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, January 10, 1967, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Hickman
Mr. Irons
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Shepardson
Mr. Treiber, Alternate for Mr. Hayes
Mr. Wayne, Alternate for Mr. Bopp

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

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

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

Mr. Fauver, Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Messrs. Hersey and Reynolds, Advisers, 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. Hilkert, First Vice President, Federal Reserve Bank of Philadelphia
Messrs. Eisenmenger, Link, Taylor, Baughman, Jones, Andersen, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, New York, Atlanta, Chicago, St. Louis, St. Louis, and San Francisco, respectively
Messrs. Meek and Monhollon, Assistant Vice Presidents of the Federal Reserve Banks of New York and Richmond, respectively
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Chairman Martin said that at this, the first Committee meeting of the new year, it might be well once again to offer a word of caution to those in attendance in reminder that the discussions and decisions of the Committee were confidential until officially made public.

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 13, 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 December 13, 1966, through January 4, 1967, and a supplemental report for January 5 through 9, 1967. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that the Treasury gold stock would remain unchanged this week. Holdings of the Stabilization Fund were about $50 million, and at the moment there were no sizable central bank orders in sight. On the London gold market, however, serious trouble appeared to be shaping up. During 1966 the gold pool lost $300 million, leaving resources at the end of the year of only $60 million. In addition, and this was not generally appreciated, during 1966 the U.S. sold $150 million for domestic uses. Thus, over the year the total drain into market uses from official stocks was $450 million--a very large figure and, as he had indicated at previous meetings, one that threatened to grow in future years.

Toward the year-end, Mr. Coombs continued, a good deal of gold had been bought for window-dressing purposes, some of which might flow back; indeed, in the first few days of the year the gold pool picked up about $11 million. But there had been two disturbing events recently. One was the First National City Bank letter which pointed up the deterioration in the supply-demand situation for gold and concluded that all new production in 1966 had gone into private hands, with none left for official stocks. The true situation was worse than that, but the publication of the National City Bank's analysis had had a highly unsettling effect on the market, which now was beginning to realize the underlying situation. A second, and more disturbing, development was the French campaign against the U.S., which was now directed at raising doubts about the official price of gold. Of course, the French were well aware of the nature of the supply-demand situation through their participation in the London gold pool. Their campaign moved into higher gear last weekend with the French Finance Minister, Mr. Debre, calling for multilateral consideration of the official price of gold. His statement was taken by the market as an official suggestion that the price of gold should be increased. Mr. Debre would meet with the other Common Market Finance Ministers on January 16 and if past experience was a guide the communique issued after that meeting might well stir up still further speculation. There had been very heavy buying of gold in London today, and thus far the pool had lost $9 million. That situation could get worse.

There had been quite a bit of discussion of Mr. Debre's press conference at the Basle meeting this past weekend, Mr. Coombs continued, and the atmosphere was one of genuine alarm. He thought it fair to say that all of the Governors were angry with the French. It was not clear what they could do about it; it would be hard for them to break with France on financial policy because of their relations in the Common Market. He hoped, however, that it would be possible to get the cooperation of other central banks in devising some sort of contingency plan for dealing with a possible breakout of the London gold price. As he had said many times before, he thought that was the single most serious threat facing the U.S. in the area of international finance, and it was more dangerous today than it had been earlier.

On the exchange markets, Mr. Coombs reported, sterling continued to be depressed by uncertainties with respect to both short- and long-run prospects. For each of the past three months the British had managed to squeeze out some small reserve gains--on the order of $40 or $50 million--but those gains were highly inadequate in relation to the volume of their debts falling due this year. They owed well over $1 billion in short-term (6 - 9 month) debt that had been on the books since last summer. In addition, they owed about $900 million to the International Monetary Fund, on which the payment date was the end of November. Thus, they had over $2 billion to be paid off within about ten months. Unless they got a major swing in their favor they were not going to make it, and their failure to do so could have very serious consequences for the international payments system. He hoped that in such an eventuality the System would be able to protect itself, but much of the answer lay in what the British themselves could do in the way of policy to bring about a significant turnaround in the situation.

There was some hope for sterling in a general easing of international credit conditions, Mr. Coombs said. The discount rate reduction by the German Federal Bank had been helpful, and it was quite possible that the Bank might cut the rate again during the next few weeks. More importantly, the Germans might reduce their reserve requirements and thus bring about some easing in their credit markets. The British took the position that their difficulties of last summer were attributable largely to general monetary tightness, and that argument undoubtedly had some merit. If they now were to recoup the losses they incurred beginning last fall they probably would have to maintain some competitive advantage in interest rates and credit availability, in order to attract some part of the funds from the U.S. and other countries flowing back into the Euro-dollar market. On balance, he thought it would be to the advantage of the U.S. to have those funds flow to Britain--not only in permitting the British to pay off their loans on time, but also because the safest place for the money to go that was being returned to the Euro-dollar market by U.S. banks was to the U.K.

Regarding System swap operations, Mr. Coombs reported that at present the System owed \$85 million to the Bundesbank, \$35 million to the Netherlands Bank, and a total of \$90 million to the Bank for International Settlements and the National Bank of Switzerland. He hoped that the debt in marks could be cleaned up in the next few weeks; it had been incurred in connection with year-end pressures which had already moderated. Repayment of the Swiss franc debt might be delayed somewhat because the Swiss took in a large volume of dollars over the year-end both outright and in one-month swaps, and the reversal of those reserve accruals had priority over System acquisitions of francs as Switzerland moved into its seasonal deficit. There was a chance that repayment of the System drawings would not begin until near the end of February, but he hoped for some repayments in February and full liquidation by the end of March. That would mean that the System's Swiss franc borrowings would be extended beyond the 6-month period usually thought of as a limit, perhaps to 7-1/2 or 8 months, but he did not see much possibility of accelerating repayment. The Treasury might be asked to issue a franc-denominated bond to the Swiss to permit more rapid repayment, but in his judgment it would be better to save that device for possible future needs. It might prove more difficult to clean up the guilder debt. In part, the problem resulted from the fact that the Dutch had no means of increasing their money supply except by running a balance of payments surplus or by maintaining domestic money market conditions that pulled money in from abroad. This primitive monetary policy was an important factor in the frequency of Federal Reserve drawings of Dutch guilders and similarly tended to obstruct the repayment process. To repay the $35 million now outstanding, it might be well either for the U.S.

to make a drawing on the IMF or for the Treasury to issue a guilder bond to the Dutch. Both possibilities were now under consideration.

On the other side of the accounts, Mr. Coombs continued, the BIS still owed the System $49 million of the $200 million they had borrowed to deal with year-end window-dressing, and he thought they would be able to liquidate that remaining debt within the next week or two. The Bank of England had paid off $100 million of its drawings under the swap line with the System and he thought that in using any reserve accruals they would give priority to repaying their remaining debt. The System swap line was the most important source of credit the British had, and thus far they had been scrupulous in paying off their borrowings. Unless some severe problems arose over the next month or two--and that was conceivable, given the pressures in the gold market--there was a reasonable chance that their debt to the System would be liquidated within roughly six months from the time it was incurred.

Mr. Brimmer noted that Mr. Coombs had said it might be helpful to the U.S. if Britain maintained some differential in interest rates. Did that imply that the U.S. should not encourage the Bank of England to lower their Bank rate?

Mr. Coombs replied that he thought the British would have a difficult problem in working out the precise means for taking advantage of an easing of credit in international markets. He felt that it would be appropriate to offer a very general comment to the effect that it might be desirable for them to maintain some differential. But it probably would be undesirable to suggest any specific ways of doing so, since some delicate political questions might well be involved.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period December 13, 1966, through January 9, 1967, were approved, ratified, and confirmed.

Mr. Coombs reported that the two swap arrangements with the German Federal Bank--the original $250 million, six-month arrangement and the $150 million, five-month arrangement negotiated on a temporary basis in September--matured on February 9, 1967. At the last Basle meeting President Blessing of the Bundesbank indicated that they would be prepared to renew the temporary arrangement and to consolidate it with the original arrangement. Mr. Coombs recommended renewal of the combined arrangement with the German Federal Bank, totaling $400 million, for a period of six months.

> Renewal of the $400 million swap arrangement with the German Federal Bank for a period of six months was approved.

Mr. Coombs then reported that the $100 million arrangement with the Bank of France would come to the end of its three-month term on February 10, 1967. That arrangement was inoperative, and it was becoming somewhat anomalous in view of the French Government's attitude, but he thought there was some advantage in continuing to maintain it as a bridge to the future when the French might be somewhat more amenable to international cooperation than they were at the moment. Accordingly, he recommended renewal of the arrangement.

> Renewal of the $100 million swap arrangement with the Bank of France for a period of three months was approved.

Mr. Coombs noted that several drawings under the swap lines would reach maturity soon. On January 25, 1967 two Swiss franc drawings would mature--one for $25 million with the BIS and one for $15 million with the Swiss National Bank. If renewed, both would be second renewals, thus extending their terms beyond the usual six-month period. As he had indicated earlier, he hoped that the seasonal weakening of the franc in the spring months would enable the System to clean up those drawings in February and March.

Mr. Shepardson expressed continuing reservations with regard to the extension of swap drawings beyond a six-month period.

Chairman Martin observed that Mr. Shepardson's reservations were well taken. He thought, however, that the Committee could approve second renewals since it was still operating on an experimental basis in this area.

Renewal of the two Swiss franc drawings was noted without objection.

Finally, Mr. Coombs noted that two drawings on the Netherlands Bank would mature soon--a $10 million drawing on January 23, and a $25 million drawing on February 7, 1967. Both of those drawings also had already been renewed once, but as he had mentioned earlier the possibilities of cleaning them up either by going to the IMF or by issuing a guilder bond to the Dutch were under consideration. In his view the guilder bond might be the more satisfactory method since the flows of funds to the Netherlands resulted from their tight credit policies, and did not reflect a basic balance of payments surplus. But whatever the method used, he thought he could assure the Committee that the System's guilder debt would be repaid within a month or six weeks.

Mr. Shepardson expressed reservations about second renewals of these drawings also.

Renewal of the two drawings on the Netherlands Bank was noted without objection.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period December 13, 1966, through January 4, 1967, and a supplemental report covering the period

January 5 through 9, 1967. Copies of both reports have been placed in the files of the Committee.

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

> Since the Committee last met the capital markets have turned in a strong performance in a buoyant atmosphere, bank credit has showed renewed strength, and the money market has weathered the stresses and strains of the tax and year-end statement dates without undue problems. In general, bank credit expansion moved ahead more rapidly and market interest rates declined further than had been anticipated at the time of the last meeting without a need to push net borrowed reserves to zero or the Federal funds rate to 5 per cent or below. And with market rates moving lower, banks were able to add to their outstanding CD's in December in contrast to the $700 million-$1 billion decline anticipated a month ago.
>
> Market expectations--shaped by additional evidence of less restraint in monetary policy, by weakness in some economic indicators, and to some extent, by developments in Vietnam--in effect succeeded in changing the relationships among the short-run monetary variables with which we are most concerned in our day-to-day operations. As the various written reports to the Committee have indicated, much of the rise in bank credit can be traced to increased borrowing by dealers to finance their substantial inventories of securities and to increases in bank portfolios of Government and municipal securities. Dealer financing needs have exerted pressure on the money market, but with the major New York City banks maintaining their dealer loan rates at high levels, there has been some restraint recently on dealers' willingness to add to their holdings. I would not now characterize dealer positions as being dangerously over-extended, but they could become a source of market pressure if the anticipated flow of corporate and public fund money to the market and continued bank demand fail to materialize at a time when there is little seasonal need for the System to supply reserves.
>
> Open market operations, as the written reports to the Committee have detailed, were frequent and large, as

they usually are in December, and were complicated more than usually by the tendency for reserves to fall short of expectations, by the shift in market expectations, and by year-end developments involving international money flows. Outright purchases of Government securities approached $1 billion, and very heavy use was made of repurchase agreements against Government and agency securities over the period. Over $4 billion in repurchase agreements were made, with the average daily balance amounting to $575 million.

