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, April 4, 1967, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Francis
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Shepardson
Mr. Swan
Mr. Wayne

Messrs. Ellis, Hickman, Patterson, and Galusha, Alternate Members of the Federal Open Market Committee

Messrs. Bopp and Irons, Presidents of the Federal Reserve Banks of Philadelphia and Dallas, respectively

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Baughman, Craven, Jones, Koch, Partee, and Solomon, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

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

Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss McWhirter, Analyst, Office of the Secretary, Board of Governors

Messrs. Link, Eastburn, Mann, Brandt, Tow, and Green, Vice Presidents of the Federal Reserve Banks of New York, Philadelphia, Cleveland, Atlanta, Kansas City, and Dallas, respectively
Messrs. Meek and Snellings, Assistant Vice Presidents of the Federal Reserve Banks of New York and Richmond, respectively
Mr. Arena, Financial Economist, Federal Reserve Bank of Boston
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Chairman Martin said that he felt honored to have been asked by the President to continue to serve in the capacity of Chairman of the Board of Governors, and would do his best to fulfill the responsibilities of that office. He considered his redesignation as Chairman not as a tribute to himself but as an indication of the attitude of the President toward the System and the importance of its work. He regretted that the President had not found himself able to waive the provisions of law that required Mr. Shepardson to retire from the Board at the end of this month rather than continuing to serve until the end of his term in January 1968. However, he fully understood the President's position, and he thought Mr. Shepardson did also. It was clear from his conversations with the President that the decision was based on a desire to carry out Civil Service

retirement procedures. Unless the Committee happened to hold a special meeting later this month, today's meeting would be the last that Mr Shepardson would attend. He was sure that all of the Committee members shared his feeling that it had been a privilege to have served in the System with Mr. Shepardson over the past thirteen years.

Mr. Hayes, speaking as Vice Chairman of the Committee, expressed the sense of pleasure that he knew everyone present had felt on learning of Mr. Martin's redesignation.

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 7, 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 March 7 through March 29, 1967, and a supplemental report for March 30 through April 3, 1967. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that the Treasury gold stock was unchanged again this week. The Stabilization Fund now had roughly $75 million of gold on hand, with no important orders in sight. In addition, the Canadians would

be selling $50 million in gold to the United States tomorrow, so the Stabilization Fund might well end up the month with a comfortable balance of more than $120 million.

On the London gold market, Mr. Coombs continued, South African deliveries continued to run well above normal and enabled the London gold pool to take in $18 million during March. The pool now had available a reserve of $106 million, which would provide a useful cushion when the flow of gold from South Africa returned to normal--or what was perhaps more likely, subnormal--levels during coming months.

Sterling was in very strong demand throughout March, Mr. Coombs said. The Bank of England took in a total of nearly $700 million in what was probably the best month sterling had ever had. Of that gross inflow, only $90 million had been allotted to a reserve increase that was being announced today; $350 million had been used to pay off central bank debt, including a $100 million payment to the Federal Reserve early in the month; and a sizable reduction in forward contract liabilities also was made. The March debt repayments left $180 million still outstanding at month-end under the so-called sterling balance credit arrangement, and that figure was reduced to $150 million yesterday. As the Committee would recall, last summer the Bank of England incurred central bank and market forward obligations of roughly $2-1/2 billion, with their

central bank debt alone rising to more than $1-1/2 billion. In effect, they had now repaid all but $150 million of their central bank debt, as well as substantially reducing their forward commitments. That represented a tremendous turnaround in their position. He would hope that the publication today of good figures for March would give further stimulus to the demand for sterling, and that April would start off well.

Mr. Coombs added that near the end of March the United States had sold to the Bank of England a total of $56 million of sterling, divided equally between System and Treasury account, that had been held under that Bank's guarantee. If sterling remained strong during April, he thought it would be wise to reduce the holdings of guaranteed sterling substantially further in order to reconstitute, as far as possible, a facility that had proved extremely useful in several difficult situations during the past eighteen months. The Bank of England had no objection to such a procedure as long as it was not carried to the point at which it would impair their end-of-month reserve position.

Elsewhere on the exchanges, Mr. Coombs reported, the German mark remained extremely strong, mainly owing to the reemergence of a huge trade surplus. Much of the dollar inflow was being channeled back into the international credit markets, however, and the Bundesbank

had, in any event, undertaken to refrain for the time being from converting into gold any increases in its dollar reserves.

Finally, Mr. Coombs said, there were indications that France might be slipping more deeply into deficit. In the next day or so the Bank of France might be announcing another reserve loss of $15 or $20 million for March, despite the fact that during the course of the month the Bank of England had purchased $80 million of French francs in anticipation of debt repayments to the International Monetary Fund. That would suggest that during March the French deficit might have run close to $100 million.

In conclusion, Mr. Coombs noted that after the last Basle meeting he had stopped off in Copenhagen and Oslo to discuss with the central banks of Denmark and Norway the possibility of their joining the swap network, with lines of $100 million each, after they had achieved Article VIII status. Both central banks indicated interest, as they had earlier. They had a good many questions regarding the purposes and operating details of the arrangements; the visits gave him an opportunity to answer such questions and to point out the mutual advantages of the swap arrangements and the responsibilities undertaken by members of the network. On the basis of those rather brief visits he thought the Danes and Norwegians could be relied on to take an appropriate attitude toward any arrangements the System might make with them. As to timing, Denmark probably

would be able to qualify for Article VIII status at almost any moment. Norway had somewhat more complicated problems which, while not serious, might delay their attaining Article VIII status for a few weeks after the Danes had done so. Both central banks preferred to join the network simultaneously, but there was some feeling on the part of the Danes that they might wish to negotiate with the System separately if the Norwegians did not resolve their problems within a reasonable time. He would hope to have some definite action to recommend to the Committee later in the month, or at least by the time of the next meeting.

Mr. Hayes asked how Mr. Coombs viewed the near-term outlook for monetary policy actions abroad.

Mr. Coombs replied that last week, in his opinion, the Bundesbank had been close to a decision to cut its discount rate again, from 4 to 3-1/2 per cent, and he hoped that they would take such action soon. If the Germans moved, the British probably would follow, and there might be a round of one-half per cent decreases by central banks. What action the System did or did not take on the discount rate this week would have a bearing on developments abroad; a reduction of 1/2 per cent in the Federal Reserve discount rate might well trigger fairly widespread cuts of the same size by European central banks.

Mr. Brimmer asked how the European central banks might react to a 1/4 per cent reduction in the Federal Reserve discount rate.

Mr. Coombs replied that he could only guess at the answer. He suspected that while a 1/2 per cent reduction in the U.S. discount rate would make it highly probable that there would be widespread similar reductions abroad, a 1/4 per cent reduction by the U.S. might inject an element of uncertainty in the minds of European central bankers, perhaps leading to less widespread and less decisive actions on their part.

Mr. Brimmer then asked about the likely effects of a general round of discount rate reductions on flows of funds between the Euro-dollar market and the U.S.

Mr. Coombs replied that if the discount rate--and, more particularly, the CD rate--in the U.S. came down, the impact on the flows in question would depend in large measure on whether Euro-dollar rates fell sympathetically. Developments in the Euro-dollar market were always difficult to predict; rates there were sticky at times, and they might remain sticky after other interest rates here and abroad moved down. In that eventuality it might be desirable to arrange for the Bank for International Settlements to draw again on its swap line with the System and to put a moderate amount of money into the Euro-dollar market in order to nudge the rates down.

Mr. Daane commented that he had talked with officials of the Bank of England last week, while in London enroute to the G-10 meeting. From those conversations he felt that Mr. Coombs was quite correct in saying that both Britain and Germany were poised to lower their discount rates, and that a reduction in the Federal Reserve discount rate might well trigger action by them. They were likely to act whether the U.S. reduction was 1/2 or 1/4 per cent, although that choice might affect the sizes of their reductions and the extent to which similar actions spread to other countries.

Mr. Hickman asked whether the U.S. would not be in a better position with respect to the Euro-dollar market if the Federal Reserve discount rate was lowered by 1/4 per cent, assuming other central banks made 1/2 per cent cuts.

Mr. Coombs replied that the outcome would depend primarily on the response of the CD rate and the Federal funds rate here, and the changes in Euro-dollar rates on comparable maturities.

> Upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period March 7 through April 3, 1967, were approved, ratified, and confirmed.

Mr. Coombs noted that the standby reciprocal currency arrangement with the Bank of France, in the amount of $100 million, would reach the end of its three-month term on May 10, 1967. He recommended

renewal of that arrangement at that time for a further period of three months.

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

Chairman Martin suggested that the Committee continue its discussion, begun at the preceding meeting, of the possible inclusion of Mexico and Venezuela in the swap network. He invited Mr. Mitchell to comment.

Mr. Mitchell noted that Mexico had already attained Article VIII status. He knew of no reason for not inviting that country to join the swap network, and he understood that the Treasury favored such a step. Accordingly, he thought the Committee should consider asking the Special Manager to discuss the question with the Mexicans. Venezuela had not yet achieved Article VIII status, and the present case for a swap line with that country was not so clear. However, they had bought gold in the past and he was not sure that the question should not be explored with them also.

Mr. Coombs said that recently he had been moving increasingly to the view that if swap arrangements were made with Denmark and Norway it would be well to take a similar step with Mexico. On checking with Treasury officials before approaching the Danes and Norwegians, he found that they not only favored arrangements with those countries but volunteered that they also would take a favorable view

with respect to Mexico. He gathered that they might have reservations about including Venezuela at this time, but would put no obstacles in the way of possible future action. In general, it would be his inclination to take the initiative with respect to negotiating with Mexico, but not to do so with Venezuela until they had achieved Article VIII status.

Mr. Mitchell agreed with Mr. Coombs' conclusion, primarily because only Mexico qualified at the moment. However, he felt it was important to recognize that the Venezuelans were highly sensitive about their position relative to Mexico. While he had no specific procedure to recommend, he thought that the Committee should proceed carefully, in full awareness that questions of national prestige were involved.

Mr. Hayes agreed that it would be desirable to include Mexico in the swap network, but he was doubtful about Venezuela at this point. While he was not in a position to assess fully the importance of the sensitivity problem, he hoped the Committee would not act prematurely on a swap arrangement with Venezuela simply because of that problem. On the other hand, if the sensitivity of Venezuela was considered sufficiently serious, that could be a reason for delaying the Mexican arrangement. He would prefer to act on Mexico alone now, while not precluding the possibility of including Venezuela in the network later.

Chairman Martin suggested that the best way of dealing with the problem might be to hold discussions with Venezuelan officials as well as Mexican, explaining the standards for membership in the network and pointing out the differences between their status and that of Mexico.

Mr. Daane said that in his discussions with Treasury officials they had evidenced more enthusiasm about System swap arrangements with Mexico and Venezuela than with Denmark and Norway. He had not gotten the impression that they made the sharp distinction between Mexico and Venezuela that Mr. Coombs had suggested.

Mr. Coombs commented that he and Mr. Daane may have talked with different officials at the Treasury who held dissimilar views. In any case, since Venezuela had not yet attained Article VIII status they were not immediately eligible.

Mr. Wayne expressed the hope that the System would not enter into a swap arrangement with a country that had not achieved Article VIII status simply because of a desire by that country to enhance its prestige. Mexico met the Article VIII requirement, but unless other countries did so he would not favor entering into swap agreements with them.

Chairman Martin thought Mr. Wayne's point was well taken; the Committee should not let questions of sensitivity be controlling. At

the same time, it would be worthwhile to make sure that the Venezuelans understood what the standards for membership in the network were.

Mr. Mitchell thought that Venezuela probably would undertake to meet the standards once they understood the importance of doing so.

Mr. Wayne referred to Mr. Coombs' earlier suggestion that one's impression of the Treasury's views regarding the desirability of particular swap lines might depend on the Treasury official with whom one talked. While he would not propose that the Committee should give the Treasury veto power in connection with all such decisions, the importance of coordination with the Treasury had been recognized from the outset of the System's foreign currency operations. Accordingly, he thought the Committee should not move ahead on expanding the network without clarification of the Treasury's position.

Mr. Solomon reported that he had talked recently with Under Secretary of the Treasury Deming, and had checked with the Deputy of the Assistant Secretary of State for Economic Affairs, about the fact that the Committee was studying the possibility of enlarging the swap network. He had been informed that both the Treasury and the State Department were agreeable to the inclusion of Denmark and Norway, and both were receptive to the inclusion of the Latin American countries if they met the requirements.

Mr. Hayes said that while, as he had indicated, he was sympathetic to a swap arrangement with Mexico he now wondered whether it might not be better to hold exploratory conversations with both Mexico and Venezuela rather than to go ahead on an arrangement with Mexico and present Venezuela with a _fait accompli_. The Venezuelans' attitude might be better if they were given an advance indication of the Committee's intentions.

Chairman Martin commented that the Committee today might authorize the Special Manager to discuss possible swap arrangements with both Mexico and Venezuela, looking toward their inclusion in the network if they met the standards.

Mr. Hayes remarked that he had the impression from the staff paper on Venezuela that that country might fail to meet standards for membership in the network other than the technical one involving Article VIII status. He would be reluctant to move ahead in connection with Venezuela without further discussion within the Committee.

Chairman Martin said he thought the major question was whether Venezuela would attain Article VIII status. As he had indicated, he thought the Committee might simply authorize discussions with Mexico and Venezuela concerning the swap network, on the understanding that Mexico probably could now meet the standards for inclusion in the network and that Venezuela would be informed as to what the standards were. He personally had talked at some length with

the Venezuelans, and they were aware of the problems in their case. The object of further conversations with them was to minimize their sensitivity to a possible approval of a swap arrangement with Mexico if the Committee should decide to take that action. But he would suggest that the Committee defer action until Mr. Coombs had held exploratory talks and brought recommendations back to the Committee.

No objection was raised to the Chairman's suggestion.

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

Mr. Daane noted that the Deputies had met in The Hague on March 30 and 31 and April 1. The bulk of the discussion was concentrated on two illustrative schemes that the Fund's staff had developed--one on a new reserve unit basis and one on a drawing right facility basis. The technical discussion of the two schemes by the Deputies had been quite useful and productive. It was clear that at least from a technical standpoint it was quite feasible to contemplate an agreement on a contingency plan for new assets. However, overhanging the discussion was the political problem posed by the attitude of the French. The question was whether or not the French would go along with a new asset and, if not, whether the other members of the Common Market would be willing to go along without the French. The political question was likely to be resolved in the very near future; the Monetary Commission of the European Economic Community was

scheduled to meet on April 6, and the Ministers and Governors of the Common Market would meet in mid-April.

