasonally adjusted annual rate in the six-month period ending with March, and the personal savings rate fell to an abnormally low level in the first quarter. Both industrial production and retail sales appear to have expanded less rapidly in recent weeks. In the auto industry, with dealer inventories high, some slackening in sales in April has led quickly to a moderate reduction in output.

Other factors tending to make some people feel that future expansion is likely to be at a less frantic pace than earlier have been the sharp drop in stock prices, the growing complaints of those concerned with housing and mortgage financing about the depressing effects of tight money and higher interest rates, and some slackening in the pace of the over-all price advance. Industrial prices have continued to rise at the earlier rate but there has been a turn-around in farm and food prices from sharp rise to moderate decline.

Granting all this, the over-all domestic economic outlook still seems to me to be for further substantial expansion in the foreseeable future. Indeed, some of the doubt about likely future developments is due to fears about the excessive rapidity of the recent rate of advance and the maladjustments in resource allocation that have already arisen in the current boom.

Moreover, the tapering off in expansion in activity that has occurred thus far this quarter has been selective and all in the consumer area. Federal Government spending, both for defense and other purposes, continues to run above earlier expectations, and business spending on fixed investment and inventories has been in line with the upper range of estimates for these types of spending made earlier in the year.

Estimates of business expenditures on plant and equipment in the first quarter, for example, were more in line with the 19 per cent increase projected for the year as a whole by McGraw-Hill recently than with the 16 per cent projected earlier by Commerce-SEC. To me, a most significant finding of the McGraw-Hill survey of business investment plans was that planned spending for 1967 through 1969 is already very large as these early estimates go.

The tapering off in the earlier unsustainable rate of economic expansion has probably meant some plateauing in the rate of over-all utilization of plant capacity. The unemployment rate has also been at or near the 3-3/4 per cent level now for the past three months. Unemployment of adult males, however, has dropped to the lowest level since World War II, with teenage unemployment drifting up again.

An important development in wage, price, productivity, and profit relationships in recent months has been a moderate pickup in wage increases. With some decrease in the rate of productivity gains, unit costs have increased on the average. Prices have risen relatively more than costs, however, and as a result profit margins have continued to widen.

This development poses some potential problems. In the first place, it has a tendency to stimulate what already is a type of current spending whose pace of advance cannot be sustained at current rates of expansion--namely, business investment. And, along with rising consumer prices, it will add fuel to labor's demands for more generous wage settlements.

In addition to the situation in Vietnam and the current high level of business investment, the development that would most likely threaten the sustainability of the current economic expansion would be excessive wage increases. This makes the current course of the cost of living and the forthcoming labor negotiations in the electrical and communications industries of considerable importance. Concern over forthcoming wage negotiations is also a prime reason for the Administration's continuing opposition to unwarranted price increases. Much of the price rise so far is reversible--so long as cost levels are not generally raised.

In conclusion, two schools of thought have developed as to the relationship of current and likely prospective domestic economic developments to current stabilization policy. What might be termed the "economic doves"--still by far the minority group--put considerable emphasis on the fact that likely future developments in military spending and in business investment, in and of themselves, will soon provide some dampening influence on expansion in total economic activity. They also feel that we have not yet seen the full effects of fiscal and monetary measures already taken. Therefore, they feel that little or no further restraint is appropriate, particularly in view of long lags in the effects of such restraint. They feel that the risk of a policy that would weaken demands in 1967--just when market forces may also be operating in that direction--outweighs the risk of inflation this year.

The "economic hawks," on the other hand, emphasize just the opposite course of events. They feel that the continuing risk of a serious ratcheting and acceleration of wage and price increases because of excessive over-all demands that are likely to occur if further fiscal and/or monetary restraint measures are not taken outweighs the risk that such additional restraint might contribute to recession later on. The large first-quarter rise in GNP with its striking price component certainly supports this point of view. Peace-loving as I normally am, I still count myself in the camp--or should I say the nest--of the hawks.

Mr. Partee made the following statement concerning financial developments:

Conditions in the money market over recent weeks have shown substantial and continuing firmness, as discussed by Mr. Holmes and reported in detail in the written material prepared for this meeting. And growing pressure on bank reserve positions--at least at the margin--is indicated by the rise in borrowings consistently above the $600 million level and the deepening in net borrowed reserves toward $300 million. Yet, in the face of these pressures, all of the aggregate banking measures--money supply, credit, and reserves--grew markedly faster in April than in the earlier months of this year. March to April annual rates of increase, on a daily average basis, amounted to 13.5 per cent for money supply, 17.5 per cent for total reserves, and 18 per cent for the member bank credit proxy.

What do these aggregate measures, sharply at variance with money market developments, tell us about the posture of monetary policy? The answer is, I think, not very much. First is the fact that there is no necessary or dependable short-run relationship between marginal and aggregate monetary variables. In fact, a major reason for framing the Committee's directive in money market and marginal reserve terms, as I have understood it, is to permit unusual and unpredictable variations in demands for credit and liquidity to be accommodated initially by the banking system. As demands fluctuate in the short-run, the associated reserves are permitted to be created or absorbed in order to avoid destabilizing--and, at times, possibly critical--changes in market conditions.

April appears to me to have been just such a period. In particular, the speed-up in corporate tax payments brought an unusual demand for liquidity--one, incidentally, that is not yet provided for in our seasonal adjustment factors, so that the "true" seasonally adjusted expansion was probably less than that reported. This demand was accommodated by the banks, not so much through direct lending to the taxpayers as through purchases of securities and an upsurge in loans to security dealers and finance companies as corporations liquidated their holdings. Presumably this credit and deposit bulge at the banks will now be reversed, if the pressure on bank reserve positions is kept up. Privately-held demand deposits are indicated to have declined slightly on balance over the last three weeks, though the banks have not yet been forced to curtail asset purchases since Treasury deposits have built up.

A second problem in judging the aggregate banking statistics is the need to take account of changes in banking's share of total credit and savings flows. Preliminary flow-of-funds estimates for the first quarter show a substantial reduction in credit flows through banks and other financial institutions, from $55 billion in 1965 to an annual rate of $45 billion in the first quarter of this year. This decline was more than offset by a very sharp rise of security sales in the market, which at the higher yields prevailing attracted direct investment of funds that otherwise might have gone through the financial institutions. Thus, deposit growth diminished markedly, not only at the banks but also at the specialized savings institutions.

In late March and April, however, the competitive position of the banks improved abruptly. Higher offering rates on CD's, posted after the prime rate increase, widened the spread as against other market instruments, and the banks were able not only to replace heavy maturities but to add $1 billion to the amount outstanding. And more vigorous competition for the savings balances of individuals and smaller businesses--in rates, terms, and instruments offered--produced a large net inflow of funds in recent weeks for the banks, partly at the expense of the savings institutions but probably also reflecting diversions of funds from direct market investment. The recent rapid rates of deposit inflow from these sources will probably diminish as the initial impact of higher bank rates wanes and also possibly as rate differentials tend again to narrow. But to the extent that more rapid bank deposit growth has simply represented a diversion from other channels--and the associated bank credit expansion merely a substitution for credit expansion elsewhere--it seems to me that there is little cause for concern.

If we look through the recent banking aggregates, on the grounds that they have been influenced strongly by temporary liquidity needs and a substitution of bank for other credit sources, then I believe that the picture that emerges for recent weeks is one of substantial monetary restraint. The money markets are tight, and they have been trending irregularly in the direction of greater tightness for some time now. Long-term bond yields have been moving up again in all categories, and have now retraced about half of their corrective declines from the extraordinary anticipatory peaks reached in March. The price firmness of recent days seems directly associated with the turbulence in the stock market. Bank business loans rose at only a 10 per cent annual rate in April, partly reflecting refinancings in the capital market, and there are increasing indications of tightening in bank lending standards and other non-price rationing measures. Finally, in the mortgage field a marked tightening appears to be in process, reflecting both the shift in funds flows away from savings institutions and also apparently reduced participation in new mortgage commitments by banks and insurance companies.

Nevertheless, in view of continued rapid economic expansion and mounting strains on labor, resources, costs, and prices, it seems to me essential to keep the pressure on in financial markets. Indeed, continued gradual tightening appears warranted, given the strength of demands for goods and services and associated credit needs. If the Committee decides that further firming in monetary policy is required, however, there are several factors arguing for a "go slow" approach. First is the very large volume of Federal agency issues and asset participation sales in prospect over the next two months, which could put considerable pressure on markets even in the absence of Treasury cash financing. Second is the unsettled state of the markets, particularly for equities; any marked monetary tightening, given present uncertainties, could bring unduly severe market repercussions. Third is the problem of the current funds position of the savings institutions and the related difficulties of the mortgage market; further diversions of savings flows should not be encouraged, at least for the time being, in the interests of financial stability.

There is also the question of how much further tightening can be induced in the money market without putting severe pressure on the discount rate and current Regulation Q rate ceilings. As for the discount rate, it would appear that primary reliance already rests on the discipline of the window, with Federal funds trading as high as 5 per cent or above; further market firming would serve to increase that reliance, but this appears to me operationally feasible. And Regulation Q ceilings are not really under much pressure now, reflecting the fact that permissible time deposit rates were raised a point or more last fall. With prime bank quotes of 5 to 5-1/4 per cent for CD's in the 60-90 day range, there would seem to be room for banks to compete to retain funds even if the 3-month Treasury bill yield were to rise close to the 5 per cent level.

Mr. Hickman noted that Mr. Partee had described the recent fairly substantial increase in time deposits at banks as being partly at the expense of savings institutions. He (Mr. Hickman) thought that was true with respect to developments in April, and he agreed that the shift in the channels of flows was not in itself a cause for alarm. However, the money supply had increased at a seasonally adjusted annual rate of 13.5 per cent in April, and private demand deposits at a rate of 16.3 per cent. Those were extraordinarily large increases, and he would not want to see them continue. He asked whether Mr. Partee was concerned about those developments.

Mr. Partee replied that such large increases might often provide grounds for concern. He had tried, however, to make several points in connection with the recent money supply increase. First, there was an extraordinary demand for liquidity in April because of the speed-up in corporate tax payments, and in the past the Committee had operated in a manner that accommodated such unusual bulges in demands to avoid disrupting markets. Secondly, the seasonal adjustment factors currently used did not make adequate allowance for the tax speed-up, and presumably when the factors were revised the increase in the seasonally adjusted figures would be less. Third, the money supply was among the series that tended to show sharp short-run fluctuations--there were large rises in June and December 1965, for example. Given the nature of the series, he thought one should not overemphasize developments in any one month. As indicated in the blue book, the staff estimated that there would be little net change in private demand deposits over the two months of May and June taken together. If that estimate proved correct, the annual rate of increase for the first half of 1966 would be on the order of 4.5 per cent, which was not very different from the earlier rate.

Mr. Hickman agreed that the money supply often showed sharp monthly changes. However, its annual rate of increase over the December-April period was about 8 per cent, which to him appeared to be far above the desirable rate. He would much prefer a growth rate on the order of 4 or 5 per cent.

Mr. Partee commented that the 8 per cent rate was obtained by including two periods of peak growth--December and March-April. If one considered a longer time span the rate would be less--although, of course, it might still be considered too high.