Repurchase agreements were a particularly useful tool during this period in view of the many uncertainties in the reserve picture. They enabled the System to make heavy injections of reserves in order to head off money market tightness on individual days, when it seemed likely that the operation would have to be shortly reversed. With dealer financing needs a source of recurrent pressure in the money markets, the repurchase agreement was a natural instrument for injecting reserves at the point of greatest need. A comparable volume of outright purchases and sales of securities would undoubtedly have subjected the markets to a series of unnecessary shocks and could have had unpredictable effects on interest rates during a difficult period. Moreover, we learned early in the period that very sizable sales of Treasury bills by foreign monetary authorities would be involved at the year-end in regular and special debt repayments to the United States. Although the precise amounts and the timing were not clear at that early date, it appeared advisable to conduct operations in such a way as to leave open an option for the System to acquire at least part of these bills, rather than be forced to sell as much as $1/2 billion or more Treasury bills in the market at the very end of the year. Quite obviously the nonbank Government securities dealers welcomed the opportunity to sell securities to the System under repurchase agreements made at the discount rate, but we did not consider it wise to give out a signal that could easily have been misinterpreted in the market by raising the rate at this particular time.

Rates on three- and six-month Treasury bills declined about 1/4 per cent over the interval, with some tendency for rates to level off at the end of the period. In yesterday's regular weekly Treasury bill auction, average rates of 4.82 and 4.89 per cent, respectively, were set on the three- and six-month bills. Rates on bankers' acceptances, commercial paper, and FNMA discount notes also moved lower over the period. Yields on intermediate- and long-term Treasury obligations declined by 20 to 50 basis points, and by the close of the period yields in the 3- to 5-year area were 1 - 1-1/2 percentage points below their August peaks, while long-term bond yields were about back to where they were at the time of the December 1965 discount rate change. Despite the build-up of the calendar of new issues, the corporate and municipal markets have maintained a confident tone. The $250 million A.T. & T. issue, which is up for bidding this morning, was expected last night to be reoffered at about 5-3/8 - 5-1/2 per cent, compared with a 5.83 yield in the last Aaa telephone issue brought to market on December 6. The new FNMA 5, 10, and 15-year participation certificates--brought to market at a uniform 5.20 per cent--received an excellent reception. The 15-year issue rose to a premium of as much as 20/32 bid, until late yesterday when the price dropped 1/2 point reflecting market rumors of an early Export-Import Bank participation certificate announcement.

The next few weeks are apt to be a testing period in the market for the pattern of interest rate relationships and financial flows that have been emerging since monetary policy entered a phase of less restraint. It will also be a period in which the markets will be assessing the implications of the various Presidential messages for the monetary-fiscal policy mix in 1967, and will be reassessing the economic outlook as each new bit of information becomes available. As the blue book[1/] indicates, monetary expansion is expected to be vigorous in January, but there are at least the usual number of uncertainties in the picture. The Treasury will be announcing in about two weeks the terms of its February refunding, and the usual "even keel" considerations will come into play in the latter part of the interval before the Committee meets again.

In response to a question by Mr. Mitchell, Mr. Holmes said that he thought that dealers' positions were not dangerously

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

overextended partly because they were not unusually large relative to other recent years; for example, dealer financing needs currently were only about 10 per cent larger than they had been two years ago. Dealers with whom the Desk had talked appeared confident of the market. They were concerned about the high level of marginal borrowing costs at New York banks, but were willing to incur some negative carry in the expectation that they would make out quite well. Their holdings of coupon issues had not expanded substantially, which was rather surprising in view of the change in expectations. Dealer financing needs had been a source of money market pressure recently, as he had noted, and they could pose a problem if the flows anticipated this month did not take place.

In reply to another question by Mr. Mitchell, Mr. Holmes said that the volume of System repurchase agreements with dealers had been quite high recently, but it usually was high in December. In December 1966 the System had financed about 12 per cent of dealer positions in Governments, compared to 7 per cent in December 1965 and 10 per cent in December 1964. Thus, the Desk had been doing a bit more through RP's recently than in earlier years, but not markedly more.

Mr. Mitchell then referred to Mr. Holmes' comment that it had been considered unwise to raise the rate charged on RP's in the recent period on the ground that such a signal could be easily misconstrued in the market. He asked whether the same situation would hold in the coming period.

Mr. Holmes replied that RP's were not likely to be made in large volume in the coming weeks of January, when the Desk probably would not be supplying reserves. He thought that a higher rate on RP's could be adequately explained to dealers.

Mr. Brimmer asked whether debt management activity was likely to interfere with achievement of Committee objectives over the next month or two, apart from sales of participation certificates and agency issues. There had been reports to the effect that as monetary conditions eased the Treasury would tend increasingly to step into the market with the objective of achieving some lengthening of the debt. In particular, did the Manager expect that the February refunding would impose a greater burden on the market than had been anticipated?

Mr. Holmes replied that it was obvious, given the 4-1/4 per cent interest rate ceiling on new bond issues, that the Treasury would not be offering a maturity beyond 5 years in the February refunding. Thinking had not yet focused on the terms of the refunding, and probably would not until the end of January approached. It was possible that the Treasury might make a split offering, involving a short-term security and one with a maturity in the neighborhood of 4 or 5 years, but no decision had been reached.

Mr. Hickman asked whether the Committee was not relatively free of an even keel restraint, at least for the first part of the coming period, in view of the facts that the refunding involved less than $4 billion in publicly-held maturing issues and that its terms were not to be announced until near the end of January.

Mr. Holmes replied that he thought the refunding would not be an especially difficult one, and accordingly that it should not constrain the Committee from changing policy today if it was inclined to do so.

In reply to a question by Mr. Swan, Mr. Holmes said that the next Treasury financing after the forthcoming refunding was likely to be a cash offering for payment in the second half of February.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period December 13, 1966, through January 9, 1967, were approved, ratified, and confirmed.

Chairman Martin then called 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:

The new information on domestic nonfinancial developments that has become available since our last meeting confirms the deceleration in the pace of the economic expansion. The staff now estimates an increase of only $7 billion in the GNP in the current quarter, despite the fact that the fourth-quarter 1966 increase has been raised to over $14 billion.

The most disturbing aspect of recent economic developments is the sharply increased extent to which production is going into inventories. Business inventory accumulation has apparently been even greater than assumed earlier and final takings smaller. Christmas sales were generally disappointing to retailers and the rise of consumer expenditures in the fourth quarter as a whole was relatively small. To lagging sales of autos and construction materials has been added less strength in furniture, appliances, textiles, and other goods.

As for prices, recent developments have been mixed, as indicated in the green book,[1] but the net result has been a slowdown in the rate of rise of the broad price indices. In the new year, prospects are for further advances, but at a slower pace.

The future course of consumption and of the whole economy for that matter will depend importantly on developments in the three main areas of more or less exogenous spending, namely, business outlays on plant and equipment and on inventories and defense spending. This is particularly true since consumption has been high relative to income for several quarters.

We have no additional direct information today on business fixed expenditures, but the data on new orders for durable goods support the finding of the November Commerce-SEC survey, namely, that the rise is decelerating. New orders were down in both October and November, in part due to lower defense orders. The level of new orders in November was the lowest in a year and the backlog of outstanding orders declined for the first time in three years. The National Association of Purchasing Agents

---

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

also states that the number of its members reporting improved new orders and higher production in December was the smallest since the 1960-61 recession.

Definitive information on the Federal budget and defense spending is still not available, but the information from the Daily Treasury Statement on recent months' spending confirms staff projections of a tapering off in the rate of increase of defense outlays beginning last quarter. But, despite a tapering off in the rate of defense spending and even if a tax increase is enacted, the Federal budget deficit for both this fiscal year and next is likely to be large. Of particular relevance to economic developments, though, is the fact that part of the deficit for the next few quarters at least is likely to be a passive reflection of a reduced rate of growth in tax revenues resulting from the projected slowdown in the economic expansion rather than of increased spending. We shall learn more about the fiscal picture shortly in the State of the Union and Budget messages.

Since business inventory developments are a key factor in the likely course of the economy in the near-term future, let me turn back to them for a second and closer look.

I mentioned earlier that recent inventory accumulation had been larger than anticipated earlier. Despite better accounting controls and higher financing costs, stock-sales ratios have been on a sharp rise since early 1966, particularly in the durable goods manufacturing industries. The rise in stocks has been largest in work-in-process in the areas of consumer durable goods, defense goods, and machinery and equipment.

What does this mean for the likely future course of inventories in particular and of the total economy in general? As for consumer durable goods, the recent rise in stocks has been in household durables as well as in autos. Production has already been cut back in many of these lines, in autos to approximately the 8-million-car current annual rate of sales. In the defense area, the rise in new orders dropped off rather sharply in October and November, and, with output of defense equipment now rising much less rapidly than earlier in 1966, defense work-in-process stocks may also be rising less rapidly from now on, particularly if some production bottlenecks are broken. Finally, in the area of machinery and equipment, the tapering off of the plant and equipment investment boom should mean a pronounced deceleration in the rise of stocks in these industries in coming months, even though the order backlog in this area is still large.

All this tends to confirm the staff estimate of a sharp fall-off in business inventory building in the current quarter, perhaps by $5 billion or more. Even such a drop is not likely to lower stock-sales ratios and as a result pressure for further curtailment of additions to inventories is apt to continue.

A sharp decline in inventory accumulation would in and of itself create another pause in the economic expansion similar to those we have experienced several times since World War II. This is a common economic forecast for the first half of 1967. It is shared by some Administration economists and by most of our staff.

The inventory deceleration will reduce market demands and put to a test the underlying strength of business capital spending programs, that is, the extent to which such programs are supported by longer-run as contrasted with short-run market prospects. The rate of increase in business capital spending is already decelerating, and if such spending actually begins to decline we shall have a situation calling for major policy alterations. In the meantime, though, even the near-term prospects for moderately reduced economic growth call for a continuation of the gradual process of overt monetary easing on which the Committee embarked two meetings ago.

Mr. Axilrod made the following statement concerning financial developments:

The policy of reduced monetary restraint initiated by this Committee in the fall appears to be gradually taking hold in financial markets. This is evidenced mainly by the increased flow of time deposit funds to banks, including negotiable CD money to large banks, and also by the more comfortable position of nonbank savings institutions. It is also seen in the further declines of market interest rates, both short- and long-term, during the past several weeks.

But in many ways the impact of the new policy on markets and the economy is not yet fully secure.

