MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, February 6, 1968, 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. Sherrill
Mr. Swan
Mr. Wayne

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

Messrs. Bopp, Kimbrel, Clay, and Coldwell, Presidents of the Federal Reserve Banks of Philadelphia, Atlanta, Kansas City, 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, Garvy, Hersey, Partee, Parthemos, and Solomon, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Messrs. Cardon and Fauver, Assistants to the Board of Governors
Messrs. Axilrod and Gramley, Advisers, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Associate Director, Division of International Finance, Board of Governors
Mr. Wernick, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Keir, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Bernard, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss McWhirter, Analyst, Office of the Secretary, Board of Governors

Mr. Heflin, First Vice President of the Federal Reserve Bank of Richmond
Messrs. Eastburn, Mann, Taylor, Andersen, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Philadelphia, Cleveland, Atlanta, St. Louis, Kansas City, and Dallas, respectively
Messrs. Bodner and Meek, Assistant Vice Presidents, Federal Reserve Bank of New York
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
Mr. Runyon, Economist, Federal Reserve Bank of San Francisco
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Chairman Martin noted that today Messrs. Coldwell and Kimbrel were attending their first meeting of the Committee since becoming Presidents of the Dallas and Atlanta Reserve Banks, respectively, and that Mr. Sherrill was attending his first meeting since his appointment to a new term as a member of the Board of Governors.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on January 9, 1968, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on January 9, 1968, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period January 9 through January 31, 1968, and a supplemental report covering the period February 1 through 5, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner said the Treasury gold stock would be dropped by $100 million today, mainly to cover the U.S. share of $82 million in the pool's losses of $137 million for January. As that figure made clear, the halt of buying in the gold market immediately following announcement of the U.S. balance of payments program did not last long. In fact, shortly after the last meeting of the Committee demand began to increase, and on January 17 there was a very heavy spurt of buying as a result of rumors that the President's State of the Union message would contain an announcement of a change in the gold price. Why anyone would believe such a rumor within two weeks of the announcement of the new balance of payments program was hard to explain, but it did underscore the very tenuous nature of the improvement that had been seen. During the remainder of the month, demand was at very much lower levels than during that outbreak, but new supplies from South Africa were sharply reduced and there was steady attrition in the pool's position. The recent developments in Korea and Vietnam had added to the drain, of course, but had not caused any very large buying in the London market. He did not think that too much comfort could be taken from that, however, because it seemed very likely that what had happened was that the over-all demand had run at a fairly high level, but had been offset in Switzerland by sales of some of the gold bought on a purely short-term speculative basis during the fall. Thus, although there perhaps had been less drain on the pool than might have been expected in view of those recent incidents, the return flow of gold that had been anticipated had not yet occurred.

In the exchange markets, Mr. Bodner remarked, the dollar had generally been strong against the continental European currencies and sterling had had a fairly good month. Those developments were, of course, partly seasonal, but it seemed fair to say that despite the sharp speculative attack on the Canadian dollar which began about mid-month, the over-all atmosphere in the exchange market had tended to improve. Early in January, there was an immediate improvement in the position of the dollar following the President's balance of payments message, but the market remained quite nervous, in part because of uncertainties about where and how strongly the program would strike. Moreover, the British had yet to announce their fiscal program and doubts about the new sterling parity, to which Mr. Coombs referred at the last meeting, continued to plague the market. In addition, there was a general expectation that the new U.S. program would result in a sharp escalation in Euro-dollar rates and traders tended to move cautiously in taking positions. After the President's State of the Union message and the statements by Prime Minister Wilson and Chancellor Jenkins regarding the U.K.'s proposed programs, the market began to settle down, and there began to be sizable outflows of funds from Germany and Switzerland, and smaller flows out of Belgium, France, and the Netherlands, as well as an increasing volume of purchases of sterling. The move toward a calmer atmosphere was reinforced by the unexpectedly large decline in Euro-dollar rates and was not seriously affected by the speculation against the Canadian dollar.