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

Before I go to my main subject, I might mention the recent indications of activity of the large banks in making foreign loans. As you know, we had a resumption of short-term bank credit outflow in March. Also, new commitments for term loans, which had become very small in February, were somewhat bigger in March and April, and this increase in commitments was not in the high-priority category of credits for export financing. These facts warn us against assuming that present monetary policy will necessarily generate further net reflows of bank credit like those of January and February.

In what I say this morning I want to focus on monetary policy in relation to the long-run development of the balance of payments. The long-run outlook for our balance of payments is dimmer now than it was a year ago, in my opinion, because of the gradually accelerating rise in U.S. industrial prices.

The real news about the balance of payments is that there is no really good news to report.

In the last three calendar quarters the deficit has averaged nearly $2 billion annual rate on the liquidity basis and about $1-1/2 billion on the official reserve transactions basis. Although exports recovered in March from their previous dip, the quarter-to-quarter increase was not so great as the rise in imports. The trade balance therefore shrank further: it had been over $6-1/2 billion in 1964 and about $5 billion in 1965, and it was down to $4-1/2 billion annual rate in the first quarter of 1966.

For many years we have been taking palliative measures to help the balance of payments in the short run, and these measures have made sense as ways of gaining time while deeper adjustments slowly got made. But thus far any evidence that adequate adjustments are being made in international competitive positions is scanty. If inflation is now going to take hold in the United States, even so mild an inflation as a 2 or 3 per cent rise a year in the general price level might make nonsense of our hopes of an adjustment.

In the past several years, the timing of most of the main changes in open market policy has been dictated by domestic considerations. The need for price stability, for the sake of the balance of payments, gave a steady tilt toward a greater firmness of policy than might have seemed necessary otherwise, but this did not call for frequent changes of policy on the basis of external developments.

This approach was absolutely right, so long as the tilt in policy in favor of price stability was strong enough. But I think we should ask now whether the time has perhaps come to bring more sharply into the foreground the long-run need for price stability for the sake of the balance of payments.

If we were concerned only with the domestic situation, the range of defensible diagnoses and prescriptions right now could be rather wide, leaving wide scope for judgment. For example, one position could embody four propositions as follows. The objective of sustainable economic growth is being undermined by too much bunching of business investment in the short run. Excess demand is leading to a spread of price inflation, and there is danger that a self-reinforcing spiral of wage and living cost escalation lies ahead. It is urgent to deal with these threats by tighter policies that would cut excess demand, because expansionary pressures will continue to be strong. In the absence of any tightening of fiscal policy, monetary policy must move vigorously to put a squeeze on the liquidity of the large banks, along with the rest of the economy.

If we were concerned only with the domestic situation, a case might be made for a very different analysis, highlighting the following four points. Much new productive capacity is being created this year. Lags in the impact of fiscal or monetary policy are long. Until we can see clearly what the effects will have been of measures already taken, monetary policy should proceed by cautious steps. The American economic and political system can tolerate a good deal of price and wage inflation, so long as expansion is maintained.

> If this second view seems indefensible today, it is because it gives no weight to the problem of external equilibrium. Price inflation has very different meanings for the domestic economy and for the balance of payments. In the modern world there is no such thing as a rollback of an inflated cost-and-price level. Domestically, tolerable adjustments can be reached if and when enough prices and incomes can be brought into line with each other at the higher level. The process may be painful and disruptive, but when it's over, it's over. Internationally, we cannot rely on foreign inflations to accelerate along with ours. Maladjustments, once created, are very difficult to remedy. Every step we take upwards on the price scale is so much lost ground.

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

Mr. Daane said that the meeting had been held in Washington on April 19-22. However, discussion actually began on Monday, April 18, in a session involving four or five key Deputies, including Under Secretary Deming, devoted to developing an outline for the Deputies' report. As the Committee would recall, the Deputies had been charged with reporting back in late spring of this year, although it now appeared that it might be early summer before a report could be agreed upon. The outline developed on Monday in effect served as the agenda for the meeting on subsequent days of that week.

The first item, Mr. Daane continued, was the introduction to the report. A draft introduction had already been prepared by the Canadian delegation which mainly quoted the original communique and had little substantive content. It was decided at the meeting to add some substance, pointing up both the need to strengthen the stability of the existing international payments system and the inadequacy of the supply of new gold for meeting the needs for secular growth of reserves.

The second section of the outline was entitled "general improvements in the international monetary system," Mr. Daane said, and included items on the adjustment process and on multilateral surveillance. Nothing really new developed in connection with the first item, but there was a clear thrust on the part of the Europeans for putting more bite into the surveillance process. They laid quite a bit of stress on the need to go beyond the expression of judgments to the application of those judgments to countries' policies, including the coordination of reserve policies. The U.S. delegation did not subscribe to that view, but the increased emphasis on multilateral surveillance by the Europeans--which was related to some extent to the skeptical view they took regarding recent U.S. balance of payments developments--was significant. The System's short-term credit facilities came up for discussion, and received general approbation. The report probably would note the usefulness of those facilities and look forward to their fuller development, but no specific recommendations regarding them were likely to be included.

The third section of the outline, Mr. Daane continued, concerned future reserve creation. The U.S. delegation stressed the wisdom of going forward with contingency planning, emphasizing the inadequacy of gold and foreign exchange for meeting the needs for secular growth in reserves. The U.S. representatives also made the obvious point that the report had to be positive on the score of reserve creation in order to reassure the world that the international monetary system could be made viable. The French view, an isolated one, was directly opposite; they held that there was no need at the moment for contingency planning, and that the real need was for a demonstration that the U.S. and Britain could solve their balance of payments problems. Such a demonstration was described as a precondition before the French would be prepared to go into contingency planning. However, they were willing to give analytical consideration to individual elements of a contingency plan, if not to a complete plan.

The discussion then turned to the form of the new assets envisaged, Mr. Daane said, covering new units, drawing rights, and a dual approach. The views of the Europeans seemed to be coalescing around a dual approach involving a new unit for a limited group of countries and automatic drawing rights for the rest of the world. In his press conference on Friday, Chairman Emminger referred to a dual approach, but what he had in mind was quite different from the U.S. proposal.

There was a general awareness at the meeting that all countries had needs for reserves, Mr. Daane said. The real question was how those needs should be accommodated. Another major issue was who would activate any new arrangement, under what circumstances, and how.

With respect to procedures, Mr. Daane remarked, it was agreed that a draft report should be prepared by Chairman Emminger, and in fact Mr. Emminger's draft had just been received. It would serve as the basis for discussion at the next meeting of the Deputies, to be held in Rome on May 17-18. That meeting, in turn, would be followed by a session in the latter part of June, hopefully to put the report in final form, and the report would be considered by the Ministers and Governors of the Group in July.

Mr. Daane observed that Chairman Emminger was trying, with U.S. support, to develop a report that had a positive emphasis. There was, indeed, a wide area of agreement, and the French were relatively isolated. Thus, it was agreed that a new unit ought to be a part of any scheme developed; and that the needs of other countries had to be taken into account in reserve asset creation. But when one got down to some important details, such as whether there should be a rule of unanimity in the activation process, and whether the new asset should be linked to gold, the questions were unresolved at this stage.

Mr. Daane noted that Mr. Robert Solomon of the Board's staff had attended the meeting as a member of the U.S. delegation and might want to add some observations.

Mr. Solomon commented that Mr. Daane had noted, quite rightly, that almost everyone at the meeting looked toward some sort of dual approach. At the same time, there had been an IMF proposal put forth by Mr. Schweitzer that would, in effect, involve a unitary approach, with a new unit created for all countries. The new unit would come into being as the second step in a two-step procedure, the first of which involved automatic drawing rights. There was some chance that the IMF proposal would prove to be a compromise more acceptable than any of the proposals on the table now, including that of the U.S., and it might turn out to be more satisfactory than the European proposals for a new unit. A new unit along the lines of the IMF proposal could not be linked to gold.

Mr. Daane added that the IMF proposals, as such, had not received extensive consideration thus far. They had been presented originally at the March meeting by Mr. Polak on behalf of Mr. Schweitzer, but had not come under discussion.

Chairman Martin noted that copies of the IMF proposal had been circulated to the Committee early in April. He thought the members also would be interested in a speech made by Mr. Schweitzer at Kronberg, Germany, on April 25, and he asked the Secretary to arrange for distribution of copies.

Mr. Daane remarked that today's Washington Post carried a report on an extemporaneous talk made by Mr. Schweitzer in Mineapolis yesterday which might also be distributed for the information of the members.

Mr. Ellis asked whether the Group of Ten Deputies were planning to make a single report or whether separate majority and minority positions would be set forth.

Mr. Daane replied that the Deputies had not yet arrived at the point at which that issue was faced. They were working hard to reach agreement. It was likely that the report would take a positive stance, stressing the areas of agreement and noting the remaining issues.

Chairman Martin then invited Mr. Hayes to comment on developments at the latest meeting in Basle.

Mr. Hayes said the Basle meeting was not particularly eventful. The subject of international liquidity was on everyone's mind but was hardly discussed; and what discussion there was indicated that the situation was confused. A sad atmosphere was created by Lord Cromer's imminent retirement as Governor of the Bank of England. A farewell dinner was held for him, and everyone felt keenly the prospective loss of a person who had battled for firm policies and was deeply respected by all. Lord Cromer felt sure that the new team at the Bank of England would take as firm a line as he had, and he thought there was some advantage in having a team that did not have a heritage of dispute.

In the discussion of the U.K. situation, Mr. Hayes continued, the Basle group seemed to be willing to give the British the benefit of the doubt on the probable effectiveness of the budget, although they were puzzled by the new payroll tax, which was a technique strange to all. Lord Cromer himself thought it was quite a strong budget that would have rather significant deflationary effects. He went so far as to say that the credit squeeze--which was considerable, since the banks had reached the limits of loans they could make--might have some undesirable consequences, and that there might be some disposition toward selective relaxation--for example, in connection with export credits. However, there was no disposition toward a general relaxation. Removal of the surcharges on imports in November undoubtedly would tend to raise imports but by that time, it was thought, the new budget measures would be having a strong bite.

Mr. Hayes went on to say the Germans had reported that their credit restraint was working more and more strongly. Dr. Blessing was impressed by the inflationary problem in Germany. He noted that, although the Federal Government had its finances under control at the moment, local governments were borrowing substantially and the capital market was in bad shape. The Federal Government had agreed to stay out of the market for the rest of the year. The Germans had a considerable balance of payments deficit on both capital and current account but the deficit probably would not continue as high over the rest of the year. Dr. Blessing regarded the deficit as an assist in his restrictive policy, and he did not mind having it as a warning to the country that it had to get its policies under control. He did not object to the loss of reserves Germany was experiencing currently but he did not want to see that loss continue indefinitely. Dr. Blessing also pointed out that higher interest rates in the U.S. and in the Euro-dollar market had been a distinct help to Germany because they had virtually checked German companies from borrowing abroad.

As to the French, Mr. Hayes said, their internal situation was good--with little inflation--and their balance of payments was highly favorable. Both their imports and exports were up sharply, and their trade balance was quite favorable this year. As Mr. Coombs had pointed out, the French showed no disposition to help by offsetting their reserve accumulations. He (Mr. Hayes) had taken the liberty of asking Mr. Brunet if it was not time to eliminate the restrictions on long-term foreign borrowing in France, and had received the interesting answer that Mr. Brunet thought so, and perhaps the Minister himself, but there were others who did not think so.