In any event, Mr. Daane continued, the political problem made it much more likely that some form of a drawing rights scheme would emerge if the negotiations were successful. The difficulty was that there was a whole spectrum of types of drawing rights, ranging all the way from some modest extension of existing drawing rights to the other extreme of transferable drawing rights that would be scarcely distinguishable from a new reserve unit. The French as well as the Belgians were clinging to the lower end of the spectrum, but in his judgment the position they favored would not solve the problem with which the Deputies had been struggling--namely, the development of a new asset that would be a satisfactory supplement to gold. The U.S. position was that while on balance it would still favor a new unit, it had never ruled out a drawing right; indeed, the original U.S. proposal had included provision for both. It was necessary to keep in mind, however, that there were differences in types of drawing rights, and that there was a real risk of being drawn into agreement on a compromise type of drawing right that would not represent a meaningful solution to the problem.

Perhaps the most important point made at the meeting, Mr. Daane said, was an observation by Chairman Emminger toward the close of the session. He noted that the Deputies faced a dilemma: it

was necessary, on one hand, to give reassurance to those who stressed the desirability of changing existing monetary institutions in an evolutionary way; and on the other hand it was necessary to convince the financial markets that the problem of constructing an acceptable supplement to gold was being dealt with effectively.

Mr. Hayes said he was not sure one had to assume that whatever decision was reached in the first instance would necessarily represent the final answer to the problem of the shortages of gold that might develop over the years. Perhaps agreement at this time on a drawing right that was unlike a new unit could be considered a constructive result, with the thought in mind that it would be possible to approach more closely to a new unit by agreements reached at some later date.

In reply, Mr. Daane noted that the current discussions had been underway for some time. If they concluded with agreement on nothing more than a modest extension of existing drawing rights, it would be highly unlikely, in his judgment, that one could expect agreement within a reasonable time on a new unit that would meet the need for secular growth in reserves. It would be another matter, of course, if agreement could be reached now on a series of sequential moves. But to take a small first step without agreement on succeeding steps was not likely to lead to a solution.

Mr. Brimmer asked whether different members of the U.S. delegation had taken different positions in the discussions.

Mr. Daane replied in the negative, noting that the Treasury representative acted as spokesman for the United States and set forth the position of the Administration.

Chairman Martin then noted that the Committee had agreed at its preceding meeting to continue the discussion today of its policy with respect to publication of information on drawings under the System swap network and on other System foreign currency operations. Observing that Mr. Robertson had offered a proposed statement of policy at the previous meeting, the Chairman invited him to comment.

Mr. Robertson said that it seemed to him incumbent upon the Committee to have a definite policy in this regard and not to rely on *ad hoc* decisions. He had not received any comments thus far from other Committee members or staff on the particular statement he had proposed, and he was not certain in his own mind that that statement represented the right policy. Accordingly, he would suggest that the staff be asked to prepare a memorandum for consideration at the next meeting setting forth alternative proposals, so that the Committee could have the advantage of different points of view.

Mr. Coombs commented that he had assumed the Committee did have a policy on publication and that that policy had been carried out. It had been his understanding from the inception of foreign

currency operations, over five years ago, that information on all of the System's operations was to be reported within a reasonable period. At that time the magnitude of the risks that would be run with such a policy was not clear, but in fact information on System operations had been brought almost up to the minute in the published reports of the Special Manager.

While he had assumed that it was the Committee's policy to have the information on System operations brought up to date in his reports, Mr. Coombs continued, he had also thought that emergencies might arise which could make deviations from that policy desirable. As distasteful as it might be to delay publication of certain information, the possibility that a need to do so might arise in an emergency argued against a definite commitment to publish information concerning all System operations on a set schedule. Fortunately, no such emergency had arisen to date.

As for the use of the swap lines by foreign partners, Mr. Coombs said, he thought that on principle the Committee would not want to publish information without their consent. Furthermore, he would be dubious about pressing them too hard to consent to publication on any specific schedule. To do so might weaken their support of the swap network by seeming to open up a risk that information on particular transactions would be released before they were fully prepared for such release.

Chairman Martin said he thought it would be desirable for the staff to review the matter along the lines Mr. Robertson had suggested, and for the Committee to plan on discussing it further at its next meeting.

Mr. Mitchell suggested that the staff also be asked to comment on the appropriateness of the form in which foreign currency operations were reflected in the System's weekly statement--namely, through changes in the items for "other assets" and "other liabilities." Perhaps that form of reporting was satisfactory; on the other hand, perhaps it could be charged that the System was inappropriately concealing information. For example, the British had been engaging in window-dressing for some months, and the System had in effect been acquiescing in that procedure, given the way it published its figures. He was not necessarily critical of the present form of publication in the weekly statement, but he would feel more comfortable if he had the staff's judgment about its adequacy. If sterling had in fact not recovered from its recent difficulties many American businessmen might claim that they had been damaged because of inadequacies in the information published by the System. The question was whether such claims would be warranted.

Mr. Hayes commented that there was merit in Mr. Mitchell's observation, but he thought the Committee had to weigh risks of that

sort against whatever risks would be run by more complete current reporting. In the specific case of the British, there were many moments last year when they were highly anxious about possible market reactions to published information, and he would rather not have been in the position of insisting on any particular publication plan. The fact that sterling had recovered perhaps could be taken as evidence that the techniques used were successful.

Mr. Mitchell agreed that no harm had been done in that particular case. He was concerned about the possibility of a less fortunate outcome.

Mr. Hayes rejoined that in his judgment the risk had been well worth taking.

Mr. Daane said he would be reluctant to see the Committee take an inflexible stance on the point; he thought that could prove detrimental to the operations of the network. Certainly, no one wanted to conceal information, but as Mr. Hayes had noted it was necessary to weigh different kinds of risks in the balance.

Mr. Brimmer observed that the Federal Reserve Bulletin regularly included information on convertible foreign currencies held by the Federal Reserve Banks, with detail by type of currency. However, the data were shown with a substantial lag; for example, the latest figures shown in the March 1967 Bulletin were for November 1966.

Mr. Mitchell said he was concerned primarily about the timeliness of the published information. The data shown in the Bulletin were too old to be of value in current decisions by businessmen.

It was understood that the staff would prepare a memorandum along the lines suggested for discussion at the next meeting of the Committee.

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 March 6 through March 29, 1967, and a supplemental report covering the period March 30 through April 3, 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:

> The easier money market conditions sought by this Committee at its last meeting facilitated a large flow of funds through financial markets over a period that included the March corporate tax and dividend dates, a Treasury cash offering of tax anticipation bills, and a heavy calendar of corporate, municipal, and Federal agency financing. Moreover, the easier atmosphere helped produce a substantial decline in short-term interest rates. Strong market expectations of an early reduction in the discount rate were reinforced by signs of economic weakness, by the cut in the commercial bank prime rate, and by discount rate moves abroad. Together these factors produced a buoyant atmosphere in the capital markets and

long-term interest rates also moved lower, although the weight of new offerings and aggressive pricing of some new issues caused temporary setbacks. At the close of the period there were some signs of developing congestion--particularly in the long-term municipal market. These and other factors affecting financial markets, of course, have been spelled out in some detail in the written reports to the Committee and in the blue book[1] and need no extensive comment here.

Treasury bill rates moved steadily down from the levels prevailing at the time of the last meeting until the unusually strong auction of March 20. After some backup, rates tended to stabilize at about 4.17 and 4.10 per cent, respectively, on three- and six-month bills as bank and other demand slackened. Late last week, however, a resurgence of demand and expectations of a discount rate change pushed rates sharply lower. In yesterday's auction average rates of about 3.98 and 3.99 per cent were established for three- and six-month bills, about 35 basis points below rates established the day before the Committee last met. There could be some reaction in rates if expectations changed regarding the discount rate and also if special stresses arise around the tax date. Taking a longer look ahead to the second quarter, however, it would appear that Treasury bill rates could come under substantial downward pressures as the Treasury pays off a total of $8.0 billion tax anticipation bills in April and June in the face of seasonal demand from State and local governments and the System. This suggests that open market operations might prudently rely somewhat more heavily on purchases of coupon issues than has been the case in recent months.

The Federal funds rate was kept in a 4-1/2 - 4-3/4 per cent range generally during the period, but large reserve injections were required to prevent the persistence of an appreciable premium above the discount rate. The persistent tendency for a premium--despite the recent volume of free reserves in the banking system--reflects the dependence of many of the larger banks around the country on Federal funds purchases and other borrowing to meet substantial basic reserve deficits, which in turn are

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

partly related to heavy dealer financing needs. Quite naturally, such banks recognize that they cannot use the discount window as a continuous source of funds, and a few have been willing to bid up the funds rate instead when their needs have been large. This is apt to be a recurring phenomenon and we should not expect the old relationship of the discount rate as a ceiling to the funds rate to be readily restored--unless, of course, we are prepared to be even more aggressive in supplying reserves to the banks.

In the capital markets the pressure of new financing may well have passed its peak, although the calendar is heavy and could build up substantially if rates decline significantly. Banks and finance companies are among the more eligible candidates lurking in the wings, and a large additional number of nonfinancial corporations may well seek to fund some part of their outstanding indebtedness. So far this year private placements have run far below the level of earlier years, but as insurance companies and other institutional investors rebuild liquidity some of the pressure may again be taken off the public market. The record March total of over $1.6 corporate bonds offered publicly was two to three times the level of offerings in March in recent years, and the first-quarter total reflects the same pattern. The heavy flotations appear the natural consequence of last year's squeeze on corporate liquidity, and of this year's extraordinary speedup in corporate tax payments to the Treasury.

As you know, the Treasury will announce the terms of its May refunding on or about April 26, before the Committee meets again. In addition to the $9.7 billion Treasury notes maturing May 15, the Treasury may well want to consider a prerefunding of June, August, and possibly November maturities. Public holdings amount to $2.9 billion of the May maturities, $1.3 billion of the June, $4.8 billion of the August, and $2.6 billion of the November maturities. A large prerefunding would require an even keel posture for the System through mid-May at least, and could add to downward pressure on short-term rates if a substantial volume of short-dated coupon issues are moved out into the 3-5 year maturity range. I should also note that the Export-Import Bank plans to offer $400 million or so participation certificates within a few days. The Federal National Mortgage Association has about $900 million PCs to offer before

the end of the fiscal year in order to meet the budget target.

As expected, the Treasury borrowed directly from the System over the weekend of March 10. Earlier the Treasury expected that a similar borrowing might be required in mid-April, but most recent estimates indicate that this will not be necessary.

As the written reports emphasize, aggregate reserve and credit measures were exceptionally strong in March. The bank credit proxy rose at a 15 per cent annual rate--compared with the 10 per cent estimated at the time of the last meeting. The rapid rate of growth of various reserve measures in recent months has, naturally, permitted banks to restore liquidity lost in 1966, and business loan expansion appears to have strengthened in March. With the tax speedup, loan demands should be strong in April, and the Board staff estimate of a 10-13 per cent rate of growth of bank credit for April does not appear to be particularly disturbing. In fact, the New York Bank projection is for a 16 per cent growth rate. If the Committee should decide to include a two-way proviso clause in the directive it would be helpful to have the Committee's ideas on an appropriate range for bank credit growth. Let me note also that although the draft directives[1/] do not mention even keel considerations such considerations might have to override implementation of the proviso clause by late in the month.

Mr. Daane asked what market reactions might be expected to reductions in the Federal Reserve discount rate of 1/2 and 1/4 per cent, respectively.

Mr. Holmes said that a 1/2 per cent cut in the discount rate probably would be taken by market participants as a confirmation of their expectations that the System was moving to somewhat greater

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

ease. A 1/4 per cent reduction probably would be taken as a cautionary signal, indicating that the market should not overestimate the System's intentions to ease. The latter action might cause some temporary backup of short-term rates and it perhaps would have some effect on longer-term rates as well. Over the long run, however, other factors were likely to lead to downward tendencies in short-term rates, as he had indicated in his statement.

Mr. Brimmer asked what consequences a discount rate cut would have for rates paid by depositary institutions.

In reply, Mr. Holmes noted that yesterday one large New York bank had lowered the rate it paid on certain consumer-type time deposits. A discount rate reduction probably would trigger similar actions by other savings institutions. Obviously the effect would be greater if the discount rate was reduced by 1/2 per cent rather than by 1/4 per cent.

Mr. Daane commented that in a conversation yesterday a knowledgeable market participant had characterized the market for securities with maturities beyond five years as a "nothing" market. He asked whether that characterization was accurate.

Mr. Holmes replied that municipal dealers were finding it very hard to place securities. However, the corporate market was handling a great volume of securities, and there was good demand for longer-term Governments, mostly in the bank maturity area.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period March 7 through April 3, 1967, were approved, ratified, and confirmed.

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

Mr. Brill made the following statement on economic conditions:

The clues available to the Committee at the time of the last meeting, foreshadowing further weakening in the economy, have by and large been confirmed by data becoming available since then. Industrial production did decline substantially further in February, with the drop broadening out into many industrial sectors, and the odds are that another decline will be reported for March. Retail sales did fall off in February, and apparently showed little improvement in March. And on the employment front, we've seen reduced overtime followed by lay-offs--a classic cyclical pattern. After the sharp February drop in the workweek, the course of initial unemployment claims in March suggests that the unemployment rate rose last month.

Before noting some of the other clouds on the horizon, let me be sure to note a few silver linings. Stabilization of prices of machinery and equipment and renewed weakening in some basic materials prices give hope for a slowing in wholesale prices of industrial commodities over-all. And with food prices declining recently, at both wholesale and retail, the consumer price index has been slowed to a small upward drift. Even if the decline in food prices has about run its course, the weakened demand situation should keep increases in other commodity prices on the moderate side in the months ahead. And, wonder of wonders, even the pace of advance in service prices seems to be slowing a bit. At least one source of upward pressure on wages and costs may turn out more moderate this year than feared earlier.

Another bit of comfort comes from the news that a start appears to have been made in reducing the overhang of excessive stocks in the hands of producers and distributors. Reports for February show a sharp drop in the rate of inventory accumulation in manufacturing, and although data for trade are not yet in, these may show some net reduction in stocks. Certainly, one can breathe a slight sigh of relief that an inventory adjustment is at last under way.

But one cannot get much satisfaction from the fact that the adjustment is taking place through reductions in output, employment, and incomes, rather than from a rebound in sales. As one indication of the problem that may still lie ahead, the slowing in manufacturing inventory accumulation in February was more than offset by a drop in shipments, leaving the stock-sales ratio higher than before--indeed, as high as in the 1960-61 recession. Failing a pronounced pickup in final sales, more production cuts must lie ahead before inventories and sales get into a balance that businesses regard as viable.