Mr. Bodner reported that developments in the Euro-dollar market had been something of a surprise to the dealers and, to some extent, to the central banks. Indeed, he thought it was precisely because rates had moved counter to general expectations that there had been the recent spate of newspaper articles and other reports attributing the developments to central bank intervention. Despite those widespread reports, to the best of his knowledge there had not been any direct intervention in the Euro-dollar market. On the contrary, over the course of January the Bank for International Settlements withdrew from the market and repaid to the System the entire $346 million outstanding at year-end and the German Federal Bank received substantial repayments on the swaps it had outstanding with German commercial banks as a result of the November and December operations. Some of the repayments by the BIS might well have been financed with other central bank funds received by the BIS for short-term deposit, but that was a normal part of its business and in no way represented intervention, either by individual central banks or on a concerted basis. However, the receipt of funds from the BIS by a commercial bank could give rise to such rumors. Similarly, sales of dollars by the Swiss National Bank to its commercial banks might also have given rise to the impression that the Swiss National Bank was placing funds in the Euro-dollar market. In fact, with the improved tone of the exchange market since mid-January the Swiss commercial banks had been buying dollars to invest their excess liquidity and the Swiss National Bank had played a largely passive role, simply selling dollars on demand at progressively higher rates.

Mr. Bodner commented that for the United Kingdom January was a disappointing month, but some progress was made. Although the net inflow to the reserves was small, the Bank of England was able to reduce slightly its overnight borrowing from the U.S. Treasury (to $490 million as against $515 million in December) and it paid off a very large amount of maturing forward commitments while still coming out of the month in the black. No progress was made on reducing commitments to the System, but the air of deep pessimism, and even of imminent crisis, that hung over the market at the beginning of the period seemed now to have lifted. Nevertheless, sterling remained vulnerable, and how far it would prove possible for the British to pay down the System swaps in February was difficult to forecast, not least because this month again there would be very heavy forward maturities.

Although those developments in the Euro-dollar market and in sterling had been of considerable interest, Mr. Bodner said, the principal feature of exchange market activity since the last Committee meeting had been the attack on the Canadian dollar.

That began around mid-month with withdrawals of short-term funds by U.S. firms, and perhaps more importantly, with large forward sales of Canadian dollars. The immediate trigger for those sales was fear that the President's balance of payments program, coming in a year when Canada's balance of payments was expected to be weaker in any case, would put great strain on the Canadian dollar. The recent experience with the sterling devaluation--and in particular the nervous state of the exchange market in early January--undoubtedly played an important role in the way the pressures mounted, as U.S. and Canadian corporations used the lessons learned with sterling to review their other foreign exchange commitments. Although the initial pressures came primarily in the forward market, they were quickly reflected in the spot market since banks were unable to find offsets to their forward purchases from customers and so sold spot as a means of covering their positions. The spot sales were absorbed by the Bank of Canada which, as the Committee knew, incurred reserve losses totaling about $350 million during January. Although the pressures eased after the Bank of Canada's discount rate increase and the related statements by the Canadian and U.S. Treasury Departments, sales had continued and the Canadian reserve announcement for January--which included reference to the fact that the Bank of Canada had drawn $250 million from the System--was followed by somewhat

Finally, Mr. Bodner said, for the dollar the period since the last meeting had been a generally satisfactory one and the Account Management had been able to make some progress in reducing System swap commitments in German marks, Dutch guilders, Belgian francs, and Swiss francs. Nevertheless, substantial commitments remained outstanding and he would have a number of recommendations to make in that connection.

> By unanimous vote, the System open market transactions in foreign currencies during the period January 9 through February 5, 1968, were approved, ratified, and confirmed.

