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, February 7, 1967, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Hickman
Mr. Irons
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Shepardson
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. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hexter, Assistant General Counsel
Mr. Brill, Economist
Messrs. Eastburn, Garvy, Green, Koch, Mann, Partee, Solomon, Tow, and Young, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Fauver, Assistant to the Board of Governors
Messrs. Hersey and Reynolds, Advisers, Division of International Finance, Board of Governors
Messrs. Axilrod and Gramley, Associate Advisers, Division of Research and Statistics, Board of Governors

Mr. Wernick, Assistant 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, Ratchford, Brandt, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, St. Louis, and San Francisco, respectively
Mr. Deming, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Stiles, Senior Economist, Federal Reserve Bank of Chicago
Mr. Hocter, Economist, Federal Reserve Bank of Chicago
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on January 10, 1967, 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 January 10 through February 1, 1967, and a supplemental report for February 2 through 6, 1967. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that there would be no change in the Treasury gold stock this week. The gold balance in the Stabilization Fund would decline to less than

$19 million by the end of the month, however, which might necessitate a $100 million cut in the Treasury gold stock within the next two or three weeks.

On the London market, Mr. Coombs continued, there had been a good flow of gold from South Africa, which continued to run a moderate payments deficit. Speculative demand had been even stronger, however, and the gold pool lost an additional $21 million during January. As of the close of business yesterday, there was $47 million left of the supplementary $50 million contributed to the pool last September, but an effort would be made to get agreement for an additional $50 million if necessary. The French Government continued to harass the market with a succession of announcements designed to cast doubt on the official $35.00 price. The latest French move in that campaign, announced on January 29, was to internationalize the hitherto domestic French gold market. Those new measures now permitted French residents to buy gold on the London market and would encourage the growth of French gold custody business for nonresidents. European central banks expected that the next French move would be to withdraw from the gold pool, with some fanfare of publicity. In general, the French seemed to have deliberately put themselves on a collision course with U.S. policy, and the time might not be far distant when the U.S. would have to take fairly drastic defensive measures.

With respect to the exchange markets, Mr. Coombs said, the Committee might recall that at the last meeting he had expressed concern over the lagging recovery of sterling and the huge amount of central bank credits still outstanding to the Bank of England; and he had suggested that the best hope for bringing about a major turn for the better in the sterling market would be for the Bank of England to maintain a rate differential in its favor if the Euro-dollar market continued to ease. In fact, that was what they had done during the past month, and that policy had helped bring about a major inflow of $555 million during January. Of that amount, $30 million had been added to reserves and the remaining $525 million had been used to pay off central bank debt. The Bank of England had thereby reduced its outstanding short-term debt to approximately $800 million at the end of January, with further repayments in early February bringing the total down to about $625 million today--as compared with a peak of $1.5 billion last August. There was some hope, he thought, that the favorable trend of the past month would continue through the next two months, which tended to be seasonally strong. In any event, he thought there was a pretty good chance that the Bank of England would pay off the remaining $100 million due under its swap line with the System within the next week or so.

On the other side of the ledger, Mr. Coombs remarked, the System Account had cleaned up all of the $35 million of guilder debt that had been outstanding at the time of the last meeting, and had paid down the System's mark indebtedness from $85 million to no more than $10 million. He would hope to clean up the rest of the mark debt within the next week or so, leaving only the Swiss franc debt of $85 million. As he mentioned at the last meeting, there was a strong likelihood that the seasonal weakening of the Swiss franc would permit the repayment of that debt by the end of March. He thought it might be useful, however, to accelerate such repayment by asking the Treasury to issue a Swiss franc bond or to employ some of the System's holdings of guaranteed sterling to acquire Swiss francs on a swap basis. That might enable the books to be closed as of the end of the month with neither loans nor borrowings outstanding under the $4-1/2 billion swap network. There had been a good deal of discussion of the swap network in the recent meetings concerning international liquidity arrangements, and he thought it would be highly useful in that connection for both sides of the System's ledger to be clear at the end of February. Somewhat over $7.5 billion had been drawn under the swap arrangements since their inception; and, if the presently outstanding drawings were paid off shortly, more than 90 per cent of all drawings would have been paid off within a six-month period.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period January 10 through February 6, 1967, were approved, ratified, and confirmed.

Mr. Coombs then noted that the combined three-month standby swap line with the Netherlands Bank, totaling $150 million would mature on March 15, 1967. As the Committee would recall, a $100 million arrangement had been on the books last September when the $50 million enlargement was added. He recommended renewal of both the longer-standing arrangement and the enlargement, noting that the Dutch still seemed inclined to keep them separate. He would hope that in due course the two could be consolidated into a single agreement.

> Renewal of the combined $150 million standby swap arrangement with the Netherlands Bank was approved for a further period of three months.

Mr. Coombs noted that there was a similar combined arrangement with the National Bank of Belgium for $150 million. Of that sum, $100 million was on a one-year basis and had been renewed for that period in December 1966. The enlargement of $50 million was on a three-month basis, and would mature on March 13, 1967. He recommended renewal of the $50 million enlargement for a three-month period, and for a longer term if agreeable to the Belgians.

> Renewal of the $50 million enlargement of the standby swap arrangement with the National Bank of Belgium was approved on the basis recommended by Mr. Coombs.

Finally, Mr. Coombs said, the enlargement of the swap arrangement with the Bank of Italy in the amount of $150 million, which had been negotiated in September 1966 for a term of six months, would mature on March 12, 1967. The longer-standing portion of the Italian arrangement, in the amount of $450 million, had been renewed for a twelve-month period in October 1966. The Bank of Italy apparently would be prepared to renew the enlargement for an additional nine months, through the end of the calendar year, and he was hopeful that they would be willing to put it on a twelve-month basis. He recommended that the Committee approve a renewal of the enlargement for nine months, with the understanding that it would be put on a twelve-month basis if agreeable to the Italians.

> Renewal of the $150 million enlargement of the standby swap arrangement with the Bank of Italy was approved on the basis recommended by Mr. Coombs.

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 January 10 through February 1, 1967, and a supplemental report covering the period February 2 through 6, 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:

Interest rates again moved sharply lower during the period since the Committee last met and money flows appeared to have accelerated in all sectors of the money and capital markets, reflecting the further easing of System policy and a succession of new developments that tended, on balance, to bolster market confidence. The President's State of the Union message, calling for a tax increase and for lower interest rates, came the evening after the last Committee meeting and had an immediate impact on market sentiment. Sixteen days later, when some signs of hesitation had begun to appear in the capital markets, the cut in the prime rate and the decline in the British Bank rate again restored a buoyant tone to the market--and generated a particularly enthusiastic response to the Treasury's refinancing of $7.5 billion securities maturing on February 15. Economic indicators becoming available during the period tended to confirm the impression that there was less exuberance in the economy, the budget message was generally well taken, and developments in Vietnam were not such as to upset the better market tone.

While most of the developments during the period tended to be bullish for the markets, a note of caution appeared from time to time, mainly stemming from reports of a growing calendar of corporate and municipal issues and from the realization that the country's balance of payments deficit might well pose special problems some time in 1967, particularly if lower interest rates in the United States should lead to an outflow of capital. The very extent of the decline in rates to date from last summer's peaks made some market participants wonder whether the adjustment might not prove to have been a bit overdone, particularly if demands on the capital markets should increase further.

In the short-term markets, rates on Treasury bills, bankers' acceptances, commercial and finance company paper, and CD's all moved significantly lower over the period since the last Committee meeting. The three- and six-month Treasury bill rates declined about 25 and 35 basis points net over the period, and temporarily fell below the discount rate before backing up a bit yesterday in the face of light demand. Bidding was cautious in yesterday's regular weekly bill auction, and average issuing rates were set at about 4.53 and 4.52 per cent on the three- and six-month issues, up 4 and 6 basis points, respectively, from the rates set a week earlier.

Open market operations succeeded in maintaining a generally comfortable tone in the money market. Bank credit, as measured by the credit proxy, expanded more rapidly than had been expected during the period but not, in my judgment, so rapidly as to have required implementation of the proviso clause--although the threshhold was about reached. The System absorbed reserves over the first three weeks of the period, but then turned around to provide reserves over the last three days, with the net effects of these operations about offsetting over the period as a whole. The reserve absorptions were accomplished mainly by redeeming some portion of maturing Treasury bills held in the portfolio and by sales to foreign accounts, and matched sale-purchase transactions were made on two occasions to absorb temporary bulges in reserve availability. Repurchase agreements were made on four occasions to meet temporary reserve needs, but the scale of such operations was far less than in the preceding interval between Committee meetings.

During the statement week ended last Wednesday, money market conditions were very easy as the result of float created by the Chicago blizzard, with the Federal funds rate below the discount rate much of the time. Perhaps we should have done more than we did to prevent the excessive ease that developed, but as we viewed the statistics at the time, this would have required publishing net borrowed reserves of $250 million or so on the same day the Treasury would be announcing the results of its refunding. We consequently decided to be content with a net borrowed reserve position of about $50 million, with the expectation that the market would attribute the low funds rate and the low level of borrowings at Reserve Banks to the special temporary situation that existed. We thought we had succeeded in this, but a last-minute revision of the Chicago reserve figures unexpectedly added $192 million to the weekly averages, and we wound up with free reserves of $154 million. I don't believe any permanent damage was done by this lapse into easier conditions than I believe the Committee had intended, although there are some people in the market that may have read more into the published figures than was there. Firmer conditions in the money market yesterday and over the remainder of this week may help dispel some of this overinterpretation.

As noted earlier, the Treasury's offering for cash of $5.5 billion 4-3/4 per cent 15-month notes and $2 billion 4-3/4 per cent 5-year notes, both priced at a discount, was very well received. The issues were priced to yield 4.85 and 4.84 per cent, respectively, in line with market rates prevailing on the day before the prime rate changes. With the change in the market it was readily apparent that the two new issues were underpriced and would sell at premiums of at least 1/4 and 1/2 points, respectively.

Against this background there was an inevitable attraction for free riders and speculators, as well as for regular investors in Government securities. Both issues were heavily oversubscribed, with large public subscribers receiving allotments of 10 per cent of their subscriptions in the short note and only 7 per cent in the longer note. As it turned out speculative demand, while large, was not as excessive as some had feared, and the allotments were about in line with market expectations. The System exchanged its holdings of $3,294 million of maturing issues for the 15-month note. Nonbank dealers have made good progress in selling their awards of $297 million of the short note and $310 million of the longer. At last night's close the new issues were bid at premiums of 7/32 and 17/32 over the issue price to yield 4.67 and 4.71 per cent, respectively. I might note, parenthetically, that while dealer positions continue to be large, and their holdings of coupon issues have increased with the Treasury's refunding, they appear to be relatively cautious about building them up further. Their recent profit experience has, of course, been very good. Contributing to this caution has been the heavy municipal calendar, the large volume of participation certificates to be marketed by the Federal National Mortgage Association and the Export-Import Bank by mid-year, and the suspicion that the decline in corporate bond yields may bring more financing into that market.

Had it not been for debt limit problems, the Treasury would most likely have announced an offering of $2-1/2 billion June tax anticipation bills before the end of this week for payment around February 24. It now looks as if congressional action on the debt limit will not come much before mid-month, and could be longer postponed if an unexpected floor fight develops over minority party proposals to link an increase in the debt limit to proposals for bringing participation certificates under the debt ceiling and for permitting the Treasury to finance up to $6 billion outside the 4-1/4 per cent interest rate ceiling. The latter proposal has a great deal of merit and is acceptable to the Treasury, but it is bound to cause lengthy debate and would be better considered apart from the immediate need to raise the debt limit.

As we look into the period ahead I would not anticipate any movement of interest rates comparable to those experienced in recent weeks in the absence of either further monetary policy moves towards ease or major public pronouncements that give rise to further expectation of lower rates or some move towards peace in Vietnam or some very bad economic news. I think that I would agree with the blue book[1/] that some technical upward adjustments in long-term rates are a possibility, although some further decline in rates could also develop, particularly if there is a general move to a 5-1/2 per cent prime rate. The bill rate, too, could tend to stabilize somewhere around the discount rate, although some minor movements above and below 4-1/2 per cent would not be particularly surprising. As far as the credit proxy and other aggregate measures are concerned, I believe that we should be very cautious in interpreting the available measures because of the tenuous nature of seasonal adjustments in this period of rapid change in financial flows.

As you know, the Board staff is projecting an increase in the credit proxy of about 9 - 11 per cent (annual rate) for February, or perhaps somewhat less if Euro-dollar borrowings by banks are taken into account. Our projections at the New York bank would show a slightly slower rate of growth, centering about 8-1/2 per cent. It would, of course, be helpful to me in interpreting whatever directive the Committee decides on at this meeting if the members of the Committee would indicate their views as to whether these expectations are roughly consistent with

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

the policy posture they favor. I should emphasize that while the blue book anticipates only a 2 per cent rise in the credit proxy from the end of January to the end of February, this result is heavily conditioned by the forced postponement of the Treasury's cash financing and, as the blue book notes, there should be a considerably sharper expansion in early March.

Mr. Maisel asked the Manager about the latter's attitude, given the Committee's directive, with respect to intervention in the market at the end of a statement week to smooth small changes. He (Mr. Maisel) had been somewhat surprised, for example, by the matched sale-purchase transactions the Manager had made in the recent period, and he wondered whether it might not have been preferable to leave the market to itself when it was moving in the direction the Committee desired.