What are the prospects that the inventory problem will be eased by a revival in final sales this spring? Taking it category by category, the only sure source of expansion in the near-term appears to be in Government spending. Federal spending for defense is running a shade higher than in the budget estimates, and will probably continue to do so--as best as one can speculate on the course of military activity and needs. Indeed, defense orders have been holding up the whole new orders series. Federal spending for nondefense purposes is also moving up faster than anticipated earlier, in part because funds impounded at the height of inflationary worries are now being released. And State and local spending appears slated to continue to rise at least as rapidly as in recent quarters. All in all, it seems most likely that Government outlays will add from $5 to $6 billion to GNP in the spring quarter.

Private spending for final product, however, doesn't seem to be going anywhere, on balance. While the longer-run housing picture still seems bright, the near-term picture is still uncertain. Funds are flowing into thrift institutions at a rapid pace, but thrift institutions are behaving thriftily, using their inflows in large measure to reduce indebtedness rather than to expand mortgage lending. It takes time to turn the housing

industry around, and although the turn will undoubtedly be more in evidence by summer and fall, the impact of easier credit conditions on construction is not likely to contribute significantly to a rise in GNP over the next few months.

Nor is there much basis for expecting a significant contribution to rising GNP from business fixed investment over the near-term, even with easier credit conditions and restoration of tax incentives. Declining sales, profits, profit margins, and order backlogs, along with rising excess capacity, are countervailing considerations. We'd probably be doing well if investment spending just held its own over the next quarter or so, with rising construction spending offsetting a likely decline in plant and equipment outlays.

It seems to me that if an orderly inventory adjustment is to continue without depressing levels of economic activity too much further, consumers will have to begin to spend more liberally, particularly for durable goods. It is not enough to pin one's hopes on a decline in the saving rate, which in any event usually occurs in recessions because income drops more rapidly than consumption patterns can be adjusted. Spending a larger share of a dwindling income can still mean declining markets for goods. We need a bulge in sales in absolute terms.

Near-term resurgence in consumer spending for goods can't be taken for granted, however, just because the saving rate has already moved up to a relatively high level. After three years of a saving rate fluctuating between 5 and 6 per cent, we have tended to assume that a 7 per cent rate is unsustainable, even for relatively short periods. Yet it has held up before. For almost three years, from early 1956 to late 1958, the saving rate stayed in a 6-1/2 to 7-1/2 per cent range. Over this period, while spending for nondurable goods about kept pace with disposable income, outlays for durable goods fell far behind. In fact, there was a decline in the physical volume of durables purchased by consumers. And through this period, manufacturing capacity utilization rates fell, as the industrial plant planned and ordered in the 1955 environment of booming consumer expenditures came on stream at a time when consumer spending propensities were subdued.

I'm not forecasting as long a drought in consumer spending ahead of us now. But I do emphasize that we

cannot be certain that the drought will end this quarter or next, no matter how much optimism the Survey Research Center at the University of Michigan reads into its surveys. Consumer attitudes are important, but the problem is more than psychological. Lay-offs and shortened workweeks bite into consumer capacity to undertake major expenditures.

Further declines in retail sales may not be in prospect, but the basis for a turn-up in sales soon is not clear, either. To cite 1958 experience again, revival in consumer spending lagged the revival in incomes by roughly two quarters. Currently, we're expecting deceleration, rather than revival, in income growth this spring. Resumption of faster rates of advance in disposable income is not likely until expanding Government spending is supplemented by incomes generated through rising private spending. Even further and faster increases in construction activity may not be enough to spark a broad and substantial upturn in consumption without additional injections into the income stream, perhaps through enlarged social security benefits.

For the near-term, then, our work seems cut out for us. We have to continue to make credit conditions even more conducive for consumers--and business and governments, also--to finance income generating expenditures, at least until the forces of expansion are firmly embedded. Much of our easing to date has been absorbed in restoring the liquidity wrung out of both borrowers and lenders last year, and this type of credit demand has kept the cost of financing long-term expenditures relatively high. Rates and terms on long-term debt have some way to go before they will reach levels that actually rekindle spending demands. It would appear premature, therefore, for the System to moderate its easing efforts at this stage.

Mr. Ellis asked whether the staff had backed away from the projections for the second half of 1967 that it had presented to the Committee in the course of the chart show given at the February meeting.

Mr. Brill noted that the second-half projections included in the chart show were those of the Council of Economic Advisers;

the Board's staff had not given any projections of its own for that period. The staff was now reevaluating the Council's projections, but was not yet ready to present its conclusions. Much would depend on the assessment of the outlook for the Federal budget, including the Administration's proposals for increased social security benefits.

Mr. Hickman, after complimenting Mr. Brill on his presentation today, noted that the staff of the Cleveland Reserve Bank thought it could detect evidence of some leveling in durable goods sales in the Fourth District during March. He asked whether the Board's staff had the same impression for the nation as a whole.

Mr. Brill replied that he had just received word that automobile sales did level off in March. However, it appeared that sales were not much different from production, which would suggest that there was little further reduction in inventories.

Mr. Koch made the following statement concerning financial developments:

> Bank credit expansion and capital market flotations have been very large in recent months, and a question that has no doubt come to your minds is whether these large financial flows suggest that the process of gradual monetary easing begun last fall has gone far enough for the time being. It is to this question that I shall address most of my remarks this morning.
>
> We had been expecting strong demands for credit and capital this spring, but apparently the volume of financing has been somewhat larger than projected. This may strike one as odd in view of the fact that the nonfinancial situation in the economy has been weaker than had been contemplated.

Also, the decline in long-term interest rates has been smaller than projected, even though time and savings deposits have increased rapidly at both commercial banks and at nonbank financial intermediaries and the narrowly-defined money stock has increased fairly sharply.

In the capital markets, the demand for financing has been particularly strong in the case of business corporations. Gross new corporate security flotations in the first quarter approached $6 billion.

Businesses have been borrowing heavily in the capital markets in part in order to regain a more balanced maturity structure of their indebtedness and in part in order to rebuild their liquid assets. However, it is doubtful whether aggregate net corporate liquidity has been built up much yet, despite a sharp rise in corporate holdings of certificates of deposit. The rise in liquid assets has been matched by a sharp increase in accrued business tax liabilities.

Also, business borrowing from banks in the first quarter was quite large, with demands concentrated in January and March, months of the heaviest tax payments. Borrowing will no doubt continue heavy this month--our staff estimates that corporate tax payments may total about $3-1/2 billion more than last year. Outstanding business loans are likely to rise in April even though a substantial amount of bank credit is expected to be repaid out of the proceeds of bond financing. In May and June taken together, though, corporate tax payments may only approximate those of last year. Thus, the crush of business financing demands on both the banks and the capital markets may be on the wane.

Despite continuing large business demands for credit, commercial banks have also been able to begin to rebuild their liquidity by adding substantially to their holdings of short-term securities and money market loans. Reserves have been more readily supplied and deposit inflows have been substantial, first of large-denomination and consumer-type CD's, and more recently of demand deposits and, surprisingly, even savings deposits.

Total bank time and savings deposits increased at an annual rate of 18 per cent in the first quarter, a rate that far exceeded the earlier projection. This growth included a rapid runup of large-denomination certificates of deposit to an outstanding volume of over $19 billion, about $1/2 billion above the earlier August peak.

The narrowly defined money supply has grown at an annual rate of 6 per cent in recent months. Much of this growth occurred in late February and March. It may have been due in part to increased corporate balances accumulated prior to tax payments and perhaps in part to increased consumer caution and decreased consumer spending on autos and other durable goods.

As a result of these more favorable deposit inflows, on a daily-average proxy basis total bank credit rose at over a 15 per cent annual rate in the first quarter, and on an end-of-month basis at a little over a 12 per cent rate.

The rise in business loans has occurred even though banks have not yet aggressively sought loans and have reduced their interest rates only with great reluctance and hesitation. Despite sharp increases in short-term security holdings in recent months, the loan-deposit ratio of the weekly reporting banks is still about 69 per cent, as compared with the peak of 72 per cent reached last fall. Many banks, like businesses, apparently are not yet satisfied with their liquidity positions, particularly in view of their apparent general acceptance of the presumption that a brisk economic expansion will develop before the end of the year.

The nonbank financial intermediaries, too, as Mr. Brill has suggested, have experienced very satisfactory fund inflows thus far this year. Like commercial banks, though, many of these institutions are also rebuilding their liquidity before they actively begin to beat the bushes for mortgage loans.

As for interest rate behavior in recent months, the decline in short-term rates has been faster, and that in longer-term rates more sluggish, than projected. If, as an interim target, we are seeking to reattain the financial conditions prevailing around late 1965, we are already there in the case of, for example, the 3-month Treasury bill rate, but still have perhaps a 1/2 per cent to go in the case of the Aaa corporate bond yield. And, although mortgage yields have declined more promptly than in earlier periods of monetary easing, the extent of the decline has been inhibited by high and sticky rates on time deposits and savings and loan shareholdings.

What does all this mean for current monetary policy? I must confess that I began my preparation for today's assignment with some trepidation about the size of recent increases in such financial aggregates as total reserves, bank credit, and the money supply. The more I reviewed the situation, though, the more I began to realize not only that these increases were only a little larger than those we projected earlier, but also that they were needed to rebuild the liquidity of the economy. The liquidity positions of both business enterprises and financial institutions had fallen to exceptionally low levels last summer, and it is necessary to rebuild them substantially and promptly if businesses are to be encouraged to invest and institutions to lend.

Finally, I feel that the current situation calls for a prompt reduction in the discount rate by 1/2 of 1 per cent. The market has already more than discounted a 1/4 per cent decline and probably largely a 1/2 per cent cut. If we do not go the whole 1/2 per cent, expectations will be disappointed and it might require large open market operations to keep another February-type reversal of credit market developments from occurring.

A 1/2 point decrease in the discount rate would give the capital markets a needed shot in the arm. It would likely mean lower corporate bond yields and, hopefully, would help to unstick the high rates on time deposits and shareholdings. As a result, it would contribute to a further reduction in the cost of mortgage credit, a development that is essential for a more adequate rate of over-all economic growth later in the year.

Action decreasing the discount rate by 1/2 per cent would be most consistent with proposed alternative B of the draft directives. As the blue book suggests, this would no doubt mean some further easing through open market operations, illustrated by an increase in free reserves to, perhaps, the $300 - $400 million range.

Mr. Ellis asked whether, if the market had already fully discounted a 1/2 per cent decrease in the discount rate, it would be necessary to buttress such action with open market operations to produce free reserves in the $300-$400 million area.

Mr. Koch said he did not think the market had fully discounted a 1/2 per cent decrease in the discount rate. In any case, the effect of a discount rate action was likely to be mainly psychological, and that effect probably would have to be backed up by open market operations to produce lasting easier conditions. The two actions need not be simultaneous, of course, since a discount rate cut would in itself have a temporary easing effect. He agreed with Mr. Holmes that it would be appropriate to provide reserves in part through operations in coupon issues.

Mr. Hickman said he concurred in the view that further easing was necessary. He wondered, however, whether a 1/2 per cent cut in the discount rate might not trigger a flow of funds abroad.

Mr. Koch replied that he had been addressing himself solely to domestic considerations. However, he thought Mr. Coombs' comments earlier today bore on the point in question.

Mr. Swan referred to Mr. Koch's observation that recent high rates of bank credit growth were justified by the need to rebuild the liquidity of the economy. He asked how much longer such growth rates might be necessary before the desire for liquidity was satisfied, at least to some degree.

Mr. Koch said that while he thought there was still some distance to go in meeting liquidity needs, he did not know how far that distance was. The growth rate of bank credit would have to be

watched, however, particularly if economic conditions improved and the demand for credit strengthened over the next few months.

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

> Large weekly deficits in March have made the over-all payments figures for the first quarter--so far as we know them--pretty gloomy. Through March 29, the liquidity deficit for the quarter approached $1 billion, seasonally adjusted, and the official reserve transactions deficit for the quarter exceeded $1-1/2 billion. Both figures are much larger than those published for the fourth quarter, and much larger than the quarterly averages that we have been expecting for the year 1967.
>
> The first quarter numbers do not represent any fundamental new deterioration from the fourth quarter. The increase in the liquidity deficit is wholly explained by three special types of transactions, none of which is closely related to economic activity or monetary conditions. First, we received no debt prepayments in the first quarter, whereas we had received nearly $200 million of such payments in the fourth quarter of 1966. Second, shifts of foreign official assets into nonliquid forms (at least through March 29) were about $200 million smaller than in the preceding quarter. Third, U.S. oil companies paid nearly $300 million equivalent to Libya for 1966 taxes in March of this year, whereas last year the corresponding payments were not made until April. (It may be that the seasonals--which are currently being revised--should be somehow adjusted for this.) On all other transactions than these, the deficit on the liquidity basis was roughly the same in the first quarter as in the fourth.
>
> Similarly, on the official settlements basis, the first and third of the special transactions mentioned, plus repayment of Euro-dollars during the early weeks of the year, in contrast to net inflows during the fourth quarter, explain the change in the balance. Since we argued last year that the Euro-dollar inflow should not be taken as representing a fundamental or lasting improvement, it would not be helpful now to treat the long-anticipated reversal of that flow as a fundamental deterioration.

But one can take only limited comfort from the fact that the bad first quarter was really no worse than the bad preceding quarter. We need to reassess future prospects in the light of these disappointing recent figures, of longer-run developments, and of the changing cyclical situation and associated changes in policy.

Government analysts have been meeting during the past week to make such a reassessment. They incline to the view, which I share, that--leaving aside for the moment such special transactions as debt prepayments and shifts of foreign official assets--the liquidity deficit may come out between $2 billion and $2-1/2 billion this year, down a little from last year's $2.8 billion, reckoned on a comparable basis. If in addition, as the Treasury staff now supposes, new special transactions can be arranged this year in about half of last year's large volume, the published liquidity deficit for the year might not differ much from last year's $1.4 billion.

This is roughly the same projection that the Board's staff has been giving you for several months. To cleave to it, despite the much worse figures of the past two quarters, is to project a considerable improvement in the quarters ahead. This may sound adventurous. But it is firmly rooted in the application of past relationships to recent and prospective economic developments.

The details of the projection are about as before. A sharp drop in merchandise imports from recent levels, coupled with some further modest expansion in exports, seems likely to make the trade surplus and the surplus on all goods and services about $2 billion better this year than last. The import drop will reflect the lower rates of GNP growth and inventory accumulation, and especially--with some lag--the recent and prospective decline in the capacity utilization rate in manufacturing. Equations fitted to past experience suggest that the import decline should have begun in the first quarter. And indeed, imports did drop in February, although 2- and 3-month averages did not yet show a significant decline.

Partly offsetting the current account improvement, there is still expected to be some deterioration on capital account. Direct investment outflows are now expected to increase by about 10 per cent year to year, though not from the swollen fourth-quarter rate. U.S. corporations plan some further increase in foreign

spending, and will probably not increase their foreign borrowing.