Mr. Bodner noted that, in addition to the drawings discussed by Mr. Coombs at the preceding meeting of the Committee, two more drawings in Belgian francs would mature soon. One for $10 million equivalent would reach the end of its first three-month term on February 28, and another for $5 million would come to the maturity of its second term on March 6. The Treasury was currently proceeding with plans for an International Monetary Fund drawing that would include Belgian francs, Dutch guilders, and Italian lire. He anticipated that that drawing together, perhaps, with some other arrangements with the Belgians, should provide funds for the liquidation of all outstanding System commitments in Belgian francs. Nevertheless, he would recommend a second renewal of the $5 million drawing should that prove necessary because of any delay in completfirst renewal for the $10 million drawing, should it not prove possible to acquire sufficient Belgian francs in the current negotiations to clear up all outstanding drawings. The System also had $4.9 million of forward contracts in Belgian francs maturing for the first time during the period from March 6 to March 13, and he recommended renewal if necessary. Those contracts had been entered into by the Belgian National Bank for System account in the unsettled period following the devaluation of sterling.

Chairman Martin commented that he and Mr. Robertson had attended a meeting at the Treasury Department yesterday at which there had been some discussion of whether the planned IMF drawing should be of a size to permit liquidation of the System's swap drawings in full or in part. There had not been an opportunity, however, to review all of the considerations bearing on the matter.

Mr. Bodner said that the Account Management had suggested that the Treasury draw a sufficient amount of Belgian francs to liquidate all outstanding System swap drawings. There was sentiment at the Treasury, however, for keeping the size of the total drawing within the United States' gold tranche position in the Fund, and perhaps working out some supplementary offset arrangements with the Belgians in connection with the shift of the NATO headquarters to that country. The Account Management certainly hoped that all six months, could be cleared up. It was his impression that the Belgian authorities were expecting that all System swap drawings on the National Bank would be repaid shortly.

> Renewal of the two drawings on the National Bank of Belgium, and of the outstanding forward contracts in Belgian francs, was noted without objection.

Mr. Bodner reported that during the period since the preceding meeting the Account Management had been able to make substantial progress in acquiring German marks to pay down the System swap drawing on the German Federal Bank, which would come up for a first renewal on March 15; the balance on that drawing had now been reduced to $180 million. He anticipated that it would prove possible to reduce the commitment still further by its maturity date, but full repayment might take somewhat longer. Consequently, he recommended renewal of that drawing.

> Renewal of the drawing on the German Federal Bank was noted without objection.

Mr. Bodner then said that a $200 million drawing on the Bank of Italy would reach its first maturity on February 29. To date there had not been a sufficient reversal of the Italian position for any progress to be made in repaying that drawing and he recommended renewal.

In response to questions by Mr. Robertson, Mr. Bodner said that the total of outstanding System drawings on the Bank of Italy large enough to permit repayment of System lire drawings in full would exceed the U.S. gold tranche position in the IMF--a result which, as he had indicated, the Treasury was inclined to avoid. Assuming that the $200 million System drawing that matured soon would be renewed, the Account Management would be continuing its discussions with the Treasury of the possibility of clearing up all outstanding lire drawings by going to the Fund or perhaps by making some other arrangements. It had been hoped that there would be some outflow from Italy, and the Italian authorities themselves had expected an outflow, but it had not occurred as yet.

Mr. Robertson then asked whether the posture of the Account Management on the matter ran counter to the Treasury's desire to keep its IMF drawing within the U.S. gold tranche.

Mr. Bodner replied that the Account Management was, of course, interested in clearing up System drawings, many of which had been outstanding for quite a long time, as soon as feasible. Accordingly, it was discussing possible means of doing so with the Treasury. At the same time, it recognized that decisions regarding IMF drawings were the Treasury's responsibility.

Renewal of the drawing on the Bank of Italy was noted without objection.

Mr. Bodner then remarked that substantial progress had been made in reducing Treasury commitments in Dutch guilders and some reductions in short-term commitments were made possible both by an outflow of funds from the Netherlands and by the issuance to the Netherlands Bank of a guilder-denominated Treasury certificate. That was the first occasion on which the Dutch were willing to purchase such a certificate and it was linked specifically to outstanding Dutch post-war debt to the U.S. The System had two $10 million drawings on the Netherlands Bank coming up for second renewals on March 5 and 14, respectively. Although it was hoped that those drawings would be liquidated by then through a Treasury drawing on the Fund or through some further outflow of funds from the Netherlands, he would recommend renewals of both drawings for an additional three-month term should there be a delay in clearing them up. In addition, between February 28 and March 4 the System had $18.8 million equivalent of forward contracts in guilders maturing for the first time. He recommended renewal of those contracts should that prove necessary.