For one, the substantial rise in the money supply from its recent mid-November low point appears to have been in large part a short-run response to a decline in U.S. Government deposits. We have not yet had evidence that at current levels of interest rates the privately-held money stock is capable of sustained moderate growth--say, at a rate much above the 2 per cent of 1966.

For a second, the lending policies of banks and other financial institutions do not yet appear to have altered definitively toward less restraint. Some probing in that direction is probably in train, but our contacts with banks in recent weeks suggest that a wait-and-see attitude still predominates.

And for a third, the recent interest rate declines were in part based on expectations--expectations not only that monetary policy was easing but that domestic business expansion was weakening and that fiscal policy would in one way or another not be a very massive expansionary force in the period ahead. I would not rule out the possibility that interest rates could rise, at least temporarily, over the weeks ahead. On the other hand, if expectations of business weakening prove correct, even current interest rate levels may turn out to be too high to provide the needed encouragement to economic demand.

While one's view as to the likely strength of demands for goods and services is fundamental to one's appraisal of the appropriateness of current interest rate levels, the condition of lending institutions is also a highly relevant factor. The stringency that developed in these institutions along with the 40-year record market interest rates of last year resulted in a marked further erosion of their liquidity positions. For commercial banks this is most dramatically illustrated by the rise last year in loan-deposit ratios (with dealer loans excluded) at New York City banks from around 70 per cent to 80 per cent. The adverse experience of such banks, savings and loan associations, and life insurance companies suggests that a significant relaxation of lending policies depends in good part on at least a partial restoration of their liquidity positions. And for both of those developments to proximate each other in time might require not only clearer signals as to prospective economic and fiscal events but also clearer signals from the monetary authority as might be indicated by some further reduction in interest rates--or, at a minimum, efforts to forestall any reversal of the recent interest rate declines.

The need to encourage a relatively prompt relaxation of lending standards at financial institutions is based in part on the nature of the economic imbalances that at the moment appear to be developing. A principal danger to the economy, as Mr. Koch has pointed out, seems to come from a probable relatively sharp decrease in inventory accumulation over the period ahead. While some inventory readjustment appears to be unavoidable, its speed and scope might be modified somewhat if banks were more accommodative of business loans. The inventory adjustment might also be tempered if consumer spending on goods, both durable and nondurable, could be relatively well maintained; and given the University of Michigan consumer survey evaluation that consumers are gloomy, but not outright pessimists, an easing of bank lending terms on loans directly to consumers and indirectly through finance companies might just make additional spending attractive or possible for some of the less dour consumers.

Construction and home-building is, of course, the area which might be encouraged to provide most of the offset to any developing weakness in other economic sectors; and it is an area which has traditionally--and very recently--been quite responsive to changes in the financial environment. Recent monetary policy actions appear to have stopped the deterioration in mortgage markets, and set in motion forces--such as the renewed flow of savings funds to nonbank institutions--which should eventually yield an actual easing of conditions. This will depend on a continued good experience for savings and loan associations. But, if a prompter reversal of present market tightness is desired, it will depend on further declines in long-term market interest rates so as to increase the relative attractiveness of mortgages to other financial institutions such as banks and insurance companies.

It would appear that the easing of lending terms and conditions that major financial institutions seem to be approaching could be made more secure, and probably usefully hastened, if open market operations were conducted in such a way as to sustain continued bank reserve growth and to risk a temporarily rather rapid expansion. In this context, it may be desirable to attain a somewhat lower Federal funds rate and a lower level of member bank borrowings than has prevailed on average in recent weeks--perhaps even a level of borrowings that would bring the net reserve position of banks close to zero and the Federal funds rate to around 5 per cent. If that were done, it is possible, but by no means certain, that the resulting expansion of reserves would be fairly rapid on average. But such an expansion would be desirable during the turn-around phase of monetary policy in the degree that it permits a decline of interest rates, a restoration of bank liquidity, and some relaxation of bank lending standards ahead of, rather than merely in reaction to, a reduction in loan demands.

It is, however, particularly difficult to anticipate and quantify the interrelations among aggregate reserves, marginal reserve measures, and interest rates in the period ahead--given the diversity of economic forecasts and pressures and the unknown credit market reaction to tonight's State of the Union message and the forthcoming Federal budget. It is not difficult to conceive, for example, of upward bill rate pressures if dealers were to run from their current extended bill positions. On the other hand, it is also not difficult to envision circumstances--such as worsening business news--which might even make it desirable for open market operations at some stage to be conducted so as to give more direct encouragement to the flow of funds in long-term markets by including significant purchases of intermediate- or longer-term coupon issues. The slackening of the investment boom appears to indicate that this winter's burst of corporate security issues is likely to fade in the spring; as a result, investor funds might be relatively quickly channeled to the mortgage market once it became clear that interest rates on other long-term securities would be substantially reduced. I put forth the suggestion for System purchases of coupon issues with some tentativeness, but as indicative of the kind of flexibility in approach that monetary policy might wish to keep in reserve as some of the current uncertainties are resolved.

Mr. Mitchell asked which, if any, of the alternative draft directives submitted by the staff[1/] Mr. Axilrod thought was consistent with the policy course he was recommending.

1/ Appended to these minutes as Attachment A.

Mr. Axilrod replied that alternative B could be consistent with the course he recommended, depending on the interpretation the Committee placed on the phrase, "somewhat easier conditions in the money market."

Mr. Brimmer commented that by adopting alternative B the Committee would not necessarily be implying that it wanted to go as far as Mr. Axilrod recommended, and the latter agreed.

Mr. Daane referred to Mr. Axilrod's comments about possible System purchases of coupon issues, and asked whether he thought that present conditions were parallel to those in the latter part of 1961 when "operation twist" was begun.

Mr. Axilrod replied that he had not had such a parallel in mind. In the 1961 period the U.S. balance of payments was an important factor in the decision to begin purchases of coupon issues. While balance of payments considerations might again be relevant to the question, he had been addressing himself to the fact that it might be desirable to get a more rapid reversal of conditions in the mortgage market, and he had thought of open market operations in coupon issues as a possible means of reducing the typically long leads and lags in that area.

Mr. Wayne commented that the policy course Mr. Axilrod had recommended seemed to him to be more closely represented by alternative C of the draft directives than by alternative B.

Mr. Axilrod remarked that such a policy could be consistent with either of those alternatives, depending on what interpretations the Committee placed on their language. The problem he had seen with alternative C was that it called for "expansion in bank credit at a moderate rate," and under the course he recommended the expansion rate in the short run probably would be quite rapid. But that alternative might be taken as consistent with his policy recommendation if the Committee interpreted the word "moderate" as applying to the longer run, and was prepared to tolerate a rapid short-run expansion as banks acted to improve their liquidity positions.

Mr. Swan observed that, as he had interpreted the analysis in the blue book, a shift to somewhat greater ease might well mean more rapid bank credit expansion over the longer run but at the same time it might have little effect on the January growth rate.

Mr. Axilrod said his interpretation of the blue book discussion was that a move toward further ease at this meeting might result in bank credit expansion on average in January at an annual rate higher than the 7 - 9 per cent projected under unchanged money market conditions, as banks seized the opportunity to capture CD money and to restore their liquidity positions, but that the growth rate in the following months of the winter would be lower.

Mr. Maisel asked whether the matter might not be clarified by concentrating on expected future developments rather than on what had already happened. As he understood it, much of the expansion included in the projection of a 7 - 9 per cent growth rate on average in January reflected strength in the latter part of December, rather than expected strength in the weeks ahead.

Mr. Axilrod agreed. He noted that the blue book projected a 4 - 6 per cent growth rate between the end of December and the end of January, and that it implied no strengthening in February.

Mr. Maisel asked whether it was not also expected that over the period from this meeting to the next bank credit would grow at a rather low rate.

In reply, Mr. Axilrod said that that would be his guess.

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

> In the fourth quarter of 1966, two new tendencies appeared in U.S. international transactions. The trade surplus began to improve. And the capital accounts began to deteriorate. Both tendencies had been expected, though perhaps not so soon.
>
> In anticipating these tendencies, all of us have felt concern about the possibility that the trade improvement might come more slowly than the capital account deterioration, so that the over-all position would get worse before it got better. We have also felt concern that even over the longer span of a year or more, the payments position might not show any significant improvement.
>
> Recent events offer no comfort on either score, but neither do they add to the gloom. The fact that the

capital account deterioration outweighed the trade improvement between the third and fourth quarters seems to have resulted so much from special and erratic influences that it tells us little that is new about future prospects.

The only recent changes in capital flows that we can yet identify relate to U.S. bank credit and to U.S. liabilities to the Euro-dollar market. The renewed moderate outflow of bank credit in October-November probably did not reflect much change in the lending attitudes of U.S. banks. Instead, it seems likely to have resulted from more active foreign use of existing lines of credit, perhaps because of year-end stringencies, and some bunching of term-loan disbursements without significant change in the rate of new commitments. One would expect that large U.S. banks, as their reserve and liquidity positions ease, would begin to make foreign loans more readily at about the same time that they ease their domestic lending. But the October-November outflows seem to have come too soon to be related to any such general change.

The leveling off and subsequent decline of U.S. banks' liabilities to their foreign branches since mid-November is more likely to have reflected the first effects of reduced tightness in domestic financial markets and in bank positions. But year-end influences play such a large role in these flows that we cannot yet judge whether the repayments to the Euro-dollar market came mainly at U.S. initiative or instead reflected mainly year-end difficulties in attracting wanted funds. Hence in this case, too, the recent experience provides little guide to the magnitude of future flows. It does seem likely, however, that given the large banks' preoccupation with their liquidity positions, they will want to make further repayments to the Euro-dollar market before giving the green light to their loan officers.

These available data on fourth-quarter capital flows by no means explain what happened in that quarter. There must also have been a substantial deterioration on other items. One can only guess at the possibilities. Direct investment outflows, having fallen below the expected yearly average in the third quarter, may have increased in the fourth. There may well have been a reversal in the errors and omissions item, which had turned unusually favorable in the third quarter, presumably reflecting unrecorded capital inflows generated by the sterling crisis and by the extreme tightness of credit here during the summer. There could also have been some further deterioration in military and service transactions, but these transactions as a group do not often show large quarterly changes.

The improvement in the trade balance from the third quarter to October-November is a good deal easier to interpret than the changes on capital account; it probably represented the beginning of a new trend that will continue through at least several calendar quarters. Merchandise imports in October-November were little higher than in the third quarter. Imports of materials, which account for about two-fifths of the total, actually declined, even though within that category steel imports remained at record highs. Imports of materials tend to fluctuate like domestic production of materials, but with wider cyclical amplitude. If GNP develops as projected in the first half of 1967, with a sharp reduction in the rate of inventory accumulation and some decline in production of materials, there is likely to be a substantial decline in imports of materials.

Imports of capital equipment increased further in October-November, but they should level off soon if the domestic projections of a leveling off in business spending and an easing of capacity pressures are fulfilled. Thus, even if imports of some consumer goods continue buoyant, I would not expect total merchandise imports to increase appreciably in the months ahead.

Exports, meanwhile, should continue to advance. The pace will probably slow down from the 13 per cent annual rate registered from the third quarter to October-November. There were temporary elements in that advance, and there may be some weakening in Canadian demand for U.S. products. Demand has also been weakening in Britain and Germany, but our exports to those countries have already declined and may not fall much further.