There was some undertone of concern about the U.S. balance of payments at the meeting, Mr. Hayes remarked. Some cynicism was evident on the part of certain central bank governors about the credibility of U.S. assurances, since statements that balance or near balance in U.S. payments would be achieved soon were followed by statements that balance did not seem to be in sight as yet.

Mr. Hayes concluded by noting that some progress was being made on the negotiations for short-term credit assistance to the U.K. to cover run-downs of sterling balances. Although there still were some open issues raised by a few parties to the negotiations he believed that the remaining details would be worked out. Mr. Coombs might have something to report to the Committee on the subject at the next meeting.

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

> The economy is increasingly displaying the characteristics of a typical cyclical boom aggravated by the influence of Vietnam developments. The data that have become available in the meantime suggest a stronger outlook than at the time of the last meeting. The business reports continue to picture an economy operating under conditions of sharply expanding demand and progressively greater resource limitations. We begin to see signs of a wage drift rooted in spreading labor shortages. At the same time industry is operating at close to capacity. It would be comforting if one could anticipate a rise in capacity and productivity sufficient to meet growing demands. As it is, rising demands, supported by a bank credit expansion of hardly diminished strength, are clearly adding to price and wage pressures. We may say that the patient is already running a low fever, and there is a very big risk that the fever will rise, even though recent stock market developments may provide some of the much-needed dampening influence.
>
> This would be bad enough from a purely domestic point of view. But I am increasingly impressed by the implications of rising costs and prices for our balance of payments prospects this year. I had an opportunity in Basle to observe the effect on European central bankers of the change on our domestic scene from an orderly but vigorous

expansion to an atmosphere where everything is straining at the seams. Frequent contacts with commercial bankers and financial and business leaders of various countries confirm the impression that this is going to be a critical year for the dollar. There is no need to stress in this group the importance of maintaining a fully competitive position in world markets and to avoid excessive demand pressures which tend to stimulate imports and to discourage exports. After last fall's ringing assurances by the highest authorities in the Administration that payments equilibrium will be achieved in 1966, our entire international bargaining position--and not only in the economic sphere--will be seriously hurt if 1966 shows a deterioration. New reports on the probable size of direct investment abroad are discouraging. Unless we make strenuous efforts to redress this unfavorable prospect, we may find ourselves in an even worse position than a few years ago, when the dollar was subject to grave suspicion abroad. This time, with several years of additional deficits in back of us, our leeway in the form of potential foreign credit to the U.S. will be considerably more limited.

Under these circumstances, the need for restraint is clear. The classic methods for exercising restraint under present conditions involve fiscal and monetary policy. The latter has, of course, moved quite a distance since last November toward tighter restraint, but our policy moves have not as yet put a sufficient damper on inflationary pressures. April credit figures, which reflect a number of special factors and thus are not necessarily indicative of the underlying trend, suggest nevertheless that the economy continues to be supplied with credit at a rate considerably in excess of the possibilities for expanding real output. Restraint takes some time to affect the various parts of the financial structure. Gradual tightening has already produced some retrenchment and moderation, but also some anticipatory borrowing as well as strains and stresses on financial markets. While we could, and probably should, move somewhat further in the direction of greater monetary restraint, I think that caution is called for. With many key interest rates higher than at any time in the postwar years, the risks of forcing monetary policy to carry the burden alone are not inconsiderable. I would also stress that it is hard to think of any further action on the monetary side that could have an important immediate effect in dampening the inflationary atmosphere without undesirable and perhaps somewhat unpredictable effects on financial markets.

The obvious need is for a significant and prompt assist in the form of greater fiscal restraint. I have been very much disappointed to observe the great reluctance of the Administration, probably in large part for political reasons, to embrace the widespread proposals for a tax increase. I am glad that the Chairman made such a forthright statement a few days ago on the need for a prompt and adequate tax increase. We probably all agree that restraint on Government spending must be part of any move on the fiscal side, but it seems fairly clear that sufficient restraint on spending is not so far in the making. I feel that the conscious use of fiscal policy to affect general business conditions represents a big advance in public policy, but if this new weapon is to be used effectively it must be resorted to in both directions.

Meanwhile, as I have already indicated, we should be doing what we can in the monetary area to restrain the rate of bank credit expansion, by pressing a little harder on the availability of bank reserves. This might, of course, mean somewhat higher interest rate levels, although some degree of further tightening may have already been discounted by the market.

After an appropriate short interval following the delivery of Treasury securities on May 16, we should aim at somewhat deeper net borrowed reserves. Given recent market gyrations, it is more than ever difficult to pinpoint a level of net borrowed reserves that would avoid a sharp rise in open market rates and consequent expectations of an imminent increase in the discount rate. But I believe that a figure centering around $350 million would be appropriate, with borrowings around $700 million. The Manager should be given enough leeway to make adjustments if market pressures threaten to become too intense. Even a moderate and orderly upward movement in rates is likely to push the Federal funds rate occasionally to, or even above, 5 per cent, as banks are forced to make fairly substantial adjustments in their assets position, in particular if loan demands continue strong even though some demands for funds have been rechanneled into the capital markets.

> While I realize that conditions might develop which would lead us to consider a further discount rate action, I do not feel that we have reached the point as yet. Clearly, such an increase would raise the complex question of the proper action with regard to Regulation Q ceilings. In the meantime, the contemplated goal of open market operations for the next policy period does not seem to require any change in the directive, and I therefore favor alternative B.

Mr. Francis said that total demand for goods and services had been rising excessively. Gross national product, in current dollars, had risen at a 10 per cent annual rate since the third quarter of last year compared with a 7 per cent rate in the previous year. With the economy operating at virtual capacity, growth in real output had not kept pace. Since the fourth quarter real GNP had risen at a 6 per cent annual rate compared with an 8 per cent rate in the previous quarter. As a result, prices as measured by the implicit price deflator rose at a 3.6 per cent rate in the most recent quarter, double the rate of the previous quarter. That was the largest quarter-to-quarter increase in prices in many years. The rise was probably understated since the standard price measures did not take fully into consideration elimination of discounts and deterioration of quality. There were indications that prices would have risen even more without the Presidential guidelines, which were becoming increasingly difficult to maintain.

The contribution of monetary policy to total demand for goods and services had continued to be very great, Mr. Francis said. pending had been facilitated by a continued rapid flow of bank funds.

Total commercial bank credit, which rose about 10 per cent in 1965, had continued to expand at about that same rapid rate in early 1966.

Since the expansion in bank credit had exceeded the volume of saving in the form of time deposits, demand deposits had continued to rise at a very fast pace, Mr. Francis noted. Demand deposits had risen since early February and also since last November at more than three times the average rate of increase since 1956. The money supply of the country, reflecting primarily the jump in demand deposits, had risen at an 8 per cent annual rate since early February and since last November, and at a 6 per cent rate since a year ago. Money had not risen so rapidly over any other twelve-month period in twenty years; the next highest rate of growth for a year was 5.6 per cent during the Korean War. It seemed inappropriate to add to the stock of money so rapidly at a time when total spending was excessive.

The great increases in bank credit and the cash balances of the public might have been fostered by a strong demand for credit, Mr. Francis noted. Yet, he felt the System had to assume responsibility for the banking system's rapid expansion, since member bank reserves to support the growth had increased at an advanced rate. Net System purchases of securities had been a chief factor adding to reserves. Since February the System had not offset gains of reserves from other factors, particularly Treasury operations. In short, for almost a year it had been feeding the extraordinary demand for loan funds at a rapid rate by a policy of permitting only slightly firmer money market conditions.

Not only had monetary actions been expansive but the fiscal situation was now in the fourth quarter of the most stimulative high employment budget of the past 13 years, Mr. Francis continued. The outlook was for continuation and possible intensification of fiscal stimulation during the rest of the calendar year. That was a highly expansive policy when the need was for public policy restraint on total demand. He believed cuts in Government outlays and/or an increase in taxes would be appropriate.

At the same time, irrespective of what might be done fiscally, there seemed to Mr. Francis to be no justification for continuing monetary expansion at extraordinarily high rates. A necessary step in cutting back on the excessive monetary demand for goods and services was to reduce substantially the rates of increase of total member bank reserves, of bank credit, and of the money supply.

The Committee could control the quantity of those magnitudes by appropriate purchases or sales of Government securities, Mr. Francis observed. He believed it should pursue such a course, with only secondary consideration given to other objectives such as day-to-day money market stability. Preoccupation with such other objectives for the past ten months had let the Committee to substantial monetary expansion that he interpreted the directive to have said it did not want, and the Committee had thereby continued to contribute to excessive total demand.

The wording of the directive might have been partly responsible for the unintended monetary expansion, Mr. Francis remarked. There had now been ten or eleven months when the directive had continuously called for a moderation or restriction of expansion in bank reserves, bank credit, and money, and at the same time had called for only slightly firmer money market conditions. Those instructions had been inconsistent in the face of the unusually strong demands for credit, and there had been very rapid increases in bank reserves, bank credit, and the money supply.

Mr. Francis suggested that the directive now clearly state that the primary objective of the Committee was to obtain a slower rate of growth in member bank reserves, bank credit, and money. To attain those goals, the Committee should be willing to accept the levels of short-term interest rates, net borrowed reserves, or other money market conditions that were necessary.

It seemed strange to Mr. Francis that some analysts had implied that monetary policy had done about all it could to resist inflation when the banking system had been expanding at record rates. Also, fears of financial panics or other disruptive consequences of a further rise in interest rates seemed exaggerated in view of the fact that rates in foreign countries had been much higher and on occasion had risen faster than U.S. rates without serious consequences. Any resultant higher interest rates might be beneficial to the U.S. balance of payments.

If the Committee should now achieve restriction of monetary expansion, and if that should lead to excessive difficulty in administering the discount window, the System could then consider raising discount rates, Mr. Francis said. Of the three alternative directives submitted for consideration, alternative C seemed to fit best his idea of what policy should be.

Mr. Patterson reported that evidence of tightening financial conditions in the Sixth District seemed to be concentrated in the mortgage market and at related financial institutions. Since the South was a net importer of mortgage funds, the effects of the changes in the availability of funds in the national markets were quickly transmitted to the Sixth District. Earlier in the year the inflow of new mortgage funds was practically cut off. Now that flow seemed to have been restored somewhat, partly because of the raising of the contract rate ceiling on FHA and VA mortgages. Nevertheless, so far as he had been able to determine, no mortgage bankers were originating loans without specific commitments. The chief local source of mortgage funds, savings and loan associations, had also been reduced. Net new savings growth at savings and loan associations in the District States was about 12 per cent lower through the first three months of

1966 than in the corresponding period last year, and loan repayments were down 7 to 8 per cent. Unofficial figures for April indicated a much deeper decline with the outstandings at some associations down from the end of last year.

The slowdown in the inflow of funds to the savings and loan associations reflected, of course, competition for time deposit funds by the District's commercial banks, Mr. Patterson said. In the large cities advertising campaigns were being pursued vigorously, and it was understood that more of the banks in the smaller cities were entering the competition by posting higher rates on savings certificates.

More of the expansion in business loans this year was accounted for by loans to trade concerns and manufacturers of nondurable goods than was the case last year, Mr. Patterson noted. That development, together with the high rate of consumer spending that characterized the first quarter of this year and the growth in consumer loans, suggested that the consumer might be exerting a stronger influence on the demand for credit than formerly. Banking figures pointed to one conclusion. They gave little evidence of any slowdown in bank credit growth in response to a more restrictive credit policy.