> Renewal of the drawings on the Netherlands Bank, and of the forward contracts in guilders, was noted without objection.

The System also had made good progress since the preceding meeting of the Committee in reducing commitments in Swiss francs, Mr. Bodner said, bringing the total outstanding swap drawings down by $213 million, from $650 million to $437 million. He anticipated further progress as a result of continuing outflows of funds from

Bank of additional Swiss franc-denominated Treasury notes. The System also had $5 million of forward contracts in Swiss francs that would mature on February 20 for the first time and he recommended their renewal for a second three-month term.

Renewal of the forward contracts in Swiss francs was noted without objection.

In conclusion, Mr. Bodner said that the Bank of England had two swap drawings on the System that would mature in the near future--one for $500 million that would come to the end of its first three-month term on February 20, and one for $50 million that would come to the end of its second three-month period on February 29. Although there had been some net inflow to the United Kingdom in recent weeks and the prospects seemed reasonably good for additional inflows this month, he would recommend renewals of both of those drawings if requested by the Bank of England.

Renewal of the two swap drawings on the System by the Bank of England was noted without objection.

Chairman Martin then invited Mr. Solomon to report on the recent meeting of Working Party 3 that he had attended.

Mr. Solomon remarked that the Working Party had met in Paris on January 23 and 24, in its first meeting since the President's announcement of the new balance of payments program. Most of the meeting was devoted to a discussion of the program itself and of the policy reactions of other countries to it. Although not every member of Working Party 3 represented a surplus country, all of the major surplus countries were members, and their reactions were highly constructive and quite heartening. On their own initiative, the members indicated that they accepted the discriminatory aspects of the program, recognizing that for the United States there was no real alternative to discrimination against surplus countries. No one--particularly not the European countries whose economies were not booming--looked with favor on deflation in the rest of the world as a consequence of efforts by the United States to improve its balance of payments. While they accepted the discrimination with good grace, they hoped it would be temporary.

Beyond that, Mr. Solomon said, the Europeans--again on their own initiative--recognized the nature of the policy actions that were required of them in response to the U.S. program. Specifically, they recognized that the program would have some deflationary effects in Europe, insofar as U.S. direct investment was reduced and American tourist expenditures dropped off; and that it would tend to put pressure on their money and capital markets and on the Euro-bond market--with possible spill-over into the Euro-dollar market--insofar as credit demands in those markets were increased by borrowings by U.S. corporations and by the demands of borrowers from third countries that would normally have raised funds in the United States. They indicated that it interest of the world economy, to adopt sufficiently expansive fiscal and monetary policies to offset the effects of the program on aggregate demands and on financial markets in their countries. And they recognized that such a course could well involve a reduction in their foreign exchange reserves. Even the French representative was anxious to have other continental European countries pursue expansionary domestic policies; he commented that Europeans should not allow undue concern about the level of their monetary reserves to keep them from doing so.

Thus, Mr. Solomon concluded, the initial reaction in Europe to the U.S. program, at least with respect to policy intentions, was very good indeed. He did not think one could have asked for a better reaction. It remained to be seen what policies would actually be followed as the year unfolded. Actions to stimulate domestic expansion had already been begun in France and Belgium, and hopefully other countries would carry out the policy intentions they had stated at the WP-3 meeting.

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 domestic open market operations for the period January 9 through 31, 1968, and a supplemental report covering February 1 through 5, 1968. Copies of both reports have been placed in the files of the Committee.