Mr. Holmes said that the problem, as he saw it, concerned the speed with which the market was moving. Thus, on Tuesday, January 17, when the money market was extremely easy and net borrowed reserves for the week appeared very low, participants were tending to interpret the market situation as indicating that the Committee wanted easier conditions than it in fact did. The Desk decided to make some sale-purchase transactions on that day, and those transactions introduced a note of caution into the market which he thought was consistent with the Committee's intent. On the following day unexpected pressures developed in the market after West Coast banks had suddenly terminated their dealer lending operations. In this situation the Desk reversed operations, supplying reserves through repurchase agreements. In short, on Tuesday the Desk absorbed reserves to give a signal to the market and on Wednesday it supplied reserves.

Mr. Maisel said he questioned the philosophy that the market had to be given day-to-day signals by the Desk.

Mr. Holmes replied that he did not hold to such a philosophy. The Desk had remained out of the market over much of the recent period, but there had been occasions when operations were considered useful.

Mr. Brimmer noted that on the day to which Mr. Holmes had referred a question had been raised on the eleven o'clock conference call about the Committee's intent when it had authorized the use of matched sale-purchase transactions last summer. His feeling was that the Committee had authorized the Manager to enter into such transactions at his discretion, and had not intended that they should be used only under the temporary circumstances of the time. Since there had been some difference of opinion on the matter among those participating in the call he thought the question should be brought to the attention of the Committee.

Chairman Martin said his understanding was that the Committee had authorized matched sale-purchase transactions and had not withdrawn the authorization. He then asked Mr. Holland to comment.

Mr. Holland noted that the Committee had initially approved such transactions in July 1966 during the emergency for open market operations created by the airline strike. Subsequently the Manager had engaged in such transactions on several other occasions when temporary reserve excesses arose, and had kept the Committee informed concerning their use.

Mr. Holmes said it was his recollection that several members had commented on the usefulness of the device.

Mr. Hickman remarked that he had participated in the eleven o'clock call recently and had the impression that the Desk had intervened in the market in almost a minimal way in what was a difficult and turbulent period. While he had had some questions about matched sale-purchase transactions when they were originally proposed last July, he now thought they were useful. In any case, the Manager had made relatively little use of them in the recent period.

Chairman Martin said it was well that Mr. Brimmer had brought up the subject. If there was no objection, he would propose to have the record show that matched sales-purchase transactions were an instrument that could be used by the Desk in the regular course of its operations.

No objection was made to the Chairman's proposal.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in

> Government securities and bankers' acceptances during the period January 10 through February 6, 1967, were approved, ratified, and confirmed.

Chairman Martin noted that a memorandum had been distributed under date of February 1, 1967 regarding criteria for increasing membership in the Federal Reserve network of reciprocal currency arrangements. (A copy of this memorandum has been placed in the Committee's files.) He invited Mr. Solomon to comment.

Mr. Solomon said the memorandum had been prepared in response to the Committee's request at the meeting on November 22, 1966, when the question of extending the size of the swap network had been discussed and the central banks of four countries in particular had been mentioned as possible additions--Denmark, Norway, Mexico, and Venezuela. The memorandum attempted to consider the more general question and to develop for Committee consideration some systematic and objective criteria for membership in the swap network that would be readily explainable to countries both inside and outside the network.

In response to the Chairman's request for comment, Mr. Coombs said it seemed to him that the paper Mr. Solomon and his associates had prepared was a very good one. His only comment related to the discussion of possible disadvantages of enlarging the swap network. On the basis of the System's operating experience to date, he did not consider the risks to be serious in connection with the first three possible dangers noted--namely, that new members of the network might tend to hold fewer uncovered dollars; that many countries, impelled by prestige considerations to seek membership in the network, might attempt to demonstrate eligibility by appearing less willing to hold uncovered dollar balances; and that any damping of fluctuations in new members' reserves might increase public sensitivity to such fluctuations as did occur and thus lead to unwise policies designed to minimize even temporary fluctuations. Such developments, in his judgment, were not very likely. As to the fourth possible development noted--that certain present members of the network would be dismayed by a widening of the membership--Mr. Coombs thought that might well occur, especially on the part of the Dutch, Belgians, and French. Those countries might be somewhat disturbed because the entry of the Danes and the Norwegians would dilute their influence in matters relating to the dollar. On balance, however, that might be a desirable development.

With respect to the question of timing, Mr. Coombs noted that the Danes and the Norwegians had already indicated interest in joining the network and he hoped that an encouraging and sympathetic response could be given to them with a view to bringing them in by the late spring. There seemed to be somewhat less urgency with respect to Mexico and Venezuela, with whom the Treasury already had swap lines of $75 million and $50 million, respectively.

Mr. Mitchell remarked that he thought the staff memorandum was a valuable addition to background materials; it set forth some general principles under which the Committee could proceed, and that would be preferable to continuing to act on an ad hoc basis. While the memorandum did not go deeply into political questions, it was clear that the Committee had to protect its swap network against political attack to the degree possible, and one of the great advantages of the memorandum was that it laid out a factual and theoretical groundwork for protecting and justifying the network. However, he would want to consider adding another criterion to those listed for considering the inclusion of particular countries--the volume of U.S. trade with the country. He had discussed that matter with Mr. Solomon, who did not wholly share his view. But it seemed to him (Mr. Mitchell) that in terms of international relationships the trading partners of the United States were more important to it than countries that happened to use dollars in transactions. Accordingly, he would like to see the tables accompanying the memorandum expanded to include a table showing the U.S. trading position with each of the countries listed.

With respect to Mr. Coombs' point on timing, Mr. Mitchell thought that it would be well to initiate conversations with all four of the countries that had been suggested. He was not sure that the Venezuelans were prepared to qualify, but the swap line they had with the Treasury did not strike him as a substitute for membership in the

Federal Reserve network. On the whole, he was highly pleased with the staff memorandum and hoped that the Committee would give it favorable consideration.

Mr. Wayne said he would not attempt to substitute his judgment for those who had spoken, but he was not persuaded by the staff memorandum that there was justification for extending the network aside from the political considerations, and he had some reservations about extending the network for political reasons. Accordingly, he would like to see more discussion of the justification for adding countries.

Mr. Robertson indicated that his view was similar to Mr. Wayne's. He thought the criteria developed in the memorandum represented a long step forward on a path the Committee should be exploring. However, he also thought that in a matter of this kind the Committee should move slowly since its steps, once taken, could not be easily retraced. While criteria could be adopted which at the moment seemed to eliminate certain countries, if the network was broadened somewhat there was likely to be great pressure to include countries that did not meet the criteria. The Committee should give careful consideration to the hazards involved in broadening the network.

Mr. Daane said that while he thought the points Mr. Robertson had made were valid, the advantages of expanding the network seemed somewhat stronger to him than stated in the memorandum. As the recent discussions of the whole area of monetary reform had progressed the concept of participation had been broadened and the matter was now viewed as a responsibility of all members of the International Monetary Fund. The U.S. position throughout the discussions had been in favor of a wider rather than a narrower concept in terms of participation, and expanding the swap network would be supportive of this. There also would be advantages to expanding the network in terms of the System's operations, and he did not regard those advantages as merely political. Every country merited equal consideration in deciding whether it met the criteria established for membership. He would favor moving slowly when new ground was being broken, but he did not think this was entirely new ground. He thought the Committee should consider the memorandum favorably.

Mr. Hayes said he found himself of much the same view as Mr. Daane, although he recognized the reasons for caution in expanding the network. The considerations advanced by Messrs. Solomon and Coombs did not strike him as essentially political in nature. They were economic considerations, and there was a real logic for including more countries on purely economic grounds. The basis on which one negotiated with individual countries might well differ in each instance, and he personally did not feel qualified to say that negotiations should proceed rapidly with one country and slowly with another; he would prefer to leave such decisions to the staff members operating in the field from day to day. He agreed with Mr. Coombs' point about the Scandinavian countries; he thought there was some advantage to having additional European countries in the network that were not members of the Common Market. He had nothing against inclusion of Mexico and Venezuela. It should be recognized that inclusion of two Latin American countries would raise some question in the minds of others, but there were so few that were likely to qualify that he did not think the problem would be serious. He had a generally favorable view of the matter.

Mr. Brimmer said he supported the expansion of the swap network. He agreed that it was wise to have additional European members, but he thought it might be particularly useful to the United States to have western hemisphere countries in--especially Mexico, which evidently could meet the criteria and might be willing to join. He wondered if the subject had been discussed with the Treasury Department and, if so, whether they had any attitude toward it. Finally, while he agreed with that part of the second proposed criterion which read, "The central bank, with its government's approval, . . . should be prepared . . . to exchange relevant information freely and frankly, without diplomatic participation and intervention," he hoped it would be agreeable to the Committee for the diplomats to be kept acquainted with the negotiations.

Mr. Coombs said he had held only brief discussions with the Treasury on the subject. It was his impression that the Treasury would like to continue its swap arrangements with Mexico and Venezuela, but that it would have no objection to the inclusion of those countries in the System's network. In general, he thought the Treasury would support the proposal. It was also his impression that the proposal would be warmly welcomed by the central banks of Mexico and Venezuela.

On the point that had been raised regarding political aspects, Mr. Coombs continued, he felt sure that the approach that had been made by the Governors of the Banks of Denmark and Norway had no political overtones. In his earlier comment about diluting the influence of the French, Belgians, and Dutch he had not meant to refer to the Governments but rather to the central banks, which had taken an unduly aggressive attitude with respect to U.S. negotiations with other countries.

Mr. Mitchell said that in his earlier reference to political aspects he had meant to employ that term in a broad sense. He viewed the System's relationships with all central banks as basically banking relationships. But those relationships tended to shade into the political area, and it was with that political periphery that he thought the Committee had to be concerned. It seemed to him that if the network of central bank relationships was well conceived the political infringement would be minimal. The network should have a basis--a justification and a logic--which made it immune to political attack.

Mr. Wayne noted that he had raised the question of justification, but he would add that he was not objecting to enlargement of the network. It seemed to him that the principal responsibility for broadening international liquidity lay with the IMF and with Governments, and that when the System entered into swap arrangements it should do so with the recognition that its prime responsibility was to protect the interests of the United States. He would like to see a somewhat better case made for extending the network in terms of the nation's interests.

Mr. Daane said that the two matters to which Mr. Wayne had referred were quite separate and distinct. The liquidity discussions in their present form were concentrated largely on the construction of a new reserve asset, which presumably would take its place alongside gold and currencies in international reserves. The swap network, on the other hand, was designed to deal not with the basic problem of growth in reserve assets but rather with volatile flows that might prove upsetting to the U.S. dollar in the first instance and to the functioning of the whole international monetary system in the second. He thought the basic question at issue with respect to any proposed swap arrangement was the contribution it would make to the protection of the dollar.

Mr. Wayne responded that he had seen no evidence to indicate that swap arrangements should be made with Mexico or Venezuela on the basis Mr. Daane had mentioned.

Chairman Martin said that the staff paper struck him as an excellent contribution. Personally, he had been leaning toward the view that the System's network should be broadened when it was possible to do so. He thought the swap network was one of the distinctive achievements of the System, but Mr. Robertson's point that the Committee should move slowly in broadening it was a good one. If Mexico and Venezuela were included there would be pressures to add other countries. On a matter as important as this he thought it would be desirable for the Committee to consider today's discussion as preliminary in nature and to withhold action pending further consideration. He would not want to hamper negotiations but since there were differences of opinion he suggested that the Committee postpone action until its next meeting to give members time to study the issues further.

Mr. Scanlon said that he favored enlarging the swap network, but he questioned whether the Committee could rely on the staff memorandum alone to provide the basis for decisions with respect to particular countries. The various criteria were well outlined in the paper and the disadvantages and advantages of enlarging the network were noted. However, he thought that the basis for selecting the particular cut-off points mentioned--in terms of reserves, foreign trade, and so forth--was not sufficiently documented. The Committee had to justify those cut-off points; otherwise it would be in the position of simply selecting points that would admit the particular countries it wanted to include in the network. He recognized, of course, that an element of judgment would be involved in any cut-offs.

Mr. Solomon replied that the cut-offs noted in the memorandum had, indeed, been deliberately selected to include the four countries in question. The purpose for doing so was to determine what other countries would be eligible on criteria that included those four countries.

Mr. Scanlon agreed that the memorandum had made that point quite clear. Nevertheless, he believed that further consideration of the criteria was required if the Committee was to be able to defend them.

Mr. Solomon said the staff could undertake to prepare papers on each of the four individual countries for the Committee. He did not know whether it would be possible to complete all of the papers before the next meeting, but as many as possible would be done by that time.

Chairman Martin said he thought it would be useful to have as many such papers as possible. He repeated his suggestion that a decision on expanding the network be held over in the hope that final action could be taken at the next meeting.

There was no disagreement with the Chairman's suggestion.

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

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

> Each year at about this time, the staff presents to the Committee an analysis and critique of the GNP projection underlying the Administration's budget. Some of the problems we encounter remain the same from one year to the next. For example, the official projection, as published in the Economic Report, does not include sufficient detail on the quarterly time path or on expenditure components to permit a close assessment of the financial implications of the model. As usual, we have supplied these details--in close consultation with the Council--and believe the patterns are reasonably accurate, even though unofficial.
>
> What is new this year is the role that monetary policy is given in achieving the economic levels forecast by the Administration. Although the press and business journals have apparently done a better than usual job in describing the official economic outlook, what hasn't been made clear--as far as I know--is just how much monetary easing would be required to keep the economy on the growth path envisaged by the Council. This is the focus of the staff's analysis this morning. The state of the art limits us to rather rough approximations, but our estimates of financing needs are probably close enough to provide a reasonable basis for evaluating alternative long- and short-run strategies for monetary policy.
>
> The first step in the process is a detailed examination of the official model to delineate critical expenditure areas and timing patterns. Mr. Koch will begin the analysis.