Some reversal of bank credit flows, from reflow to renewed outflow, is still anticipated. Through February, this had not happened. But Japanese borrowers will be seeking funds here later in the year.

Finally, net outflow of Government grants and capital will also be larger, as a result mainly of military and civilian aircraft financing by the Export-Import Bank.

Two aspects of the recent projection discussions are of particular interest to this Committee. First, it appears that any shortfall of GNP this year below about a $775 billion figure would not yield much net additional benefit to the current account. A deep recession would cut U.S. imports so sharply that it would probably have serious and early repercussions on activity abroad, and hence on U.S. exports.

Secondly, the group did not feel it necessary to specify its assumptions about U.S. monetary conditions in detail in order to project capital flows. The feeling seemed to be that interest rates in Europe and Canada would continue to move generally parallel with U.S. rates, and that the limitations on U.S. capital outflows imposed by the IET and the voluntary programs would make outflows of U.S. capital relatively insensitive to moderate changes in rate differentials.

Thus, so long as U.S. monetary policy is seen to be reasonably well suited to domestic requirements, so that confidence is maintained, the way in which policy unfolds in detail may not matter much for the balance of payments this year. This country has been placed in the position of taking the lead internationally in coping--or not coping--with world-wide recessionary tendencies. Britain, Canada, and probably other European countries (as Mr. Coombs has already suggested), are likely to follow that lead. Hence, although the payments position remains unsatisfactory, there seems to be little that U.S. monetary policy can do at this juncture either to help it or to harm it.

This is the case, I think, even with respect to Euro-dollar flows and the official settlements balance, for which the group of Government analysts makes no projections. Within wide limits, there may be little that this Committee can do, even if it wished to, to speed or retard a further reflow to Europe this year.

Clearly there will be a large official settlements deficit this year. Our February guess of $3 billion or more still seems valid, and more than a little disturbing. But so long as Britain and Germany are on the other end of it, we may not be confronted with large gold losses or the necessity of making large IMF drawings. And in a longer perspective, it will be right, I think, because of the ebb and flow of Euro-dollars, to average out the two years of 1966 and 1967 at a deficit of about $1-1/2 billion a year. That is no better than 1965, but also no worse, despite the Vietnam war.

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

Nearly all of the business statistics in recent weeks have confirmed a further slackening of the economic expansion. Bad weather doubtless played a part, but it is not the whole story. The deterioration has been a bit more than I had expected a few weeks ago. I find the inventory situation disappointing, with evidence that the needed inventory adjustment is still in its early stages. A cautious attitude on the part of consumers has clearly contributed to the recent sluggish record.

Despite all this, I hold to the view that what we are seeing is probably only a pause and that the economy is likely to become much stronger later in the year--although the timing of this strengthening may have been somewhat deferred. In general, confidence remains high, and there are strong underlying forces in the economy--forces which have been strengthened by the further easing of fiscal and monetary policies in recent weeks. I am impressed by the important stimulative role being played by the Federal budget, particularly in the second half of calendar 1967. This stimulus will be substantial even with enactment of the proposed surtax as of July 1--and without enactment of the surtax at that time, which looks increasingly unlikely, the fiscal stimulus will be of near-record proportions. In fact I can see cause for concern over the possibility that the budget will be highly stimulative at a time,

later in the year, when private demand is expanding rapidly. These prospects underline the need for greater flexibility in the timing of fiscal actions.

Meanwhile, although prices are now relatively stable because of the slackening in demand, we still face a serious threat of excessively generous wage settlements and resulting cost-price pressures. The need to take this threat seriously becomes all the clearer when we analyze the balance of payments statistics for 1967 to date. The liquidity and official settlements deficits for February and most of March indicate sharp further deterioration in our international accounts, despite an improvement of the trade surplus in February. It may well be that the worsening of our accounts reflects precautionary transfers of corporate funds to foreign affiliates in anticipation of new controls or taxes on direct investment outflows. Such anticipatory transfers apparently occurred already in substantial amounts in the fourth quarter of 1966.

I would interpret the present state of the balance of payments as clearly deteriorating. The liquidity deficit in 1966 was $1.4 billion; in the fourth quarter of that year it was at an annual rate of $2-1/4 billion; and in the first quarter of 1967 it is estimated at an annual rate of about $4 billion. The balance on the official reserves transactions basis was in surplus in 1966 as a whole, but it was in deficit at an annual rate of about $1 billion in the fourth quarter; and calculations at the New York Reserve Bank suggest a first-quarter deficit at a rate of about $7 billion. These figures are decidedly disturbing and, as I will note later, I believe a reference in the directive to the balance of payments deterioration they reflect merits consideration.

As for bank credit, it now seems clear that all three months of the first quarter showed a very rapid rise in bank credit; and a similar performance seems in the cards for April. Much of the expansion has been in investments, so that loan-deposit ratios have dropped substantially from their extraordinary peak. The money supply in March showed the largest monthly advance in the postwar period; and there have also been sizable gains in commercial bank time and savings deposits, as well as large savings inflows into the thrift institutions. These credit developments have been generally gratifying, following the shortfall of bank credit of

last autumn, and they appear appropriate in the light of the current state of the economy. Business loan growth in March seems to have been a good deal larger than anticipated, although a minor portion of it reflects the banks' endeavor to increase their liquidity by acquiring acceptances. Loan demand continues rather strong, in part perhaps because of the unusually heavy corporate tax payments due next month.

It seems to me that monetary policy has been doing about all that could be expected of it, with open market operations contributing importantly to easier credit conditions over recent months, and with last month's reduction in reserve requirements lending further support to the policy of greater ease. In view of the very rapid increases we are witnessing in most of the monetary variables which we usually think of as "intermediate objectives," I think open market policy should remain essentially unchanged over the next four weeks. In view of the likelihood of a reduction in the discount rate in the near future, I do not feel that money market conditions should remain the principal policy criterion but would suggest rather that we try to maintain about the present degree of reserve availability. Free reserves fluctuating in the $200 to $300 million range will probably be consistent with the objective of keeping about the present degree of ease. The Federal funds rate should, of course, be expected to adjust to any new discount rate level. We should avoid placing excessive reliance on the Federal funds rate, since it is noticeably affected by the prevailing spirit of reluctance among commercial banks to borrow at the discount window. Thus, reasonable fluctuations in the funds rate should be permitted.

As for the directive, the first paragraph as drafted by the staff appears to be generally acceptable. As I mentioned earlier, however, a reference to the recent deterioration in the balance of payments might be useful. Accordingly, I would suggest replacing the sentence on the balance of payments in the staff's draft with the following sentence: "The balance of payments has been deteriorating despite some recent improvement in the foreign trade surplus." It seems to me that the second paragraph should call for "maintaining about the present degree of reserve availability." With this modification, I like alternative A and am glad to see inclusion of a

two-way proviso. This would give appropriate recognition to the fact that bank credit expansion has recently been running at what are historically very high rates. This was fine on a temporary basis, but a long-run continuation of a growth rate of some 15 per cent would certainly be excessive. For April, in view of the tax speed-up, I would not be unduly concerned if the credit proxy were to run somewhat above the current estimates, but I would expect the proviso to become operative if this difference were to become very wide.

This brings me to the question of a possible discount rate reduction. There is much to be said for keeping all of the major instruments of monetary policy more or less in step when we have a significant change in business and credit conditions and a consequent change in policy, as has occurred over the past four or five months. Market rates have been moving down significantly, and some of them are of course well below the discount rate. It would seem to me highly logical to bring the discount rate now into better alignment, and, in so doing, minimize one element of uncertainty as to the intent of official credit policy. Since many of the Reserve Banks have directors' meetings this week, the question of timing presents no great difficulty. I find it a good deal more puzzling to decide whether the reduction should be by 1/2 per cent or by 1/4 per cent.

In favor of the smaller reduction of 1/4 per cent, one could point to the following arguments:

(1) Since such a move has been fully discounted by the market, it would presumably not lead to further reductions in market rates. In fact, it might cause at least a temporary backing-up of rates from current levels.

(2) The uncertainty in the business outlook might counsel a moderate move which could be reinforced or reversed in the light of further developments. It would leave us an opportunity for a further cut if business should turn out to be weaker than now seems likely or if knots should develop in the capital markets. At the same time it might make it easier for policy to turn around should this be necessary before the year is out.

(3) There is some risk now, especially in view of the very large volume of corporate

bond offerings, that a larger reduction could trigger wrong expectations and eventually lead to serious congestion which could only be eliminated by substantial further easing of credit.

(4) There may also be something to be said for accustoming the market to the use of smaller and more frequent changes in the discount rate than has been customary.

I find at least as many arguments in favor of a 1/2 per cent reduction:

(1) The present rate of 4-1/2 per cent is quite high historically. Perhaps a change from such a level should not be too niggardly.

(2) Historically, 1/2 per cent is the usual amount by which the discount rate has been changed in recent years.

(3) A move by 1/2 per cent would avoid the uncertainty that might be caused if the market should remain poised in expectation of another reduction.

(4) The larger cut would be more effective in nudging mortgage rates downward with consequent advantages of speeding recovery in the housing industry.

(5) A 1/2 per cent reduction would place the System in a position to move more vigorously on the up side should that become necessary.

(6) From an international standpoint, the present is probably a good time in which to make a decisive discount rate reduction if we plan to do so at all in the coming months. There have been a number of rate cuts abroad, and others might be encouraged by a move on our part, especially if it were a move of 1/2 per cent. There is a good deal to be said for staying "in phase" as much as possible with our foreign counterparts if economic conditions permit; and already there are some signs that European economies might gain renewed vigor a little later this year, and in such circumstances occasions for foreign rate reductions would probably vanish.

(7) In terms of our own balance of payments, a reduction at this time of 1/2 per cent in our

rate would probably have little adverse effect. For the time being, despite the disturbingly large size of the deficit, dollars are being accumulated largely in central banks, such as those of England and Germany, where they are not causing problems in terms of our gold stock. Later on, our room for maneuver might become much more limited if this geographical pattern should change.

(8) A reduction of 1/2 per cent would be a clear-cut, strong move and would not give an appearance of uncertainty and hesitation in System policy.

Last week I had an opportunity to discuss this whole matter in a preliminary way with our directors. There were divided views, with some of the directors reluctant to make any rate reduction at this time because of their belief that the economy would soon be expanding strongly again. In general, I think I could summarize their attitude as being one of caution. On balance, I would favor a discount rate reduction of 1/2 per cent. I believe, however, that such a move should be publicized as confirming the recent shift in market rates and as a means of bringing the discount rate into line with our other policy instruments, rather than as a significant move of further ease. An approach along these lines might minimize excessive expectational effects on market rates.

Naturally, I await with interest the views of the others at today's meeting.

Mr. Ellis remarked that belatedly, and therefore fortunately, the New England economy was exhibiting those recessionary signs that had characterized the national economy for the last several months. The seasonally adjusted unemployment rate for February remained unchanged at 3.3 per cent (the U.S. rate was 3.7 per cent) but initial claims for unemployment compensation, as of March 18, had for six weeks been exceeding such claims for the corresponding

period of 1966. For the preceding five weeks they had trailed year-ago levels. District measures of factory output and average weekly hours of manufacturing both turned down slightly between January and February.

Mr. Ellis reported that the Boston Reserve Bank had been watching the mortgage market closely to detect changes stemming from the shifting flow of funds through savings banks and insurance companies. A gradual decline had been recorded for January and February in the number of banks charging 6 per cent or more for residential mortgages. Bankers reported that the trend continued in March. It was interesting to note, however, that the number of savings banks offering higher rates on regular and special notice accounts was still increasing. Also, they were shifting to rates compounded and credited on a monthly rather than a quarterly basis.

The Boston Reserve Bank's survey of the eight largest life insurance companies in New England revealed that policy lending by February had dropped more than half from its late fall peak rate, Mr. Ellis noted, but it remained about double the 1965 "normal level." Their new commitments of funds for real estate mortgage loans to business in February nearly matched the average monthly level for 1965. Their residential mortgage new commitments had risen slightly but were less than half their average in 1965. Of course, all those commitments were for 1968 projects. They had no money to commit for this year.

Turning to monetary policy, Mr. Ellis said that two types of analysis--both present in the green book[1] and staff comments--defined a sort of Hobson's choice of monetary policy. The evidence was overwhelming that the economy was in a "recessionary" or "slow growth"--and therefore unsatisfactory--posture. Monetary stimulation--designed to stimulate housing--was an obvious need that the Committee had moved forcefully to provide. Its success since November was registered in the 6.8 per cent annual rate of increase in the money supply, the 15 or 20 per cent rates of increase in aggregate reserve measures, and the sharp increase in bank credit, based on sharp growth in both demand and time deposits.

By the same token, Mr. Ellis continued, the evidence from the same sources was persuasive that the economy might be expected to be expanding quite acceptably in the last half of the year. By itself, that expectation would be quite reassuring were it not for the knowledge that monetary policy works with a lag--even though the extent of lag cannot be precisely defined. To the extent that the Committee was fighting short-run problems with long-run weapons, it was storing up problems to be combatted later. That was perhaps an unnecessarily long way to emphasize that the longer the Committee pursued a policy of continued easing the more carefully it should

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

weigh prospective immediate gains against prospective future problems. His personal Hobson's choice arose when he tried to apply such a dictum in the context of policy for the next four weeks.

Mr. Ellis said that the trend and existing level of bill yields, the widely reported market expectations, and the desirability of using the discount rate instrument in harmony with other monetary policy instruments all counseled reducing the discount rate prior to the Treasury's refunding action later this month. The only question was how much. As the Board members knew, a week ago the directors of the Boston Bank chose a 1/4 per cent reduction. In his judgment, the question of how much to lower the discount rate depended on the kind of signal the System wished to convey to the market. At present rate levels, a cut of 1/2 per cent would carry the connotation that the System encouraged and intended to support both lower rates and further reserve easing, as implied by the discussion in the blue book of the probable effects of such a discount rate action. A cut of 1/4 per cent would be more passive; it would reflect a desire to confirm continuation of monetary ease, but it probably would have a neutral effect on market rates and expectations. Equally important was the likelihood that such a change would avoid possible interpretation that the System's concern had increased to the point at which it was prepared to force monetary policy into

a more aggressive posture. A move of 1/4 per cent would fit the established pattern of successive modest steps and avoid the "panic button" accusation. It would also minimize the exposure to flows of funds abroad.

All of that, Mr. Ellis remarked, tied back to his earlier observations about achieving present objectives while minimizing further problems. He believed the policy actions the Committee had already taken might be expected to have substantial and extensive impact in the next three months. In particular, a slower rate of new corporate issues should allow long-term rates to reflect more of the movement that had occurred at the shorter end of the market. He was prepared to postpone the further easing of net reserve positions that might be associated with a discount rate reduction of 1/2 per cent.