Behind those District financial developments was a continuing high level of economic activity, Mr. Patterson continued. With the insured unemployment rate in the District down to 1.8 per cent and with the scarcity of skilled workers, however, manufacturers might find it more difficult to increase their production in the coming months in accordance with the usual seasonal pattern in the District.

Despite the generally rosy tone of the statistics, Mr. Patterson remarked, a few businessmen saw some difficulties ahead. Such straws in the wind had not assumed major proportions and were generally confined to possible slowdowns at individual businesses or types of business. For the District the picture remained one of buoyancy, with demands pressing on resources and available credit.

When it came to the national scene, Mr. Patterson saw nothing to show that the description found in the first paragraph of the directive adopted at the last meeting of the Committee no longer held. The domestic economy was still expanding vigorously, industrial prices were continuing to creep upward, and credit demands remained strong. Thus, the policy of restricting the growth in the reserve base, bank credit, and the money supply still seemed to be appropriate.

What bothered Mr. Patterson was that the Committee had not been at all successful in restricting the growth of the reserve base, bank credit, and the money supply, even though it had moved toward larger net borrowed reserve figures. In the meantime, borrowing had increased substantially and the reserve base, bank credit, and the money supply had gone on expanding--indeed, at accelerated rates. Total reserves, which rose at seasonally adjusted annual rates of 4.6 and 3.3 per cent in February and March, respectively, rose at a 17.9 per cent rate in April. Other reserve measures and the money supply behaved in a similar fashion.

If the demand for credit continued strong and member banks continued to go to the discount window as they had in recent weeks, operating to produce a net borrowed reserve figure of aroung $300 million would do nothing to prevent an accelerated rate of expansion, Mr. Patterson believed. At the very least, the Committee should operate so as to return to the rate of reserve expansion that prevailed in early 1966. That would, of course, imply a much deeper net borrowed reserve position than that of the last few weeks. He favored alternative B of the draft directives.

Mr. Bopp said that, with no let up in the pressures of demand and with hopes for a tax increase slowly dwindling, it appeared to him that decisions on monetary policy assumed even more critical importance than in the recent past. It was especially important for current policy to try to ascertain insofar as possible the impact of measures already taken.

Five months had now passed since the increase in the discount rate, Mr. Bopp noted. During that time, a progressive tightening of marginal reserve availability had occurred and significant upward pressures on interest rates had developed. Evidence had also been seen of a change in bank attitudes toward lending, occasional postponements of issues slated for the capital markets, and an increasingly slim margin--indeed, in many cases a disappearance of the margin--between commitments of life insurance companies and inflows of lendable funds.

A significant tightening had also been seen in the home mortgage market, Mr. Bopp continued. A survey just completed at the Philadelphia Reserve Bank of Third District mortgage lenders showed a dramatic change recently in both the cost and availability of money. Mortgage rates had jumped from a January range of 5-1/4 - 5-3/4 per cent, depending on downpayment, to 6 per cent generally for all conventional home mortgages. On FHA and VA insured loans, the average discount was now 3 points, and by mid-summer FHA expected the average discount to be 4-1/2 points. So far lenders had not made changes in percentage downpayments for mortgages; however, lenders were more critical of credit standings, ability to pay, and other obligations.

Mr. Bopp commented that money tightened during 1966 primarily because insurance companies and savings and loan associations had less to lend for home financing. Half of the savings and loan associations contacted no longer accepted mortgage applications from non-depositors. Many of those had recently experienced net deposit outflows for the first time in memory. The association officials blamed the high rate of interest and the small denomination feature of commercial bank CD's for their plight.

Insurance company funds for home mortgages were reduced in early 1966, Mr. Bopp said. Among surveyed companies, three large institutions had bowed out of home mortgages since January. None of the insurance companies foresaw a return to the home mortgage business in the next couple of years. One large institution was over-committed for industrial loans through 1968 and now accepted applications for 1969 delivery only. Another was committed into 1967.

Yet, Mr. Bopp observed, despite those various examples of credit tightening, the fact remained that bank credit, bank reserves, and the money supply had continued to grow at a rate in excess of that desirable in the present business environment. Of course, the Committee did not really know all it should about the linkages and lags of monetary action and it did not know precisely how far it could go in cumulating tightness without undesirable effects on the capital markets. However, in his judgment, some gradual move toward further restraint was desirable to curb the excessive flows of money and credit. If the Committee moved gradually now, it might be able to avoid sharper action sometime in the future and thereby prevent a rapid shift in the credit environment and in market sentiment that could be particularly unsettling. Additional restraint should be imposed gradually and in a probing fashion. He favored alternative B of the draft directives.

Mr. Hickman observed that the latest information on the business situation showed that excess demand continued in all major sectors of the economy: business, government, and consumer. So long as demand pressed on capacity, prices would continue to rise. The latest rise in industrial prices between mid-March and mid-April was simply another illustration of fundamental imbalances that now existed in supply-demand relationships.

Despite widespread evidence of overheating, Mr. Hickman said, several straws in the wind suggested some possible cooling off of the situation, as Mr. Koch had indicated. Painful as they were to some, the weaker stock market and some slackening of auto sales and output were highly desirable under present circumstances. A serious weakening of auto demand would have a retarding influence on steel output--which, incidentally, showed no increase in April on a seasonally adjusted basis, for the first time in many months. If defense spending leveled off, if capital spending moderated, and if Congress held the line on nondefense spending, it might be that the Committee would find in retrospect that the economy had already passed the inflationary crest. But he had been disappointed on that score many times before; the weight of the evidence at the moment still pointed to inflationary overheating.

In that situation, and in view of the weakening U.S. balance of payments situation, Mr. Hickman felt monetary policy should move further toward restraint. Since higher income taxes seemed unlikely in the foreseeable future--whatever might be their economic logic--monetary policy had to fill the void. In so doing, the Committee should be willing to go as far as was needed to eliminate excess demand and price inflation. Unfortunately, the Committee had not been too successful since the date of the last discount rate increase. The rates of expansion of bank reserves, bank credit, and the money supply that occurred in December and again in April were simply too high to be tolerated.

The problem, as Mr. Hickman saw it, was that the Committee had been paying too much attention to net borrowed reserves and money market conditions, and not enough to aggregate reserve measures. An attempt to maintain limited variations in net borrowed reserves and interest rates had resulted in undue expansion in all key monetary variables. Given what was known about the relationship between money and prices--which, despite the Chicago school, was far too little--it would seem appropriate at this time to allow total reserves to expand with real output at an annual rate of no more than about 5 per cent, rather than the 8 per cent annual rate of increase that had occurred since January or the 17.5 per cent increase of April.

Mr. Hickman recommended that in the weeks ahead the Committee try to hold the rate of increase in total reserves to 5 per cent or less, even if that should mean further deepening of net borrowed reserves to the $500 million or $600 million levels. On the other hand, the Board's staff suggested during last Friday's telephone hookup, in which he participated, that roughly the desired rate of reserve growth might be achieved in May with net borrowed reserves around the $300 million level. In any event, the Committee should seek to moderate reserve growth rather than to stabilize net borrowed reserves. The course of action he preferred seemed to be best expressed in alternative C proposed by the staff, although he would not vote against alternative B if that was the consensus of the Committee. The situation was so serious that he would forget the current Treasury financing, and would get on with the main job of trying to check price inflation.

Mr. Brimmer remarked that he would not comment extensively on the strength of the current economic situation, which already had been discussed at some length. He would say, however, that he hoped the Committee would not over-react to any dissatisfaction with the rate at which it was exerting restraint. He certainly would not want to see the Committee attempt to make up now for whatever deficiencies there may have been in its recent operations.

Mr. Brimmer shared the concern of Messrs. Hayes and Hersey about the balance of payments situation. Those working with the

Cabinet committee on the balance of payments were extremely disappointed by recent developments, and saw nothing in the policy tool kit that would lead to much improvement over the rest of 1966. If anything, the situation had deteriorated in the last few weeks; as the evidence came in, it looked as though the 1966 deficit might well be closer to $2 billion than to $1-1/2 billion, although the figure could not be pinned down firmly as yet.

The results of the voluntary restraint program by the business community were particularly disappointing, Mr. Brimmer continued. It had been anticipated that the program, which began in 1965, would result in a saving of $1 billion in 1966 in direct investments abroad. While a clear reading was still not possible, it appeared that corporations had saved substantial parts of their two-year quotas in 1965, and that if they used their remaining quotas in 1966 the net gains through that part of the voluntary restraint program would be disappointing. The results of the voluntary restraint program of banks warranted some optimism, although, as Mr. Hersey had indicated, there were reasons for not being overly-optimistic in that area. However, he remained rather optimistic about bank flows because he felt that the domestic pressures on banks would hold down their outflows over the rest of the year. Other parts of the Government's present program did not appear particularly powerful, although the Cabinet committee was continuing to work on the problem and might well come up with some effective proposals. In general, it was important that sight not be lost of the developing seriousness of the situation.

With respect to credit policy and the directive, Mr. Brimmer thought the Committee should not be insensitive to the conditions now prevailing in financial markets. He agreed that the condition of markets should not be made a primary objective, but it was necessary to recognize that--even aside from developments in the stock market--the pressures on some financial institutions were already severe. The Committee should not overlook the parade of agency issues that already was taxing the market and would tax it further. Those issues might well be disorderly as well as sizable. Moreover, the Committee should remain sensitive to the situation of Government security dealers who, after all, were an essential element in the process of open market operations. Personally, he would not favor instructing the Manager to dump a large amount of securities into the market, because it might be well beyond the capacity of the dealers to absorb them. The Committee members all had a sense of history, and while it would not be desirable to be overly-concerned with the possibility of a financial panic the members should remain alert to the extremely sensitive situation in some markets.

Mr. Brimmer agreed that the Committee should proceed further with tightening. He was willing to suggest a net borrowed reserves objective to the Manager, on the understanding that it would not be viewed as a rigid target for operations. While there was no way of knowing whether a net borrowed reserve figure of $350 million would lead to a sufficient degree of restraint, it might be a good proxy and he suggested that it be kept in mind. Member bank borrowings might well rise to $750 million or $1 billion. He thought the Manager should press ahead with those figures in mind, on the assumption that the current Treasury financing was just about completed.

Mr. Maisel agreed with previous speakers that the Committee had to carefully examine its record for the past five months. It should decide whether it was or was not satisfied with the manner in which it had shaped its open market operations

The question the Committee had to answer, Mr. Maisel said, was how close its actual operations had come to meeting its overall policy objectives. He was not questioning the manner in which the Desk had carried out its instructions. He was concerned with the sub-goals the Committee seemed to have adopted because of a failure to specify its goals more completely; with the manner in which the Committee had instructed the Desk; and with the results of its actions. In December the Committee chose to restrict credit growth. Since January 11, 1966, its policy directive at each meeting had called either for moderating, maintaining low, or restricting growth in the reserve base, bank credit, and money supply.