Mr. Koch then commented as follows:

The economic model underlying the Administration's budget assumes a rise in GNP of almost $50 billion over the year ending in the fourth quarter of 1967. The increase projected by the Council of Economic Advisers amounts to about 6-1/2 per cent--significantly smaller than the gain over the preceding year.

In constant dollars, or real terms, however, growth is expected to maintain the 4 per cent rate of the past year, with price increases accounting for a smaller part of the rise in current dollar GNP. Average prices of goods and services, as reflected in the deflator, are assumed to increase about 2-1/4 per cent during the year.

The pace of activity slows decidedly in the first half of 1967, with quarterly GNP increases averaging $9-1/2 billion, well below the average in 1966. The weakness, however, is relatively short-lived. After mid-year, activity is expected to accelerate briskly and by the end of the year GNP gains would approach the very large gains of late 1965 and early 1966. In contrast to last year, Federal defense expenditures slow down during 1967, and expansion in private expenditures becomes the decisive factor sustaining economic growth.

The first half slow-down results mainly from a sharp decline in the rate of inventory buildup and a reversal of the uptrend in stock-sales ratios. In the fourth quarter, business inventory accumulation climbed to an annual rate of $15.6 billion--a new postwar peak--and the stock-sales ratio rose to the highest level since mid-1961.

A downward adjustment in inventory investment thus seems likely, particularly in view of the slowing in private final sales late last year, and the smaller advance in prospect for defense spending. The decline in the rate of inventory accumulation projected in the CEA model continues until mid-year. The stock-sales ratio recedes--but not to the low of early 1966.

The reduced growth of GNP in the first half, though mainly the result of the dropoff in inventory accumulation, also reflects a slackening in Federal purchases. But the substantial step-up projected by the CEA for private final sales (including purchases by State and local governments) prevents the first half from being considerably weaker. A rapid turnaround in residential construction expenditures and substantial gains in consumption provide the major impetus for the growth in final sales.

This bullish outlook for private final sales permits the speedy cleanup of excess inventories. Postwar inventory adjustments generally have been sharp, and have acted as a drag on private final sales and over-all economic expansion for several quarters. In 1957-58, for example, the adjustment in inventories occurred from lower levels of accumulation, but private final sales leveled off. In 1967, by contrast, final sales are projected to accelerate. Even during the inventory adjustment of the Korean War period, private final sales advanced less than in the 1967 projection, and inventory investment turned negative before the adjustment was completed.

In the Council's model, housing is one of the most important sources of stimulus for expansion during 1967. The expectation is that housing starts and residential construction expenditures will begin to rise soon, and accelerate after mid-year. By the fourth quarter, housing starts are back to a 1.5 million annual rate, and expenditures have almost completely recovered the sharp decline in 1966.

Consumption also rises briskly in the first half, following a pronounced lag at the end of 1966. Gains in the last half continue sizable, as the contractive influence of the mid-year income tax increase is offset by higher social security payments. Growth in consumption for the year exceeds last year's increase. Higher spending is concentrated in nondurable goods and services--autos and other durables are expected to show little change.

This optimistic view of consumer spending depends, in part, on a continued growth in disposable income about as fast as in 1966. But consumers also spend a somewhat larger portion of their after-tax income, and the savings rate declines in the last half to the low rate of 4.7 per cent.

Business fixed investment, on the other hand, would be a relatively neutral influence in 1967. It shows only a small further rise early in the year and then stabilizes. This ends the remarkable 5-year expansion which raised fixed capital outlays to the highest share of GNP in the postwar years. Termination of the investment boom is consistent with expectations of declining profit margins and reduced capacity utilization. As a share of GNP, business fixed investment would decline moderately.

Our staff projections of GNP in the first half, shown in the green book[1], are less optimistic than those of the CEA. For inventories and Federal purchases, our projections are close to those of the Council. But we are not persuaded that private final sales will rebound so vigorously that they offset much of the drop in inventory accumulation.

Turning to major components of private final sales, we do not look for a sudden surge in consumption. Certainly, there is no evidence of it in recent retail sales figures or in surveys of consumer spending plans. Nor are we as optimistic as the Council concerning the speed of the recovery in residential construction, where we expect the increase to be delayed until the second half. Despite the rapid revival in savings flows to thrift institutions, getting a housing boom under way takes time. Finally, we are somewhat less sanguine about business fixed investment over the near-term. In our view, all this adds up to a slower growth in final sales over the first half.

Even if we accept the Council's more optimistic first-half estimates, and then translate their GNP figures into changes in physical output and capacity use, we find that the increase in manufacturing production slows appreciably this year. Output would not increase in the first half, and the moderate gain after mid-year would raise the production index only about 3 per cent for the year. With capacity continuing to grow, the utilization rate would fall to 87 per cent by the fourth quarter--the lowest level since late 1964.

Unemployment, however, would remain about as low as in 1966. For while employment gains in manufacturing would be small, substantial increases in service expenditures, State and local government purchases, and residential construction would generate strong demands for labor in these industries.

Labor force growth this year, moreover, is expected to be more in line with normal trends, in constrast with last year's extremely large increase. The decline in labor force growth would be reflected in a smaller increase this year in employment, since unemployment is projected to remain relatively stable. Even though the projected

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

increase in the Armed Forces is less this year, the gain in civilian employment would also be much smaller.

Mr. Wernick, turning first to the wage and price implications of the projections, continued the presentation as follows:

Last year's sharp increase in hourly compensation was not unexpected in the context of high over-all demands, rising consumer prices, and a tight labor market. Wage gains after mid-year generally followed a 5 per cent pattern. Meanwhile, productivity growth in manufacturing slowed, and there was little further gain in output per manhour after mid-year. Unit labor costs then began rising faster, and in the last quarter of 1966 were 2.7 per cent higher than a year earlier.

As we interpret the labor market implications of the Council's projection, we see little basis for expecting a change in the trend of hourly compensation, despite some easing in industrial employment indicated for the first half. Lagged effects of last year's consumer price increases, together with higher minimum wages, point to continued gains of 5 per cent or more in hourly compensation. With capacity utilization declining, while manufacturing output grows slowly, a sharp increase in output per manhour does not seem likely to us, so we are projecting only a moderate rise. Consequently, unit labor costs should advance about as rapidly as in the latter half of 1966.

The upward movement of wholesale prices slowed late in 1966, as the influence of improved supplies--for foodstuffs and a number of sensitive materials--outweighed cost pressures on industrial commodities.

In the consumer sector, prices of foods began to decline in the fall, and the rise in the consumer price index then slowed appreciably. But demand and cost pressures remained strong for the broad spectrum of consumer services, and these prices continued to rise at a 5 per cent annual rate.

Favorable developments with respect to food prices and materials, together with some slack in capacity use, might continue to offset upward cost pressures on industrial prices--in the early months of 1967. But with profit margins under pressure, and the pace of activity accelerating in the second half, it seems optimistic to assume that the rise in prices can be kept close to 2 per cent during 1967, if economic activity does advance in line with the Council's projection.

As we noted earlier, the Council's model has the economy bouncing back quickly from the inventory adjustment of the first half. But the deficit in the Federal budget is not the principal factor accounting for the speed of the recovery. The quarterly pattern for the national-income-accounts deficit projected by the Council does suggest some fiscal stimulus during the first half, but the deficit in this period stays close to the fourth-quarter 1966 level. Thereafter, it tapers off, and turns into a small surplus by early 1968.

The declining deficit after mid-year partly reflects the slower advance of expenditures following the large rise proposed for social security benefits in the third quarter. Subsequently, expenditures rise more slowly than in 1966, mainly because of the moderated expansion in defense spending.

Receipts, meanwhile, are bolstered by continuing growth in private incomes and scheduled tax increases. The effect of the Administration's income tax proposal is concentrated in the third quarter, when receipts rise rapidly. Social security taxes also advance in January 1968.

If fiscal policy provides so little of the impetus to the second-half acceleration in GNP growth, what, then, accounts for the quick and vigorous recovery from the inventory adjustment?

The Council appears to assign the strategic role to easier monetary policy in its assessment of economic performance in 1967. The rebound foreseen for the second half would be unlikely unless private final sales responded promptly and strongly to measures of monetary ease. Business incentives to invest in fixed capital would be weakening in the first half, but ample availability of credit at low costs could be an important sustaining factor. Also, consumer spending has recently been sluggish, but here, too, the cumulative effect of last year's credit restraint may still be taking its toll.

It is in the housing sector that dependence of the Council's projections on monetary easing is most clearly evident. Starts must turn up soon, retrace last year's abrupt decline, and reach 1.5 million units by the fourth quarter. Residential construction expenditures also recover most of the 1966 decline. The implication is clear: mortgage funds must soon become cheap and readily available. Monetary ease sufficient to stimulate this rapid recovery in housing would, of course, directly affect other types of spending, such as business fixed investment and consumer durables. And since increased expenditures in these areas would raise incomes and output, there would also be an induced increase in spending, especially for consumer goods and inventories.

We conclude, therefore, that the financial assumptions underlying the Council's GNP model imply a return to conditions in the mortgage, and in other credit markets, broadly similar to those prevailing, on average, during 1965. This conclusion provides the basis for our financial projection, which will be presented by Mr. Gramley.

Mr. Gramley commented as follows:

The financial conditions implicit in the Council's GNP model suggest the likelihood of a rise in borrowing relative to net investment. Last year, even though net investment outlays rose, household and business borrowing declined. Tight money took its toll in private credit expansion, especially in the last half.

In 1967, net investment in the CEA model drops abruptly, mainly because of reduced inventory accumulation. Nevertheless, our financial projections suggest that if the investment total were realized, borrowing would stay close to last year's level, narrowing the gap between investment and borrowing.

The increase in borrowing relative to spending occurs mainly in household use of mortgage credit. Mortgage money must be amply available to finance new construction, and also to meet pent-up credit demands to finance existing property transactions. The ratio of mortgage borrowing to housing expenditures, which fell precipitously in 1966, thus is projected to rise toward the 1964-65 peaks.

Corporate borrowing was also limited last year by severe restrictions on the availability of bank loans, and corporations made deep inroads into liquid asset holdings late in the year. Some liquidity rebuilding seems in prospect. Thus, corporations are projected to borrow about as much in 1967 as in 1966, even though their investment in real assets is lower and their gross retained earnings higher. Borrowings would be especially large in the first half, when the final instalment on accelerated tax payments is made, but would tail off in the final six months.

This half-year pattern shows up mainly in bank loans, which are projected to rise somewhat more in the first half than in the same period of last year. Loan growth slows appreciably in the second half, when the stimulus of tax borrowing is withdrawn, and inventory accumulation is quite low. The projection also calls for another big year for bonds and stocks, since corporations seem likely to stretch out debt maturities this year to improve their liquidity positions.

In sum, funds raised by private nonfinancial borrowers during all of 1967 are projected at about last year's average level. Credit expansion would once again be higher in the first half, but with mortgage borrowing rising over the year, the half-year pattern would be less uneven than in 1966.

Total Federal borrowing, including sales of participation certificates indicated in the budget, would be about $9 billion for the calendar year, compared with $7 billion in 1966. And perhaps it would be well to recall that the Federal deficit often turns out to be larger than depicted in the January budget document. Foreign borrowing, as measured in flow of funds accounts, is projected to increase, reflecting easier domestic credit conditions.

This total of funds raised is substantial--a bit larger than the advanced levels of 1965 and 1966. High rates of credit expansion would be required at banks and other financial institutions to make this amount of funds available on favorable terms.

To stimulate residential construction, an abundance of funds must flow into nonbank intermediaries specializing in housing finance. Inflows of shares and deposits to savings banks and associations would have to be restored to about 7 per cent--or near the 1965 pace. Marked improvement has already occurred--in December, the net inflow equaled the 7 per cent annual rate projected for all of 1967. Special factors influenced December gains, however--including larger interest credits, a high fourth-quarter savings rate, and a return flow of money transferred earlier to the securities markets. Maintaining this growth rate through all of 1967 would likely require some further widening of the yield spread between market instruments and savings shares.

In the banking system, the amount of credit expansion consistent with a significant thawing in lending policies depends importantly on bank desires to rebuild liquidity. The ratio of securities to total earning assets has declined markedly in recent years, to about one-third by the end of 1966.

Growth of total loans has been quite rapid throughout this long period of economic expansion. Last year, loan growth fell below the extraordinary 1965 pace, but the growth of total bank credit fell even more, and security holdings were reduced for the first time since 1959. Moreover, bank attitudes toward liquidity were colored by the discovery that CD's could not always be counted on as a source of reserve adjustment.

Our projection calls for banks to rebuild liquidity somewhat during 1967 as an accompaniment to relaxing loan policies. The projected improvement in the ratio of securities to earning assets is small, but--with loan growth projected at nearly $17 billion--a $10 billion expansion in security holdings would be needed to accomplish it.

Total bank credit would thus have to rise by $27 billion--about a 9 per cent rate--for the full year. Growth would be largest in the first half, in line with the more rapid expansion of credit demands during this period.