With shipments still rising to most other countries, the rate of growth in total U.S. exports ought not to fall below, say, an 8 per cent annual rate over the months ahead. This rate, with imports level, would raise the annual rate of trade surplus from about $3-1/2 billion in the low second half of 1966 to perhaps $5 billion or so in the first half of 1967.

Since net outflows of capital (excluding foreign liquid funds) may increase by a roughly offsetting amount between these two half-years, the liquidity balance seems likely to remain above a $2 billion annual rate. In addition, there will probably be outflows of foreign liquid funds. So the official settlements deficit also will probably exceed a $2 billion rate, in marked contrast to the exceptional surplus registered during the half-year just ended.

These guesses, as I suggested earlier, are not significantly different from those of a month ago. What, if anything, do they imply for monetary policy, when taken together with domestic prospects?

My answer is the same one that Mr. Hersey gave you at the last meeting. I can see no way in which monetary policy actions can improve the near-term payments outlook--gloomy though it is--without jeopardizing the longer-term outlook. If for balance of payments reasons, monetary policy should seek to minimize capital outflows by denying an easing that domestic conditions seemed to require, the resultant further weakening of the domestic economy would be likely eventually to have adverse repercussions on activity abroad and hence on U.S. exports. In particular, if we should hesitate to ease as economic activity slackens, Britain would have to hesitate also, and the German authorities too might move more slowly than seems desirable. These three countries together have a decisive influence on the world economic climate.

It remains essential, of course, to minimize domestic inflation of prices and costs, since these are the touchstone of the longer-run payments adjustment. But within that constraint, the objective of working toward long-run equilibrium in international payments is probably best served at this time by policies aimed at the domestic objective of sustaining growth.

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

As we enter a new year it should be helpful to look back over the old year and see how successful we have been as a nation in attaining our broad national economic goals of: (1) maximum sustainable growth, (2) reasonable price stability, (3) maximum practicable employment, and (4) equilibrium in international payments.

We have done best on the employment goal. Indeed, there have been many shortages of skilled labor, and even of unskilled labor in a number of places. Economic growth was high in 1966 but the high rate was not sustainable. After several years of relative price stability, 1966 was marked by upward price pressures, and as the year ended, further price increases appeared in prospect. A severe balance-of-payments problem has become even more acute.

The combination of strong private demand and an additional stimulus from Federal fiscal policy put heavy, indeed excessive, pressure on our resources of men and equipment. Not only did the boom bring price increases at home, but it also contributed to a deterioration of our international trade surplus. Monetary policy was left with too much of the burden of fighting inflation. Money was tighter than it had been in decades.

As the year-end approached, the hectic pace of business and credit expansion subsided, interest rates declined from their peaks, and there was some relaxation in the severe credit pressures of the summer.

How about 1967? Some forecasters see a business slowdown or recession in 1967. Housing is in a slump, the capital boom is moderating, and consumers appear more hesitant. But the question is basically whether we are in a pause, or about to take a definite and cumulative turn downward. The growth in business spending for fixed investment and for inventories will doubtless be slower in 1967. On the other hand, we may expect a revival in residential construction. In any analysis of the economic outlook defense spending is a vital factor; indeed it is now a major factor. Although we will have to wait a week or so before we see the President's budget message it is reasonable to assume that in the coming year there will be a substantial increase in such expenditures over last year. With continued over-all investment demand and high Government spending, a continued uptrend in consumer spending seems likely. It seems to us, on balance, that in 1967 as a whole an excessive expansion in demand is a greater danger than recession. In this connection, I note that the staff's analysis concentrated on the early part of the year.

Although food prices have declined recently, the consumer has seen a persistent rise in the prices of nonfood commodities and especially of services. Labor cost per unit of output has been rising, and despite the relative stability of wholesale prices during the last couple of months, a cost-price push seems likely. The demands of organized labor are likely to be high, and there are likely to be greater pressures on corporate profits.

Our balance-of-payments record for 1966 is again discouraging. The deficit on a liquidity basis is likely to be well over $1-1/2 billion, compared with $1.3 billion in 1965. Had it not been for special transactions which were more than twice as great in 1966 as in 1965, the 1966 deficit would have exceeded $3 billion. Every effort should be made to improve our trade balance. A determined effort to check inflation at home is essential to keep our exports competitive and to dampen the high demand for imports. It is difficult to see an improvement in our international balance of payments in 1967. Indeed, without a large amount of special transactions, the deficit on a liquidity basis is likely to be worse, and it is hard to foresee such a large amount of special transactions.

The problem of financing the deficit is likely to become more acute in 1967. On an official settlements basis we had a surplus of perhaps $1/2 billion in 1966. But this good showing depended essentially on high interest rates in the United States which provided foreign private holders of dollars with an incentive to hold on to, and to increase, their dollar holdings because of the good return on them. Thus Euro-dollar lending to American banks through their foreign branches increased by $2-1/2 billion last year and helped finance the deficit. It is inconceivable that additional lending of this magnitude could occur this year. Any substantial decline in interest rates in the United States relative to rates abroad could well bring a reversal of these flows. In any case the implications for our gold stock are ominous.

The resumed advance in bank credit in December and the projections suggesting a further rise in January are encouraging. A persistence of the earlier declines in bank credit would have been incompatible with our goals. It is worth emphasizing, however, that the loan-deposit ratios of banks are still very high--much higher than they were at the beginning of 1966. Many bankers tell us that they want to improve their liquidity position before they seek a substantial expansion in loans.

Over the coming months the mix of monetary policy and fiscal policy will be of particular importance. We may have to wait, however, for the President's budget message to learn of the Government's proposed expenditures and the way in which the Administration expects them to be financed. In the meantime, it seems to us, there should be no change in credit policy. We believe that, until the next meeting of the Committee, open market operations should be conducted with a view to maintaining about the currently prevailing conditions in the money market. Under such a policy one might expect the Federal funds rate to fluctuate above the 5 per cent level, with rates on three-month Treasury bills near their present levels. The range of net borrowed reserves could be wide, but free reserves should be avoided, because their appearance would be likely to bolster market expectations of further monetary ease; these expectations are already strong, in part because the rescinding of the System's statement of September 1 on business loans and discount administration has been widely interpreted as an overt act emphasizing a System intent to continue easing pressure on bank reserves.

Since I think that the proper policy prescription is "no change," I favor alternative A of the draft directives prepared by the staff. I have difficulty in trying to comprehend alternative C and its implications for the conduct of operations. It originally seemed to me that it raised more issues than it settled, and the discussion following Mr. Axilrod's remarks confirmed that view. Even if it means no change, I would prefer to use language similar to that used in the past to indicate no change. I think that the meaning of alternative A is clear. I endorse it.

Mr. Francis observed that growth in total demand for goods and services had slowed somewhat. In view of that moderation and of a restrictive trend in most aggregate measures of monetary action, the Committee at its last two meetings adopted a less restrictive course. Beginning in November the Manager of the Account had been asked to attain somewhat easier conditions in the money market with an objective of fostering moderate growth in money and credit. Subsequently, lower interest rates, lower net borrowed reserves, and other indications of ease developed in the money market. However, it was not certain that the aggregate monetary measures had evidenced less restriction.

In the last few weeks, Mr. Francis continued, commercial banks had obtained more funds and were probably lending or investing more. Both time deposits and demand deposits had gone up, and it appeared that total bank credit had expanded. However, one hesitated to conclude at this point that expansion in those magnitudes and the evidence of ease resulted primarily from System actions or that they were having an expansionary effect on economic activity. The rise in time deposits might merely reflect the facts that, with declining market interest rates, banks were now able to compete for CD funds, and that the disintermediation of last fall was now being reversed without any net gain of funds to borrowers.

The rise in demand deposits and bank reserves in the last several weeks might also be misleading, Mr. Francis said. Around the middle of the final month of each of the last ten quarters, there had been a marked increase in demand deposits. Hence, the current rise might reflect in large measure a problem of seasonal adjustment.

Mr. Francis recalled that Mr. Partee, in his review of recent financial developments at the last meeting of the Committee, had noted that despite some easing of money market conditions banking aggregates had consistently shown shortfalls from projected levels for some months. Although increases in reserves and money had been recorded since mid-December, there was no reason to believe that the problem of obtaining a moderate amount of monetary growth, which had been the desire of the Committee, had been solved.

Mr. Francis noted that the staff projected a marked rise in total reserves from December to January, but those reserves were expected to be utilized in supporting Government demand deposits and time deposits, as the reversal of the disintermediation was expected to continue. Private demand deposits, according to projections, would decline and money would remain about unchanged. With those projections, and with the experience since last summer of shortfalls in final data from projected levels, special effort might be required in order to move toward a less restrictive course including expansion of the money supply.

If the prospects for total demand were as weak as the staff indicated, Mr. Francis concluded, it behooved the monetary authority to do all it could to alter that situation. The Committee should not be satisfied with "a gradual reduction in the degree of monetary restraint" mentioned on page 6 of the blue book. Assuming the relation among variables which was outlined on page 6 of the blue book, he suggested the Committee should aim for positive free reserves, a Federal funds rate below 5 per cent, and a bill rate about at the discount rate. It should strive for an upward trend of the money supply at about a 3 per cent rate.

Mr. Francis thought that alternative B of the staff drafts, with some alteration, would fit his approach to the situation. He would alter its language to read ". . . System open market operations until the next meeting of the Committee shall be conducted with a view to attaining such conditions in the money market and such an increase in total reserves as are necessary to assure a moderate rise in the money supply. . . ."

Mr. Patterson remarked that most of the bankers in the Sixth District with whom he talked had told him that requests for loans from their good customers were still greater than they could satisfy and that they saw no signs of a general letdown in the pressures for credit. However, the statistics they reported told a somewhat different story.

Loans at all member banks had been practically unchanged for three months after account was taken of seasonal influences, Mr. Patterson noted. In some areas of the District loans were actually lower. Average interest rates on new business loans charged by the banks in Atlanta and New Orleans were unchanged between September and December, after a 38-basis point gain between June and December and a 30-basis point gain during the spring quarter. In December Sixth District member bank borrowing was the lowest since

July 1966, and much less reliance was placed by District banks on the Federal funds market. Of the banks included in the Quarterly Survey of Bank Lending Practices, as of December 15 only a minority reported loan demand as moderately stronger. The rest reported loan demand as essentially unchanged or moderately weaker.

District bankers were inclined to attribute those developments to their having adopted firmer lending practices, Mr. Patterson said. They inferred that any slight reduction in requests for loans at their banks resulted partly from the realization by potential borrowers that it would be fruitless to apply for a loan. Some bankers stressed their desire to get into a more liquid position. Indeed, there actually was some shifting in the security portfolios of the large banks in December, and loan-deposit ratios at all member banks had declined since September. Moreover, some restriction in their lending and investment volume had resulted from a less-than-seasonal increase in demand and time deposits at the larger banks and a downtrend in deposits, on a seasonally adjusted basis, in the last three months in some areas of the Sixth District. Some change in deposit trends, however, was suggested by the statistics for the large District banks in late December, when time deposits rose slightly.