What had the facts been? Had the Committee been kidding itself? In place of moderate or restricted growth, each monetary or credit index showed a much sharper growth rate in the past five months than it had in the previous five. With the exception of future mortgage funds, interest rates--which were not included in the Committee's directive--were the major items that were tighter and those, it was recognized, were a function of market expectations even more than of the Committee's own action. He disagreed rather completely with Mr. Partee's analysis and he agreed with the previous speakers. The Committee had to differentiate between moves caused by shifts in demand and those it allowed, or caused, in supply. It was not an answer to the claim that the Committee allowed a very rapid credit expansion to say it rose only 70 or 90 per cent as fast as banks and businesses wanted it to expand. He believed Mr. Partee's analysis led to a complete abdication of the System's role in determining monetary policy. Such analyses and stress on marginal rather than total reserves led to the conclusion that if businesses wanted loans and if banks wanted to lend, the Committee had to go along with their desires.

Mr. Maisel said he hardly thought that the Committee could conclude that it had done much toward combatting inflation during the past five months. _Au contraire_, when members looked at total reserves or nonborrowed reserves, either of which he took to be the principal measure of the Committee's actions, they must all be appalled at the Committee's results. He found it difficult to believe the figures but, if he read them correctly, in the five months since December 1 the Committee had poured more reserves into the banking system than were furnished in the entire previous year. In fact, if the figures were correct, since December 1 the total increase in reserves had been larger than in any full year since 1951. The growth in the money supply, bank credit, and business loans had been equally large.

In Mr. Maisel's view, those results did not accord with either the Committee's intent, its statements, or sound policy. While all members recognized that there might be a considerable lag between changes in money and credit and changes in the world of production and prices, the Committee had stressed that monetary policy was flexible and therefore was able to move at least the monetary variables in a fairly rapid manner. Now that did not seem to be the case. The fifth month after the System's policy change saw the largest growth of any in most of the money and credit variables. The Committee apparently had followed sub-goals such as feel of the market, net reserves, or the need to offset shocks, and as a result it had moved in a direction opposite to its real policy aim.

Mr. Maisel believed that if the reserve picture were not turned around at once, the point might well have been passed where it made sense to talk of and use monetary policy as a method of restraining demand. The System might well have generated all of the costs of a publicized policy shift without gaining any of the benefits expected from such a change in policy. Since more than a record year's supply of reserves had already been furnished, it seemed clear to him that it was no longer sufficient to talk about moderating growth. The Committee should press for a reduction in total reserve availability on a seasonally adjusted basis, even if that meant a very sharp increase in net borrowed reserves. He would support alternative C for the directive. If there was sufficient sentiment around the table, and there seemed to be, he would be willing to try to redraft it in a considerably more emphatic form and with stress on total reserves rather than with the present emphasis on the marginal measures.

At the same time, Mr. Maisel urged again that the Committee give more information to the market. Since any real effort to correct the present situation was going to have to be made obvious to all, he thought that the use of a change in reserve requirements, with its resultant publicity, might be a simpler and more certain procedure than searching again for a level of net borrowed reserves that would bring the Committee to its ultimate goal. However, if there was no agreement on a change in the reserve ratio, he thought it should be made clear by official statements that the Committee was trying to restrain credit through open market operations and that it did not think that either a change in the discount rate or in Regulation Q need accompany such a decrease in reserves. He did not think the Committee should feel constrained, as he thought the Manager indicated it had been, to furnish reserves because the market might misinterpret the published free reserve figures in any week. The Committee ought to improve its communications instead.

Mr. Daane said he agreed essentially with the positions of Messrs. Hayes and Brimmer and would not take the time to repeat their analyses. He thought the domestic economy was still overheating, and he was perhaps even more pessimistic than Mr. Hersey and Mr. Brimmer regarding the outlook for the balance of payments this year. He remained hopeful that fiscal policy action would be taken, and he shared Mr. Brimmer's concern about the sensitive state of financial markets and the implications of some existing rate relationships. He favored alternative B for the directive, reminding the Committee that the Treasury had just completed an unsuccessful financing that had yet to be digested.

Mr. Mitchell commented that for the most part he shared the concern others had expressed in the discussion today and agreed that it was important for the Committee to get control over the rate of monetary expansion. He did think, however, that the Committee had accomplished a little more than had been acknowledged.

There was a little evidence that the economy was getting some tranquilization, and that was due partly to the efforts of the System. The psychological environment was much better at present than it had been in February or at the end of January, and it would be helpful to the Committee's objectives if the present tone continued in the stock market and if additional auto companies cut back their production schedules.

Mr. Mitchell still thought it might be possible to achieve the necessary degree of restraint without a change in the discount rate, but if a discount rate increase was required he would be agreeable to it. However, he was not in favor of any action that would result in increasing the Regulation Q ceilings. The System's policy actions had already put so much pressure on the housing industry that it was writhing in anticipation of a serious cut-back later this year, and it would not be desirable to put additional pressure on that sector at present.

As to the directive, Mr. Mitchell said, the modest steps implied in both alternatives B and C seemed consistent with the present discount rate. Of the two, he preferred alternative C. However, if he were to put his preferences in his own language they would be, first, to keep bank lending conditions firm--to discourage backsliding in the tight policies at many banks, and to encourage the spread of such policies to other banks. Secondly, he thought that growth in bank credit and the money supply as projected by the staff was larger than desirable, and that another bulge such as occurred in March-April should be avoided. He was sympathetic to the staff's view that the seasonal adjustments were inadequate, and he thought Mr. Maisel might be interpreting the figures too literally. Nevertheless, he would make a slowing of money supply and bank credit growth in the next few months the overriding consideration. He was uncertain about the level of net borrowed reserves that would be consistent with that objective; it might be $350 million, but if a deeper figure was required he would not be concerned. Nor would he be worried about the level of the Federal funds rate. If banks were willing to pay 5-1/2 per cent for deposits they would not balk at paying even more, if necessary, for Federal funds.

It seemed to Mr. Mitchell that a good deal of what had been accomplished in restraining bank credit growth had been the result of discount window administration, and he thought the System's discount officers should be congratulated on their work. The informal talks that the Reserve Bank Presidents had held with bankers also were helpful. Hopefully, by these means the System might at least temporarily keep a considerable degree of restraint on banks of a type that might not even show up in the banking statistics.

In Mr. Mitchell's judgment the present was an extremely critical period. The economy might be at or near a turning point, and it was quite likely that there would be developments soon that would make a change in the Committee's policy desirable. For that reason he wondered whether the Committee should not consider scheduling another meeting in Washington in two weeks. Telephone conference meetings were useful when some narrow action required consideration, but they were not very satisfactory for purposes of more general deliberation.

In concluding, Mr. Mitchell noted that he favored as firm a policy as possible at present without a change in the discount rate.

Mr. Shepardson said he also thought it unnecessary to repeat views that had already been expressed. He was particularly impressed--and concerned--with the point made by Mr. Hersey and implied by Mr. Koch that when ground was lost with respect to prices and wage rates the situation might be irreversible. Food price increases ordinarily were reversible, since the country's agricultural capacity was large and production could be expanded rapidly. Rises in food prices thus were not critical except as they contributed to the cost of living and the latter was one of the bases on which wage rates were determined. But increases in industrial prices were not as easily reversible; and, accordingly, they should be prevented if possible.

Also, Mr. Shepardson continued, like others he was concerned that despite the Committee's statement in successive directives that its policy was to restrict growth in reserves, bank credit, and the money supply, the increases in all three continued to be greater than desirable. In his judgment the Committee should be watching total reserve availability, which was rising too rapidly.

Mr. Shepardson favored alternative C of the draft directives. He noted that Mr. Maisel had mentioned the possibility of modifying the language of the draft. He (Mr. Shepardson) would replace the phrase "with a view to attaining some further gradual reduction in net reserve availability," with the phrase, "with a view to attaining a reduction in reserve availability." The staff's language implied that some reduction already had occurred in reserve availability, and he did not think that was the case.

Mr. Wayne reported that business continued to show considerable vigor in the Fifth District although there was some evidence in the Reserve Bank's latest survey and in the statistical record that the rate of advance might have slowed somewhat. Declining growth rates, for instance, appeared in both nonfarm employment and factory man-hours in the two most recent months for which figures were available. The survey showed further increases in manufacturers' new and unfilled orders, but fewer respondents reported gains than in surveys taken one and two months earlier. Reports of higher wages and prices, however, were more numerous than before.

Regarding general expectations, Mr. Wayne continued, the survey showed some diminution of optimism among bankers but not among businessmen. Materials shortages had been reported with increasing frequency by manufacturers and contractors, while shortages of skilled labor had become an acute problem for some of the District's principal industries. Textile producers cited their difficulties in retaining experienced workers, along with low existing pay scales, as evidence that the 3.2 per cent wage guidepost had questionable validity in their case. Certain wage increases to textile workers were mentioned in the press over the past weekend. He expected that that movement would spread throughout the industry rather quickly and that, including fringe benefits, the effective increase would be nearer 5 per cent than 3.2 per cent. Furniture manufacturers reported that hardwood shortages were forcing use of substitute materials to maintain production. The evidence, briefly, suggested that output growth was being slowed by resources limitations.

As for the national economy, Mr. Wayne said, fairly complete statistics seemed to bear out the widely held impression that the first-quarter rate of advance was not sustainable and that its persistence even into the near-term future would confront the economy with serious overemployment problems.

It was disturbing to Mr. Wayne to consider the preliminary figures on aggregate reserves and reserve related measures for April. According to those preliminary figures, the growth of reserves, bank credit, and money, after allowance for seasonal factors, was of the order of the unusual expansion that occurred last December. He was aware of the problems of seasonal corrections in those data and he would not like to make too much of a single month's figures. Yet it might be appropriate to note that such rates were hardly compatible with a declared policy of restraint.

With respect to current policy, Mr. Wayne saw little reason to interpret the fragmentary April figures as a reason for any relaxation in restraint. About one-third of the first-quarter increase in GNP was attributable to higher prices, and pressures of such a magnitude would not be quickly dissipated. Moreover, the prospect of any contribution toward restraint from fiscal policy struck him as distinctly dimmer now than it was a month ago. On the other hand, he would be eager to avoid stepping on the brakes too hard. He could readily agree that it was necessary to keep the market under pressure and to hold reserve availability in check.

Yet he wondered about the meaningfulness of free reserves and market tone targets in the present booming business environment.

It seemed to Mr. Wayne that the present situation required that the Committee take whatever action might be necessary to keep the rate of growth of total reserves, credit, and money at considerably more moderate levels than those prevailing last month. In February and March the Committee succeeded in tightening, both in terms of the marginal and of the aggregate measures, and those tightening moves were wholesome. He had a suspicion that April might have unraveled some of the Committee's work, primarily because of basic weaknesses in its policy criteria. He believed the Committee would be on firmer grounds if it observed the movement of required reserves more closely and accepted a relatively higher level of net borrowed reserves if required reserves moved up more rapidly than normal for this time of year.

The approach suggested recently by Mr. Robertson appeared particularly appropriate in the weeks ahead, Mr. Wayne said. He would be prepared to accept the risks of higher rates that such a course might involve. He emphasized, however, that he did not refer to higher ceilings under Regulation Q for he feared that some banks, including the money market banks, had failed to show due prudence in shaping their current policies.

As to the directive, alternative C with the amendment proposed by Mr. Shepardson appeared preferable to Mr. Wayne.

Mr. Clay reported that business activity in the Tenth Federal Reserve District was continuing to expand at a rapid rate. Employment was growing, unemployment was low, and skilled labor was very scarce. Employment growth was particularly strong in defense-oriented industries, such as aircraft, ordnance, and explosives.