The accompanying deposit expansion would likely be registered principally in bank time deposits. The projected rate of 13 per cent is below that for 1965--when interest rates on time deposits rose sharply--but well above the rate for 1966. This year, accelerated growth would be stimulated mainly by the decline in market interest rates relative to those on time deposits. Time deposit expansion has already achieved a 17 per cent annual rate in January, but this high rate reflected shifts of existing assets from the money market accompanying the sharp decline in short-term market yields, and is not expected to continue. Offering rates on CD's recently have been cut back, and the weekly gain in CD's at New York banks last week was moderated.

Expansive policies giving rise to rapid time deposit growth would, of course, reduce interest rate incentives to economize on money holdings, and money stock growth would accelerate also. Our projection of a 4-1/2 per cent growth rate in 1967 represents a rough judgment, based on recent experience, as to how the public might distribute its deposit increase between demand and time deposits. With this distribution, bank reserves would have to increase by about 7 per cent to support the deposit expansion.

Sources of funds supplied to borrowers would be altered appreciably by these large inflows to commercial banks and nonbank intermediaries. The bank share would return to 36 per cent, or close to the 1965 level, while the share supplied by nonbank intermediaries would also recover the ground lost in 1966. As usual, the offset would be a marked reduction in the share supplied by the nonfinancial public directly to credit markets through security purchases.

This decline in the public's share, in our projection, does not reflect the attraction of increased rates on savings deposits pulling funds from the securities markets. Average yields on deposits and shares are not likely to change much this year, apart from downward adjustments in CD rates. The reduced attractiveness of market securities would thus reflect reductions in their yields.

Market interest rates already have declined abruptly from last fall's peaks. In the long-term securities markets, expectations have been a fundamental factor, and a continued high rate of bank credit expansion would likely be needed to validate the decline that has occurred. Nevertheless, it seems probable that interest rates would have to fall further to be consistent with the GNP model and our financial flow projections.

As a rough judgment, rates on long-term marketable securities--represented here by corporate new issues--might have to fall by another 25 basis points, or more, to about 4-3/4 per cent--by mid-year or earlier. For three-month bills the drop in rates might well be greater, since the present yield curve is less steeply sloped than is customary for a period of easy credit markets. A range around 4 per cent for bills would be consistent with the long rates projected, but the shape of the yield curve would be affected importantly by the Treasury's debt management policies this year.

Mr. Reynolds will continue the presentation, focusing on the international implications of the GNP model and the financial projection.

Mr. Reynolds then commented as follows:

The easing of domestic credit conditions that has been described would significantly affect international capital flows, although the IET and the voluntary restraint programs should help insure that outflows of U.S. private capital will not mushroom as in 1964. Net outflows into direct investments and foreign securities may not change much. But bank credits to foreigners could easily swing from last year's $300 million reflow to an outflow of $1/2 billion this year, even if European financial markets continue easing. In total, net outflows of U.S. private capital are likely to increase by roughly $1 billion, mainly reflecting the swing in bank credit.

Short-term borrowing abroad by U.S. banks through their foreign branches would be even more strikingly affected by domestic financial ease. Liabilities to foreign branches tripled last year, rising by $2 billion in the second half alone, when the U.S. financial squeeze was tightest and when funds were being shifted out of sterling. We expect a substantial reduction in these liabilities this year--part of which has in fact already occurred. Mere cessation of last year's inflow represents a change in flow of $2-1/2 billion. To the extent that liabilities to branches decline, the change, and the resulting deterioration in the official settlements balance, is that much greater.

For transactions in goods and services, the Council's GNP model suggests a marked improvement this year, in contrast to the worsening on capital account. Exports of goods and services should continue rising despite slackened demand from Canada, Britain, and Germany during the first half; shipments to Japan and to nonindustrial countries will be expanding vigorously.

The rise in imports of goods and services slackened at the end of 1966. Total imports should decline in the first half of this year because merchandise imports will decline. In the second half, however, merchandise imports and the total will be rising again.

The favorable balance on goods and services should increase during the year; but it will be flattening out at year-end, at a rate about $2-1/2 billion higher than in 1966 but $1 billion below the peak attained in 1964.

Merchandise imports will decline during the first half mainly because of the effects that reduced inventory growth will have on imports of industrial supplies. These imports should temporarily fall almost as much as they did in 1960-61. Imports of nonfood consumer goods should level off; much of the recent rise has reflected adjustment by automobile companies to the 1965 agreement with Canada. Imports of capital goods should also level off as domestic pressures on capacity diminish.

Results of our projections for 1967 within the Council's framework thus include an improvement of about $2 billion on goods and services, and a $1 billion increase in net outflows of U.S. private capital. There could also be a decline of $1 billion in net inflows of foreign nonliquid capital. Investments by foreign official and international agencies in nonliquid U.S. assets may be more difficult to arrange this year. Also, debt prepayments may be smaller.

In terms of the over-all balance, these and other minor changes add up to a probable enlargement of the liquidity deficit this year. Of longer-term importance, if domestic demand is advancing as swiftly by year-end as the Council anticipates, and especially if prices and costs rise more than it anticipates, the improvement on trade might be relatively short-lived.

The balance on official reserve transactions would shift from last year's small surplus to a large deficit. For 1966 and 1967 together, the average deficit on reserve transactions might be roughly $1-1/2 billion, which would be about the same as in 1964 and 1965. The ballooning of this deficit in 1967 could imply another substantial drain on our gold reserves, depending on which countries gain reserves.

Mr. Brill will now discuss the implications of the projections for Federal Reserve policy.

Mr. Brill's concluding remarks were as follows:

Let me first underscore, as we often have, that the state of the forecasting art is still primitive, especially with respect to changes in relationships between financial variables and GNP. Nevertheless, our estimates strongly indicate that realization of the Council's GNP model would call for still easier conditions of bank credit and in credit markets than have developed since the turn in policy last year. The strategic question facing the Committee is whether policy actions should be directed towards creating this further ease in the months ahead, and in particular, whether continued policy easing is appropriate at the moment.

A case can be made for pushing further at this time. Our own projections of GNP for the first half are, as noted earlier, less bullish than those of the Council. But neither of us is projecting the weak economic picture often associated with periods of inventory adjustment. Final sales often weaken more than is suggested here when declining inventory investment leads to production cuts and income loss. It is much too early to conclude that this prospect can be ruled out. The production index was down in January--perhaps by a full point--and retail sales did decline. Monetary hesitation now, therefore, still runs the risk of results that are too little and too late.

But there also are serious risks running the other way. It appears to us that output per manhour will increase slowly next year. With increases in hourly compensation of at least 5 per cent, there could well be significant upward pressure on costs. In the climate of rapidly expanding activity projected by the Council for later this year, incentives would be strong to pass through these cost increases to prices.

Cost and price increases could cut short the recovery anticipated in our trade balance, so essential in light of the expected worsening in U.S. capital accounts this year. De-escalation of the international interest rate war is not a complete guarantee that monetary policy can ignore balance of payments constraints.

Finally, the odds must be carefully weighed as to whether fiscal policy will develop along the lines envisaged by the Council. We adhere to our position that military and budget officials are in a better position than central bankers to gauge the probable trend of defense expenditures. Nevertheless, barring an end to active hostility in Vietnam, the official estimates are undoubtedly best regarded as minimum estimates.

Uncertainty with regard to passage of the tax proposal, and its implications for the deficit, also raise questions for monetary policy. Instead of a decline in the Federal deficit after mid-year, there would be a significant increase if the tax proposal were not passed.

Prospects for passage of the tax bill will depend partly on the course of economic events in the first half. In the context of the slower growth projected by the Council during this period, Congressional approval is by no means certain. If our own weaker first-half forecast materializes, the chances of passage are even smaller.

Failure to pass the tax bill would, of course, change greatly the economic outlook for the second half. With the monetary easing stipulated earlier, omission of the 6 per cent surcharge would mean significantly more rapid GNP growth in the third and fourth quarters of this year and into 1968.

On balance, then, it seems to us that there are several critical aspects of the CEA projection with which forecasters' judgments may differ, with consequent differences in policy prescription. On the one hand, the projection could be overstating the strength of the economy in the winter and spring, and it could be overstating the vigor of the rebound after mid-year, particularly in consumers' willingness to spend. But on the other hand, the CEA could be overoptimistic about the likelihood of additional fiscal restraint, and even with a tax increase, the projection may be underestimating the potential for cost and price pressures emerging later in the year and into 1968.

Weighing the risks involved, it would appear to us that a prudent longer-run strategy for monetary policy would be to continue to work toward ease, but to stop somewhat short of the conditions called for in a strict interpretation of the CEA model. We don't want to carry ease so far as to require another severe wrench to the financial structure later in the year if our GNP forecasts have to be modified.

With respect to shorter-term developments, the speed of adjustment in financial conditions we've had over the past two months is somewhat frightening to an economist who is not yet sure of the consequences of rapid changes in the value of the community's financial wealth. This concerned me last March, when rates were rising so rapidly, and the converse worries me now.

Given the longer-term strategy just noted, and weighing shorter-term concerns, the staff's view of an appropriate policy decision today would be to hold the line on financial conditions until the next meeting of the Committee, while intensifying efforts to assess the effects of recent monetary

> easing on the real economy. As the blue book indicated, holding the line over the next four weeks would mean bill rates remaining in a 4.40 to 4.60 per cent range and long-term rates hovering close to their current levels. Marginal reserve availability would drop back from the storm-induced peak, with net borrowed reserves averaging close to $50 million over the period.
>
> These market conditions would, we hope, be consistent with a bank credit proxy averaging about 10 per cent higher in the month of February over the month of January, although the rise would be much less on a month-end to month-end basis. If deviations from the money and credit conditions specified should begin to emerge, I would argue that action should be prompt to dampen tendencies of rates to move up. Any persisting rise in yields could, at this juncture, inhibit the trend toward liberalization in bank and thrift institution lending policies before financing of a strong spring building season is assured. But a persisting downward pressure on yields accompanied by shortfalls from the projected banking aggregates could be signaling a greater-than-expected weakness in basic demands for both credit and goods, to which the System should respond with generous reserve provision.

Mr. Ellis said that he understood from the presentation that the staff questioned the Council's projection that the GNP deflator would rise by a little over 2 per cent in 1967. He noted, however, that the green book projected a similarly reduced rate of increase in the deflator, and he asked Mr. Brill to comment.

In reply, Mr. Brill noted that the green book projection related only to the first half of 1967. He did not recall at the moment whether there was any significant difference between the deflators projected for the first half in the green book and in the Council's model. However, what the staff questioned was the likelihood that the price rise could be kept close to 2 per cent for the full year, and in particular, in the second half.

Mr. Swan noted that among the money market conditions the blue book suggested might be taken as representing no change from prevailing conditions was a Federal funds rate in the range of 4-3/4 - 5 per cent. He asked whether such a range would not be higher than that which had actually prevailed recently.

Mr. Axilrod said that such a Federal funds rate, if anything, probably would be a shade lower than the recent average, if one excluded the effects of the snowstorm in the Midwest on the figures for the February 1 statement week. In general, the complex of conditions to which Mr. Swan had referred reflected those recently prevailing, excluding the effects of the storm.

Mr. Hickman asked whether in his concluding remarks Mr. Brill was recommending that interest rates should be permitted to ease if, with net borrowed reserves around $50 million, bank credit failed to expand.

Mr. Brill said he was suggesting that an easing in interest rates associated with a failure of bank credit to expand as expected would indicate that the economy was weaker than projected. Under such circumstances he thought that rates certainly should be permitted to decline.

Mr. Mitchell asked whether his understanding was correct that the staff projected a decline in bank loans in the first half of 1967.

Mr. Gramley indicated that that was not the case. For the full year 1967 the staff projected bank loan growth to be a little slower than in 1966, but the increase indicated was still substantial. The reduction from 1966 growth in the projection reflected relatively weak demand for bank credit in the second half of 1967, associated with the relatively low levels of inventory accumulation shown in the Council's model, plus the ending of the stimulus to corporate borrowing from the acceleration of tax payments.

Chairman Martin remarked that the chart show was highly illuminating and he thought it was an excellent presentation. The Chairman then called for the go-around of comments and views on economic conditions and monetary policy, beginning with Mr. Hayes.

Mr. Hayes commented that he also had found the presentation illuminating. He then made the following statement:

> We find ourselves in one of those periods when uncertainties in the business situation are very great, or, as we sometimes express it, when "visibility" is unusually low. Estimates of the probable strength of the economy range over a fairly wide spectrum. But I think the picture becomes somewhat clearer if we make an effort to distinguish between shorter-term and longer-term prospects.
>
> The short-term outlook is bound to be strongly influenced by the fact that the fourth-quarter accumulation of inventories was much greater than expected and that inventories appear excessive in relation to sales in a number of industries. Hence the main question

facing the economy in the near term concerns the speed and extent of the needed inventory adjustment and its repercussions on other economic developments. The momentum of the private economy may weaken further in the next few months. A slowdown in the expansion of total output is likely to continue or even to become more pronounced, and there may perhaps be some slight rise in unemployment.