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

> Financial markets underwent a substantial change in atmosphere in the four weeks since the Committee last met. The Government securities market, which had begun to exhibit greater buoyancy in the latter part of November, was favorably affected for a time by rising hopes of peace negotiations in Vietnam. But even the recent deterioration in the Vietnam situation, the uncertainties engendered by developments in Korea, and doubts about Congressional action on the tax bill failed to turn the market around; and there appears to be a worthwhile investor interest in the Treasury's offer of a new 7-year note.
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> Even more surprising than the resiliency exhibited by the long-term markets was the development of downward pressure on short-term interest rates. While the reasons for this development are not entirely clear, the evaporation of exaggerated market fears about the pressures on financial markets that were anticipated for early 1968 appears to be fundamental. It now appears that both financial and non-financial institutions had made careful preparations to meet liquidity needs, and when the anticipated squeeze in the Euro-dollar market failed to develop and the demand for bank credit fell short of expectations at a time when corporate cash flows were rising, both banks and business corporations found themselves in a better position than they had expected.
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> As the flow of Euro-dollars resumed, the major banks relaxed their competition for CD's, and declining short-term interest rates pushed fears of disintermediation into the background. Whether or not the decline in interest rates has already run its course is not clear. Some reaction is quite possible, and some hesitation was apparent in the market yesterday. But expectations of a credit crunch of the 1966 intensity, which were widely held earlier, have receded, and some investors are obviously anxious to acquire long-term debt at current interest rate levels that are still high by historical standards. By the same token, while the volume of corporate and municipal issues remains high, would-be

borrowers appear less inclined to rush into the market to meet prospective needs. It is not clear whether the more relaxed tone of the financial markets foreshadows somewhat less pressure in the real economy or is only a pause. But there is little doubt that markets have been virtually impervious to bad news, and this is certainly far from the usual case.

There has been a great deal of speculation about the reasons for the decline in Euro-dollar rates, and about the cause-and-effect relationship between those rates and our own short-term rates. Clearly, some part of the decline is seasonal in nature, while the grave uncertainties that developed in the gold and foreign exchange markets in late 1967 undoubtedly caused a more rapid run-up in rates at that time than would otherwise have occurred. Some relaxation of monetary policy on the continent has no doubt given European banks more investible funds, and with somewhat greater confidence in the dollar after the announcement of the new balance of payments program, private investors abroad may have become more willing to build up their dollar holdings--at least at short term. With the 3-month Euro-dollar rate now at 5-7/16 per cent, instead of 6-1/4 per cent or more just weeks ago, American banks have not had the problems in holding onto Euro-dollars that they had anticipated. Pressures remain intense in the Euro-bond market, however, and may at some point spill over into the short-term area.

The movements in our domestic interest rates have been covered in detail in the written reports to the Committee and in the blue book.[1/] Yields on corporate and municipal issues declined by 15 to 25 basis points from their early January highs, although some recent issues were moving slowly into investor hands at the lower prevailing yields. Yields on Treasury notes and bonds were 1/4 per cent or more below the peaks reached in mid-November although there was some backing and filling over the past few weeks. In yesterday's regular Treasury bill auction, average rates of 4.96 and 5.12 per cent were established on three- and six-month bills, respectively, down 12 and 26 basis points from the auction held the day before the last Committee meeting, but up 11 and 18 basis points from a week ago.

Rates on bankers' acceptances, on commercial and financial paper, and on CD's all were moved down over the period. The one-month CD rate is now typically 4-3/4 per cent, while 5-1/2 per cent is now generally available only on maturities of six months or longer. While rates on money market paper declined over the period, the Federal funds rate remained firm, except on a few days, averaging a bit over 4-5/8 per cent and running up to as high as 5-1/4 per cent on one occasion. Dealer loan rates also moved a bit higher by the end of the period when rates at New York banks were in a 5 to 5-1/4 per cent range. The increase in the cost of carrying inventories is already putting some upward pressure on Treasury bill rates.

Open market operations over the period had to contend with a massive shift in reserves toward the major money market banks that developed as the period progressed. On four occasions fairly sizable matched sale-purchase agreements were made to prevent the market from easing, and on two occasions when such agreements were made--during the statement weeks of January 17 and January 31--we had to reverse our stance on the last day of the period as the Federal funds rate moved above 5 per cent.