On the other hand, Mr. Patterson continued, the behavior of the latest available economic indicators continued to confirm the slowing in the District's economic activity that was reported at previous meetings. Employment apparently picked up a little toward the end of the year in contrast to the slackness during the months of mid-1966, and the unemployment rate in November fell to 3.5 per cent, the lowest since May. However, the District was sharing in the slower pace of auto sales and in the auto production cutbacks. Weakness persisted in some types of construction, and the tabulation of announcements of proposed new or expanded manufacturing plants for the fourth quarter promised a slower rate of capital expenditures in the future.

Mr. Patterson thought a reasonable conclusion that could be drawn from that mixed collection of information seemed to be something like the following: There was a strong demand for loans, although some potential borrowers were being excluded because of high interest rates and bank lending policies. The slackening in loan expansion resulted from both a slowdown in demand, reflecting a slower rate of economic expansion, and the efforts of banks to get into more liquid positions. Since many bankers were uneasy about their declining liquidity, they seemed to be welcoming any respite, no matter how small.

So far as he could determine, Mr. Patterson said, much the same conclusion could be reached in respect to the national scene. That meant that member banks now were likely to be less responsive to increased availability of reserves in expanding their loans and investments than they would have been early last year. Thus, insofar as net borrowed reserves or free reserves reflected reserve availability, a net borrowed reserve figure of, say, \$100 million was much less stimulative now than it would have been at this time last year or during a considerable part of 1966. That might explain why, despite the turn toward greater ease initiated several meetings ago by the Committee, the declining trend in the bank credit proxy had not been reversed until very recently.

In order to be sure that the recent rise in the bank credit proxy did not prove to be temporary, therefore, Mr. Patterson favored continuing to move gently toward greater ease. Currently, the net borrowed reserve figure was especially suspect as a guide to reserve availability. But if that figure was to be used, he would favor moving toward a zero position. With that understanding, he would favor alternative C of the draft directives.

Mr. Hilkert remarked that indicators for the real sector of the economy seemed to him increasingly to be pointing to a lessening of demand pressures. Conditions in the Third District continued to be generally good, as they were in the nation. However, indications of softening were appearing in the District. Manufacturing employment was off a little, and steel production had been declining, as had construction contract awards and auto registrations.

On the national scene, Mr. Hilkert found it difficult to discover any new sources of significant strength. Consumer demands and attitudes seemed relatively lethargic. Although there might be some point to the fact that construction could hardly go much lower, that did not stir hope for new strength. But most of all, he was disturbed--as apparently was the Board's staff--by the recent movement of new orders, backlogs, and inventories. The latter pointed quite clearly to involuntary accumulation.

To Mr. Hilkert, the resulting projection by the staff of a substantial cutback in the rate of gain in GNP during the first quarter was significant. Forecasts appearing daily in the press did not now generally support the view that a recession was ahead. But if the staff's projection for the first quarter proved correct, forecasts might soon become much more bearish.

Other things being equal, facts like those argued for another move toward ease, Mr. Hilkert said. He was, of course, concerned about the increase in wages now taking place and likely to continue this year. Credit ease should not proceed so fast and so far as to aggravate that development. Yet, it seemed to him there was little that monetary policy could do now to halt the trend, let alone roll it back.

In the financial sector of the economy, Mr. Hilkert noted, substantial and rapid easing in money market conditions had taken place. As pointed out in the blue book, bank credit and the money supply now seemed to be responding. In his view, that easing had not been overdone. Information coming to the Philadelphia Reserve Bank from the larger banks in the District indicated that they were not yet anxious to seek more customers, had not changed their lending policies, and were concerned about their liquidity. Rescinding the September 1 letter had had relatively little effect on their attitudes.

Another signal of the Federal Reserve's intent to ease, therefore, seemed to Mr. Hilkert to be called for if those attitudes were to be changed. On balance, he believed alternative B would be appropriate in accomplishing the desired purposes. Although he would think of the implementation of the directive as being accomplished somewhat gradually, the changes contemplated by alternative B should be sufficient to impress the market and banks that a further change was being made.

The balance of payments implications of further ease did, of course, concern him, Mr. Hilkert said. However, he looked for further improvement in the trade account as domestic expansion slackened. And, hopefully, easier credit conditions abroad might make it possible for the Committee to proceed toward easier conditions domestically without adverse effect.

Mr. Hickman commented that recent economic news revealed further moderation in some sectors and increased weakness in others. Notable developments in December were the increase in insured unemployment (reflecting mainly the cutbacks in autos and steel), the disappointing performance of retail sales, and the further (probably involuntary) buildup in business inventories. The industrial production index, on the basis of very preliminary estimates made at his Bank, showed little, if any, increase in December.

At the last quarterly meeting of Fourth District business economists in mid-December, Mr. Hickman continued, the general theme was one of increased anxiety about the economic outlook, which was reflected in a lowering of the group's forecasts--the third successive time that that had occurred. The group was concerned about the hazy outlook for defense spending, the tapering of capital spending, the profit squeeze, the erosion of new orders and backlogs, and general imbalances among major economic sectors. Their median forecast for GNP in 1967 in current dollars was $783 billion, a year-to-year gain of 6 per cent, with moderate and diminishing quarterly increases. That implied a modest increase in real GNP, something on the order of 3 per cent. Median forecasts for industrial production showed fractional quarterly increases, with the annual gain in 1967 amounting only to 3 per cent.

Mr. Hickman noted that the Fourth District business economists expected appreciable increases in unit labor costs in manufacturing in each quarter of 1967, with the average of the medians for the year up 2.5 per cent. The group expected corporate profits after taxes to remain level in the first half and to decline in the second half, with a year-to-year decline of about 1-1/2 per cent. Only about one-fourth of the group expected that taxes would be increased in 1967, and almost all thought that a tax increase was undesirable. Since he was no longer a dues-paying member in the union of business economists, he was not allowed to vote. If he could have voted, he would have been one of those voting against a tax increase at this time, largely for domestic economic reasons, but partly also because of glimmerings of hope that tensions were easing in Vietnam.

In regard to monetary policy, Mr. Hickman was pleased to note the substantial increase in both the money supply and the bank credit proxy that occurred in December. He would like to think that that reflected the economy's prompt response to the Committee's recent modest shift in policy, although the usual seasonal churning in December made it quite difficult to determine if that actually was the case. The staff's projection of no change in the money supply for January suggested to him some further easing was still needed.

Mr. Hickman's prescription for policy until the next meeting was to provide whatever reserves were needed to produce an increase in the money supply in the range of 3 to 6 per cent (seasonally adjusted annual rate), as well as to bring about some further modest reduction in interest rates. To achieve those objectives, he thought the Committee should not be constrained by the public's reaction to the published figures on the net reserve position of banks, and should permit positive free reserves to develop, if necessary. In view of the imminence of the Treasury refunding, he would prefer to move promptly in the direction of further ease. The recent reduction in the German bank rate from 5 to 4-1/2 per cent provided some basis for hope that a further modest reduction in interest rates in the U.S. would not trigger a flight of hot money from this country. He favored alternative B of the draft directives, and would be receptive to System purchase of intermediate- and long-term issues.

Mr. Brimmer said that the direction in which the Committee should move in the next few weeks seemed reasonably clear to him. He agreed with Mr. Reynolds' conclusion that the objective of long-run improvement in the balance of payments would be served best by policies that sustained domestic growth, and he thought the Committee was fortunate in having so smooth a meshing of policy requirements for the balance of payments and the domestic economy.

As he looked back at financial developments in the past few weeks, Mr. Brimmer continued, he was impressed with the strength of the markets and the magnitude of the change in expectations following the Committee's shift toward less restraint. He thought it was now incumbent upon the Committee to validate the present expectations. As some observers had noted, there had been a large reaction to a relatively moderate change in open market policy and the rescission of the September 1 letter. He thought the Committee should now do much more to insure that the money supply and bank credit would expand at rates approaching those that members had suggested were desirable at recent meetings. He was impressed by the degree of inertia existing in the banking system but he was not surprised by it, given the desire of banks to restore their liquidity positions. Nevertheless, low bank liquidity did impede the Committee's efforts to affect the economy through changes in money market conditions. It was important that bank loan expansion not rest simply on increases in loans to security dealers; it should also reflect rising loans to business.

Mr. Brimmer said he had been particularly impressed with the policy course Mr. Axilrod had suggested, and he thought that by the time of its next meeting the Committee might want to give serious consideration to that proposal for a more overt change. For the time being, however, in view of the uncertainties regarding the

Administration's tax and expenditure recommendations, he thought the proper course for the Committee was to proceed along the path it had been following recently. That led him to favor alternative B of the draft directives. At the same time, he would not want to have the level of interest rates taken as the sole key to the operations of the Desk. He would not be disturbed if the three-month bill rate declined to the neighborhood of 4-1/2 per cent. Nor would he be disturbed very much if net borrowed reserves approached the zero level or even if free reserves emerged. But it should not be the main objective of the Manager to produce those results; the main objective should be to achieve increases in bank credit and the money supply.

In the preceding discussion, Mr. Brimmer continued, a question had been implied as to whether the period with which the Committee was most properly concerned was the first half of 1967 or the whole year. He thought it was appropriate for the Committee to do all that it could to insure that economic conditions in the first half did not deteriorate to the point that the second-half conditions would be much weaker. In his judgment, unless there was sufficient easing of terms in mortgage markets, the economy was not likely to display strength in the second half.

In sum, Mr. Brimmer concluded, he favored alternative B today, and he hoped that by the time of the next meeting the

Committee would be in a better position to decide whether the course suggested by Mr. Axilroad was appropriate.

Mr. Maisel agreed with the staff analysis of the current situation. It seemed to him, therefore, that the Committee had to make clear its current goal--namely, a monetary policy that over the course of this year would help in increasing, rather than decreasing, total demand in the economy.

Given that ultimate goal, Mr. Maisel said, what influence could monetary policy have? Either through increased credit availability or through lower interest rates, monetary policy might influence those making spending decisions to add somewhat to their expenditures. More specifically, liquidity could be rebuilt, credit availability might rise so that easier mortgage terms might aid housing and that, plus some direct impact through instalment credit, might add an incremental amount to expenditures on consumer durables. There might also be marginal credit users who had been forced to run with lower inventories than they desired and with less investment in plant and equipment, but the impacts in those areas would probably not be great.

Given that basic role for monetary policy, Mr. Maisel asked, what sort of intermediate policy index could the Committee use in directing its action for the next two or three months? The Committee's main indexes could, as indicated in the alternative draft directives, be concerned primarily with either quantities or rates. The Committee could use the total increase in the amount of credit flows, or, since it had only slight current knowledge of total credit flows, it could use as a proxy either bank credit expansion or reserves furnished by the Federal Reserve--adjusting the amount aimed at for either proxy with time, if the proxy seemed to vary from the total credit movement desired. On the other hand, obviously the Committee could also set an interest rate goal on the assumption that it would require particular changes in the interest rate to bring about the desired over-all goal for spending in the economy.

It seemed to Mr. Maisel that, at the moment, the Committee would be better off if it chose as its major policy variable changes in credit and reserves, using interest rates as a subsidiary guide.

In the first place, Mr. Maisel feared that by adopting interest rates or money market conditions alone, the Committee was likely to pay too much attention to most recent events. As the green book showed, in many money market areas rates still were running 100 basis points or more over November 1965. Even while others had come down sharply, a large gap still remained. At the same time, the Committee was uncertain as to whether it was the level of rates or their change that would make the critical differences in reaching any desired spending goal.