However, while we cannot exclude the possibility of a resultant deterioration in the whole business climate, it seems much more likely that the underlying forces in the economy are strong enough to absorb the inventory drag relatively smoothly. Indeed, in the latter part of 1967 the elimination of the inventory drag and a vigorous revival of residential construction could lead to another excessive rise in private demand. I might say parenthetically that GNP projections made at the New York Reserve Bank are very close to the Council's, and perhaps a shade stronger for the second half of the year. Already the housing indicators are pointing upward, so that one very large drag on the growth of the economy over the past few quarters seems about to be reversed. Also, the boost that enlarged social security benefits will give to consumer spending will be considerable--more than enough to offset the impact of the personal income tax increase, if the latter is enacted. According to our analysis, the fiscal 1968 budget, while less stimulative than those of 1966 and 1967, will still provide greater stimulus to the economy than did the budget in the early sixties when large unused resources were available. Furthermore, the stimulus is likely to be more pronounced in the second half of calendar 1967, when private demand may well be expanding more strongly than in the first half. I hasten to add that the budgetary outlook is of course full of uncertainties, including the major question as to Vietnam developments, the possibility of additional outlays for anti-ballistic missiles, and obvious questions as to Congressional disposition of the Administration's latest spending and tax proposals.

While the current business slowdown has moderated price pressures, unit labor costs continue to rise, and I think we all agree that the prospects are disturbing with respect to possible excessive wage increases in 1967. This persistent danger of inflation has particularly serious implications when we are banking heavily on some considerable improvement in the trade surplus as a major means of reducing our international payments deficit. It may be worth noting that, without the benefits of special transactions, our liquidity deficit in 1966 would have approximated $3 billion, and on the same basis the annual rate of deficit in the fourth quarter was around $5 billion. The need for improvement in our trade surplus is highlighted by the evidence that some outward capital flows have already been induced by the easier domestic credit conditions and lower interest rates of the last few months. For example, liabilities of U.S. banks to their foreign branches are now substantially below their mid-December peak; and a further reflux of these funds would not be surprising, with the probable consequence of growing pressure on our gold stock.

The very large rise in total bank credit in January on a seasonally adjusted basis was attributable largely to security acquisitions and loans to security dealers; and business loans also rose more than seasonally. Opinions differ among bankers on the probable strength of loan demand in the coming months, but a majority of the big New York banks expect to see ample lending opportunities. Bank lending policies remain cautious despite some drop in loan-deposit ratios. There is no doubt that many large banks looked upon the Chase reduction in the prime rate to 5-1/2 per cent as decidedly premature. I believe many of them would not have initiated a move at this time even to 5-3/4 per cent, although they found that rate an acceptable compromise. One banker expressed to me the view that the 5-1/2 per cent prime rate was warranted only on the assumption that the Federal Reserve System was planning an additional major policy move in the direction of ease.

Expectations are playing a very big role in all credit markets for the moment; and it would seem wise under present circumstances for the System to avoid feeding unduly the expectation of a further easing of credit and a further major decline in interest rates. It would be well to let the market settle down after the sharp changes of the last month or two. We could easily find ourselves a little later in the year faced with the necessity of sharp back-tracking, with all the political repercussions that might accompany such an effort. I recognize that monetary policy should always enjoy flexibility, but to me that does not mean excessive preoccupation with the immediate future to the exclusion of serious longer-run problems. Moreover, the balance of payments must remain an important consideration for monetary policy and cannot simply be left to be taken care of by specific Government restrictions. It is clear that the year ahead will be difficult in this area in any case, without compounding the problem now through excessive monetary ease. Finally, as I have already indicated, we have only a rather vague view at this time of the over-all impact of the Federal budget on the economy in 1967.

I feel, therefore, that we would do well to hold to a steady policy at this time and refrain from further easing. We are achieving our objective of a revived growth of bank credit. In fact, the January rate of growth would be clearly excessive if maintained for several months running. The Board staff's projection of 9 to 11 per cent for growth of the credit proxy in February is a bit in excess of our own projection and is at the upper end of what I would consider a desirable range. I would suggest keeping about the present set of money market conditions, with the Federal funds rate generally above the discount rate--perhaps in the 4-1/2 - 5 per cent range--and a Treasury bill rate fluctuating around the discount rate but not consistently below it. This might mean small net borrowed reserves, say in the zero - $100 million area, with borrowings of $200 to $400 million. The Manager, however, needs ample leeway to deal with conditions as they develop. Having in mind our balance of payments problems, I can see a real advantage in using coupon issues to supply reserves and bills to absorb reserves--both, of course, within the limits of practicability.

As for the directive, the staff's draft with alternative A for the second paragraph seems to me excellent.1/

Mr. Ellis commented that measures of physical production and activity in New England suggested the economy was moving sideways or

1/ Alternative draft directives submitted by the staff for Committee consideration are appended to these minutes as Attachment A.

expanding slowly. Manufacturing output in December recovered part of the drop since its October peak, influenced in part by a recovery in shoe production. Gains in nonmanufacturing employment lines such as construction were enough to offset some fallback in output of nondefense durable goods. Several of the District's defense producers had order backlogs substantially above year-ago levels.

The dominant development in the financial area, Mr. Ellis continued, had been the changed or changing posture of bank lending officers. Having made substantial progress in rebuilding liquidity and finding their time deposits rising, both mutual savings banks and commercial banks in the District were in the process of re-energizing their loan officers. There soon should be some direct evidence as to whether loan demand had depth and was just waiting to be recognized or whether loan officers would have to move aggressively to put their funds to work.

Now that the budget message with accompanying materials and testimoney was available, Mr. Ellis thought it was possible to quantify to some degree the expectations and differences in expectations that underlay Committee members' approaches to monetary policy. In that respect, the staff's GNP projection for the first two quarters of 1967 performed a real service. Referring specifically to the projections as they appeared in the green book table, he counted himself as somewhat more optimistic about the rate of GNP expansion--which was set at $7 billion in each quarter. The Boston Reserve Bank's analysis of the inventory situation suggested that the fourth-quarter bulge traced principally to a corresponding unusual bulge in defense orders last June. If so, delivery against those orders would be reflected in a sharp expansion in the defense component of Government purchases in early 1967--thereby adding to the $7 billion increment forecast for GNP.

The high and sustained rate of personal saving projected for the next two quarters would set a nine-month record that had not been matched since 1958, Mr. Ellis said. Personally, he would expect a lesser rate of saving and a somewhat higher rate of consumer spending. Alternatively, it might be statistically possible to achieve such high savings rates if residential construction were to expand--but here the projection again was for virtually a no-change plateau for nine months. He was more inclined to expect that greater availability of funds would combine with some catch-up need and result in some expansion in residential construction by the second quarter of 1967. In short, he anticipated that GNP growth would exceed $7 billion in each of the first two quarters of 1967.

One of the exogenous forces Mr. Ellis expected to be at work to accelerate GNP growth would be the stimulative effect of greater credit availability. The sharp expansion in total bank credit in

December and January could be expected to continue, given the present trend of policy, if the economy remained as strong as he judged it to be.

Changed expectations coupled with the reserves the Committee had supplied had set in motion a decline in rates, Mr. Ellis noted. That run-off had proceeded to the point where the discount rate was beginning to exert a drag slowing the downward trend. To the extent that the Committee sought to stimulate investment, especially home-building, such a rate decline should be fostered. The rate decline also served to reestablish some freedom of movement for CD rates beneath the Regulation Q ceiling.

For those reasons, and to avoid the emergence of the discount rate as a prop holding up market rates, it seemed appropriate to Mr. Ellis to consider the policy possibilities of a reduction in the discount rate. There seemed little point in providing the reserves that supported the rate declines while simultaneously impeding those rate declines by retaining a discount rate level of 4-1/2 per cent. In a strategy framework, lowering the rate soon would hasten the stimulation of residential construction, which was needed. By the same token it would set up another avenue of policy action next summer if needed to restrain an economy beginning again to overheat in the possible absence of Congressional surtax action.

Mr. Ellis commented that, even with the less optimistic outlook projected in the green book, the accompanying projection of bank credit in February was for growth at an annual rate of 10 per cent, continuing the rate achieved since the Committee's November 1966 policy shift. That rate of expansion seemed entirely sufficient, in his judgment. At the same time, he would judge it entirely possible that the recent trend of declining rates had not run its course. Bill rates below 4.40 per cent and Federal funds rates near the discount rate would not surprise him in the next four weeks. All of that inclined him to prefer alternative A of the draft directives.

Mr. Irons reported that, despite some differences, conditions in the Eleventh District generally were following about the same pattern as reflected in the nation as a whole. Industrial production had declined slightly and there had been further declines in construction contract awards. Retail trade, as reflected by department store activity, was off a shade, and automobile sales continued to run below 1966 by a margin in the area of 10 per cent. Employment was up more than seasonally and the advance was rather general. On the whole, however, the recent changes were not highly significant. Agricultural cash receipts were up about 5 per cent from a year ago and prices received by farmers in the past month were about 7 per cent above a year ago.

Eleventh District banks apparently were under less pressure than banks nationally, Mr. Irons said. However, the figures around the turn of the year were suspect. Loans and investments were shown to have declined, and time deposits had increased. District banks, on the whole, were somewhat more liquid than they had been a few months ago. There had been a moderate increase in CD's, and banks reported that the demand for loans was perhaps a little less than late last year. Borrowings from the Dallas Reserve Bank had been negligible in the last few weeks; with only a few country banks and no large city banks coming to the window, average borrowings had been running in the neighborhood of $3 million.

As to the national situation and policy, Mr. Irons thought that his views were generally in agreement with those of Mr. Hayes and with those reflected in the chart show. The ease that had characterized the market during the past month had certainly been accompanied by a substantial growth in the monetary aggregates and by a sharp decline in interest rates. The question now was whether the Committee should undertake further easing deliberately--and if so how much; or whether it should attempt to maintain the existing conditions in the money market over the next month and observe developments. He would favor attempting to maintain the prevailing money market conditions. If such a course were followed he would expect that the Federal funds rate might be in a 4-1/2 - 5 per cent range, the Treasury bill rate around the discount rate in a

4.40 - 4.60 per cent range, and net reserves at zero plus or minus $50 million. He would like to see continued growth in the monetary aggregates, but at a rate somewhat below that of the past three or four weeks.

One reason he would advocate maintaining the prevailing money market conditions for the time being, Mr. Irons continued, was the possibility that the question of a change in the discount rate would be raised increasingly in the market, the press, and so forth, if the Treasury bill rate should decline to the discount rate or lower. He would not like to see a change in the discount rate at this time, and he thought there would be less speculation regarding a possible change under a policy of continuing prevailing money market conditions than would be the case if there were further deliberate and overt easing. He would favor alternative A of the draft directives.

Mr. Swan reported that economic conditions were relatively good in the Twelfth District. Manufacturing employment increased in December for the fourth month in a row. A very modest gain was recorded in the category of aerospace employment, despite the first month-to-month decline in some time in aircraft employment itself. The labor force increased somewhat faster than employment, however, and the unemployment rate rose by one-tenth of a point to 5 per cent.

Mr. Swan commented that there had been very little change in total bank credit at District weekly reporting banks from the year-end through January 25, in contrast to the considerable decline for the country as a whole. However, the data were not seasonally adjusted and there might be some differences in the seasonal patterns in the District and the rest of the country. Business loans had been maintained very well, and reporting banks had increased their loans to Government securities dealers substantially. Rather surprisingly, the banks had been able to buy sizable amounts of Federal funds for relending to dealers at a profit. The recent increase in CD's outstanding had been less rapid than elsewhere, but the earlier losses also had been smaller. And, as elsewhere, reductions in CD rates were being announced by larger banks.

There had been some recent stirrings in mortgage markets, Mr. Swan continued, with reports of interest on the part of institutional investors of the types that traditionally bought mortgages from banks. As inflows to savings and loan associations increased there had been scattered announcements of reductions in mortgage interest rates, and at least one association had indicated that it would no longer pay the high rate of 5-3/4 per cent on those special three-year certificates for which such a rate was permissible.

As to policy, Mr. Swan said he was in virtually complete agreement with Mr. Brill's recommendations. He was impressed by the rapidity of the decline in interest rates and by the pervasiveness of the decline which, to some degree, extended through almost all of the rate structure. Given the growth rates in the aggregates experienced in January and projected for February, he would be satisfied to see no change in prevailing money market conditions until the next meeting of the Committee. He would shade the targets a little from those given in the blue book; specifically, he favored net reserves in a range of plus or minus $50 million around zero, and the Federal funds rate in a range of 4-1/2 to 5 per cent, or even 4-1/4 to 5 per cent. With that interpretation, he would accept alternative A of the draft directives.

As far as the discount rate was concerned, Mr. Swan said, while it might be well for the System to start thinking about possible action at some point, he saw no reason for such an overt action at present. In particular, he did not have the impression that at 4-1/2 per cent the discount rate was impeding declines in other interest rates.

Mr. Galusha remarked that the Ninth District--the home of the bank that had initiated the recent round of reductions in the prime rate--wore its new mantle of pace setter for the U.S. banking community with something almost approaching complacency, inconsistent as that might be with an only slightly lower level of expectations. The strength in the agricultural sector caused by the high level of cash farm income had sustained country bank positions and kept support industry activity at reasonable levels.

Mortgage rates had turned down sharply, Mr. Galusha reported, with a demand for portfolio paper appearing after the doldrums of the last year. Labor leaders in the Twin Cities were pessimistic that the renewal of construction activity would occur fast enough to prevent more than a seasonal rise in unemployment, particularly with the drying up of the alternative employment opportunities in the District such as interstate highway construction. Some encouragement could be found in the search for new and expanded credit lines by the major tract builders for the upcoming season.

As to open market policy, it seemed to Mr. Galusha that the Committee was now in a position where to hold steady was a reasonable course. Before dosing the patient again, it would seem no more than appropriate to allow sufficient time for this ministration to work a little longer. He would not attempt to amplify on the comments already made with regard to money market and reserve objectives. However, he could easily vote for a "no change" directive, since he believed the Committee might have already largely succeeded in one of its basic objectives of the past few months--namely to foster a considerable recovery, later this year, in residential construction.