Growth in the credit proxy in January, as the blue book notes, was, at a 9 per cent annual rate, in the upper end of the 6-10 per cent range projected at the time of the last meeting. Had it shown only a bit more expansion the proviso clause of the directive would have clearly come into play. For February the blue book estimates growth in the proxy in the 7-10 per cent range--not much different from January. The New York Bank staff has a lower projection--centering around 5 per cent--but this may turn out to be on the conservative side. As you know, the draft directive submitted by the staff[1/] provides--insofar as the Treasury financing permits--for some firming of money market conditions if bank credit grows more rapidly than expected. As usual, it would be most helpful in interpreting the proviso clause if Committee members would indicate whether the 7-10 per cent range projected in the blue book looks about right or appears a bit excessive.

The Treasury refunding and prerefunding, on which the books close tomorrow, coupled with a sizable cash financing on which terms will be set this Thursday, pose even keel considerations for much of the period just ahead. With the relative stability of long-term rates

1/ Appended to this memorandum as Attachment A.

on Government securities below the mid-November peaks, market sentiment for a major prerefunding of the heavy August and November maturities gained strength right up to the time--last Wednesday--when the Treasury had to fix terms for the refunding of $2.6 billion maturing securities, of which $1.7 billion are held by the public. Given the market sentiment, the Treasury decided on a major debt extension effort by offering a 7-year 5-3/4 per cent note to holders of Treasury notes and bonds maturing in February, August, and November. The issues subject to refunding total about $24 billion, of which some $12 billion are held by the public. As noted earlier, the market has made a constructive response to the offering, and while estimates of the amount likely to be exchanged vary quite widely, most market participants are anticipating that $4 billion or more of the new notes will be issued. The Treasury will follow up the refunding by issuing $4 billion of a 15-month note for cash, setting the terms on Thursday of this week, with the books open on February 13, and payment scheduled for February 20 or 21. The Treasury very rightly decided to get a little ahead of its March cash needs by raising a large amount of cash now, and unless attrition is very large on the public's holding of the February maturities, the $4 billion should meet cash needs through the end of March. The Treasury will need a substantial amount of cash by early April, and this could lead them to increase the regular bill cycle sometime in late February or early March to meet part of this need. The size of the 15-month issue contemplated will probably require generous pricing, and this may tend to hold up rates on longer-term Treasury bills.

The System holds $839 million of the February maturities, and I intend, in the absence of a short-term option, to convert them into the new 7-year note. Our holdings of the new issue should be moderate in light of the expected size of the exchange, and our portfolio is certainly amply liquid.

Mr. Hickman noted that in January the money supply had increased at an annual rate of almost 8 per cent, which in his judgment was excessive in light of the current inflationary environment. While the proviso clause of the directive issued at the preceding meeting referred only to bank credit, there had been a good deal of discussion of the money supply at the meeting. He was surprised that no attention apparently had been given to money supply growth in the implementation of monetary policy during the period.

Mr. Holmes replied that, as the blue book indicated, there was a peculiar pattern of change in the deposit mix in January; on a daily-average basis, private demand deposits and the money supply were stronger than expected, and time and savings deposits were weaker. However, the average growth rate of total deposits in January was within the range that had been projected. It had been his understanding that while the Committee considered money supply changes to be important, the members placed primary emphasis on changes in total deposits as a guide in the implementation of policy. He might also note that the money supply declined sharply late in January and at the end of the month was about the same as at the end of December.

Mr. Mitchell commented that he shared Mr. Hickman's view; indeed, as the Committee would recall, at the previous meeting he had urged that a reference to the money supply be included in the proviso clause. With respect to Mr. Holmes' comment on the change in the money supply on an end-of-month basis, it had been the

Committee's practice, which he thought appropriate, to evaluate monthly changes on a daily-average basis. In his judgment the importance of the money supply was not simply as a secondary guide to policy, after bank credit; of more significance was its role as an indicator to the public of the posture of monetary policy. That fact was illustrated by the experience in a meeting the Board held last week with the Governmental Securities Committee of the Investment Bankers Association, a group that was highly sophisticated on the subject of monetary policy. At the outset of the meeting the question was raised as to when the System would do something about the "easy" credit conditions prevailing. When asked for evidence that conditions were in fact easy, members of the IBA Committee responded promptly with a reference to recent increases in the money supply. They also referred to the decline that had occurred in the bill rate. When the subject was discussed later at a Board meeting, members of the staff expressed the view that despite the behavior of the bill rate, recent money market conditions in general were consistent with the criteria the Committe had given the Manager at the preceding meeting. It seemed clear, however, that the public's impression of the recent posture of polic was not in accord with the intent of the Committee. Perhaps that was because different observers were looking at different measures.