During a period of rapid change, Mr. Maisel also feared the Committee was too likely to be bemused by the rate of change rather than by the actual level of interest rates. That was particularly true since the real demand for credit during this period was uncertain and little was known as to how much it could be expected to affect spending. There might be strong pressures to accommodate some of the backlog which had been postponed from recent periods in order simply to improve liquidity without any spending impact. In addition, if a major inventory run-off actually occurred, demand for funds might fall far below normal. In either case interest rates would not be an adequate guide of the Federal Reserve's actions or influence. They would represent a mixture of special supply and demand factors and would not mirror the total impact.

Clearly, Mr. Maisel continued, the same argument might be made against using the amount of credit as an index, but here the problems were likely to be less strong. The Committee knew that the economy had been through a period in which credit had expanded far less than normal. It should be simpler to get agreement for credit expansion to return to a normal rate. When such an expansion was achieved, it could then be determined whether that normal expansion was sufficient in terms of related interest rates, credit expansion, and liquidity to achieve the Committee's ultimate goal.

With respect to the draft directives, Mr. Maisel said, obviously he preferred the third alternative--C. He assumed that by "moderate" the Committee would, following the dictionary definition, mean avoiding extremes. Therefore, the directive should mean that the Committee was aiming at a normal or adequate movement in total deposits to achieve its goal. It seemed clear the Committee's goal should be a bank credit proxy that grew at about a 7 per cent annual rate. The blue book projection for the next four weeks showed required reserves expanding at far less than a normal rate and one not sufficient to achieve a desirable rate of expansion in total credit. Thus, to achieve the moderate expansion in bank credit called for in the directive, conditions would be needed under which required reserves would expand at a more rapid rate than that projected in the blue book. That should be the index for action used during the next four weeks. Reserves should be added unless or until required reserves were showing a far smaller run-off than indicated in the blue book. Positive free reserves might well be needed to achieve that aim and, as indicated by Mr. Axilrod, a considerably lower Federal funds rate. If the Committee was getting that expansion it should, as indicated in alternative C's proviso clause, be less concerned with rates.

Mr. Daane said that the course of System policy in recent weeks seemed to him to have been clearly appropriate as to direction.

His position at the last two meetings had reflected reservations regarding the overtness of the change and the degree of ease the Committee sought as it moved down the road toward greater ease. Those reservations, in turn, reflected confidence in the underlying strength of the economy, his skepticism as to whether public spending might not exceed current estimates in a period of war, and his concern about the balance of payments. Those considerations had led him to feel more cautious than the majority regarding the aggressiveness with which the Committee should move toward ease.

Today, Mr. Daane continued, he still felt concern about the balance of payments--he shared Mr. Treiber's views on possible deterioration on capital account--and he was no more assured than he had been earlier as to the course of public spending. He was impressed, however, by the increasing signs of deceleration in the private economy, and he thought it was necessary for the Committee to continue to move--and to demonstrate that it was moving--toward somewhat greater ease. Accordingly, he favored alternative B, in the moderate sense in which he would interpret it. He had some sympathy with the view that later in 1967 the Committee might again be confronted with a need to restrain the economy, but it seemed to him that the immediate problem was the reverse.

Mr. Daane added that he was not so sanguine as the staff, or Mr. Brimmer, that longer-run strength in the domestic economy and in the world economy would insure against a rather rapid deterioration in the balance of payments in 1967, whether on the liquidity basis or the official settlements basis. That was why he would interpret alternative B as calling for a gradual and moderate movement. Operationally, he thought there was some parallel between the current situation and that of early 1961 and thus he would favor some System purchases in the coupon area. Such purchases seemed desirable not only on the domestic grounds that Mr. Axilrod had mentioned but also for balance of payments reasons. He did not think the Committee could take great comfort in the 1/2 per cent reduction in the German discount rate in terms of the totality of international flows.

Mr. Mitchell remarked that while several people had talked about the longer-run problem for monetary policy he thought the basic problem lay in the short run, because the lags in transmitting the effects of policy changes through commercial banks to the economy at large were rather substantial. The Committee's task was to satisfy the banks' desire to rebuild liquidity so that they would reverse the loan policies they had been following--and to do so on a cautious basis, so that if there were a bounce-back in loan growth it would not get out of hand. The economic analysis presented today suggested that there would not be such a bounce-back. From his conversations with bankers, however, he gathered that they thought underlying loan demands remained strong, and that if they turned their loan officers loose the volume would build up fast. He did not think that the bankers were completely confident in their view, and he personally did not know the answer. But he thought that any policy the Committee adopted for the next four weeks should have an element of caution in it.

As to the directive, Mr. Mitchell said, he had some sympathy with the modification Mr. Francis had proposed in alternative B, which introduced a reference to the money supply. He noted that Mr. Axilrod had said that the money supply was not likely to show sustained growth, although he (Mr. Mitchell) was not persuaded that that was the case.

Mr. Axilrod commented that the money supply projection was based on an assumption of no change in money market conditions.

Mr. Mitchell went on to say that while he could accept alternative B as written, he would prefer to delete the word "somewhat," and to replace the words "significantly faster" with "very much faster," so that the paragraph would read, ". . . with a view to attaining easier conditions in the money market, unless bank credit appears to be expanding very much faster than currently anticipated." He also could accept alternative C if the final clause was deleted. Whatever the language, however, he favored continuing the trend of deliberate and steady easing, but with a readiness to pull back if and when the liquidity barrier was broken and bank credit growth became excessive.

Mr. Shepardson said there was no need to elaborate on the reports of economic conditions that had been made. He thought the main consideration influencing the Committee's decision on monetary policy for the period until the next meeting was the continuing uncertainty regarding fiscal policy. There had been some expansion in bank credit recently and the projections made on the assumption of no change in money market conditions--as contemplated in alternative A of the draft directives--were for further bank credit expansion on average in January at a 7 to 9 per cent annual rate. That seemed to him to be an appropriate growth rate at this time. In his judgment the Committee had to be concerned about the more serious implications presently evident for balance of payments developments. That fact, together with the uncertainty about fiscal policy, clearly called for the type of action contemplated under alternative A. The projections indicated that there might be no change in the money supply if that alternative was adopted. It seemed to him, however, that experience indicated that the money supply tended to fluctuate widely in the short run regardless of the Committee's policy objectives. Accordingly, he felt that the Committee should not be overly concerned about the expected lack of money supply growth at the moment, as long as there was reasonable growth in bank credit.

Mr. Wayne reported that business activity showed more signs of slowing and that expectations were definitely less optimistic in the Fifth District. In November both nonfarm employment and man-hours in manufacturing scored gains, but more recent information was quite uniformly on the weak side. On balance, manufacturers in all categories reported for December lower levels of shipments, new orders, and backlogs, and significantly higher inventories of finished goods. The insured unemployment rate rose throughout the District but remained below the level of a year ago. It appeared that a slump in demand might have caused a postponement or cancellation of price increases which had been expected in the furniture industry.

In the country as a whole, Mr. Wayne said, a gradual slowing of economic activity was becoming increasingly apparent. He had to confess that he was impressed with the pervasive downward movement of the statistical indicators. The rise in housing starts in November was about the only increase which had been reported in recent weeks. Even if that should signal a bottoming out of the housing cycle, it would still be several months before housing became a source of strength. Sales of United States automobiles in both domestic and foreign markets continued weak and production schedules were being cut back to trim new car inventories, which totaled well over 1.4 million units. Inventory accumulation by manufacturers accelerated in November, inventory-sales ratios continued to rise, and increases in finished stocks suggested that some of the recent accumulation might have been involuntary. Easing of materials prices and slower growth of order backlogs in recent months would probably reduce voluntary accumulation.

To Mr. Wayne, those widespread signs of moderation in the pace of economic advance were hopefully the signs of adjustment toward a noninflationary rate of economic growth and not the signs of emerging recession. Much depended on the degree of fiscal stimulation which the economy received in the weeks and months ahead. But the level of expenditures associated with the war effort and the question of a tax increase remained the principal uncertainties on the economic scene. While recent figures indicated a leveling off in military contract awards and defense orders, those series might provide only a hazy indication of future expenditures.

Despite the uncertainties surrounding the degree of fiscal stimulation in coming months, it seemed to Mr. Wayne that in view of increasing signs of weakness in the private sector and absence of growth in important financial variables in the second half of last year, monetary policy should continue to promote the moderate growth in the money supply, bank credit, and time deposits indicated by the preliminary figures for December. He would not like to see a rapid acceleration in the growth of those variables, but neither would he like to see the plus signs of December washed out by negative signs in January. Encouraged by the behavior of interest rates and marginal reserve measures and by the rescission of the September 1 letter, banks were perhaps becoming somewhat more willing lenders, a welcome response in view of recent slow growth in bank credit. While recognizing that in conducting day-to-day operations the Desk found it difficult to focus on aggregative measures, he believed the objective should be to encourage growth in required reserves and the bank credit proxy at something close to the December rate.

Alternative B of the staff draft directives, as defined by Mr. Axilrod, seemed to Mr. Wayne appropriate.

Mr. Clay commented that in recent weeks monetary policy implementation generally had attained the financial variables goals sought by the Committee. In view of the economic information that had become available, those monetary policy goals and attainments had been appropriate to the prevailing economic situation.

Mr. Clay said that the timing of this morning's meeting relative to the President's message and other Administration messages to follow placed the Committee under a handicap in formulating monetary policy for the next four weeks. Nevertheless, the information available concerning the prospective economic situation appeared to justify a continuation of the policy currently prevailing. More specifically, it appeared desirable that sufficient reserves be provided so that bank credit could continue to expand. That would not necessarily mean that loan volume would expand. Conversations with bankers confirmed that current loan behavior was only partially explained by lessened loan demand and limited availability of funds. Bankers were reluctant to relax their own credit restraints in a desire to improve their banks' liquidity positions.

Mr. Clay thought it was by no means clear what targets should be set in endeavoring to continue the recent improvement in the financial aggregates. One could begin by accepting the projections of financial aggregates in the blue book, as developed from page 3 to the middle of page 6,[1/] and the money market conditions specified

---

1/ This section of the blue book read in part as follows: "Bank credit expansion is likely to continue in January, but at a slower pace than indicated by the large recent week-to-week increases. The increase in the January average of outstanding bank credit over the December average may be in a 7 - 9 per cent (annual rate) range, but this includes the carry-over effect on the monthly averages of the strength in the latter part of December. From the end of December through the end of January, a growth rate in the 4 - 6 per cent range appears likely . . . . The interest rate and credit demand assumptions appear consistent with expansion of time and savings deposits at all commercial banks by about 12 per cent in January on a monthly average basis . . . . Money supply in January is expected to show little or no net change on average. Private demand deposits may decline somewhat, partly because of a projected rise of almost $1 billion in U.S. Government deposits. But private demand deposits are not assumed to decline by as much as Government deposits rise . . . . These deposit projections imply a sizable expansion in aggregate reserves in January on average--in the order of 10 - 12 per cent for nonborrowed and total reserves. For December-January together, nonborrowed reserves may show an increase around the 5 - 7 per cent range."

at the top of page 4[1] of the blue book. If those projections of financial aggregates did not generally materialize, it should be understood that instructions to the Manager would call for a modification of the money market targets such as those suggested on page 6 of the blue book.[2]

Alternative A of the draft economic policy directive, as defined in the accompanying staff notes,[3] appeared to Mr. Clay to be appropriate for the period ahead.