On that the green book was quite reassuring. The spreads between market rates and deposit rate ceilings were not too much different from what they were through a good part of 1965. In the present context, that would seem to be the important point.

Mr. Galusha went on to say that a logical concern--shared apparently by some of the blue book authors--was that somewhere along the line the Committee would get a change in expectations and, unless it acted decisively, another increase in market rates. Yet it was particularly important, what with recent experiences so fresh in mind, that market participants be continually reassured about the financial outlook. He would thus like to see the Committee's concern extend across the whole range of market rates.

With respect to the comments made on the discount rate, Mr. Galusha hoped that the inquiry into reserve requirements conducted last summer would not be overlooked and that plans for changes in requirements would at least be in workable form for possible use as an alternative means for signaling further ease, if such a signal should be considered necessary soon. He would favor alternative A of the draft directives.

Mr. Scanlon commented that the past several weeks had seen the development of increased caution in the Seventh District concerning economic prospects for 1967. Recent evidence of a marked turn in monetary policy, as reflected in most banking data, however, was tending to offset any tendency toward outright pessimism. Price increases continued to be announced for a wide variety of hard and soft goods and there prevailed an attitude that the general price level would rise as much in 1967 as last year, mainly because of upward cost pressures, especially wages. There was a growing view that corporate profit margins were narrowing, and that capital expenditure prospects were dampened as a result. He heard frequent reports of financial managers putting pressure on purchasing agents to hold down or reduce inventory investments even in cases where inventories were not large relative to sales.

Evidence continued to mount that the capital expenditure boom had lost momentum, Mr. Scanlon continued. Orders for construction machinery remained at a sharply reduced level and, more recently, new orders for various types of industrial equipment had declined markedly. Cancellations of orders, however, did not appear to have been significant. Defense work was taking a steadily increased share of District output. Some firms reported that slack in civilian demand was being absorbed by military orders. With auto sales in January about 15 per cent below last year, and with used car prices weak, output schedules for the first quarter were being reduced. Overtime and extra shifts were being eliminated in many plants. American motors had laid off more than 4,000 workers indefinitely and an additional 13,000 would be furloughed for 10 days later this month. Nevertheless, the job market in the District continued very strong.

December and January saw pronounced strength in savings and loan share accounts, Mr. Scanlon said. A number of large Chicago associations had stated that net inflows in January were the largest on record for the month, in contrast to a very poor showing a year earlier. A number of associations had announced cuts of one-quarter of a per cent in rates on new mortgages. Others, having improved their liquidity positions, were said to be interested in buying mortgages in the secondary mortgage market. As a result, prospects for home building in the District in 1967 appeared to be improving more rapidly than expected a month or two ago.

Credit at large Seventh District banks showed a contraseasonal rise in January, Mr. Scanlon observed. Much of the contraseasonal gain in business loans at District banks was concentrated in machinery manufacturing. He had no reason to believe that there had been any basic strengthening of loan demand compared with late 1966. Large Chicago banks continued to show a deep basic deficit position through the January 25 week despite increases of almost $200 million in CD money. Offering rates on all maturities of CD's had been lowered. Government security portfolios were increased further.

As to policy, Mr. Scanlon favored no change at this time and would accept the figures projected in the blue book as being associated with that position. He favored alternative A for the directive and would prefer to defer a change in the discount rate at this point.

Mr. Clay commented that the recent record and the present prospects of the economy justified the shift in monetary policy that had taken place and the continuation of an expansive monetary policy in the period ahead. There was no particular need to detail those developments and the factors involved, since they were already covered in staff materials. It could be observed, however, that a significant change had occurred in available resources and productive capacity relative to aggregate demand, and price pressures had lessened. Moreover, prospects indicated a much slower rate of advance in economic activity in the months ahead, with marked crosscurrents among major sectors of demand.

It had to be recognized, Mr. Clay said, that the Committee was not talking about a depressed economy. Presumably it was talking about policies and programs for encouraging economic growth within the limits of reasonably full employment of manpower and other resources, along with a goal of stable prices. Presumably it also was talking about relieving the uneven impact of the tight credit experience of 1966, notably with respect to mortgage markets and real estate activity.

In endeavoring to attain those goals, Mr. Clay said, the monetary policy moves thus far had been aggressive. The interest rate movements that had occurred in response to policy changes and other factors had been dramatic. The growth in most monetary aggregates had been pronounced.

In evaluating the situation for the period ahead, it seemed reasonable to Mr. Clay to assume that further financial responses would result from the policy moves already made, and time should be allowed for those developments to unfold. Moreover, the Committee must recognize that the economy was influenced by war activity and that it was still operating at a high level even though growing more slowly than earlier.

Under those circumstances, it would seem prudent to Mr. Clay to maintain essentially the prevailing money market conditions for the period ahead. Operational targets would be a Treasury bill rate in a range of 4.40 to 4.60 per cent, a Federal funds rate of 4-3/4 to 5 per cent, and net borrowed reserves of about $50 million, as described in the blue book. The anticipated increase in bank credit under such a policy, following the expansion of recent weeks, would be satisfactory. Accordingly, economic policy directive alternative A, including the proviso clause, would be appropriate for the policy desired.

Mr. Wayne reported that most measures of business activity in the Fifth District continued to ease, and business sentiment remained generally bearish. Nonagricultural employment increased in December but at a slower rate than earlier in the year, and rates of insured unemployment rose significantly in early January in all District States. In the Richmond Reserve Bank's latest survey all textile manufacturers reported lower backlogs of orders and a majority reported lower levels of shipments and new orders and higher inventories of finished goods. The survey also indicated definite weakness in the furniture and building materials industries and in some parts of the machinery and equipment industry. One large furniture manufacturer reported that he was cutting back his work force because his warehouses were filled with finished goods. Cash receipts from farm marketings in the District were up 3 per cent in 1966 compared with a national gain of 9 per cent. Net sales of Federal funds by Fifth District banks, which were abnormally high in December, advanced further to set a new record in January.

It seemed to Mr. Wayne that the transition of the economy toward a slower rate of advance was continuing, but without any significant increase in the rate of deceleration. In view of the large advances of late 1965 and early 1966, the relatively moderate adjustments of recent months would seem to indicate considerable stability in the economy. For the near future, inventory fluctuations were likely to be confusing and contradictory, but on balance the rate of accumulation should decline substantially. Similarly, he would expect some weakening in business capital outlays, with some decline in industrial and commercial construction, and he found no basis for expecting any early recovery in consumer purchases of automobiles and other durable goods. The new minimum wage law would probably give added impetus to the fairly rapid rise in unit labor costs already under way, and might impede further reductions in unemployment. On the other hand, it was reasonably clear that considerable fiscal stimulus could be expected over the next two quarters at least. In addition, the substantial improvement in the availability of mortgage funds, coupled with recent improvement in the housing statistics, would seem to offer some promise that residential construction outlays might turn the corner earlier in the year than he had anticipated. Considering the steady growth of State and local government spending and in consumer spending on services and nondurables, it seemed to him that the immediate prospects were for a continued but moderate expansion of aggregate demand. In brief, he saw little evidence of a cumulative downward movement.

In the financial area, Mr. Wayne said, the movement toward lower interest rates abroad had considerably simplified the Committee's task and underwrote, so to speak, its recent easing measures. The external problem was still acute, however, especially with respect to gold, and that should act as a restraint on the speed with which rates here could be reduced.

In the policy area, Mr. Wayne continued, the precipitate drop in the whole pattern of short-term rates in recent weeks seemed quite disproportionate to the increased reserves supplied. Although reserves, and particularly nonborrowed reserves, increased more than was desi le in the circumstances, much if not most of the rate decline was caused by the market itself. A major shift in the pattern of expectations, induced by official statements, undoubtedly was an important reason for the change, and might well have created expectations which were not realistic in view of the heavy demands likely to be made on the capital market. Another reason for the decline was a sharp turnaround in the funds used by Government securities dealers. From mid-October to mid-January those dealers built up their holdings of Government and agency securities by more than $3-1/2 billion to a record high level, and they increased their direct use of commercial bank funds by almost $2-1/2 billion. In early January that buildup receded slightly but since then it appeared to have returned to the former peak. During the same period banks were gaining large amounts of funds through increasing sales of negotiable CD's. In addition, business investment expenditures had been slowing, reducing the need for bank loans. Those developments, plus the Committee's own actions in increasing reserve availability, set the stage for the decline in rates which was triggered by official pronouncements, both here and abroad, concerning the future trend of interest rates.

In Mr. Wayne's view some decline in rates was quite appropriate and proper but the movement had gone too far too fast and had helped to create a very vulnerable technical situation. He would like to see reserve availability grow at a rate much lower than was realized in January. The February projections for reserves and the bank credit proxy in the blue book were, in his view, higher than the situation required and he would prefer to aim at lower rates. He did not favor a change in the discount rate at this time.

Alternative A of the draft directives appeared appropriate to Mr. Wayne with the associated complex of money market conditions and projections given in the blue book considered as the upper limits of acceptable conditions.

Mr. Shepardson said that the detailed developments reviewed by those who had spoken thus far appeared to him to argue for a temporary cessation in the shift toward greater ease, and to indicate that the policy described in alternative A of the draft directives was entirely appropriate. He agreed with Mr. Wayne that some of the rates of increase in aggregates projected under such a policy posture were higher than the Committee could reasonably expect to sustain. Specifically, he had in mind the projected rate of bank credit expansion, which he felt should be considered as an upper limit for the time being.

Mr. Mitchell commented that today's chart show projected two economies: six months of underheating, followed by six of overheating. He thought that the projection for the half-year immediately ahead had far greater credibility than that for the second half. The staff's recommendations might be said to suffer from a credibility gap; it was a mistake to give as much credence to expectations for the last six months of the year as to those for the first six months.

It seemed to Mr. Mitchell that the major danger in the immediate future was of a real downturn in the economy. Inventory adjustments of the kind now under way frequently--in fact, usually--triggered a downturn in over-all activity. The psychology of consumers had been deteriorating, as manifested by their recent spending rates. In immediate prospect were a flattening in business fixed investment and a decline in the index of industrial production. The index had not changed in the past three months and a slight decline was projected for the next six months, which would mean nine months of no increase. Those were matters of reasonable certainty rather than, like the projections for the second half, of conjecture.

Accordingly, Mr. Mitchell thought that the best policy for the Committee would be to move somewhat further in the direction of ease than it had already. The economy was at a point of incipient recession and the System's posture would be stronger if it responded to that fact. He saw no immediate danger in a little further easing. The Administration's budget message called for some fiscal policy action in the second half of the year, a step the Committee had thought desirable. The Federal Reserve should take a courageous step toward easing now, just as it had acted courageously in moving to firm last year. He would strongly urge that the Committee adopt alternative B for the directive.

Mr. Daane said that he subscribed to the policy prescriptions of Messrs. Hayes, Irons, and Brill, on the basis of much the same reasoning as theirs. A considerable degree of easing had already been achieved and was publicly recognized. The balance of payments problem was becoming increasingly serious. Also, the Committee technically was still in a period of even keel, although the market performance suggested that the current financing would not be a consideration for open market operations beyond the payment date.

In the light of all of those circumstances, Mr. Daane continued, he thought a steady course was the right one, and he would accept the thrust of alternative A of the draft directives. But to indicate just how steady a course he favored, he would delete the word "about" from the staff's draft, so that the directive would call for maintaining "the prevailing conditions" in the money market rather than "about the prevailing conditions." He recognized that one could not expect all of the relevant variables to remain in the same relationship, but deleting "about" would indicate how steady a course was desired. Frankly, he did not like the proviso clause in alternative A; the reference to "current expectations" troubled him because one could never be sure of his expectations. The formulation of the corresponding clause in alternative B was better, but he would prefer a directive with no proviso clause at all. As to the discount rate, he would not favor a change at this time; in his judgment, such an action would be premature.

Mr. Maisel said he did not see much difference between the two alternative directive drafts prepared for this meeting. He would like to see a greater amplitude of fluctuation in the Federal funds rate and other money market rates. Market participants should be prepared to take risks and should not be led to expect the System to bail them out regularly.

Mr. Maisel shared Mr. Daane's view that neither version of the proviso clause in the staff's drafts would be appropriate. But rather than deleting the proviso entirely, he would recommend that it be formulated to meet the problem that was most important at present: the vulnerability of medium- and long-term interest rates to upward pressures. The recent rate declines had reflected expectational factors, and a small change in expectations could have important effects on rates in the period ahead. Accordingly, he would favor calling for maintenance of current money market conditions--although allowing for more movement in market rates--and for supplying more funds to the market if there were a sharp run-up in medium- and long-term rates. Specifically, he would suggest a proviso reading, "but operations shall be modified as necessary to attain somewhat easier conditions if expectational or seasonal factors appear to be causing a rise in medium- and long-term rates."

Mr. Maisel thought that the Committee did not have to be concerned about a decline in rates, since such a development would reflect a weakening in demands for credit. But a rise in rates would primarily reflect a change in expectations, as well as a large need for funds in the first half of the year related, not to economic conditions, but to the pattern of tax payments and the desire for increased liquidity. With respect to the speed of the recent rate adjustment, he had been surprised to discover on checking that it was not as fast an adjustment as had occurred in the two preceding periods of shifts to greater ease, and so he was not concerned about it.