Agriculture was providing a substantial impetus to income growth in the Tenth District, Mr. Clay said. Cash receipts from farm marketings continued well above year-ago levels, and the District increase was much greater than for the country as a whole. Agricultural prospects for the current year in the District continued distinctly favorable, despite the possibility that the wheat crop might have suffered severe freeze damage in southcentral and southwestern Kansas, northwestern Oklahoma, and southeastern Colorado.

In the commercial banking field, Mr. Clay continued, both loans and investments at District weekly reporting banks declined more during the first 4 months of this year than in 1965. Deposit experience had been stronger, with demand deposits down only about half the seasonal decline shown in 1965 but with time deposits rising more slowly. At the same time, however, member bank borrowing had been in larger volume than last year, and reporting banks had been net purchasers of Federal funds more regularly.

On the national scene, despite recent developments in the auto industry and the stock market, the resource-price squeeze appeared to intensify rather than lessen, and the price inflation problem was becoming more severe. Accordingly, Mr. Clay felt that further restraint was needed on the growing aggregate demand for goods and services. Additional fiscal restraint would be highly desirable. In fact, that was the action that should be taken, but that could not be done by the Federal Reserve. Within the limits permitted by the maintenance of the present Federal Reserve discount rate, the Federal Reserve should continue to apply pressure on the commercial banking system and the financial markets in line with the current directive's provision for "restricting the growth in the reserve base, bank credit, and the money supply."

Unless economic pressures did lessen, it appeared highly doubtful to Mr. Clay that a combination of such a monetary policy and current fiscal policy would provide the necessary restraint on inflationary pressures. Unless additional fiscal policy action was taken, the Federal Reserve System would probably face the very difficult decision as to whether credit restraint should be increased substantially further--balancing the need for restraint on the growth in aggregate demand for goods and services against the repercussions on the financial structure from substantial credit tightening from present interest rate levels.

The draft economic policy directive with alternative C for the second paragraph appeared satisfactory to Mr. Clay for the period immediately ahead.

Mr. Scanlon remarked that, despite some reassuring signs that the excessive growth of demand might be moderating somewhat in some sectors, the evidence, over-all, indicated that inflationary pressures remained dominant and should be subjected to somewhat greater restraint. Order backlogs continued to rise. Most businesses continued to report that they were paying higher prices and receiving slower deliveries. Labor stringencies were reported from almost all Seventh District centers, large and small. Virtually all consumer goods remained in good supply and retail markets appeared to be competitive although merchants reported that orders for replacement stock often were at somewhat higher prices and had to be placed with longer lead time.

Construction projects continued to utilize available resources fully, Mr. Scanlon said. In the first quarter, construction contracts in the Midwest were up 32 per cent from last year, compared with an 11 per cent rise for the U.S. All major categories of construction in the area, except public buildings, showed gains ranging upward from 14 per cent.

Mr. Scanlon noted that farmers were buying machinery and equipment at a rapid pace, well above that expected by most manufacturers. Farm land values in the District showed a larger increase in the first quarter than in any quarter of recent years. Good farm land was now up about 10 per cent over a year ago, with increases reported for all District States.

The growth of total loans appeared to Mr. Scanlon to have slowed in April at District banks, especially at the largest banks in Chicago and Detroit. At most other banks expansion continued at a fairly rapid pace. Some net repayment of business loans at the large banks was in keeping with the usual seasonal pattern. It might reflect a more restrained lending posture on the part of those banks, but repayment of bank loans by firms that had recently raised funds in the capital market was also a factor. All things considered, the evidence did not suggest any easing of over-all demands for funds.

Reserve positions of the major Chicago banks had shown marked improvement over the past month reflecting both loan reduction and deposit inflows, Mr. Scanlon observed. In late April both the number of banks and the amount of borrowing at the discount window declined, but that now appeared to have been temporary. The figures on reserves, money, and credit for April all indicated a substantial rise in the rate of expansion compared with either March or the first quarter as a whole. Part of that rise could be attributed to temporary factors, seasonal adjustment difficulties, and reduction of Treasury deposits to an abnormally low level, as Mr. Partee had pointed out. Nevertheless, in his (Mr. Scanlon's) judgment, under current conditions of resource utilization, recent rates of expansion in money and credit were clearly too high and should be reduced.

The recent period illustrated strikingly, Mr. Scanlon said, that tighter conditions in the money market had not been sufficient to avoid a sharp acceleration in monetary growth. Nonborrowed reserves had been supplied at a rapid rate and increased borrowings had added further to reserve aggregates. While some short-term money rates had increased, other yields were still well below early-March levels. It seemed clear that if the Committee was serious about slowing money and credit expansion to rates more consistent with the growth of physical capacity to produce goods and services, and, hence, with stable prices, and given a continuation of strong credit demands, it would be necessary to cut back much more sharply on reserves provided through open market operations. Such action probably would push interest rates up further and increase borrowing pressure at the discount window, and it might well necessitate another discount rate increase.

In Mr. Scanlon's view the large reserve expansion in March and April resulted in part from the Committee's inability to foresee the strength of credit demand and continued heavy reliance on free reserves and interest rates in setting policy goals and formulating directives. Viewed in retrospect, Committee policy might have been better if total reserves or possibly some other aggregative reserve measure had been given priority in policy guides and directives. He believed the growth rate of total reserves should be cut back to a rate no greater than, say, 3 per cent, so long as the economy continued to operate with fairly clear evidence of an inflationary gap.

As to the directive, Mr. Scanlon was not entirely clear on the reasons for the use of the term "net reserve availability" in alternative C and "reserve availability" in alternative B. But he believed alternative C as amended by Mr. Shepardson came closest to the policy he would like to see adopted.

While he would like to avoid an increase in the discount rate, Mr. Scanlon would not resist such a move at any time it was evident that the administration of the discount window was being seriously complicated by the low rate.

Mr. Galusha commented there was little if anything that needed saying this morning about economic conditions in the Ninth District. The District economy continued to grow very much in the pattern of the national economy. Recently a few reports had been received of a rather sharp slowdown during April in the rate of growth of retail sales. But he could not at this time be sure how general the slowdown was and, in any event, he would not want to read too much significance into it--any more than he would want to read too much significance into the much publicized temporary layoff by General Motors. The business community was becoming apprehensive about the pending minimum wage proposals, which would have a significant impact on wage structures in the Ninth District.

If there was a problem in the Ninth District, Mr. Galusha said, it was in the continuing unhappiness of the country bankers--an unhappiness which not infrequently found expression in notification of withdrawal from the System. The situation was not a good one and he would urge again that the Board give further consideration to a reserve requirement "break" for small banks. It might be, as he had pointed out at the previous meeting of the Committee, that now would be a good time to announce an increase in the average reserve requirement and, in the same breath, a change in the structure of reserve requirements.

With what might be parochial concern, Mr. Galusha continued, he was very pleased to see the Board, in its Annual Report, reiterate its desire for a reserve requirement structure based on bank size and ask for the power to set reserve requirements for all insured banks. Possibly that was the way the problem should be solved. Still, some interim relief for small banks would be most helpful. In passing, he would also compliment the Board on its statement--again, in its Annual Report--on non-par banking. Would that it had the desired effect, for that was not the least of the obstacles to the millenium Mr. Mitchell had described in recent public statements.

It was in part the problem of small banks, mutual savings banks, and the politically powerful influential savings and loan associations that made Mr. Galusha think now was a time for proceeding cautiously in the direction of further monetary restraint. Of course, there were additional reasons, domestic and international--most of which had been mentioned in Committee meetings at one time or another--for believing that the overly exuberant economy would be better checked by a tax increase than by further monetary restraint. That, it seemed to him, was ultimately why the Committee should go slowly now. A dramatic move toward great restraint--involving increases in discount rates and Regulation Q ceilings--could sharply reduce the likelihood of a tax increase.

There might still, though, be room for increase in interest rates and in the rationing of credit, Mr. Galusha remarked. There were indications in the Ninth District, at least, that System policies were biting deeper. Curtailment of the Minneapolis Reserve Bank's discount window had forced the big banks into paying rates for funds in the 5 per cent area, and that in turn had a spill-over to their lending policies--there were indications that they were making efforts to ration credit.

Mr. Galusha believed the Committee's goal, specifically, should be a modest increase in open market interest rates over the coming four weeks. Possibly that could be achieved without a further increase in net borrowed reserves; but if not, then, in his opinion, the Desk's target ought to be on the other side of $300 million. Perhaps the $350 million figure mentioned by Mr. Hayes was appropriate.

In sum, Mr. Galusha felt this was a time for applying gradual further restraint. And he would underscore the word "gradual." Accordingly, he favored alternative B of the draft directives.

Mr. Swan reported that employment in the Twelfth District rose further in March, although at a slightly lower rate than in January and February. Unemployment edged down one-tenth of a percentage point to 4.5 per cent. Aerospace companies again added substantially to the number of their employees. In lumber markets, which had been under considerable pressure recently, new orders declined in April but with substantial order backlogs prices held firm. Residential construction, however, posed substantial problems. Housing starts were up slightly in March but great concern was being expressed by builders and lenders about shortages of funds and rapidly rising interest rates, resulting from competing demands and the reduced availability of funds from savings and loan associations.

In the four weeks ending April 27, Mr. Swan said, District weekly reporting banks expanded their outstanding credit sharply--at a much higher rate than in the same period last year. That expansion was based on a very substantial increase in both demand and time deposits. The time deposit increase was due to a rise in public deposits; the decline in savings deposits was greater than the rise in other time deposits of individuals, partnerships, and corporations. As a result of the rise in total deposits, District banks remained in a relatively easy reserve position during April despite the increase in bank credit. Banks maintained or increased their net sales of Federal funds and did not borrow substantially from the Reserve Bank. However, that situation might be changing; in early May Federal funds sales were down somewhat in the District and there had been a slight increase in borrowings at the discount window.

As to the national situation, Mr. Swan said he had little to add to the comments already made regarding the strength in demand and the price pressures existing. In terms of policy, he had felt that the February and March results were not at all unsatisfactory, given the unusual situation in January following the discount rate increase. As some others, however, he was disturbed--and somewhat confused--by the April developments. He had to say that the discussion this morning had not lessened his confusion, and he was at a loss as to how to interpret those developments. Consequently, he drew some hope from the conclusion in the blue book that more gradual rates of growth in bank credit and deposits were likely in May if pressures on banks continued about as at present. He joined those who would like to see some further gradual deepening in net borrowed reserves, perhaps to the $350 million level, with some recognition at the same time of developments with respect to total reserves. He favored alternative C of the draft directives, both because he thought it was appropriate in terms of the current situation and because, as a matter of principle, he thought some account should be taken of total reserves in the second paragraph of the directive. He would prefer the version of alternative C proposed by the staff rather than as amended by Mr. Shepardson.

Mr. Swan said he would not favor an increase in the discount rate, if one could be avoided, until it was clear that the action was following rather than leading market developments. But he was not as sanguine as some about the possibility of maintaining the existing discount rate, given the current levels of the Federal funds rate. Sooner or later high Federal funds rates were likely to lead to pressures at the discount window that would require the System to raise the discount rate.