Within the alternatives outlined in the blue book, Mr. Ellis anticipated that a 1/4 per cent cut in the discount rate, supported by continuation of present efforts to preserve an easy money market, would continue but not accelerate the rapid growth in reserve aggregates, bank credit, and the money supply. In effect, he was in agreement with the last sentence in the full paragraph on page 8 of the blue book, which said substantially that. In fact, that whole paragraph, with a change in title, outlined a course of policy he believed appropriate. The preceding paragraph was labeled

"Further ease through open market operations alone." The paragraph on page 8 might be made parallel in concept and acceptable to him by adding a new final word to the title, to read "Further ease with discount rate cuts alone."1/

Mr. Ellis concluded by observing that for the second paragraph of the directive he would favor either alternative B, interpreted in terms of the blue book language he had cited, or alternative A amended in the manner suggested by Mr. Hayes.

Mr. Irons reported that in the Eleventh District the adjustment in economic conditions that had been under way for some time was continuing, although it did not appear to be accelerating or to be causing much disturbance. The employment situation had changed

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1/ The paragraph to which Mr. Ellis referred reads as follows: "Further ease with discount rate cuts. A 1/4 point decline in the discount rate to 4-1/4 per cent would tend essentially to do little more than confirm current levels of security yields. It would become more likely that the Federal funds rate would move below 4-1/2 per cent, assuming free reserves in their recent range. It would also serve to lower dealer lending rates somewhat, and thereby take some potential upward pressure off bill rates in the longer run. Over the short-run, though, the 3-month bill rate may rebound from its very recent 4 per cent level, and perhaps fluctuate in a 3.90 to 4.15 per cent range over the next four weeks. If accomplished soon, a small discount rate cut could also smooth market adjustments around the mid-April tax date. The expansion in reserve and monetary aggregates could very well remain within the ranges earlier indicated for an unchanged monetary policy since borrowers and banks have to a great extent already built in a discount rate reduction of at least this size into their decisions."

relatively little recently; in fact, employment in manufacturing had shown the normal seasonal rise, and employment in services and government had increased more than seasonally. Some increase in total employment was expected during the current month. Industrial production was down, with decreases in various durable and some nondurable goods industries offsetting gains in transportation equipment and aircraft. Construction activity was perhaps showing some signs of increasing. Retail trade, as reflected by department store sales, was running about 7 per cent over a year ago, and cumulatively for the year to date was about 3 per cent over a year ago. The District had not felt the impact of the decline in automobile sales quite so much as the country as a whole.

Mr. Irons said that there recently had been relatively strong demand for loans, reflected mostly in categories other than commercial and industrial loans. Banks had added to their investments as they sought to improve their liquidity positions, and their loan-deposit ratios were better than they had been a few months earlier. Borrowing from the Federal Reserve Bank continued to be negligible; in fact, it was less than $1 million yesterday, as low as it had been for some time. Looking beyond the next few months, bankers in the District generally were expecting a continuation of easy credit policy until a turn in the economic situation appeared.

At the national level, Mr. Irons continued, the course of business activity continued to be characterized by adjustments that were leading to a degree of weakness in various sectors of the economy, as reflected in the green book. The most notable adjustments were in the inventory area. It was true that stock-sales ratios had not improved, but some encouragement was offered by the fact that inventories themselves were coming down. There had certainly been a sharp easing of bank reserve positions. As indicated in the blue book, the much easier credit policy was being reflected in marked reductions in short-term rates. There also had been some declines in long-term rates although, as would be expected, they were not as large as in the short-term area. During the past several months the System had injected a substantial volume of funds into the market and, in general, had eased conditions significantly. Those policy actions had at least partly succeeded in accomplishing their objectives; a large volume of reserves had been provided at low cost, and certainly the severe strains evident a few months earlier had been moderated.

At present, Mr. Irons said, he would recommend maintaining about the same degree of ease as had characterized the money and credit markets during the past month. He did not think additional ease was needed at this time from the standpoint of either rates or availability. Recent growth rates in financial aggregates such as

the bank credit proxy, while suitable for the short run, probably were excessive for a sustained period. He would prefer alternative A for the directive.

Mr. Irons added that he personally would like to see no change in the discount rate at this time, although he knew that arguments could be arrayed against that position. He was concerned that a discount rate reduction, no matter how its purposes were described, would be taken as another clear and definite step in the direction of further ease, and would lead to further sharp declines in short-term rates and increases in the availability of funds at banks. However, if the rate were to be reduced, he would favor a cut of 1/2 per cent rather than of 1/4 per cent.

Mr. Swan reported that the unemployment rate in the Twelfth District was unchanged in February after recording a sharp drop in January. Manufacturing employment showed virtually no change but total nonfarm employment edged up. It appeared from limited figures that average weekly hours of production workers in manufacturing in California decreased by only 0.1 in February, compared with a decline of 0.7 nationally. That difference perhaps was related in part to the smaller emphasis on production of automobiles and appliances in California than in the rest of the country.

Credit extended by weekly reporting banks in the District grew quite rapidly in the four weeks ending March 22, Mr. Swan

continued, in contrast to a decline in the corresponding period of last year. The increase in securities holdings was very large, and was about equally divided between municipals and Governments. From the first of the year through March 22, total credit rose more at weekly reporting banks in the District than at such banks elsewhere. Much of the rise was due to increases in loans to securities dealers, while business and real estate loans declined. There were indications from some banks that inquiries regarding real estate loans had increased substantially recently, but such interest was not yet fully reflected in loans extended and in some cases not even in commitments made. The credit expansion had been quite consistently supported, in part at least, by continued net purchases of Federal funds by the larger District banks. Borrowings from the Reserve Bank were higher in February than in any month since September 1966. Such borrowings declined in March, however, and in the week ending March 29 they were zero.

Yesterday, Mr. Swan said, after a large New York bank reduced the rate it paid on certificates of deposit of less than $100 thousand, he had made a quick check with some of the District banks and learned that they did not contemplate taking similar action for the time being. Apparently, California savings and loan associations did not intend to lower their dividend rates at present, and the banks planned to maintain their time deposit rates at levels competitive with rates paid by the associations.

In Mr. Swan's judgment, the Desk had carried out Committee policy extremely well over the past month. The developments that had occurred--including the decline in bill rates, the fact that the Federal funds rate was finally reduced below the 4-3/4 - 5 per cent area, the increase in net free reserves, and the growth in the bank credit proxy--were all quite satisfactory to him. The fact that the decline in longer-term rates was relatively limited was explainable in terms of the heavy volume of offerings in the bond market. He was not sure that the problem of "unsticking" long-term rates was a significant one at present; if there was some reduction in the demands made on capital markets soon, those rates would move down by themselves.

In thinking about policy for the period ahead, Mr. Swan continued, like Mr. Koch he had started with the question of how long it would be necessary to maintain the rather substantial rates of increase achieved over the last several months in bank credit, money supply, and the like, and whether still larger increases would be desirable. The latter seemed quite doubtful to him. He thought a discount rate reduction would be appropriate for the sake of consistency with other recent policy actions of the System and possibly to provide further confirmation of the System's present policy posture. As to the size of the cut, like Mr. Ellis, he found the description on page 8 of the blue book of the probable results

of a 1/4 per cent rate reduction quite satisfactory. It was difficult for him to believe that the discount rate could be reduced by 1/2 per cent without having that action interpreted as a significant further move toward greater ease. In general, he would question the desirability of the System's taking that kind of step at this point, whether by a discount rate change or otherwise. Consequently, he had been thinking in terms of a reduction of 1/4 per cent, with the thought in mind that, if economic conditions weakened to a greater extent than he considered likely, the System would not hesitate to make another reduction promptly.

There were only two arguments that he could see on the other side, Mr. Swan continued. The first was Mr. Coombs' observation that a 1/4 per cent reduction in the Federal Reserve discount rate might lead to less widespread and smaller reductions by other central banks than a 1/2 per cent cut would. While he was not in a position to assess fully the effects on other countries, he suspected that some discount rate action by the System, even if not a 1/2 per cent reduction, would be sufficient to encourage rate reductions abroad. The other point that concerned him was that of timing of the second 1/4 per cent reduction if it should prove necessary. Presumably the System would be precluded from acting in May by the Treasury financing, and action in June also might not be possible if there was another

Treasury financing at that time. If further discount rate action was to be foreclosed for three months, there might be some question about the appropriate size of the initial action. On balance, however, he favored a 1/4 per cent reduction at this point. He had not had an opportunity to discuss the question with the full board of directors of his Bank, but the matter had been raised at a meeting of the executive committee, where mixed feelings had been expressed.

Mr. Swan said he would have some difficulty in accepting alternative A for the directive, in light of the expected discount rate action. He could accept alternative B if it were interpreted to call for maintaining the slight further easing in money market conditions that would probably follow a 1/4 per cent discount rate reduction. It should be explicitly recognized that the Desk should try to offset any backup in interest rates that might result from market disappointment with the size of the reduction.

Mr. Galusha reported that the Minnesota legislature had passed the par clearance bill yesterday, and that that might stimulate the South Dakota legislature to take similar action. Hopefully, within 18 months non-par clearance would be a thing of the past in the Ninth District.

Perhaps the most interesting bit of financial information gained in his usual pre-FOMC meeting queries, Mr. Galusha said, was the speedup reported in the time schedule of previous long-term

commitments. In one instance a borrower was being urged to draw down immediately funds previously programmed for late 1968. In visiting with business leaders of the Twin Cities, he found a basic confidence in the ability of the economy to respond as the year wore on. Skilled labor continued in extremely short supply.

Agricultural credit, though, was responding slowly, Mr. Galusha observed. In the Reserve Bank's latest survey of agricultural credit conditions, it received virtually no responses indicating an easing of loan rates, short- or long-term. Apparently there had been a modest increase in the number of country banks seeking new farm loans, though, so perhaps some reduction in rates would come along soon.

According to the Reserve Bank survey, Mr. Galusha said, there was considerable pessimism among country bankers about farm incomes. A frequent opinion was that reports should be expected of more and more farmers who were unable to repay their loans on schedule and of further declines in spending by farmers on producer and consumer durables. Nor was there any indication that farmers generally would be availing themselves in any substantial measure of the opportunity to increase plantings. The U.S. Department of Agriculture would have to place their bets on the benevolence of God and the weather instead of the farmer for increased production this year. The mood of agriculture seemed rather dark. With holding actions and farmer boycotts, the midwest was hardly waking joyously to spring.

Turning to monetary policy, Mr. Galusha said he continued to be a crepe-hanger. He had to report growing concern among city bankers about their being, as they put it, returned to the circumstances of November 1965 and before. In those areas, like the Twin Cities, where the competition for consumer CD's was intense among all financial institutions, the first to move might be severely penalized. The move yesterday by a New York bank to lower the rate paid on consumer-type CD's might be infectious but he was afraid it might be something less than contagious. The president of one of the District's large banks had argued that the Board would have to change Regulation Q to correct the increasing imbalance between bank lending and borrowing rates. He (Mr. Galusha) found it distasteful even to contemplate the Board taking on the task of assuring a profitable spread between those rates. But, at the same time, he did believe that District banks were going to go through agonies in getting their consumer deposit rates down and, in that connection, that a half-point reduction in the discount rate would be quite helpful. It might even be that, if Reserve Banks generally and the Board decided on a discount rate reduction, in announcing the change the Board should indicate an expectation that lower consumer deposit rates would follow.

Were there to be a discount rate change soon, Mr. Galusha said, he would favor holding free reserves within a $250-$300 million range.

But, again, he would suggest that whatever the free reserve target, it should be qualified by an insistence that money market rates not rise--except perhaps in slight, brief flurries.

Mr. Galusha said that the proviso clause in alternative A of the draft directives would seem to give the Desk sufficient latitude to cope with whatever conditions might arise from a discount rate change. However, he had no preference between the two alternatives.

Mr. Scanlon said that in the interest of time he would summarize the remarks he had prepared and submit the full statement for the record. He then summarized the following statement:

> With March and a period of relatively favorable weather behind us, we see no evidence in the Seventh District of renewed strength in business activity. Increasingly, the situation resembles the latter portion of 1957 when production of both producer and consumer durable goods was declining.
>
> Retail sales have remained sluggish, judging by trends in bank debits, savings, consumer credit, and trade reports.
>
> Periodic reductions have been made in forecasts of near-term output for steel, autos, trucks, furniture, and appliances.
>
> The effort to reduce inventories is widespread. Many bankers find that the need of customers to carry larger than expected inventories is playing a significant role in recent strong loan demand. Virtually all types of materials and components that were in short supply during most of 1966 now are readily available. Lead times on aluminum and brass products have shortened dramatically and prices have softened. Forgers and most types of foundries now are actively seeking new business.
>
> All District States reported new claims for unemployment compensation to be substantially above a year ago in the first three weeks of March. For Wisconsin and Michigan

these claims are the highest for any comparable period since 1961. For Illinois, Iowa, and Indiana, claims, although above the year-ago levels, are still low in comparison with the early 1960's.

While mortgage terms have eased somewhat, scattered evidence shows building permits issued in January and February to be at very low levels. Sales of existing homes are said to be improving. The preponderant view in our area continues to be that no substantial gain in residential construction will occur until after midyear, with new apartments likely to be especially slow. The need to arrange financing, prepare sites, and assemble work staffs will take time.

The banking figures for March continue to reflect relatively weak credit demands by consumers. The growth in loans to business at District banks, on the other hand, was even more rapid than for the U.S. and exceeded the pace set in any of the past three years. For the first quarter through mid-March, business loans of District weekly reporting banks, excluding acceptances, were up 4 per cent, compared with a 2 per cent nationwide gain. However, there are reasons for attributing a considerable portion of the demand for bank credit to temporary factors such as tax payment needs, as well as the financing of exceptionally large inventories. Much of the rise during March was attributable to manufacturing industries.

While the Chicago banks' needs for funds prior to April 1 were of about the usual magnitude, they were able to cover these needs without much difficulty and with relatively little resort to the discount window. These banks have acquired more than $180 million of funds in the CD market in the past month compared with a decline in March 1966.

The money supply--the only aggregate monetary series which did not increase sharply in January and February--rose rapidly in March. In large measure the failure of the money supply to rise concurrently with reserves in the earlier months may be attributed to the strong demand for CD's as market rates of interest declined sufficiently to permit banks to again market CD's successfully. The acceleration in the growth of money supply in March may reflect satisfaction, at current rates of interest, of the pent-up demand for CD's by business firms and for CD funds by banks. If this is the case the money supply could be expected to increase more nearly in line with the rate of growth of total reserves in coming weeks, except as offset by changes in Treasury deposits.