Mr. Brimmer said that it would be helpful for the Committee to keep in mind the inherent conflict between the need to provide some additional stimulus to domestic activity on the one hand, and the requirements of the balance of payments situation on the other. Mr. Hayes had suggested that the Committee should buy coupon issues when supplying reserves and sell bills when absorbing reserves. That had become known as "operation twist." His own feeling was that while operations of that type obviously had been helpful earlier in the expansion that was now slowing down, it might be somewhat risky for the Committee to attempt to use them again. He was suggesting, not that "operation twist" would not work, but that it might not be the most appropriate instrument at present.

Like Mr. Mitchell, Mr. Brimmer was concerned about the longer-run domestic outlook. He did not agree that the staff's analysis suffered from a "credibility gap"; rather, that analysis had persuaded him that the outlook was not as strong as implied by the projections of the Council and of the New York Bank, and that a much reduced rate of growth in activity was in prospect. In that connection, the Committee should accept the role for monetary policy implied in the Council's report--that of providing the stimulus necessary to hold up private expenditures while inventory growth was slackening. He thought most Committee members shared that view and that their differences were concerned primarily with the pace of the shift toward ease.

In Mr. Brimmer's judgment it would be desirable for the Committee to give particular attention to the structure of interest rates at this time. He was particularly concerned about the struggle going on in the banking community with respect to the prime rate; he had welcomed the reduction to 5-1/2 per cent by a few banks, and hoped that they would not decide to move back up to the 5-3/4 per cent rate established by most banks. For the time being he would want the Desk at least to keep market interest rates from rising. He favored a three-month bill rate not over 4-1/2 per cent and, if possible, the Federal funds rate might well be kept under 5 per cent. He could not say what level of free or net borrowed reserves would be consistent with those rate targets and therefore would leave open the question of the net reserve figure to be sought. In any case, the objective of insuring that the lower prime rate set by some banks remained in effect might imply somewhat more liberal provision of reserves than otherwise.

In sum, Mr. Brimmer favored moving cautiously toward a little more ease. Such a policy struck him as particularly important in view of the strains that would be placed on financial markets by the large issues of participation certificates now planned. Alternative B was his choice for the directive.

Mr. Hickman commented that further signs of leveling and weakness were apparent in the latest economic indicators. Production was declining and the increase in consumption had slowed. Because of a slowdown of inventory accumulation in some industries, the production index might decline by as much as two points in the first quarter of 1967, according to the estimates of his staff. A reduced rate of inventory accumulation was confirmed by the Reserve Bank's most recent survey of Fourth District manufacturers. Retail sales apparently slipped further in January, following a decline in December to last summer's level; and the outlook was for further weakness in the months to come. One favorable consequence was that most recent price changes had been moderate; but the steady rise in unit labor costs had put serious pressure on profit margins.

In the Fourth District, Mr. Hickman continued, the rate of insured unemployment rose slightly in January, the third successive monthly increase. In ten of the fourteen major labor market areas of the District, insured unemployment, on a seasonally adjusted basis, was higher at the end of January than in late December. Bank debits and manufacturing activity in most major industrial centers of the District (as measured by industrial consumption of electric power) had trended downward in recent months.

Nevertheless, Mr. Hickman thought the Committee should not overreact to recent evidence of business slack. Thus far, the initial response to the shift in monetary policy had been largely confined to financial markets and flows of funds among financial intermediaries. Responses on the real side of the economy, to the extent they were identifiable, hopefully would occur later on.

In Mr. Hickman's view, an even-keel policy was called for until the next meeting of the Committee, partly because of the Treasury refunding, and partly because of the progress that had already been made towards a less restrictive policy. A steady market tone for several weeks would have an additional advantage of discouraging speculative excesses, which fortunately seemed to have been minimal thus far.

To be specific, Mr. Hickman said, he thought that until the next meeting the Committee should attempt to keep bond yields about where they were, and the 91-day bill rate and the Federal funds rate below the discount rate most of the time. Net reserves were perhaps almost too erratic in this transitional period to be useful, but the type of rate structure he envisaged might be compatible with an average level around zero over the next four weeks. A general acceptance of the 5-1/2 per cent prime rate would in his opinion be highly desirable, since it would narrow the differential between bank lending rates and open market rates, and thus stimulate business borrowing, the rate of growth of bank lending, and the money supply.

Mr. Hickman would, however, not press for further monetary ease at this juncture, partly because a further elevation in prices of fixed-income securities might encourage speculation, with an eventual reaction of bond prices in the opposite direction. Also, an even-keel policy until the next meeting would give the real side of the economy time to respond to the current monetary and financial environment. He favored alternative A of the staff drafts, but would interpret it as calling for slightly more ease than the situation described in the blue book.

Mr. Hilkert remarked that Presidential messages appearing since the last meeting had a distinct bearing on open market policy. To judge by those messages, the prescription for monetary policy was quite clear: namely, ease.

Deciding the course of policy was not so simple as that for at least three reasons, Mr. Hilkert continued. First, the outlook for business might well follow the Council's pattern of first-half weakness and second-half strength; but it might not. That meant, among other things, that the appropriateness of a tax increase in mid-year remained to be seen. A second reason why formulating monetary policy was more complex than the recent messages suggested was the balance of payments. As he read the signs, there was little new action planned to deal with a worsening of the payments deficit. And a third reason was the outlook for cost-push inflation. While there was not much that monetary policy could do at this point to prevent it, undue ease could aggravate it. Consequently, policy could not simply follow a straight path toward ease. At times it might have to deviate from that course, depending on relatively near-term developments.

Mr. Hilkert reported that the Philadelphia Reserve Bank had tried to supplement the customary indicators of such developments by contacts with businessmen and bankers at the local level. There was always a danger, of course, in limited samples. But, with that reservation, discussions with some twenty-five businessmen in a cross-section of industries shed some light on current policies, particularly with respect to inventories. He had been impressed with the generally optimistic attitude toward inventory accumulation.

True, about half the companies covered believed inventories were above desired levels. But adjustments in many cases already had been made and would not require sharp cutbacks in production in early 1967. Accumulation in many cases had been in goods-in-process because of bottlenecks and shortages. The main area of involuntary accumulation had been in industries related to automobile production.

Those findings were somewhat contrary to the tone of the green book, Mr. Hilkert noted. If they were at all valid for the nation as a whole, they suggested that an inventory adjustment early this year might be accomplished fairly smoothly and without substantial repercussions on production and investment.

At the same time, Mr. Hilkert continued, bankers saw loan demand remaining fairly strong. They were not sure just how strong; in fact, projections that the large Philadelphia banks had been supplying to the Reserve Bank had been so erratic that little reliance could be placed on them. Nevertheless, bankers felt sufficiently confident about loan demand that they had reduced their prime rates only reluctantly and intended to grant loans at the prime rate very selectively.

Mr. Hilkert commented that that information from businessmen and bankers served as a reminder that the economy was still strong. An adjustment in the rate of expansion was under way, but it might proceed more smoothly than believed a few weeks ago. Meanwhile, growth of credit had been impressive. The staff's projections for February were encouraging, and if his reading of the inventory situation was correct, they might even be exceeded. The shift in market rates had been sharp and rapid, and a slower rate of decline would seem more appropriate to the economic situation immediately ahead.

Even apart from even-keel considerations, therefore, Mr. Hilkert was inclined to recommend no change. He would hope such a policy would maintain credit market conditions about where they were and would continue to promote substantial growth in credit. Alternative A of the draft directives would best accomplish that end.

Mr. Patterson said that recent developments in the Sixth District were generally similar to those in other parts of the country that had already been described. Accordingly, in the interest of time he would not make the comments on District developments that he had prepared, but would submit them for inclusion in the record. Those remarks were as follows:

> The latest available business statistics for our District do not make very exciting reading. They are moving in about the same direction they have been moving for some time. Weakness is still confined to just a few sectors, such as lumber, textiles, and metals. Employment and income continue on an upward course. Retail spending

is sluggish. In short, the District is not experiencing a recession, but is sharing in the general moderation of activity.

In the financial area, our region, too, is experiencing some of the same developments emerging elsewhere. Mortgage conditions have significantly improved. Our local mortgage bankers tell us that national lenders have returned more rapidly than anticipated. All in all, considerable optimism has developed that increased availability of mortgage money will revive housing rather quickly.

Our large commercial banks recently experienced inflows of time deposits at one of the fastest paces we can recall. Already, they recouped nearly all of their previous losses in negotiable CD's. Being slow in lowering their CD rates helped them in this respect. In fact, our biggest bank continues to hold its CD rate slightly above New York's level in an attempt to draw in more time money. Our country banks also gained significant amounts of time deposits in December and January. All of this growth was in CD's. Passbook savings have declined. As far as we can tell, the bigger banks are using the new time money to repay borrowings, replenish liquidity, and add slightly to tax-exempt portfolios.

Bank lending, on the other hand, is still anything but exuberant in our District. Business loans, in fact, are down much more this January than in early 1965 or 1966. Yet we get the distinct impression that some bankers wanted to relax lending standards before changing the prime rate. Competitive factors, however, left them no alternative. I infer from this that potential loan demand in our District is still pretty high.

Although our banking fraternity may not be entirely typical in this respect, some bankers evidently believe that their customers will knock on doors as soon as they see that the welcome mat is back out. More than one banker has attributed his bank's weakness in loans to reluctance of former customers to borrow because of previous denial. Many of these people will undoubtedly be back for loans as soon as the banks make it clear that they again are willing to lend for construction, inventories, and land acquisitions. While I recognize that some of this potential loan demand will evaporate as inventory adjustments are speeded up, some potential loan demand exists and with proper stimulation should come to the surface. In the interim, it is our job to determine to what degree we should stimulate bank lending.

Mr. Patterson added that on glancing backward he found that the Committee had succeeded in restoring confidence in financial markets. It had reversed the decline in deposits and helped bring short-term rates down sufficiently to encourage a considerable expansion in time deposits. Those goals had been achieved far more quickly than he would have imagined. Looking ahead, there was every reason to believe the economy was not going to return to a boom course. The liquidity position of many banks remained unsatisfactory, and there were still many other lagging effects of past credit restrictions in evidence. All of that suggested that an increase in reserve availability was in order unless the Treasury calendar or foreign interest rate developments stood in the way. In other words, it seemed to him that, if the Committee wanted to be effective in encouraging bank loan expansion, policy had to move toward slightly further ease. In line with that position, he favored a slightly positive free reserve target and alternative B for the directive. He believed, however, that discount rate action at present would be premature.

Mr. Francis commented that economic activity remained strong. The public sector had grown at an advanced rate while there had been some slowing in the growth rates of private spending and production in recent months. Some of the goods produced might have been going into involuntary inventory expansion, a potential drag on the economy in the near future.

In view of the excessive total demands and inflationary pressures of last summer and early fall, Mr. Francis thought the moderation in the growth of private demand had been desirable. The economy was still operating at virtual capacity. Demand-pull inflationary pressures seemed to be somewhat reduced although cost-push elements were increasing. Monetary restraint since early last summer had been a major factor in the slower expansion of total demand; fiscal actions had actually become more stimulative, according to the presentation in the Budget and the Economic Report. The budget plan indicated that fiscal action would continue to be extremely expansive over the next few months and, indeed, through fiscal 1968.

In view of the slowing in total demand, Mr. Francis said, the Committee had been concerned since last November that monetary actions might become too restrictive, particularly if there was a lag between such actions and their effect on the economy. The Manager of the Account had been asked to attain easier conditions in the money market to promote a noninflationary growth in money and credit. The money market had eased, as evidenced by marked declines in interest rates and an accompanying smaller average borrowing from Reserve Banks. The Federal Reserve had been supplying a substantial amount of reserves to member banks through open market operations. Bank credit had been expanding sharply, although much of the gain might reflect merely a reintermediation of funds that temporarily passed through other channels. The money supply appeared to have risen at an annual rate of about 1/2 of 1 per cent since November (adjusted for the quarterly patterns in that series) compared with a 1.5 per cent rate of decline in the previous six months.

For the next month Mr. Francis suggested that the Manager attain a further gradual easing in money market conditions with a view to fostering a slightly faster monetary growth. The three-month Treasury bill rate might fluctuate around 4.25 per cent, Federal funds might trade at the discount rate or lower, and excess reserves might average about $100 million more than borrowings at the Federal Reserve. The Committee was walking a tightrope; too rapid monetary growth was likely to be inflationary, while no monetary expansion was apt to lead to a rise in idle resources. As an intermediate target, he preferred to have the money supply rise at a 2 or 3 per cent annual rate. He strongly favored alternative B of the draft directives.

Mr. Francis concluded with the observation that he would not change the discount rate at this time. Holding the rate at 4-1/2 per cent had not significantly deterred the rise in market interest rates last year and he did not think it was deterring rate declines at present.

Mr. Robertson presented the following statement:

I am very appreciative of the timing as well as the content of the chart show we had this morning. This strikes me as a time when it is more than ordinarily appropriate for us to give attention to the longer-run as well as the immediate consequences of policy alternatives. With the Budget, the Economic Report, and now our own staff's projections before us, we are about as well equipped for that task as we can reasonably hope to be.

In a nutshell, none of these presentations move me to call for a program of aggressive further monetary easing at this juncture. On the contrary, they lead me to expect that we may need to move into a gently stimulative money and credit environment for much of the first half of this year, with reasonable policy possibilities for the second half ranging from moderate further monetary stimulus to some mild turn toward restraint, depending upon a host of intervening developments. All this is highly conjectural, of course, and its relevance to today's decisions is complicated by the fact that we currently seem to be rewriting the record book on monetary lags--i.e., the speed of response to monetary policy. Nonetheless, I am inclined to regard the prospects for 1967 as arguing that we should be a little careful of going too far too fast in further monetary easing right now.