Mr. Mitchell then asked the Manager whether it would have been feasible, by taking a different approach to open market operations, to prevent the recent decline in the bill rate.

Mr. Holmes replied that in his judgment the bill rate decline could have been prevented only at the cost of an extremely tight money market, with Federal funds trading in a 5-1/8 to 5-1/4 per cent range or even higher. During the period the market was engaged in a fundamental reappraisal of the outlook, a reappraisal that probably was not based on a belief that the System had shifted to an easier policy. As to the public's interpretations of System policy, he might note that the New York Times--while perhaps not the best index for the purpose--had interpreted the weekly statistics as indicative of a firmer System policy in two of the three latest statement weeks.

Mr. Hayes remarked, apropos Mr. Mitchell's question, that if moderation of bill rate fluctuations had been an objective of open market policy in 1967, the System would have flooded the market with reserves during the long period when bill rates were under strong upward pressures.

Mr. Mitchell then referred to Mr. Holmes' comment that bank credit growth in January was "within the range" projected. It seemed to him (Mr. Mitchell) that it would be appropriate to begin implementing the proviso clause gradually if the growth rate approached the limit of the projected range, rather than waiting for it to move outside that range before reacting.

Mr. Holmes commented that as he had understood the Committee's intent the proviso clause was to be brought into play only if bank credit growth appeared to be outside the range of expectations. The procedure Mr. Mitchell proposed could, of course, be followed if the Committee so desired.

Mr. Maisel said he did not agree that monthly figures on a daily-average basis were necessarily the best guide for evaluating changes in the money supply. At present, for example, he thought the important question concerned the course of the money supply in coming weeks rather than its average level in January relative to December. In that connection, he noted that the money supply was at a peak at about the time of the visit of the IBA Committee and had since been declining. Secondly, he would prefer to continue giving primary attention to the measure of total deposits represented by the bank credit proxy rather than to the money supply.

Mr. Brill observed that several points should be kept in mind in evaluating the results of open market operations in relation to the Committee's objectives. First, if the Committee attempted to specify its objectives for <u>all</u> of the financial variables it could, in effect, be engaged in over-determination, in the mathematical sense of that term. The staff's analysis of relationships might be in error, or there might be some basic change in the economic situation or in the attitudes of market participants; in either case, it was not likely that every objective specified would be realized in every time period.

Moreover, Mr. Brill said, the evidence for the recent period indicated that, apart from the mix of deposits, almost every variable fell within the range that had been specified for it in the previous blue book. In the present state of the art the staff projections were necessarily formulated in terms of ranges rather than point estimates, and as it happened most of the interest rate variables were near the lower end of the ranges projected and most of the aggregative variables near the upper end.

One area in which the outcome was completely different from the projections, Mr. Brill continued, was in the composition of deposits. Total time and savings deposits had been projected to rise on average at an annual rate in the 2 to 5 per cent range; in the event, they declined slightly. No increase had been projected in the money supply, but it rose at an 8 per cent rate. Evidently the public's desire for demand, as opposed to time, deposits was greater than the staff had assumed.

Clearly, Mr. Brill said, some indication of priorities among the Committee's targets was desirable. If the Committee had given priority to a money supply target in the recent period the outcome for interest rates might well have been highly disturbing to the members. With respect to deposits, up until now the Committee had given priority to the total rather than to components.

Mr. Swan noted that the money supply was expected to show little change, and perhaps to decline, in February. Thus, if one averaged its behavior over January and February the increase shown would be much smaller than in January alone. He asked about the outlook for March.