The failure of interest rates to decline as sharply since their peaks of last Autumn as in either 1958 or 1960 in light of strongly expansionary policy probably reflects both a strong desire of business and consumers to rebuild liquid assets and the very moderate softening of business activity thus far.

In considering the proper stance of monetary policy, one's judgment of the magnitude of the current adjustment in the economy is critical. If we expect only a slight weakening, then the very stimulative measures recently taken may be setting the stage for excessively strong rise of demand several months hence. On the other hand, if economic activity is expected to decline or move sideways for a considerable period, continuation of the current expansionary policy would seem appropriate.

It appears to our staff that the current adjustment probably will be moderate, largely because of expansionary monetary and fiscal actions already taken. It appears also that recent rates of expansion of reserves, money, and credit are excessive from any long-term point of view. Since it seems that monetary policy affects employment, production, and income with considerable lag, it is possible that large and extended swings in reserve growth may have an unstabilizing effect on activity. Nevertheless, because of the possibility that the current active demand for credit reflects largely needs associated with past rather than future activity, I would favor continued rapid expansion of total reserves and/or money supply until we see some additional readings on business indicators.

Mr. Scanlon added that it was difficult for him to look upon a discount rate change as being urgent at a time when the monetary indicators were expanding as rapidly as they had been recently. However, he joined those who favored the approach on page 8 of the blue book involving a 1/4 per cent reduction in the discount rate. Believing that a 1/4 point decline would be a confirmation of what the market had already discounted, he would not oppose such a move.

He would regard the action as just getting the discount rate more in line with other rates, possibly to be followed soon by another change of 1/4 point if needed. That would emphasize rate flexibility on the downside, hopefully paving the way for flexibility on the upside when appropriate.

Mr. Scanlon noted that he had had some difficulty in deciding which alternative he would prefer for the directive. Since the explanatory material characterized alternative A as being consistent with no discount rate change, however, he favored alternative B, as interpreted by Mr. Ellis.

Mr. Tow reported that moisture conditions were below normal in most of the Tenth District, and a severe drought continued in a substantial part of the winter wheat belt. Over the last five days considerable rain had fallen along the eastern part of the District, with variable amounts ranging up to five inches at Kansas City. As that region also was dry, those rains were beneficial. The real drought area, which involved central and southwestern Kansas, western Oklahoma including all of the Panhandle, northern New Mexico, and southern and southeastern Colorado, was not included in the area of rainfall. Much of the wheat in the drought area could not be saved now even by rain, but moisture would be helpful to some of the wheat and also for pasture and feed crops. Because of the lack of

moisture and the lower level of agricultural prices this year, farm income in the Tenth District probably would be distinctly lower in 1967 than in 1966.

Turning to the national economy, Mr. Tow said that both current and prospective economic developments called for a continuation of an expansive monetary policy. Most of the evidence concerning the private sector of the economy pointed in that direction. As was frequently the case, the appropriate degree of such monetary easing was not equally clear.

Evidence had to be given to the market that pursuit of such a policy remained a System objective, Mr. Tow continued. That did not mean that any dramatic action was required, but it did mean that there should not be any reasonable basis for assuming at this juncture that the System had ceased to pursue that course. The main objective should be to encourage a further but moderate easing of interest rates, particularly with a view to encouraging lower long-term rates. In the process of carrying out such a policy, member bank credit expansion probably would continue in line with that of recent months.

Mr. Tow thought that the instruments used should be both the Federal Reserve discount rate and open market operations. Although some persuasive arguments had been made today for a 1/2 per cent reduction in the discount rate, he still felt--as he had before today's meeting--that the reduction should be 1/4 per cent, so that it would

be a confirming rather than a leading action. In his opinion, despite the levels to which Treasury bill rates had declined, a reduction of 1/2 per cent would definitely be a leading action. Open market operations should be the instrument used to assure a moderate degree of further easing of interest rates. The aim would be to go somewhat beyond the confirming action as suggested by the 1/4 per cent discount rate reduction, but to stop considerably short of the degree of ease, as described in the blue book, that would be associated with a 1/2 per cent discount rate reduction. It did not seem to him that that would involve an acceleration in the rate of expansion of reserves and bank credit; it would probably result in expansion rates essentially in line with those of the recent past. Alternative B of the draft directives would be consistent with the policy course he favored.

Mr. Wayne reported that business activity in the Fifth District continued to weaken. A special survey of the Richmond Reserve Bank's regular business panel showed that finished inventories had increased in the past three months and were above desired levels, especially in the textile and furniture industries. Collections on accounts receivable were also slower than six months ago. Some marginal textile plants had been closed and it was reported that more might follow if present softness continued. The Reserve Bank's regular survey showed continuing declines in new and unfilled orders, hours worked, and prices received for finished goods. Nonagricultural employment increased slightly in

February, but factory employment declined. Factory payrolls also were down significantly. Except for West Virginia, insured unemployment rose in all District States in February, but remained below the national average. The only bright spot in the District economy was a slight rise in the construction index in February. In agriculture, the entire District peach crop was seriously damaged by frost, but 1967 planting intentions for principal crops were above those of a year ago.

At the national level, it was clear to Mr. Wayne that the economy was in the middle of a significant adjustment. Whether or not that was a "recession", it seemed clear to him that the present trends of the economy would produce a substantial amount of idle resources in the near future. Policy over the past three months had recognized that fact and in that period reserves had been pumped into the banking system at a rate that was impressive by any standards. Free reserves showed a $350 million swing for the period, from minus $100 million to plus $250 million, and projections of total reserves through March indicated a quarterly increase larger than in any other quarter in the past ten years. In addition, over $800 million of reserves had been made available by the reduction of reserve requirements.

As for policy, Mr. Wayne felt that in the past three months the Committee had supplied reserves at a rate which could be justified only

on grounds of a transitory effort to change market sentiments. As he viewed the market today, the Committee's lavish provision of reserves lately had been only partially successful in producing the desired result. The heavy buildup in the calendar of corporate and municipal offerings had held up the long end of the rate structure and had prevented the ease that had been generated in some parts of the market from reaching that end. Yet it seemed to him that it was precisely in the long end of the market that more ease was needed. Rate reductions there, coupled with the prospective reinstatement of tax incentives, were the best hope for cushioning the weakness in business capital investment and for speeding up recovery in mortgage markets and in housing.

It seemed to Mr. Wayne that over the next few weeks credit policy could make a further contribution only to the extent that it could break the log jam in the long end of the market. For that reason he would like to see open market purchases shifted, whenever feasible, to the coupon area or to agency issues. To the same end, he would like to encourage some shifting of capital market borrowing to the banking system. The recent reduction in the prime rate was a welcome move in that direction but his own feeling was that that rate should come down further. He was encouraged also by the declines in CD rates in the past week. It seemed to him highly desirable to

maintain downward pressure in those areas, but without increasing the rate of reserve creation. In any event, a reduction in the discount rate struck him as an especially appropriate step to take at the present juncture. Such a move would consolidate the System's recent easing action and at the same time it would promote desirable adjustments in the rate structure.

Mr. Wayne found himself in general agreement with Mr. Hayes and, on balance, favored a reduction of 1/2 per cent in the discount rate. However, he would prefer, until the next meeting of the Committee, the open market posture suggested by alternative A of the draft directives, especially with the double-proviso clause. Despite comment to the contrary, he did not find those two proposals inconsistent.

Mr. Shepardson remarked that at this meeting of the Committee, probably the last that he would attend, he would note that his service with the System had been a most challenging and rewarding experience. He was grateful for the opportunity to serve on the Board and the Committee, and he wanted to express to everyone present his appreciation for the friendships held out to him.

As to policy, Mr. Shepardson's views were similar to those of Mr. Wayne. Certainly the System had been providing reserves at a very ample rate. The recent rates of expansion in both bank credit

and the money supply, while desirable in a transition period, were too high to be sustained for long. As Mr. Ellis had suggested, by pushing too far toward ease now the Committee very likely would be building up problems for the future. Accordingly, he favored alternative A of the draft directives, modified as Mr. Hayes had suggested to call for maintaining the present degree of reserve availability. Such a course would make it less likely that open market operations would push the expansion in money and credit to rates higher than those recently prevailing.

With respect to the discount rate, Mr. Shepardson said that he would be averse to taking any action that might be considered a leading action. He thought, however, that a reduction of 1/2 per cent would be desirable at this time in view of the levels to which some rates--particularly bill rates--had fallen in recent days, and in view of the stickiness of other rates, which perhaps reflected psychological factors more than credit availability. A reduction of 1/2 per cent now also would make it more feasible to raise the discount rate later in the year if that became necessary.

Mr. Mitchell said he also favored a 1/2 per cent decrease in the discount rate. As Mr. Hayes had suggested, that action should be accompanied with no fanfare. With respect to the financial aggregates, he wondered whether the satisfaction some had expressed this morning

regarding what had been achieved in the recent transition period was wholly warranted. GNP in the first quarter of 1967, as projected by the staff, was 6 per cent higher than a year earlier, but in February the money supply was only 1.4 per cent above February 1966. Money supply expansion accelerated in March, but growth in the twelve months ending then was still only 2 per cent. It was clear that there still was some catching up to be done, and he saw no reason to be alarmed about the pace at which the money supply and bank credit had been growing recently.

Mr. Mitchell then referred to Mr. Hayes' proposed replacement for the statement on the balance of payments in the first paragraph of the draft directive. He (Mr. Mitchell) had understood Mr. Reynolds to say that there had not actually been any significant change in the over-all payments position, at least relative to the fourth quarter, and that real improvement was occurring in the trade balance. In view of Mr. Reynolds' analysis, he would not favor the language Mr. Hayes had proposed.

Mr. Mitchell concluded by noting that he preferred alternative B for the second paragraph of the directive.

Mr. Daane commented that economic conditions certainly warranted the System's continuing an ease policy and continuing to make that policy clear, but how much ease should be sought was to

him a much more difficult question. One problem he had with the blue book analysis--and with the comments of a number of speakers today--was that, in a sense, too sharp a separation was made among the System's instruments. Thus, the blue book first discussed seeking further ease through open market operations alone, and translated that into a free reserve target range of $300-$350 million. It said little about open market operations in discussing the implications of a 1/4 per cent reduction in the discount rate. It then indicated that a 1/2 per cent discount rate cut "would probably require a follow through over the weeks ahead in the form of somewhat larger free reserve positions," which might be taken to imply the $300-$350 million range mentioned earlier as consistent with further ease in the absence of a discount rate change. He would approach the problem from the other direction, by saying he favored somewhat greater reserve availability; that, to him was the key. He agreed with the view that it was necessary to go somewhat further in providing liquidity to the economy.

It was less easy to say by how much the discount rate should be reduced, Mr. Daane continued. A week ago he had thought that a 1/4 per cent cut would be consistent with somewhat greater reserve availability and would confirm to the market the viability of current interest rate levels. But as he sensed more recent developments in

the market, that was no longer true. His present view, based partly on conversations with several market participants, was that a 1/4 per cent cut would be interpreted more as a cautionary signal than as a stimulative one. As one market participant had put it, market expectations had already placed the System in the position of having to make a 1/2 per cent change if it were to take a meaningful action. He was a little unhappy about being led by the market in that manner; he would have much preferred a 1/4 per cent reduction now, to be followed at a later point by a similar reduction if it was decided that continued easing was desirable. He was not sure that the course Mr. Hayes advocated--of reducing the discount rate by 1/2 per cent and standing pat on reserve availability--was a consistent one. A 1/2 point reduction in the discount rate was likely to generate market expectations that would outrun the reserve availability conditions the Committee would be seeking if it adopted alternative A with the amendment suggested by Mr. Hayes.

In sum, Mr. Daane said, he would favor somewhat greater reserve availability and whatever discount rate change would be consistent with that goal. He felt that a 1/2 per cent cut was more likely to be consistent, but he would not be averse to 1/4 per cent cut if it would not produce undesirable reactions. He was inclined toward alternative B for the directive, but would amend it to call

for operations "with a view to attaining somewhat greater reserve availability."

Mr. Maisel said he would discuss two separate questions today. First, he would urge that more operations take place in the longer end of the coupon market; and, secondly, he would comment about open market operations and the proper level of the discount rate.

Mr. Maisel thought the Desk was to be congratulated for its greater recent activity in coupon issues. It would be useful over the next two months to concentrate still more of the Committee's efforts in coupon issues, preferably with maturities of over five years. Interest rates on longer-term bonds and mortgages--the areas in which monetary policy was expected to do the most good in the coming year--had lagged abnormally behind short-term rates. Concentrating more purchases in the longer area might aid in cutting that lag.

Mr. Maisel said he was not suggesting an "operation twist." In order to avoid any assumption that the Committee was attempting to hold short-term rates up, coupon issues should not be bought when it was necessary to sell bills. In the past year, except for its most recent operations, the Committee had been relatively inactive in the coupon market. Considerably larger transactions

could be undertaken without causing the Committee to move outside the pattern of previous years. The System's portfolio also showed a considerable scope for coupon purchases in terms of past traditions. In addition to narrowing the lag between current Committee policy and the desired monetary objectives, action in the coupon area might aid in maintaining expectations and thus might slow somewhat the rush to get into the long-term market.

With respect to current policy and the discount rate, Mr. Maisel believed the alternative directives offered were not achievable in terms of their stated objectives. Alternative A, with its related discount prescription, could not "maintain prevailing easier conditions." Assuming it were tied to a "no-change" policy for the discount rate, it would mean that in the attempt to maintain current ease, far more total reserves and marginal reserves would have to be furnished than under alternative B; and, even then, interest rates would back up a good deal.

In the past four months, Mr. Maisel continued, the amount of ease in the market with respect to rates, and also with respect to bank credit expansion, had occurred only partly through the Committee's own action. Much more of existing market conditions had been brought about by the expectational forces in the market.

Mr. Maisel reported that last week he spent three days talking to over 50 officers of about 10 bank and nonbank dealers. While their statements clearly were partly self-serving, their general views of the market and their conclusions seemed to make sense and to agree with the logic of the current situation. All agreed that current market rates and activity assumed that the discount rate would be changed. All agreed that there would be a sharp reaction in expectations and rates if the discount rate were not changed prior to the announcement of the next Treasury operation. In the midst of such a reaction, any attempt to maintain "prevailing easier conditions," as directed by alternative A, would require an exceedingly large injection of reserves.