Mr. Irons commented that conditions in the Eleventh District were somewhat typical of national conditions, with strength apparent throughout the economy. Such major indexes as employment, production, construction, department stores sales, and new car sales were continuing to move up more or less steadily or were maintaining high levels. The employment situation remained tight, with a very strong demand for labor by the electronic and defense industries. The most recent data for residential construction showed a little improvement, but whether that would be lasting or not remained to be seen; the District had the same problems in the mortgage area that were being reflected in other parts of the country.

During the past few weeks, Mr. Irons continued, there had been growing evidence of some firmness at District banks, similar to the national situation. Borrowing from the Reserve Bank tended to increase from time to time, depending on conditions in the Federal funds market. Recent city bank borrowing usually was in the $6-$8 million range and country bank borrowing in the $6-$9 million range, but the total would go up to $50 or $55 million when some large city banks came in for a day or so. It was reasonable to assume that there would be continued pressure placed on the discount window by the larger banks if conditions in the market firmed and the Federal funds rate rose further. The larger banks in the District had been net purchasers of Federal funds recently, with their average weekly purchases running about $800 to $850 million, and their sales about $200 to $250 million.

Demand deposits and time and savings deposits had both increased during the past three or four weeks, Mr. Irons noted. There was a net decline in savings deposits about equal to the increase in time deposits, possibly indicating a shift of funds into CD's. Despite the fact that bank credit was increasing, bankers said that they were being more selective in granting loans. Most of the loan increase during the period was not in commercial and industrial loans but in loans of a financial character and other types. On the whole, there was no change in the steady upward movement in the economic situation in the District, and some evidence of firmer conditions in banking.

Nationally, Mr. Irons observed, the Committee recognized that boom conditions were prevailing and that deterioration was occurring in the balance of payments. Those circumstances pointed to the need for a firmer and more restrictive policy. But he thought the firming should be gradual; there should not be a crash program, or a drastic change in policy. Some attention also should be given to the levels of interest rates and to the pressures and stresses in financial markets. He would like to avoid an increase in the discount rate as long as possible, but he thought that if the Committee continued to tighten pressures would increase for discount rate action as interest rates rose.

Mr. Irons agreed with those who had suggested that it would be desirable to look to the aggregate reserve figures and not to net borrowed reserves alone. One reason for considering aggregate as well as marginal reserves was that more restraint was exerted on banks in the course of a transition to a deeper level of net borrowed reserves than in maintaining that deeper level once it was achieved. He personally preferred alternative B for the directive but would not object to alternative C. Indeed, there might be some psychological advantage to alternative C in that it introduced a reference to required reserves.

Mr. Ellis said that three highlights might serve to illustrate the taut conditions in the New England economy. Of pervasive importance was the tightness in the labor market. The March unemployment rate reached 3.5 per cent and insured unemployment continued to decline in April. In Boston, the Reserve Bank participated with 36 firms in a group survey of the local labor market. In presenting the Bank's budget to its directors yesterday, he had reported the possibility that the wage projection incorporated might have been outdated by changes within the past two weeks. Seven of the 36 participating firms had increased starting rates for inexperienced personnel by $2.00 to $5.00. Five of the seven had also raised salary structures 4 to 6 per cent, and all seven had granted general or modified across-the-board forms of salary increases.

Undergirding the general strength, Mr. Ellis continued, were both high volume operations and sharp expansion rates in the durable goods industries, particularly those affected by defense production. The index measuring the region's electrical machinery industry in March stood 15 per cent higher than a year ago. Durable goods producers had reported plans to expand their capital outlays by 38 per cent this year and to concentrate more on plant expansion.

In reflection of those trends, Mr. Ellis said, loan expansion at District banks had been pervasive and violent if not explosive--at an annual rate of 19 per cent in the past year and 25 per cent in the last six weeks. First District banks as a group had been net buyers in the Federal funds market since last November. Country banks had come to the discount window for amounts running four and five times above year-ago levels. City banks had also become more frequent borrowers but were satisfying most of their reserve needs by borrowing in the markets for negotiable CD's, Federal funds, and short-term notes. The bank that pushed the Federal funds rate to 5-1/8 per cent last Friday (May 6) borrowed 207 per cent of its total required reserves in those markets during April. The average for eight New York City banks for the same period was only 202 per cent.

Whichever way the Committee looked, Mr. Ellis said, there were ominous aspects in the staff analysis presented in the green book[1/] prepared for this meeting. Looking backward, the Committee was advised that: (1) a third of the first-quarter GNP increase represented higher prices; (2) industrial commodity prices were rising at a rate between 3 and 3.5 per cent and threatening to block any long-run improvement in the balance of payments; (3) labor costs per unit of output in manufacturing had been edging up; and (4) in spite of longer hours, the real weekly spendable earnings of factory workers with three dependents had not increased in the past year.

Still looking backward, Mr. Ellis found that despite the slight stiffening in reserve availability represented by higher Federal funds rates and deeper net borrowed reserve positions, nonborrowed reserves ballooned during April. In effect, the Committee lost ground in its long-run objective of moderating the expansion of total credit and the money supply.

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

The forward-looking observations, Mr. Ellis said, were equally ominous: (a) unfilled orders continued to rise in all major industry groups; (b) resurveyed capital spending plans suggested even larger expansion plans than earlier reported; (c) defense needs translated into rising outlays beyond budgeted levels, and Congress was expanding nondefense spending beyond Administration requests; (d) the U.S. balance of payments experience seemed more likely to worsen from the weaker position in the first quarter than to improve.

Facing those prospects, Mr. Ellis found the arguments for a tax increase to be overwhelming. Yet a Presidential request at this moment for such action might result in a self-defeating general loosening of the purse strings in subsequent Congressional voting. Tactics possibly called for delay in requesting a tax increase until major Congressional actions were complete and Congress sought to adjourn for campaigning. On that line of reasoning, if business conditions remained as inflationary in June as they were now, he would consider it likely that the President would request and obtain a tax increase.

In that context, Mr. Ellis said, the central issue of monetary policy became a choice as to how far to proceed in further tightening pending a decision on increased taxes. For the past several meetings, and especially yesterday, the Boston Bank's directors requested that Mr. Ellis express in this forum their sense of urgency that monetary policy was not adequately restrictive in view of lagging fiscal restraints. While agreeing with them in analysis, he had persuaded them that, in view of the present pressures on savings institutions a further increase in discount rates, with a subsequent attendant need to reconcile Regulation Q ceilings, should be postponed until a tax decision was reached. Meanwhile, it was appropriate to explore what leeway remained for continued gradual lessening of reserve availability in order to achieve the Committee's basic objective of restricting growth in the reserve base, bank credit, and the money supply. Experience last month demonstrated that if credit demands swelled sharply they would overwhelm any modest barrier and reserves would flood out--as they had in April, at a 17.5 per cent annual rate. It was attractive, therefore, to contemplate a directive such as alternative C under which reserve availability would be somewhat conditioned by the extent of demand for reserve expansion.

Employing the "phrases of art" identified by Mr. Holland at the Committee's last meeting, Mr. Ellis remarked, he would define alternative C to encompass a net borrowed reserve target of $350 million as a floor if reserves continued their sharp expansion; and he would expect borrowings to consistently exceed $650 million on a weekly average basis, and the Federal funds rate to ride in the 4-7/8 to 5 per cent range. Since the use of Treasury bills in reserve adjustments had lessened the bill rate seemed less sensitive to reserve positions, but he would still expect some stiffening of 3-month bill rates, to 4.75 per cent and higher.

Mr. Ellis observed that he wished the staff had expressed alternative C in terms of pressure on bank reserve positions, noting that Mr. Partee's analysis today had been expressed partly in those terms. He (Mr. Ellis) urged the adoption of alternative C, however, because it called for considering the movements of required reserves as well as net borrowed reserves. He would omit the reference to the Treasury financing because he thought it gave more than the intended emphasis to even keel considerations.

Mr. Robertson then made the following statement:

> Once again the materials presented to us by the staff, and the comments around the table this morning, describe an economy that is under even more upward pressure than was foreseen a month or two ago. While the automobile industry may be undergoing a bit of an adjustment at the moment, it is clearly the exception. The general picture is one of high demand growth, mounting pressure upon labor and plant capacity, and continued industrial price advance.
>
> This is the kind of situation in which we should be using monetary policy to generate as much restraint as we think it is reasonable and prudent to apply. All of us know this is an easier objective to state in theory than to apply in practice. We thought we were taking actions to firm up conditions gradually in March and April--and probably we did get some firming of bank lending conditions--but at the same time over-all demand was so strong that bank credit expanded rapidly and this gave rise to large additional reserve-injecting operations by the System. The growth in bank loans, investments, and deposits must be reduced to more modest proportions, and the very recent signs of slowdown are not enough, in my own judgment, to assure such a reduction in the absence of further gradual tightening of bank reserve positions by System open market operations.
>
> Accordingly, I would direct the Manager to press net borrowed reserves gradually deeper, beginning as soon as the current Treasury refunding operation is concluded. In giving a directive to the Manager, I think we should take pains to guard against such developments as took place last

month, when we had much higher rates of expansion in bank credit and money than we would willingly have sanctioned ahead of time. The staff noted that April would see rapid rates of growth in the reserve and monetary aggregates, but the growth rates turned out to be even more rapid. Economic prediction is an art--not quite yet a science--and our staff has, I believe, developed the art close to its outer limits. I have only praise for their efforts in the green and blue books and elsewhere, and hope their efforts continue.

All that being said, the fact remains that if we want to be sure that growth in credit and money slows from its recent rate, we should express our wishes more definitely in the operative second paragraph of the directive. For instance, although the staff analysis in the blue book notes that growth in bank credit will slow over the next two months, I would want the Account Manager himself actively to contribute to this result if it does not appear that the market will do so.

To help slow down credit growth, I would want to deepen the net borrowed number gradually by around $25 million a week so that it would rise from $300 million to $400 million over the next four weeks. If required reserve growth proves larger than expected, I would hasten the rise in the net borrowed reserve number and even let the number rise above $400 million. On the other hand, if there were a definite weakness in required reserves, I would let the net reserve position of banks fall somewhat short of the aforementioned weekly goals.

I realize the Manager will have a difficult time making the judgments involved in such an instruction. There are two pieces of advice that might be helpful to him, however; first, at the moment there is more danger in being too easy than too tight; and second, if bank credit looks as if it is rising noticeably above a 6 per cent annual rate, the banks should be forced to borrow the additional required reserves, even if borrowings turn out to have risen only temporarily, unless this pushes net borrowed reserves above $500 million.

I assume that this kind of policy may foster a continued upward adjustment in bond market rates, and I would not mind seeing most of the effects of the March-April bond market rally wiped out in the process. I would also expect that it would gradually step up pressure in the money market, and I hope we will not be too deterred by that kind of manifestation of market restraint either.

I recognize that my net borrowed reserve suggestions involve driving banks considerably deeper in debt at the discount window, and I regard that as part of the process of restraint. I recognize further that this might trigger

> speculation about a possible discount rate increase, and I am prepared to face up to such a change eventually if the circumstances become compelling. What I am not prepared to countenance is a further increase in the Regulation Q ceiling on time deposits; indeed, it may only be by holding the line on Regulation Q that we finally calm down the bank credit expansion.
>
> It appears to me that alternative C of the draft directives might accomplish the ends I seek, although it should be read to permit some flexibility on the down side of net borrowed reserves as well as the up. The market virtues of operating with a net reserve target can thereby be combined with the anti-cyclical virtues of paying close attention to the related aggregates--which means, in the current environment, at least seeing that potentially inflationary credit demands are not fully accommodated.