Mr. Scanlon commented that economic developments in the Seventh Federal Reserve District in recent weeks had presented no surprises. There were indications that excessive pressures on productive resources had eased further. Unemployment compensation

1/ This material read as follows: "These projections assume that the 3-month bill rate stays roughly within the recent 4.75 - 4.85 per cent range over the period ahead, that net borrowed reserves fluctuate around $100 million, and that Federal funds and dealer loan rates back down somewhat from recent high levels of around year-end."

2/ This material read as follows: "If the Committee wishes to continue a gradual reduction in the degree of monetary restraint, it might call for open market operations to achieve a set of money market conditions that might include a net borrowed reserve position averaging close to zero and Federal funds averaging near 5 per cent. This would, in all likelihood, bring the 3-month bill rate down to a 4.60 - 4.75 per cent range."

3/ The staff notes suggested using the complex of money market conditions cited in note 1/ as a description of the general kinds of conditions to be maintained if alternative A were to be adopted by the Committee.

claims in December were somewhat higher in each of the District States than in December 1965, but were still at very low levels. The increases had been particularly evident in automobile manufacturing centers. Also, the rise in help-wanted advertisements in major newspapers, while increasing somewhat further, had not maintained the spectacularly large increases of earlier months.

Price increases continued to be announced in a variety of goods and services, Mr. Scanlon noted, notwithstanding the evidence of better balance in the over-all supply-demand situation. The demand for construction equipment had weakened further and major firms in that industry did not see an early end to that development.

In conversations with businessmen, Mr. Scanlon said, he detected a greater sensitivity to the possibility of their finding themselves with excessively large inventories. A number of firms had reported plans to reduce inventories. That had been noted especially in steel-using firms, even though there had been some evidence recently of strengthening demand for steel. But thus far, the transition to a more balanced supply-demand situation had been orderly and had not engendered excessive pessimism.

On the banking scene, Mr. Scanlon remarked, District banks shared in the rather sharp increase in credit during December. Loan expansion reflected mainly the temporary needs of securities dealers and finance companies. Increases in business and consumer loans were relatively small compared with other recent Decembers. The recent growth in deposits which had accompanied the easier money market had made it possible for the large banks to acquire some Governments as well as to make additional money market loans, and the largest banks had shown a significant reduction in their loan ratios since early December. Some rebuilding of liquidity was to be expected, and banks as well as dealers might find many Governments and municipals attractively priced, given the expectation of further declines in interest rates in the period ahead.

Mr. Scanlon reported that large District banks had acquired more than $150 million through net sales of negotiable CD's since mid-December, and had shown substantial gains through savings-type certificates following their recent boost in rates offered on those instruments. While they had attracted some new money, large banks in Chicago estimated that about three-fourths of the gain in CD's under $100,000 denomination resulted from the transfer of other deposits in the bank. Current rate relationships appeared conducive to continued growth in deposits and credit.

As to policy, while Mr. Scanlon would not be satisfied with the large magnitude of the increase in bank credit and reserves projected for January if there were reason to expect it to continue, he was happy to see them both on the plus side again. Even after the sizable increase projected for January, total reserves would still be below the levels of last September. In view of the signs of hesitancy in the private sector of the economy, he thought it desirable to continue the upward momentum in total reserves, possibly over the longer range at a somewhat slower rate than projected for January, but hopefully at a sustained rate.

Mr. Scanlon said that his views on policy closely paralleled those of Mr. Mitchell. While he could accept alternative B of the draft directives in light of Mr. Axilrod's explanation, he favored alternative C since it provided for a wider range of fluctuation in money market conditions if that proved to be a necessary consequence of operations directed at maintaining the desired rates of growth in monetary aggregates. He believed that the Committee could stabilize either aggregate reserve measures or money market conditions, but that it probably could not stabilize both concurrently.

Mr. Galusha reported that the indices of economic activity in the Ninth District confirmed the District's historic lagging role, for most of those measures reflected a considerable momentum. Recent personal interviews indicated a developing pessimism, however.

In the Ninth District, no less than in the nation, the situation of banks eased appreciably during December, Mr. Galusha said. Total deposits of District banks increased more than seasonally; for weekly reporting banks, the rise in total loans and investments was double the usual seasonal increase. The December drop in the average loan-deposit ratio was very sharp at weekly reporting banks, and those banks ended 1966 with a lower average ratio than they had at the end of 1965. The largest Ninth District banks were able to increase the average maturity of their CD's somewhat. And, finally, he might mention that among Twin Cities bankers speculation had turned to when a reduction in the prime rate would come.

In a way, Mr. Galusha observed, all that was gratifying. Banking developments, both in his District and in the nation, could be interpreted as showing that Committee policy was having the desired effect. But the Committee was perhaps some way still from getting the supply-side loan response that appeared to be needed. That suggested that pressing further--continuing the trend to lower market interest rates--would be appropriate. In that regard, it was of considerable importance that the Bundesbank had been so obliging. Possibly now the Bank of England would follow the Bundesbank's lead.

For himself, then, Mr. Galusha favored a slight--and he would emphasize the word slight--further reduction in market interest rates at this time. He recognized, though, that there was something to be said for pausing now--for holding to the status quo at least briefly--although with a Treasury financing to be announced late in January, that hold could be too lengthy.

But one thing was clear, Mr. Galusha said. The Committee could not afford a return of market rates to previous, higher levels. According to the blue book, the recent welcome decline in the bill rate was in considerable measure the result of expectations. But from tonight on, and for the next few weeks, expectations could prove quite volatile. And the Committee should not, he believed, allow any change in expectations to result in higher interest rates. It could be that, to maintain the present structure of rates, the level of net borrowed reserves would have to be reduced somewhat--possibly to between zero and $100 million.

Without knowing what the President was going to say tonight and in messages to come, Mr. Galusha continued, it was not easy to talk of policy targets. But perhaps it was enough for the Committee to agree that, at the very least, the Manager should be given all the latitude possible to resist fully any trend to higher interest rates stemming possibly from disappointments about announced fiscal policies. Either alternative B or C of the draft directives appeared appropriate.

In concluding, Mr. Galusha said he might replow an old furrow and urge again that further thought be given to structural reform of reserve requirements and, more particularly, to lower requirements for small banks. At the moment he was at least as concerned with the

System's image in Sleepy Eye as in Zurich. Lest that appear excessively parochial, it might have further usefulness for the System because--depending upon what the Administration decided about taxes--the Committee might want some way of dramatizing a switch to still greater monetary ease and, unfortunately, a reduction in discount rates would seem out of the question at present.

Mr. Swan said that in December business loans of Twelfth District weekly reporting banks again rose considerably more than in the rest of the country, as they had in November, although the increase was somewhat less than in the same month last year. Also continuing in December was a greater than national increase in total time and savings deposits at commercial banks, as large negotiable CD's outstanding increased somewhat more than elsewhere. Some indications were appearing that the larger banks were reluctant to go beyond six months' maturity in their large CD's. Although most banks still indicated that the matter was subject to negotiation, one bank had adopted a definite policy of not going beyond six months. Also, one bank had announced a reduction in maximum rate, from 5-1/2 to 5-1/4 per cent, on long maturity CD's.

There were strong indications in the latest survey, Mr. Swan continued, that in both the District and the nation the lending practices of most banks were unchanged from three months earlier. Four of the 17 reporting banks in the District indicated that loan demands had weakened in the past three months, but none reported that they expected demands to be weaker in the first quarter of 1967. Similarly, their willingness to make loans remained essentially unchanged. The only cases of increased willingness to lend involved two banks, which expressed that attitude with respect to consumer instalment loans. At the other extreme, eight of the 17 District banks indicated reduced willingness to make mortgage loans on multifamily structures. Those findings suggested to him there was still some question of the availability of supply to be worked out before much reaction could be expected in the lending policies of banks. Like Mr. Mitchell, he was somewhat concerned about banks' attitudes regarding the strength of underlying loan demands.

As to monetary policy, Mr. Swan said, it seemed to him that the relatively gloomy cast of both the green book analysis and the discussion today suggested that the Committee perhaps should move somewhat further in the direction of ease. However, he did not believe that the evidence was sufficiently clear to justify a marked move at this juncture. In view of the balance of payments situation, the still relatively tight labor market, the fact that the Administration would be announcing its current economic policy views before the Committee's next meeting, and the fact that a Treasury financing, even though not a major one, lay ahead, he would prefer to see a rather gradual change over the next two weeks, rather than a more abrupt move that might lead to various kinds of undesired market interpretations. He would certainly like to see some increase in bank credit, and also in the money supply. He favored alternative B, but because he would interpret "somewhat easier conditions" rather conservatively, he was not sure that he advocated the same specific targets as others who also favored that alternative. He would hope to see the bill rate around 4-3/4 per cent, the Federal funds rate around 5 per cent, and marginal reserves ranging from $100 million net borrowed reserves to zero, but not becoming positive. He agreed with Mr. Brimmer that if much easier money market conditions developed and interest rates moved down further the Desk should not try to offset those changes, but that such conditions should not be actively sought. He also saw no objections to operations in the longer term area on a fairly small scale.

Mr. Swan noted that some sentiment had been expressed in favor of adopting alternative C, which called for fostering moderate bank credit expansion, for the second paragraph of the directive. The second paragraph specified the Committee's immediate goal, and he thought that it should be formulated in terms of conditions in the money market, as in alternative B. However, he would suggest including a reference to the objective of accommodating bank credit expansion since it had been the Committee's practice during most of last year to refer to bank credit in the concluding "policy" sentence of the first paragraph. The third sentence of the staff's draft of the first paragraph noted that "bank credit expansion has resumed"; the last sentence of that paragraph might be revised to say that it was the Committee's policy to foster money and credit conditions, "including bank credit expansion", conducive to noninflationary economic expansion.

In a final comment on the first paragraph, Mr. Swan said he appreciated the staff's suggestion that the language of the balance of payments reference should be changed even though no change in substance was proposed, in order--as the notes attached to the draft said--to indicate that the payments balance was receiving the continuing attention of the Committee. But the new language the staff proposed, by referring to "trends in international transactions", seemed to imply a more basic change in the situation than in fact there had been. Accordingly, he would suggest continuing the reference used in the previous directive.

Mr. Irons reported that economic conditions were generally strong in the Eleventh District. At the same time there were the cross-currents and the indications of slowing rates of growth that were evident in the national economy. Slackening in autos, construction, and other areas was partially offset by the generally high level of activity prevailing. Employment was up in virtually all categories, and the unemployment rate was low--about 2 per cent. There were signs that labor market pressures might have lessened somewhat, but not significantly. Production in the District also was up. On the other hand, department store sales had not been as favorable as had been hoped. Construction activity was a little lower than might have been expected, but the difference was not of large magnitude. Sales of automobiles had been relatively favorable; in December they were within 1 per cent of the year-ago volume.

As to District financial conditions, Mr. Irons continued, there were increases in the past month in commercial and industrial loans, demand deposits, and both total time deposits and CD's. The reserve positions of District banks were somewhat less strained than earlier. Banks still were borrowing through the Federal funds market but in smaller volume. Borrowings from the Reserve Bank for window-dressing purposes normally were expected over the year-end, but this year there had been virtually no activity at the discount window in that period.