The people with whom he had talked, Mr. Maisel continued, also agreed virtually unanimously that a 1/4 per cent change in the discount rate would be construed as indicating that the System believed that it might have to reverse monetary policy sharply in the near future and thus was reluctant to go to 4 per cent. As a result, more than half felt that a 1/4 per cent change in the discount rate would also cause a downward shift in expectations. It was too late to think the System could make two separate 1/4 per cent rate changes. Again, far more reserves would have to be furnished in order to maintain the current amount of ease and the current interest

rate pattern. Banks could not be expected to continue to buy securities with their reserves if they felt the System was uncertain about the near future. They also indicated that a 1/2 per cent change would be interpreted as reflecting a System desire for further ease, but the reaction might not be great because expectations had already been at work.

Mr. Maisel concluded that only a 4 per cent discount rate would enable the System to maintain prevailing easier conditions without a massive infusion of reserves. Either no change in the rate or the smaller change would mean that the System would have to furnish reserves both to take the place of the forces arising from current expectations and to offset the effect of a sharp reversal in expectations. Either alternative A or B for the directive might well require much larger reserves than indicated unless the discount rate were reduced by 1/2 per cent.

As a result, Mr. Maisel said, he supported alternative B and a full 1/2 per cent decline in the discount rate. With such a combination, he thought slightly lower short-term rates would result, although developments in the last day or two clearly indicated that even the 1/2 per cent decrease had been almost fully discounted by the market.

With the discount change and more operations in coupon issues, Mr. Maisel observed, greater impact on long-term rates also could be expected. That might be possible without any near-term increase in the marginal reserve measures compared to the present. That policy would probably give a rate of expansion in bank credit and the money supply close to recent rates and that, too, he would find acceptable.

Because of his feelings, Mr. Maisel concluded, he would prefer to see alternative B reduced one degree in wording, by changing the phrase "attaining somewhat easier conditions" to read "maintaining the prevailing easier conditions"; and by changing the proviso clause to call for "attaining somewhat easier conditions" if bank credit was expanding less than expected, rather than calling for "still easier conditions" in that eventuality.

Mr. Brimmer said he would urge the Reserve Banks to consider reducing the discount rate by 1/2 per cent. He thought that somewhat greater reserve provision would be required in conjunction with that action if the Committee was to achieve the objectives the members had in mind. Accordingly, he preferred alternative B for the directive, perhaps with changes along the lines suggested by Mr. Maisel.

Mr. Brimmer noted that he favored a 1/2 per cent cut in the discount rate partly because he would like to avoid a need for the Board to change Regulation Q at this time to force deposit interest

rates down, in the manner Mr. Galusha had indicated one banker recently suggested. The way in which Regulation Q had been used in 1966 was not, in his judgment, the most desirable; while deposit rates tended to be sticky, the System should not put itself in the position of manipulating Regulation Q ceilings as an alternative to relying on the workings of market forces. A discount rate reduction of 1/2 per cent would be helpful in persuading depositary institutions to lower the rates they paid. It also would be helpful in encouraging European central banks to take similar action. Even if the System had a second opportunity to lower its discount rate later in the year, he would hope that it would not plan now on two 1/4 per cent reductions, since the second action might have little effect on foreign central bank actions.

Mr. Brimmer also favored encouraging the Manager to take advantage of opportunities to buy coupon issues, in order to help overcome stickiness in long-term rates. At the same time, he was not recommending an "operation twist"; he was not disturbed by the fact that short-term rates had been going down.

Mr. Brimmer said he shared Mr. Mitchell's concern about the appropriateness of the statement on the balance of payments that Mr. Hayes had proposed for the directive. The statement would

imply that the improvement in the trade surplus had been more than offset by deterioration on capital account, and he questioned whether that could be demonstrated.

Mr. Hayes commented that his purpose had been to make a broad statement on the balance of payments situation, without pinpointing particular figures, such as those for the liquidity or official settlements deficits before or after seasonal adjustments. While the official settlements balance in particular had worsened drastically, considering the various measures together it seemed to him that the over-all picture was clearly one of deterioration.

Chairman Martin noted that Mr. Solomon had an alternative suggestion, which read: "The balance of payments remains a serious problem despite some recent improvement in the foreign trade surplus."

Mr. Daane said he would not favor that language because it conveyed some implication of an improvement in the payments balance. Certainly there had been no improvement; it would be more accurate, in his judgment, to convey the sense of some deterioration.

Mr. Brimmer said he was giving special weight to Mr. Reynolds' comments about the new projections by Government analysts. He recalled that Mr. Reynolds had said that, leaving aside the various special transactions, it appeared as if the liquidity deficit would be somewhat smaller in 1967 than in 1966; and if one assumed that the

special transactions would have a favorable effect this year about half as great as they had last year, the published liquidity deficit, including such transactions, would be about unchanged. On the other hand, the balance on the official reserve transactions basis probably would deteriorate this year, primarily because of the reflow of funds from U.S. banks to their foreign branches. Accordingly, the language suggested by Mr. Solomon might be better than that in the staff draft.

Mr. Hayes referred to Mr. Brimmer's comment that he was giving special weight to the projections that Mr. Reynolds had mentioned. In his (Mr. Hayes') judgment, those projections contained a large element of hope. The Committee traditionally had based the statements in the first paragraph of the directive on developments actually observed rather than on hopes or expectations, and he thought it should continue to do so.

Mr. Brimmer agreed with Mr. Hayes' comment on the directive, but added that it was his impression that the projections took into consideration all of the available evidence, including the latest figures.

Mr. Hayes then noted that he would not favor Mr. Solomon's proposed language since the only detail mentioned was the improvement in the foreign trade surplus. If there had been any change in

the over-all situation it had been for the worse rather than for the better.

Mr. Hickman observed that the economy apparently continued to slide in March, so far as could be determined from available data. As the Committee knew, it was sometimes possible to detect early changes in direction from the statistics for the Fourth District because of the dominant role of durable goods manufacturing in that District. While it was necessary to guard against being too bearish, the latest signals provided little indication of a turnaround. Latest District data on manufacturing employment and payrolls, as well as steel production, nonresidential construction, and car sales, all showed significant declines. Insured unemployment increased in March in ten of the fourteen major labor market areas of the District, and the over-all increase was sharper than in the nation.

The regular quarterly meeting of Fourth District business economists was held at the Cleveland Reserve Bank in mid-March, Mr. Hickman noted. The group's latest forecasts of industrial production and of GNP were almost uniformly lower than they had been three months earlier. Three months ago, the median forecast for industrial production showed quarterly increases throughout 1967 for an over-all gain of about 3 per cent; at the latest meeting,

the group expected no change from the reduced first-quarter level until the fourth quarter, and then a slight rise, for an over-all gain of about 1-1/2 per cent. The general tone of the discussion at the meeting was even gloomier than the numbers would indicate, as evidenced by frequent reports of declining orders and an end to increasing backlogs. Softness was indicated in orders for trucks, electrical machinery, aluminum, and flat-rolled steel products. His staff was even more bearish than the Fourth District economists; the staff expected a further decline in production in the second quarter, along with rising unemployment.

Mr. Hickman felt that the System had accomplished much since the last meeting of the Committee, and the Manager was to be congratulated for his skillful execution. More of the same was clearly needed. Some of the things he would like to see the System accomplish in April were: (1) a continuation of the recent rate of expansion of money and credit; (2) a 91-day bill rate around 4 per cent, and a Federal funds rate below the discount rate; (3) continued downward pressure on intermediate- and long-term rates to encourage an enlarged flow of funds to the mortgage market; and (4) net free reserves about $300 million.

That list was consistent with the staff's alternative B, Mr. Hickman said. In addition, he thought the time was now ripe for a discount rate reduction--the stage had been set internationally,

domestic money market participants expected it, and the economy needed it. His directors were ready to act on a recommendation, either this Thursday or next. Should the reduction be 1/4 per cent or 1/2 per cent? Before today's meeting he personally had favored the smaller move, to conserve ammunition. But, after hearing the discussion around the table today, he was inclined toward a reduction of 1/2 per cent. In any event, he would like to move as soon as possible in view of the impending Treasury refunding. The important thing was to move as closely together as possible.

Mr. Hickman thought the System should seek at all costs to prevent the type of backup in interest rates and bond yields that occurred in February, since that might interrupt the smooth flow of funds through financial markets. The Manager should move promptly through open market operations to prevent any signs of congestion from developing in the bond market, even if free reserves might rise temporarily to very high levels. The present situation in the bond market contained elements of instability caused by the buildup of the Blue List, the continued heavy corporate calendar, and the possible reversal of some long positions by free riders and speculators.

Mr. Bopp remarked that the debate about whether the economy was in a recession still went on at the Philadelphia Reserve Bank,

just as it did elsewhere. There was agreement, however, that the economy was continuing to slow down and that gloomy expectations were spreading.

That was apparent from an informal survey of Third District businessmen the Reserve Bank had just completed, Mr. Bopp continued. The canvass was a resurvey of a group with whom the Bank had been in touch about two months ago in an effort to get an up-to-date picture of the inventory situation. At that time many of the businessmen had felt that inventories were relatively high, but they expected that an upturn in sales would help them adjust inventories without significant cuts in production or employment. Now, however, half of those companies reported that the expected sales had failed to materialize and that they had cut production. A number planned further cuts. Some of those who planned no immediate change said they would need signs of renewed strength soon to justify the current level of operations. None of them felt conditions would improve before summer. However, none expected an actual downturn in business this year, and most looked for new strength by the fourth quarter.

Mr. Bopp found confirming developments in Third District banking. Tax borrowing in March was very light and prepayments had been picking up, although some of that reflected funding through

capital market financing. Faced with waning loan demand, a majority of the large banks were revising their growth projections downward.

Sentiment was becoming weaker and more uncertain, Mr. Bopp continued, but there still was an underlying confidence in the economy. There was a question of how much more monetary policy could do to keep that confidence alive. Nevertheless, at this critical phase, policy might help to determine whether there was mainly an inventory adjustment or a cumulative downturn. The impact of the adjustment on employment and incomes already had become apparent, and the adjustment still had a way to go. It was desirable to continue to minimize those adverse secondary effects on employment and income.

Given those developments, Mr. Bopp said, it would be well for the Federal Reserve to confirm its intention to continue ease. The easiest way to accomplish that was by an early reduction of 1/2 per cent in the discount rate. A smaller reduction might have little easing effect because the market had already discounted some reduction. In fact, because in recent history rate changes had usually been in 1/2 per cent steps, a smaller reduction could have an adverse effect on business sentiment.

The recent increases in money and credit had been all to the good and should be continued, Mr. Bopp thought, particularly

since some rates had been sticky. Net free reserves running at $300 million or above would seem appropriate in order to accomplish that and to bring about a further decline in rates. He favored alternative B of the staff draft directives, although in light of the discussion today he did not feel strongly on the point.

Mr. Patterson said that since recent economic developments in the Sixth District were generally similar to those for the country as a whole that had already been reported, he would not take the time to review them. Looking at the national banking figures, he came to the conclusion that credit was readily available. Banks evidently had accumulated enough securities by now to satisfy even an upsurge in loan demand, although he would concede that many were still rebuilding their liquidity. Therefore, he wondered if the point had not come to take a hard look before inundating the economy with reserves. If a recession were around the corner, that would be the correct path to follow. But, as of now, he still saw too many inconsistencies in the economic indicators, such as rising incomes, on the one hand, and sluggish retail spending, on the other.

It used to be said that monetary policy was determined by what was going on currently and never by prospects for the future, Mr. Patterson observed. The Committee had come a long way from that,

as the use of the green book testified, and he might add that it was a good thing it had. Personally, however, he found that future developments in two of the most important sectors in the economy--inventories and defense--were extremely unclear. Because of that poor visibility, it seemed to him that right now the best policy to follow was to wait until the Committee was more certain of the future before easing further. For those reasons, he believed that the Committee should not try to push rates down further at this time.

On the other hand, Mr. Patterson said, this was hardly a time at which a rise in interest rates was wanted. Perhaps one of the best ways to avoid such a rise would be to lower the discount rate. Otherwise, there might be a risk of misleading the market regarding the System's policy posture and seeing a possible repetition of the interest rate reversal of early February. It was largely with those considerations in mind that the executive committee of his Bank's board of directors, with his endorsement, voted in favor of a 4-1/4 per cent discount rate last week. In his opinion, such a modest move would give the necessary flexibility for whatever discount rate action the System might want to undertake in the future.

Mr. Patterson favored alternative A for the second paragraph of the directive, with one amendment. Following the opening phrase reading "To implement this policy," he would insert the phrase "against the background of a small cut in the discount rate."

Mr. Francis commented that it had been adequately pointed out this morning that spending and production growth rates had slowed in recent months. To date, however, data did not indicate a serious economic contraction but rather the kind of adjustment that the Committee sought last spring and summer. Despite the softening in demand, employment and personal incomes had continued to rise at high rates. At the same time, upward pressures on prices had desirably lessened; goods were more readily available, and bottlenecks had been reduced. In general, the economy was probably healthier than it was last summer.

There were, to be sure, some disconcerting developments in the economy which could lead to an undesirable economic contraction, Mr. Francis said. The high inventory-to-sales situation, the underemployment of workers at some firms, and the relatively high burden of consumer debt repayments were examples of those drags. However, economic conditions were being stimulated by Government stabilization actions which could more than offset the dampening forces. According to commonly used measures, the budget

had been very stimulative, and indications were that it would become more expansionary in the quarter just commencing. In the last two or three months, monetary actions shifted markedly from restraint to ease.

Mr. Francis thought that recent monetary expansion had been desirable in view of current economic conditions and outlook. From what was known about the lags with which monetary expansion affected the economy, that expansion should have a desirable stimulative effect late this spring and in the summer. What was done in the immediate future might have most of its effect in late summer and early fall.

Mr. Francis believed the Committee should continue to assure monetary expansion. Since the imperfections of data were so great and the knowledge of linkages and lags was so limited, it was very difficult to judge whether the rate of monetary expansion in the last two or three months had been too great, too limited, or about right. At the last meeting of the Committee it was apparent that monetary expansion had occurred. Yet, past experience with those data left room for doubt as to whether adequate expansion would be sustained. Now, however, it seemed to him that there was little doubt that monetary expansion had been achieved at a very rapid rate. Over the past three months total reserves had gone up at a

17 per cent annual rate, bank credit at a 15 per cent rate, and money supply at a 5 per cent rate.

In considerable measure, Mr. Francis continued, the expansion of bank credit had reflected reintermediation and further intermediation by the commercial banking system. That aspect of recent bank credit growth and its accompanying expansion of total reserves probably had a neutral effect on the economy. Therefore, he thought the 15 per cent rate of increase of total bank credit and the 17 per cent rate of increase of reserves overstated the degree of monetary stimulus. However, quite aside from the bank intermediation factor, bank reserves had been expanded sufficiently to allow the money supply to increase at a 5 per cent annual rate in the last three months. That was a very high rate, historically, and suggested that the Committee should consider the possibility of excessive expansion as well as the possibility of inadequate expansion, as provided in alternative A of the staff draft directives. Overreacting to the monetary contraction of last summer and fall would create future problems.