Mr. Robertson added that he favored the amendment to alternative C proposed by Mr. Shepardson. He had no strong view as to whether or not the reference to the Treasury financing should be deleted. He would suggest an amendment to the final sentence of the first paragraph of the draft directive; in the phrase, "and to help restore reasonable equilibrium in the country's balance of payments," he would replace the word "help" with the words "strengthen efforts to." He suggested that change because he thought the time had come at which monetary policy had to take a more active role in the effort to improve the payments balance.

Chairman Martin said that the views of Committee members did not seem very far apart today. He would like, however, to sound a note of caution. There was real turbulence in financial markets at present--perhaps more than generally realized--and recent monetary policy had been a major factor in bringing it about. He did not think the Committee should be too dissatisfied with monetary policy because of the recent trends in banking aggregates. In his judgment, the Committee should not press too hard in an effort to get more precise results; it would take time to iron out conditions such as existed at present in the stock market, at savings and loan associations, with respect to the balance of payments, and with respect to the current dislocations in the money market. Although he did not like the recent banking figures any more than others did, he felt that patience was needed in getting the results desired. Over the weekend he had re-read the Committee's minutes for the period subsequent to the 1957 reduction in the discount rate. He noted that for a long time then the Committee had sought actively to ease, but the money supply figures had failed to respond. Now the Committee was trying to firm, and perhaps it was seeking to make the figures respond more actively than the course of events would permit. The money stream was swollen now, as it had been in the latter part of 1965. At that time, in his view, conditions in financial markets had reached the point at which it was almost impossible to navigate; the prime rate existing then had been a boulder in the stream. The flow of funds was better now, but there still were many dislocations. For example, while according to a recent report the difficulties of savings and loan associations in the Twelfth District were not as great as had been feared, they were quite serious in one or two cases.

In sum, Chairman Martin said, he thought the Committee should not press too hard now in the belief that monetary policy alone could achieve price stability; it was just one important element in the picture. Perhaps all members of the Committee--and he included himself tended to think at times that monetary policy could do more than it in fact could. He was not in disagreement with the policy that the majority favored today, but he hoped that the System would not find itself in the position of having raised the discount rate after the crest of the cycle had been passed. If it did, it was likely to bear all the blame for subsequent developments. The System had been through that experience several times before and he hoped it would not be repeated. He thought the System had to brake the inflation in 1957, and in his judgment the price stability that prevailed from 1961 to 1965 would not have been possible if the earlier inflationary psychology had persisted. Nevertheless, the business decline then had been attributed to the Federal Reserve. He thought the Committee should bear that in mind--although he did not suggest that it should shirk its responsibilities.

Chairman Martin said he did not know what the Administration would do with respect to fiscal policy. In his judgment there had been a good deal of progress in the past six months in public understanding of the problem of inflation; the current dialogue in the press about policies to deal with inflation would have been impossible

6 months ago. Some real gains had been made, and he would repeat that the Committee should not press too hard on monetary policy alone.

The Chairman observed that he was agreeable to either alternative B or alternative C for the directive. He would be somewhat concerned about Mr. Shepardson's proposal that the words "further gradual" be deleted before "reduction in net reserve availability," because he favored a gradual approach. He thought it was quite important at this juncture that the Committee not move in an abrupt way.

Mr. Shepardson said he had not intended to suggest an abrupt move. He had taken exception to the word "further" because he did not think there had been a reduction in reserve availability. He proposed deleting the word "gradual" because, as he had noted at previous meetings, he thought that word had been overemphasized.

Mr. Koch drew attention to the fact that in alternative C the staff proposed to introduce the word "net" before "reserve availability." The phrase could then be taken to refer to net borrowed reserves, which had been deepened over the past few months.

Mr. Shepardson remarked that he had had total reserve availability in mind in stating that no reduction had occurred.

Mr. Mitchell commented that Mr. Shepardson's criticism of the word "further" was valid if applied to the Committee's previous directive. He agreed with Mr. Koch, however, that the word did not pose a problem in alternative C as drafted for this meeting.

Mr. Maisel said that as he understood the sentiment of the members today the variable with which the Committee was concerned was total reserves. The references to "reserve availability" in recent directives were ambiguous, and he thought the staff had tried to formulate alternative C in a manner that removed that ambiguity.

Mr. Daane indicated that he was not sure the Committee intended total reserves to be used as an operational target.

Mr. Hayes said he did not think the Committee could discard net borrowed reserves as an operational guide. Granting that total reserves should be used to the extent practicable, one could not be sure that the short-run observations of that variable were meaningful. He asked the Manager whether he thought there would be problems in operating under the instructions contained in alternative C.

Mr. Holmes said he would note first that except for its final clause the language of alternative C was close to that of B; he would read both to call for some deepening of net borrowed reserves, perhaps to around the $350 million area. The final clause implied that if required reserves were higher than seasonally projected the marginal reserve figure should be deepened further by some amount--Mr. Robertson would have them go as deep as $500 million. Present projections indicated a decline in required reserves over the next few weeks. Thus, if required reserves did not decline along the projected lines, he would understand alternative C to call for net borrowed reserves deeper than $350 million.

Mr. Daane commented that Mr. Holmes' statement illustrated the problem he had with alternative C. The view that a reduction in reserve availability was called for was widely held today, but if the Committee required the Manager to deepen net borrowed reserves below $350 million it inevitably would cause a considerable readjustment in market rates that could lead to a discount rate change. He had not suggested any particular figure as a target for operations, and he thought the Committee had to be wary of the danger of precipitating the kind of wholesale market adjustment that he did not think was called for at present.

Chairman Martin then said he wished to make his position clear with respect to a discount rate increase. He thought that if such an action were to be taken it should follow market developments and not be forced by the Committee. That was why he felt the Committee should not press too hard in deepening the net borrowed reserve figures, and that conditions should be allowed to tighten gradually.

Mr. Mitchell agreed with the Chairman but felt nevertheless that the recent experience with total bank credit and the money supply was somewhat disheartening. If the staff projections should prove faulty he thought the Manager should move in the direction suggested by Mr. Robertson. He would rather not see a discount rate increase, but would prefer such an increase to a repetition of the March-April developments.

Mr. Maisel said there seemed to be a conflict today between the members who thought that the Committee had set money market rates as its primary goal, and those who thought that the goal had been formulated in terms of total reserves. Members in the two groups had different views of the monetary policy that would be appropriate for the next period. The problem, as he saw it, was that in the past five months the Committee had used money market conditions as a sub-goal, with the result that there had been a substantial expansion in bank credit.

Chairman Martin thought that Mr. Maisel's observation involved an element of judgment. He did not feel there was any difference between his own position and Mr. Maisel's except with respect to timing In his opinion considerations of cost and availability of money could not be kept separate indefinitely; the question was how moves should be timed. Personally he did not feel that he had had a money market sub-goal in mind, but different people measured things differently.

Mr. Hayes said he would inject a cautionary note on the subject of the sensitivity of market conditions. He did not believe the Committee could completely ignore the effects of its actions on the market He would remind the members that there had been occasions, even in the past year or two, when conditions in the market had suddenly become rather critical. It was important that the Committee do what it could to prevent disorderly conditions. Perhaps the matter was a side issue, but the members should not lose sight of the possibility of rapid market disruption. To him that argued for acting gradually rather than precipitously.

Mr. Brimmer agreed with Mr. Hayes, and said he would not favor deleting the word "gradual" from the second paragraph of the directive. He had been inclined toward alternative B but would be willing to accept alternative C provided that the word "gradual" was retained. He also would favor using the word "net" before "reserve availability," and on that basis he would consider it appropriate to retain "further" since there had been a deepening of net borrowed reserves.

Chairman Martin said he thought alternatives B and C as drafted by the staff were substantially the same from the standpoint of the Manager's operations. He wondered, however, whether the amendment to C suggested by Mr. Shepardson would not require the Manager to deepen net borrowed reserves below $350 million.

Mr. Holmes observed that most of those favoring alternative B seemed to be more concerned about possible disruption in financial market conditions, while those who favored C were more concerned about the movements in the aggregate statistics. That appeared to be one significant difference between the two groups, although neither of the draft alternatives mentioned market conditions specifically.

Mr. Robertson remarked that no one around the table wanted to disrupt the market; what the majority desired was a gradual but steady reduction in the availability of reserves. It should never be assumed that the Committee would overlook the possibility of disruption in market conditions. That possibility was a reason for the degree of latitude that would be given to the Manager in instructions of the type he (Mr. Robertson) proposed. At the same time, he thought that the rate at which reserve availability was being reduced should be speeded up, although it should still be gradual.

Mr. Hickman said that he would endorse Mr. Robertson's statemen To summarize his own position briefly, he favored alternative C for the directive, retaining the word "gradual"; he would be very much concerne about any actions that disrupted the money market; he would want attent paid to aggregate reserve availability as well as to net borrowed reserves; and he would not want to see interest rates rise so high that the discount rate would have to be increased immediately.

The Chairman commented that he thought Mr. Robertson had made the point well--no one wanted to disrupt the market. How to achieve the results the Committee desired was a problem that had to be left to the Manager.

Mr. Daane observed that he would be concerned about a deepening of net borrowed reserves beyond the $350 million level, an area which he thought might be a danger zone. As he had indicated, he would prefe alternative B for the directive.

Mr. Hayes said that he also would prefer alternative B. If the members considered the language calling for "some further gradual reduction in reserve availability" to be too mild, the word "some" might be deleted.

Mr. Shepardson commented that while a net borrowed reserve target might be meaningful in a period of transition to a deeper target level, to hold net borrowed reserves at any particular level would mean meeting whatever demands for reserves arose and thus would not necessarily imply restraint. The Committee had been applying some restraint recently, but the movement had been overly gradual relative to the expansion in demands, and for that reason the Committee had failed to accomplish its objectives.

Chairman Martin commented that no one could say with assurance how strong the demand for reserves would be in the coming period.

Mr. Shepardson agreed. He added, however, that he thought the additional clause of alternative C, calling for a greater reduction in net reserve availability if growth in required reserve did not moderate substantially, was intended to meet that problem.

The Committee then turned to the suggestions that had been made regarding revisions in the draft directive language submitted by the staff. After further discussion, it was agreed that the reference to the Treasury financing should be retained and that Mr. Robertson's suggested revision of the phrase relating to the balance of payments in the last sentence of the first paragraph should be adopted.

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

The economic and financial developments reviewed at this meeting indicate that the domestic economy is expanding vigorously, with industrial prices continuing to rise 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 strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, while taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some further gradual reduction in net reserve availability, and a greater reduction if growth in required reserves does not moderate substantially.

It was agreed that the next meeting of the Committee would be held on Tuesday, June 7, 1966, at 9:30 a.m.

The meeting then adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

May 9, 1966

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on May 10, 1966

First paragraph

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

Second paragraph

Alternative A (preserving about the current degree of firmness)

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

Alternative B (continued gradual firming)

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

Alternative C (degree of firming conditioned by movement in required reserves)

To implement this policy, while taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some further gradual reduction in net reserve availability, and a greater reduction if growth in required reserves does not moderate substantially.