The national picture had already been well described, Mr. Irons said. He recognized that most indicators showed a tendency towards slower growth, but here again the differences were small. The major uncertainty continued to be the nature of the actions that would be taken in the public sector. Some of the answers on that subject would be obtained from the President's State of the Union message this evening, and more would be forthcoming in messages to be delivered over the next few weeks. The markets seemed to have adjusted to the considerable shift toward ease that had been made by the System. It was the general feeling in his District that credit policy had become easier; the question was how much easier policy would be.

Mr. Irons commented that he was disturbed by the deterioration in the balance of payments and the possibility of worsening in the gold situation. The problems in those areas were serious, and they probably deserved an increasing amount of thought and attention on the part of the Committee.

Today, Mr. Irons said, he would favor maintaining an even keel, continuing the present conditions in the money market. The figures that a number of other members had indicated they would like to see emerge seemed appropriate to him. He was not sure that it would matter a great deal which of the three alternative directives the Committee adopted. He thought the staff had done an excellent drafting job, formulating each alternative to incorporate a concluding phrase that appropriately modified the earlier language. On balance, however, in view of various considerations--including the Treasury financing, the basic economic situation and outlook as he saw it, the uncertainties with regard to the public sector, and the balance of payments situation--he favored alternative A.

Mr. Ellis said that the New England economy, measured in real terms, appeared to have slowed its rate of advance. Manufacturing workweeks shortened slightly in November, and the man hour index declined a fraction. The index of factory output likewise leveled in November from its October peak. Manufacturers' shipments in the fourth quarter declined from the previous quarter, as they had projected, but were scheduled to rise sharply in the current quarter.

Bankers continued to report strong loan demand, Mr. Ellis noted, but they were taking moves to restore liquidity before expanding lending. Liquidity ratios had risen more than seasonally and loan-deposit ratios had dropped noticeably since late November. At least one bank had cut its interest rate on large short-term business loans by 53 basis points, and the average for the large Boston banks had been a cut of 43 basis points in their lending rates between the September and December surveys. Meanwhile, they had become more selective in the rates they would pay for long-term CD money.

Mr. Ellis reported having listened to some very direct language about the inequity of the revised voluntary foreign credit restraint program. The thrust of one protest was against the 10 per cent limit on loans to developed countries since they were the countries most likely to be able to qualify for non-export related loans. The thrust of another protest was directed to the inequity of delaying access to the 109 per cent quota. Those "less cooperative" banks who by last fall had reached their ceilings seemed free to disburse repayments without regard to the 10 per cent limit. Insofar as the banks felt they had been penalized for not having used their quotas, and insofar as they might be expected to have more lendable funds during 1967, it seemed only logical to expect them to move to and hold at their ceilings for fear of losing their quotas permanently. If that course was followed, it would naturally have a substantial negative impact on the U.S. balance of payments. He thought that was important if the Committee had any inclination to view the VFCR program as a shelter against an outflow of the funds it was putting into the economy.

Turning to monetary policy, Mr. Ellis said that the weight of evidence emerging since the Committee's last meeting had served to confirm the short-run forecasts of the staff that the temperature of the economic climate had been slowly cooling, which had been a clear objective of the Committee's policy only six months ago. The evidence also revealed that the shift in monetary policy commenced in mid-November had introduced a changed--and more optimistic--outlook for credit availability and effective market performance in the months immediately ahead. The paramount issue of policy was whether the easing trend should be accelerated or the present posture maintained. As Mr. Axilrod had noted, fundamental to one's judgment on that score was his evaluation of the underlying strength of the economy. His (Mr. Ellis') own resolution of that issue was that the economy was unlikely to experience anything more than a temporary "inventory" pause--a helpful consolidation period--if the country was committed to support a continuing war effort in Vietnam and continued expansion of other Government services at Federal, State, and local levels. He was inclined to view consumers as ready to utilize their enlarged incomes to expand spending when credit was available and uncertainties were reduced--conditions that seemed likely to prevail increasingly in the next several months, especially when the outlines of the Federal budget became clear.

Mr. Ellis confessed to a considerable difficulty in persisting in such an optimistic viewpoint while studying the well-presented analysis of the green book. By the same token, he found no difficulty in believing that the Committee had already obtained perhaps 80 per cent of the impact associated with public recognition of its change in policy. How hard should the Committee push to obtain the other 20 per cent? Should it flood the reservoir to insure leakage to the economy? To postpone any further moves toward easing while awaiting the fiscal counterpart to the Committee's monetary actions seemed almost costless in terms of monetary effect to be achieved in the interim, and yet it would preserve a greater range of policy alternatives for selection when better information was available. In common with Mr. Mitchell he did not rule out the possibility of a bounce-back in bank lending.

His premise that a "wait and see" posture would be virtually costless in a policy sense rested, Mr. Ellis observed, on the blue book evaluation of the manner in which bank credit expansion had resumed. The bank credit proxy had expanded at an annual rate of 7 per cent since the Committee's policy shift of mid-November and it was projected to expand at 7-9 per cent average rate in January without a further change in policy. Time deposit growth had resumed since mid-November at an annual rate of 10.3 per cent, which was equal to the growth rate in the first half of last year--and was a rate that the Committee used to think of as excessive. Without further policy change, growth in time deposits was projected to accelerate to 12 per cent in January. The staff opened its blue book discussion of prospective developments, absent further policy actions, by indicating that "Bank credit expansion is likely to continue in January, but at a slower pace than indicated by the large recent week-to-week increases." From the end of December to the end of January the staff expectation was for bank credit expansion at a rate in the 4 to 6 per cent range, with net borrowed reserves averaging around recent levels. Total reserves were projected to rise at a 10 - 12 per cent annual rate on average in January. In his judgment those projections were an entirely acceptable prospect and they encouraged him to specify as "targets" the underlying assumptions of a 90-day bill rate in the 4.75 - 4.85 per cent range, net borrowed reserves fluctuating around $100 million, and Federal funds and dealer loan rates somewhat below their high year-end levels.

As he considered the three alternative directives, Mr. Ellis said, he had somewhat the same feeling as Mr. Irons had expressed--their implications were rather similar. That led him to wonder why the Committee should accept any alternative other than A, which provided for modification of operations if bank credit growth deviated significantly from expectations. Adoption of either of the other alternatives would logically mean that the Committee sought expansion in bank credit at a rate in excess of 7 - 9 per cent, in reserves at a rate in excess of 10 - 12 per cent, and in time deposits at a rate in excess of 12 per cent. To seek such growth rates would seem to him to go beyond what might be called a "gradual" change. Accordingly, he favored alternative A.

Mr. Robertson then made the following statement:

It is obvious that the effects of our easing of monetary policy are gradually spreading through the financial system, even though responses have been exaggerated in some markets by expectational influences, while being restrained in others by overhangs of caution, uncertainty, and institutional inertia.

As yet, there have been few signs of any effects of such credit easing on actual spending decisions--they could hardly have been expected so quickly, given what we know about monetary lags. The business statistics flowing in seem to be indicating greater and greater moderation of underlying expansive forces, leaving us with a present rate of deceleration of growth that we would not want to see continued for very long. Nonetheless, the economy still possesses significant elements of strength, to which some added buoyancy will be given as the easier credit climate begins to affect business decisions. I see no need, therefore, for aggressive further monetary easing today (particularly with the Government's fiscal program for calendar 1967 still up in the air). Furthermore, I am not sufficiently complacent about future price increases to be willing to push hard on the monetary accelerator at the first signs that the economy might slow down more than we contemplated when restrictive policies were formulated last year.

I do think it is essential, however, for us to continue the gradual relaxation of monetary restraint that we launched a few weeks ago. We should be trying to create an environment in which we foster an orderly and moderate bank credit expansion, with some moderate recovery in large CD outstandings, a continued reasonable growth in consumer-type time and savings deposits (but not so vigorous as to pull funds away again from other savings intermediaries), and a money supply expansion that is neither so large nor so small as to have import for a significant change from the current flow of spending.

To foster these intermediate objectives, we should seek some further easing of net reserve availability and related money market conditions in the interval between now and late January when "even keel" considerations come to the fore. This means that I would like to see net borrowed reserves running regularly below $100 million (and perhaps occasionally positive), and

> that I would dislike to see the Federal funds rate hanging up around 5-1/2 per cent or higher, or the bill rate running up appreciably and giving off confusing signals to the market. But I want to emphasize, as I have in the past, that these money market factors should not be looked at as ends in themselves, and we should be quick to take moderating action as suggested by the "proviso" clause in the directive if our aggregate credit objectives are not being fostered.
>
> As a practical matter, I know the Manager cannot reasonably expect to hit all the targets I have cited. Deviations in individual measures will inevitably occur, and they can even be positively helpful, so long as they are not disruptively large, because they will serve to keep both us and the market from settling into ruts. If, therefore, the Manager can manage to achieve some kind of average of the results I have been describing, I will be satisfied.
>
> With these views in mind, I would be prepared to vote for alternative B for the directive, as drafted by the staff.

Chairman Martin commented that the Committee members seemed for the most part to be in agreement today. He personally was quite well satisfied with the way policy had gone since the decision to change; the Committee had been pursuing an easier, but not an easy, policy--a distinction he thought was significant--and he would want to continue on that course. Adoption of alternative B today would seem to him to be quite clearly consistent with such a policy. He thought some rather disturbing operational problems could be encountered if the Committee adopted alternative C. At its next meeting the Committee would have more information on prospective fiscal policy that could be taken into consideration, but for the time being he would propose adoption of alternative B as drafted.

The Chairman then suggested that the Committee vote on a directive consisting of the staff's draft for the first paragraph and alternative B for the second paragraph.

> Thereupon, upon motion duly made and seconded, and with Messrs. Irons, Shepardson, and Treiber dissenting, 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 further moderation in various expansionary forces and sharply increased inventory accumulation. The pace of advance of broad price measures has slowed, although upward price and cost pressures persist for many finished goods and services. Partly reflecting the recent modification of monetary policy, financial market conditions have become less taut than earlier and bank credit expansion has resumed. With respect to the balance of payments, trends in international transactions indicate a continuing serious problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions conducive to noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, and taking account of forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be expanding significantly faster than currently anticipated.

It was agreed that the next meeting of the Committee would be held on Tuesday, February 7, 1967, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

January 9, 1967

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on January 10, 1967

FIRST PARAGRAPH

The economic and financial developments reviewed at this meeting indicate further moderation in various expansionary forces and sharply increased inventory accumulation. The pace of advance of broad price measures has slowed, although upward price and cost pressures persist for many finished goods and services. Partly reflecting the recent modification of monetary policy, financial market conditions have become less taut than earlier and bank credit expansion has resumed. With respect to the balance of payments, trends in international transactions indicate a continuing serious problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions conducive to noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A:

To implement this policy, and taking account of forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the currently prevailing conditions in the money market, but operations shall be modified as necessary to moderate any apparently significant deviation of bank credit from current expectations.

Alternative B:

To implement this policy, and taking account of forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be expanding significantly faster than currently anticipated.

Alternative C:

To implement this policy, and taking account of forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to fostering expansion in bank credit at a moderate rate, but operations shall be modified as necessary to limit any sharp easing or firming of money market conditions.