To that end, Mr. Francis suggested that the Committee provide for maintaining the same money market conditions as those of the past two weeks and include a double-edged proviso clause;

namely, if the pertinent intermediate objective appeared to be expanding inordinately, the money market be permitted to tighten; if the intermediate measure appeared to be expanding too slowly, market conditions be eased.

If the Committee selected the rate of increase of member bank deposits as its operating guide and used the staff's projected pattern of data for April and May, Mr. Francis would suggest a target growth range of 10 to 13 per cent per annum from March to April compared with the 15 per cent rate since December. Assuming that time deposit growth slowed to about a 12 per cent rate from the 18 per cent rate of the past three months and that other factors moved as expected, there might be no increase of the money supply from March to April. That would be appropriate in view of the anticipated extraordinary transfer of funds to the Treasury in April and a return flow in May. That would give the Committee about a 5 per cent rate of increase of money for the February-May period as a whole.

As to the discount rate, Mr. Francis preferred to leave it unchanged for a while longer, partly because of difficulties the System might face if it had to raise it later. Open market operations could inject an adequate supply of bank reserves, and there did not appear to be any need to give the market a psychological jolt at this

time. Also, it was not yet clear that market interest rates would continue to decline more than a month or two. Thereafter, if spending and demands for credit accelerated, as he envisaged, market interest rates were apt to rise again. Hence, a discount rate decrease now might have to be quickly followed by an increase.

In Mr. Francis' opinion the System's decision about the discount rate should not be affected by the market's expectations. The System should fix the discount rate on its own merit. Last summer the System operated for a time with the discount rate far below the bill rate yet was able to limit monetary expansion. Now he thought monetary expansion could be adequately stimulated even though the bill rate was below the discount rate. Combining that procedure with the experience of last summer, possibly the System could get away from using the discount rate as a necessary indicator or confirmation of monetary policy and action. If the discount rate was to be changed at this time, however, he would prefer a 1/2 per cent reduction to one of a 1/4 per cent.

Mr. Francis favored alternative A of the draft directives.

Mr. Robertson presented the following statement:

> The evidence before us indicates that the economy is in the midst of a necessary transition, and that what is called for on our part is the provision of an accommodative credit atmosphere to insure that the economic adjustment is both brief and constructive.

As I read the financial figures, it seems clear that we have made very substantial progress in this direction. Certainly the data bearing on flows of funds suggest that credit supplies are becoming ample. At commercial banks, both time and demand deposits are climbing about as briskly as in the most stimulative periods in the years 1961-1965. And this is not a case of "robbing Peter to pay Paul"--banks are not simply taking these funds away from other lenders. On the contrary, reports suggest large inflows of funds are also accruing to other savings intermediaries and even to the long-term bond markets directly.

Some observers have been unhappy at how little in the way of interest rate declines, in the longer-term area, has accompanied this resurgence of flows. I, myself, am more concerned with flows than with rates, but I recognize that there can be times and places when a sticky interest rate structure is indicative of a problem of restricted flows that the System ought to be taking into account. What might be appropriate System action in such circumstances, however, is open to debate.

Suggestions have been made that we should revive an "Operation Twist" for this purpose, which moves me to say a few words on that subject.

Quite aside from whether any real economic advantage flowed from Operation Twist, which is questionable, the part actually played in the Operation by Federal Reserve purchases of longer-term securities in the open market has been grossly exaggerated. On the record, it is greatly overshadowed by such influences as sharply increased commercial bank intermediation, under the liberalized Regulation Q ceilings that were provided. Furthermore, a considerable portion of official purchases of coupon issues, by the Federal Reserve as well as the Treasury, served essentially to mop up the overhang of securities in the market that resulted from aggressive Federal debt-lengthening activities on the part of both the Treasury and its underwriters.

Any use of this twisting path will jeopardize, and continued use will extinguish, the traditional "independence" of the System, which I, for one, would like to avoid. If the impact of Federal debt lengthening needs to be moderated, I would prefer doing it by means of a judicious tailoring of

debt management operations themselves, rather than using the Federal Reserve to pick up the pieces. (I am aware, of course, that this has not been a problem recently, but I also am aware that before this Committee meets again the Treasury will have faced a major quarterly refunding decision that may make these comments timely once again.)

Most important from a longer-run point of view, however, is what Federal Reserve purchases aimed at a particular objective can do to the effective functioning of the private market mechanism. I remain persuaded that such System operations can easily lure private market participants into depending upon System buying power and quickly conforming their pricing to System rate goals, without ever giving the kind of "feedback" signals of the changing intensity of private market supplies and demands that are so essential to effective dealer operations, and also to good and timely monetary policy formulation. I, for one, therefore, am opposed to Federal Reserve intervention in the market for longer-term securities at this juncture as part of a new application of Operation Twist.

If this is one of those times when longer-term bond, mortgage, and deposit rates are proving so sticky as to inhibit free and accommodative credit flows, then I favor dealing with the problem by increased reliance on those instruments of monetary policy that tend to exert more downward pressure upon interest rates per dollar of reserves released than typically results from an analogous-sized open market operation. I refer to changes in discount rates and reserve requirements. Either one of these instruments can exert an interest rate influence quickly and with less debilitating effects upon private market mechanisms than outright open market purchases of long Governments.

We used a reserve requirement cut very effectively in early March to achieve both timely reserve injection and a rally in market rates. I think we can use a discount rate cut now with equal effectiveness. And because I would prefer to see Federal Reserve downward rate pressure on some of the sticky loan and deposit rates applied through this indirect means, I would favor a full 1/2 point cut in the discount rate as soon as it can be done. (A 1/4 point change might seem equivocal to the markets, and I would like for us to be in an unequivocal position. Money market rates have now declined enough so that a 1/2 point cut would not appear extreme, and I believe credit conditions generally would be benefited by such a step.)

> With these thoughts in mind about the uses of other policy instruments, I would favor directing the Manager to conduct open market operations in such a way as to bolster and sustain the easier money market conditions that might be expected to emerge with a discount rate cut. Specifically, I would vote in favor of alternative B as drafted by the staff. I could accept some of the changes that have been suggested, but so many changes have been proposed that it might be best to stay with the staff language. I must say that I would still prefer the kind of proviso clause construction that I advocated at the last meeting, namely, two-way proviso language but with the understanding that deviations of bank credit on the upside would have to be a good deal larger to be interpreted as "significant" than would deviations on the downside. I still think it represents good economics, in a period when we have more cause to be worried about economic contraction than about exuberance.

Chairman Martin said he did not think the members of the Committee were as far apart in their thinking today as might appear from some of the comments that had been made. At the same time, it seemed to him that the spectrum of views presented in the go-around was particularly helpful in contributing to constructive thinking about the problems currently facing the System.

Before today's meeting, the Chairman continued, he had thought that he could accept either a 1/4 or 1/2 per cent reduction in the discount rate. However, certain comments in the go-around had convinced him that a 1/2 per cent reduction would be the right action now. If there was any likelihood that a 1/4 per cent cut would be followed by another similar reduction soon, to establish a 4-1/4 per cent discount rate would be confusing to the market in a period just

before a Treasury financing. That struck him as a highly persuasive argument for a 4 per cent discount rate.

Chairman Martin favored alternative B for the directive, although he thought the Committee might want to consider the amendments to the staff draft that Mr. Maisel had proposed. He doubted that a two-way proviso clause was necessary or desirable at this time.

Mr. Koch observed that it seemed clear from what Mr. Holmes and others had said that there would be some easing in money market conditions, viewed broadly, if the discount rate was reduced by 1/2 per cent. That raised a question of consistency if, as Mr. Maisel had proposed, the directive called for "maintaining the prevailing easier conditions in the money market." He would suggest using the language of the staff's alternative B, calling for "attaining somewhat easier conditions," on the understanding that the easing envisaged was expected to be brought about by the discount rate action rather than through open market operations.

Mr. Maisel commented that the understanding Mr. Koch had mentioned was what he had had in mind in making his suggestions for the directive.

Mr. Holmes remarked that while there might be some problem in finding the appropriate language for the directive, he thought the

Committee's intent was quite clear: if discount rate action tended to produce easier market conditions, that tendency should not be offset by open market operations. On the other hand, easier conditions should not be actively sought by open market operations independently of the effects of the discount rate change.

Mr. Hayes said he thought Mr. Koch's point was well taken. As he understood the Committee's intent, the discount rate change should be the main source of easing. Open market operations would be used to back up the effects of the discount rate action, but would not be employed in themselves to achieve further ease.

Chairman Martin said he was agreeable to accepting the language of the staff's alternative B on that basis. Several other members expressed agreement with the Chairman's statement.

Mr. Hayes asked whether the Committee would be averse to employing a two-way proviso in alternative B, to be interpreted in the manner Mr. Robertson had suggested. In his judgment that would result in a much better directive. While he doubted that the upper side of the proviso would be called into play in the coming period, to include it would indicate that the Committee was aware of the possible problem of excessive bank credit growth.

Chairman Martin said he thought it would be clear that the Committee was aware of that problem in any case.

Mr. Swan remarked that a two-way proviso, even if interpreted as Mr. Robertson had suggested, would seem to him to change the whole tone of the directive. He would much prefer the language of the staff's draft.

Mr. Daane observed that while in general he was sympathetic with the use of a two-way proviso, he did not think one was needed at this particular juncture.

Mr. Hickman concurred, noting that if bank credit appeared to be rising excessively the Committee could hold a special meeting to consider a possible change in its instructions.

Chairman Martin then referred to the earlier discussion of the balance of payments sentence in the first paragraph of the directive, and indicated that Mr. Reynolds now suggested the following language: "The balance of payments deficit increased in the first quarter despite some improvement in the foreign trade surplus."

There was general agreement on the language Mr. Reynolds had proposed.

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

The economic and financial developments reviewed at this meeting support earlier indications of a marked slowing of expansion in over-all economic activity. Retail

sales have continued sluggish and curtailment in the rate of business inventory accumulation is in process. Average commodity prices have changed little recently, but unit labor costs in manufacturing have risen further. Bank credit expansion has remained vigorous, short-term interest rates have declined markedly further, and long-term rates have moved down somewhat despite very heavy securities market flotations. The balance of payments deficit increased in the first quarter despite some improvement in the foreign trade surplus. In several important countries abroad, monetary and fiscal policies have eased further in response to slackened economic activity. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to combatting the effects of weakening tendencies in the economy, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, 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, and to attaining still easier conditions if bank credit appears to be expanding significantly less than currently anticipated.

Chairman Martin then said that he would like to add a few words on the subject of the discount rate. He thought it should be recognized that responsibility for initiating discount rate actions lay with the Federal Reserve Banks. If the directors of any Bank felt strongly that the rate should be established at 4-1/4 per cent, he personally would not be inclined to vote to disapprove such a rate. He saw no harm in having a discount rate of 4 per cent at some Banks and 4-1/4 per cent at others, at least temporarily.

Mr. Brimmer noted that while several Reserve Bank Presidents had expressed a preference for a 4-1/4 per cent discount rate in the

course of today's discussion, he had not detected much evidence that they felt strongly. On the other hand, at least one President had indicated that he had favored a 4-1/4 per cent rate earlier but now preferred a 4 per cent rate. He personally would hope that the Reserve Banks would think carefully about the possible disadvantages of announcing a split discount rate in the existing environment.

Messrs. Mitchell and Hickman indicated that they also thought it was important to have a uniform discount rate.

Chairman Martin agreed that it might be best if all Reserve Banks moved to a 4 per cent rate. But to make that statement was not the same thing as insisting on uniformity, which he was not inclined to do.

Mr. Ellis said that he would prefer to have the Board defer action with respect to the 4-1/4 per cent rate established last week by the directors of the Boston Reserve Bank until the directors could meet again and consider the matter further.

In response to a question by Mr. Wayne, Chairman Martin said that he would not consider it necessary for all Banks to move together. The Board's present thinking on timing was that if three, four, or five Banks had established new discount rates by Thursday of this week it would approve those changes, and plan on acting promptly with respect to new rates established subsequently by other Banks. In any case, the Board would not take any action on discount

rates before Thursday. In that connection, it was important that the discussion of discount rates at today's meeting be held in confidence until the action was announced.

Mr. Robertson then reported that the "eligible paper" bill, which would permit member banks to borrow from the Reserve Banks on any sound asset without paying a penalty rate of interest, probably would be passed by the Senate shortly and then would be taken up by the House of Representatives. One of the first questions likely to be raised in the House was whether the System was prepared to deal with the wide range of collateral that would be eligible under the bill; it had been suggested that System personnel might be relatively inexperienced in appraising mortgages, municipal securities, and the like. Consequently, it seemed desirable for the System to launch a program to provide any necessary training for its personnel. He would suggest setting up an *ad hoc* committee with Reserve Bank and Board representation to assess existing training needs and to develop a program for dealing with them. If the Reserve Bank Presidents and Board members thought such a course would be worthwhile, initiating actions could be taken immediately.

Mr. Hayes noted that the Presidents' Conference Committee on Discounts and Credits had an interest in this area and would be glad to work on implementing a program such as Mr. Robertson had suggested.

No objection was raised to instituting a program of the type Mr. Robertson had proposed.

Chairman Martin then noted that the Committee had planned to continue its discussion today of the implications of the "Freedom of Information Act" for the Committee's procedures. In that connection, memoranda from the General Counsel and the Secretariat, making certain recommendations, had been distributed on March 29, 1967.[1/] In view of the lateness of the hour, however, he suggested that the planned discussion be postponed until the next meeting.

There was no disagreement with the Chairman's suggestion.

It was agreed the next meeting of the Federal Open Market Committee would be held on Tuesday, May 2, 1967, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

1/ Copies of these memoranda have been placed in the Committee's files.

ATTACHMENT A

CONFIDENTIAL (FR)

April 3, 1967

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on April 4, 1967

FIRST PARAGRAPH

The economic and financial developments reviewed at this meeting support earlier indications of a marked slowing of expansion in over-all economic activity. Retail sales have continued sluggish and curtailment in the rate of business inventory accumulation is in process. Average commodity prices have changed little recently, but unit labor costs in manufacturing have risen further. Bank credit expansion has remained vigorous, short-term interest rates have declined markedly further, and long-term rates have moved down somewhat despite very heavy securities market flotations. Recently there has been some improvement in the foreign trade surplus but none in the over-all balance of payments. In several important countries abroad, monetary and fiscal policies have eased further in response to slackened economic activity. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to combatting the effects of weakening tendencies in the economy, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing easier 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, 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, and to attaining still easier conditions if bank credit appears to be expanding significantly less than currently anticipated.