I am impressed with how much we have already set in train in the way of relaxation of financial restraint. Interest rates have dropped sharply, the financial system has rebuilt a good deal of liquidity, and the rise in money supply, time deposits, and nonbank savings instruments suggests that the liquid asset holdings of the private sector as a whole must also be mounting more substantially. A less tangible but nonetheless significant influence is the sharp recovery in values of all kinds of capital assets that must have accompanied the recent drop in yields and climb in bond and stock prices.

At the same time, it is worth emphasizing that these developments do not have the look of the kind of rush for liquidity that can accompany an economic contraction. Some corporations and municipalities are already stepping up their capital flotations, both to fund old debts and to finance current and future spending. What we cannot yet judge with any real certainty is how many other borrowers will respond affirmatively as the effects of relaxation of restraint spread and the availability and cost of credit improve for consumers, businesses, and would-be home owners.

That process takes time, and the reports to date suggest that it is still very much under way. I am prepared to go slow in pushing further reserve easing actions, however, until we can have a little more feedback of evidence as to whether or not the relaxation to date may have been enough to begin to bolster borrowing and spending plans over the longer run. Otherwise, by overreacting to short-run increases or the lack thereof, we could trap ourselves into a kind of abrupt "stop-go-stop" monetary policy--that I would prefer to avoid--that might damage confidence not only in financial institutions but in the efficacy of monetary policy itself.

All things considered, I would be willing to settle for a general policy of no further deliberate change between now and the next meeting. I would, however, like at least to guard against any appreciable back-up in interest rates or money market pressures, because I would not want to risk reversing the easier and more confident credit expectations that have so recently emerged. Furthermore, I feel that it would be desirable if we could move progressively back towards a posture in which we (and I refer to the members of the Committee) were a little less solicitous of every money market wiggle. For practical purposes, this adds up to an instruction to the Manager not to worry about offsetting every temporary downward fluctuation in the money market, but to resist any sizable upward fluctuation.

I would still expect the proviso clause to shade the over-all cast of operations in such a way as to moderate unexpectedly strong bank credit deviations, but I am not going to worry about a proviso-initiated firming of conditions, since in that circumstance credit demand should be proving sufficiently stronger than expected to withstand any accompanying minor adjustment in rate expectations.

With this general policy view, I could vote for either alternative A or B of the staff directive drafts, so long as either was interpreted as encompassing a leaning toward easing about like "resolving doubts on the side of ease", and as meaning that the Committee would not be concerned if its implementation resulted in a showing of positive free reserves--even for successive weeks.

Chairman Martin said he found himself in almost complete agreement with Mr. Robertson's position. After studying the question carefully in preparation for today's meeting, he had concluded that he could accept either alternative A or B of the draft directives. It was clear to him that the Committee's policy should be one of ease, but to overreact could be self-defeating in the sense that it might result in a need to reverse policy later. It also was clear to him that the discount rate should not be changed for the time being. He would favor leaning toward ease within the framework of a continuation of present policy. Although the Treasury financing did not call for a rigid even-keel posture at this juncture, it did provide some grounds for what might be called "semi-" even keel.

The majority of members seemed to think alternative A was the more suitable for the directive, Chairman Martin continued. He had no objection to Mr. Daane's suggestion to delete the word "about" from the staff's draft. However, he did have some question about Mr. Maisel's suggestion to formulate the proviso clause in terms of movements in medium- and long-term interest rates. He preferred the type of proviso clause included in the staff's draft.

Mr. Daane said he thought that deleting the word "about" would meet the problem Mr. Maisel had in mind, by indicating that steadiness was desired in interest rates. He would not favor introducing the type of proviso clause Mr. Maisel had suggested.

In response to Mr. Brimmer's remarks about "operation twist," he (Mr. Daane) would certainly favor some shift toward operations in coupon issues. He saw no reason for rejecting a tool that the Committee had found useful in the past in reconciling conflicts in its domestic and balance of payments objectives.

Mr. Hayes said he strongly supported retention of the staff's proviso clause, which was consistent with similar clauses the Committee had been using all along. It introduced a desirable reference to an intermediate objective in terms of bank credit developments, to supplement the more immediate objective in terms of money market conditions.

Chairman Martin asked if other members cared to express views with respect to the proviso clause, and several indicated that they would prefer to retain the version in the staff's draft.

Mr. Brimmer said he would like to suggest a modification of the language of alternative A which, if acceptable to the majority, would permit him to join them in voting favorably. His suggestion was to add the words "of ease" after the word "conditions," so that the directive would call for "maintaining the prevailing conditions of ease in the money market." The purpose of the change would be to indicate that the money market conditions sought were somewhat closer to those specified by alternative B than was indicated by the original language of alternative A. He thought that his suggested language was consistent with the proposals of Chairman Martin and Mr. Robertson for "leaning toward ease"; if that view was shared by a majority of the Committee it should be reflected more specifically in the directive.

Chairman Martin and Messrs. Hickman, Robertson, and Wayne indicated that they would have no objection to the language Mr. Brimmer had proposed.

Mr. Hayes said that he preferred the staff's original language because of the problems of defining the term "ease" in Mr. Brimmer's formulation, but he did not feel strongly on the matter.

Mr. Mitchell said he thought the underlying issue should not be papered over by semantics. The virtue of alternative B was that it called specifically for somewhat easier conditions and he thought that the Committee would be in a better posture if it adopted that alternative for the directive.

Mr. Hayes commented that it had appeared to him that a majority of the Committee favored the type of policy described in alternative A.

Mr. Brimmer said that the language change he had suggested was not intended to paper over the issue, but rather to call for a policy intermediate to those of alternatives A and B--somewhat closer to A than to B but definitely beyond A.

Mr. Maisel observed that if Mr. Brimmer's language was interpreted as calling for "leaning toward ease" he was prepared to vote for it.

Mr. Holmes said that he would interpret the proposed language to mean that the Desk should try to resist any sharp rises in rates but not declines in rates, while going along with small changes.

Mr. Daane said he would accept that statement as reflecting the Committee's intent even if the original language of alternative A was not modified.

Thereupon, upon motion duly made and seconded, and with Mr. Mitchell 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, with continued large inventory accumulation. The pace of advance of broad price measures has slowed, although upward price and cost pressures persist for many goods and services. Interest rates have declined markedly, financial conditions generally are considerably easier, and bank credit expansion recently has been vigorous. While interest rates abroad have also declined, trends in international transactions indicate a continuing serious balance of payments problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, 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 the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing conditions of ease in the money market, but operations shall be modified as necessary to moderate any apparently significant deviations of bank credit from current expectations.

Chairman Martin then invited Mr. Daane to report on the meetings of the Group of Ten Deputies which he had attended recently.

Mr. Daane said that the Deputies had held a meeting in London on January 24 and then had met jointly with the Executive Directors of the IMF on January 25 and 26. At the Deputies' meeting Chairman Emminger had distributed a partial text of the communique that had been released by the Ministers and Governors of the Common Market following their meeting at The Hague in the preceding week, which read as follows: "The Ministers and Governors, anxious to confirm their solidarity on a question as important as the international monetary problem, have decided, while pursuing the examination of the plans discussed hitherto, to instruct their experts in the Monetary Committee of the E.E.C. to study the improvement of the methods of international credit without delay." As Dr. Emminger pointed out, that statement had been misinterpreted by the press to mean that the French had agreed to shelve the question of an increase in the price of gold in exchange for agreement to abandon contingency planning for a new reserve asset in favor of working toward improving the credit facilities of the IMF. That was not true.

In clarifying the matter, Mr. Daane continued, Dr. Emminger made four points. First, he called attention to the phrase in the communique which read, "while pursuing the examination of the plans discussed hitherto," and indicated that that phrase referred to the work of the Group of Ten and to the joint meetings on contingency planning, and had been inserted to make it clear there was no intent on the part of the Common Market countries to impede or interrupt that work. Secondly, Dr. Emminger noted that the reference to "the improvement of the methods of international credit" (to be studied by the Monetary Committee of the E.E.C.) was to the new French suggestions introduced at the Hague meeting. He implied that the French had nothing really concrete to offer on the subject of international credit; and it was Mr. Daane's own impression that they had advanced the suggestions primarily as a diversionary tactic. Dr. Emminger's third point was that a decision as to whether the French suggestions should be inserted into the work of the Ten or of the joint meetings would depend on the outcome of the Monetary Committee's studies. The fourth point--and the one of perhaps greatest interest to the Open Market Committee--was that there had been an agreement at the Hague meeting that the question of the gold price should be shelved for the time being, and the Dutch Prime Minister was authorized to so state at the press conference following the Hague meeting.

After those remarks by Dr. Emminger, Mr. Daane continued, the French took sharp exception to the statement that the gold price question had been shelved. Mr. Perouse said that the French had not asked for an immediate increase in the price of gold, and "one could not put back in the drawer what one had not taken out of the drawer." In effect, the French position was that it was appropriate to discuss the problems of gold, including that of price. They had, in fact, continued to discuss the subject at the subsequent sessions.

The two most significant items on the agenda at the joint meeting, Mr. Daane said, dealt with the conditions and circumstances of activation of a contingency plan, and with decision-making. Perhaps the most significant development was the manner in which both groups approached the question of conditions for activation. As the Committee would recall, a statement issued by the Ministers and Governors of the Ten in August 1966 called for two preconditions for activation: improvement in the balance of payments position of members--a point directed particularly at the U.S. and the U.K.--and a better working out of the adjustment process. The consensus at this meeting was that such conditions could not be defined precisely or applied in a rigid manner. Surprisingly, that view was expressed by, among others, some members from Common Market countries, who pointed out that they could conceive of the need for reserve asset creation arising even with a continued moderate deficit in the U.S. balance of payments. Similarly, they viewed improvement in the adjustment process as a continuing process, not capable of clear-cut delineations. Thus, there definitely had been a softening of attitudes on the preconditions for activation.

On the question of decision making, Mr. Daane said, a "bicameral approach," involving a separate vote outside the Fund for a limited group, was rejected. Mr. Van Lennep of the Netherlands made a strong case for a "double-majority" procedure in which a limited group would have special voting rights within the Fund. This approach too was criticized by representatives from outside the Ten. Instead, the approach taken was to lay greater stress on consultation prior to formal decision-making. Interestingly, there seemed to be a general consensus that reserve creation should be built into the IMF framework, with the scheme to be operated through an affiliate of the Fund. Although not all issues had been resolved, it was becoming increasingly clear that decision-making would be fully within the IMF or an affiliate. As Dr. Emminger had put it at the press conference, that was gratifying progress.

Mr. Daane added that the French had tried to have the problem of gold placed on the agenda for the next joint meeting, to be held in Washington in late April. Mr. Schweitzer had firmly rejected that proposal, saying that the only purpose of the joint meetings was to develop a plan for reserve asset creation, and Dr. Emminger pointed out, in turn, that the Deputies' mandate from the Ministers and Governors of the Ten had specifically excluded the subject of the gold price. Mr. Deming, Mr. Hockin of Canada, and Mr. Van Lennep also had spoken against the French proposal.

In sum, Mr. Daane said, from the entire set of meetings one got a clear sense of further progress with respect to contingency planning, which was favored by all of the Europeans except the French. The joint meeting was marked by a spirit of constructive advance similar to that at the first such meeting in Washington last November. One could take a generally optimistic view and say, as Dr. Emminger had in his press conference, that while the full plan might not be agreed upon by the time of the meetings in Rio de Janeiro this autumn, the main elements of a plan might be agreed upon by that time.

In a concluding observation, Mr. Daane said that the other main item on the agenda at the Group of Ten meeting--which was carried over in part to the joint meeting--dealt with the question of holding and use of the new asset. A working group made a preliminary report at the London meetings in which three approaches were distinguished--a holding limit, a transfer ratio linking gold to the new asset, and a creditor ratio. There seemed to be less and less sentiment for the second of those approaches.

Following Mr. Daane's remarks, Chairman Martin said that he would report briefly on his visit last week to London, where he had spoken before the Overseas Bankers Club. He found that people at the Bank of England were very much encouraged by the progress Britain had made recently, on which Mr. Coombs had reported this morning. He had been interested to find a general feeling in London that France's decision to internationalize its gold market was taken deliberately in order to make it more difficult for Britain to join the Common Market. Some South Africans with whom he had talked were quite convinced that the move would have no effect on the practices of their country; they felt that the shipping arrangements between South Africa and London offered benefits to them that would offset the possibility of higher prices in the Paris gold market. The Chairman concluded by expressing the hope that the recent gains in British reserves would continue.

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

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

February 6, 1967

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on February 7, 1967

FIRST PARAGRAPH

The economic and financial developments reviewed at this meeting indicate further moderation in various expansionary forces, with continued large inventory accumulation. The pace of advance of broad price measures has slowed, although upward price and cost pressures persist for many goods and services. Interest rates have declined markedly, financial conditions generally are considerably easier, and bank credit expansion recently has been vigorous. While interest rates abroad have also declined, trends in international transactions indicate a continuing serious balance of payments problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, 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 the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market, but operations shall be modified as necessary to moderate any apparently significant deviations of bank credit from current expectations.

Alternative B

To implement this policy, and taking account of the current 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 than prevail at present, unless bank credit appears to be expanding significantly faster than currently anticipated.