Mr. Brill replied that the staff had not yet agreed on projections for March. He would note, however, that the blue book projections for the various categories of deposits for February were heavily affected by the Treasury financing--that is, bank underwriting of that financing was the dominant element in the growth projected for the bank credit proxy in February--and that the Treasury's financing needs would probably be much smaller in March.

Mr. Mitchell commented that while he, of course, would not advocate any procedure that involved over-determination, he was not wholly persuaded by Mr. Brill's argument. In giving its instructions to the Manager at the preceding meeting the Committee had not intended to move toward ease, but the recent behavior of the money supply had led the IBA Committee to conclude that the System was in fact easing. He was concerned about that development

Mr. Holmes noted that at times during the period there had been flows of funds toward major money market banks of the type that typically produced easier conditions in the money centers. On several such occasions, when the Federal funds rate dropped to 4.5 per cent or below, the Account Management had stepped in decisively with matched sales-purchase transactions; on two such occasions those operations had forced the Federal funds rate up to 5 per cent.

In response to a question, Mr. Holmes said in their discussion with the Board the members of the IBA Committee might possibly have over-stated the degree to which they thought market conditions had eased, in the hope of eliciting information with regard to the System's policy intentions.

Mr. Wayne remarked that the discussion seemed to him to reflect a continuing problem that was largely of the Committee's own making. In recent years the Committee had shifted away from use of the money supply in formulating its objectives; it had emphasized total deposits, the proxy for bank credit, for this purpose. The consequences of that choice were now arising to plague the Committee. He agreed that it was necessary to decide whether priority should be given to total deposits or to demand deposits. As to recent developments, it was his impression that the Manager had been told to focus on the bank credit proxy.

Mr. Brimmer asked whether the Manager felt that the firmer conditions prevailing at the time of the preceding meeting had in fact been maintained; in his (Mr. Brimmer's) judgment, they had not been. Secondly, he noted that the draft directive before the Committee called for "maintaining about the same conditions in the money market as have prevailed on average since the preceding meeting of the Committee." If, as he thought, there had been a slippage from the firmer conditions that had prevailed prior to the January 9 meeting, holding to recent conditions would mean greater ease than had existed in early January. It would be desirable, if feasible in a Treasury financing period, to make up the lost ground. That led him to ask whether even keel considerations had to be given as much weight now as they typically had been in the past.

Mr. Holmes said he found it difficult to accept the conclusion that the money market had eased. It seemed to him that the bill rate was the only money market variable that one could point to in support of such a conclusion; as measured by the Federal funds rate, member bank borrowings, and free reserves, conditions were as firm now as in early January. The bill rate had, indeed, moved lower, but most recently it had been rising and had retraced about half of its earlier decline. He would attribute the fall in the bill rate to an over-reaction in the market to the fact that the worst of the earlier fears about a year-end credit crunch had not been realized. The market frequently acted like a pendulum, with a rapid run-up in rates as a result of concerns of one sort or another, followed by a reaction. It was true that the growth in the credit proxy in January was near the upper end of the projected range but, as he had mentioned earlier, it was within that range.

Mr. Brimmer commented that Mr. Holmes' position might be supported by considering each of the variables separately. However, when the decline in the bill rate was considered in conjunction with the fact that growth in the credit proxy was near the upper end of the projected range it would appear that the earlier firmer conditions had not been maintained.

Mr. Hayes did not agree with Mr. Brimmer. In his judgment it was necessary to distinguish between the consequences for bill rates and other interest rates of changes in market psychology, on the one hand, and the consequences of changes in bank reserve positions on the other. He had always felt that the latter were the more important for the Committee's purposes. The Committee could not ignore changes in market psychology, but if it tried to adapt monetary policy to every shift in market attitudes it was likely to find policy being whipsawed.

In reply to a question by Mr. Mitchell, Mr. Holmes said he thought there was very little difference between current money market conditions and those that had prevailed on average since the preceding meeting, except that the psychology of the market was different from that of a few weeks ago. As he had noted, bill rates had been rising in the last few days; he would not be surprised if they moved a bit higher.

Mr. Daane said he subscribed to Mr. Brill's thesis that the Committee would be asking too much if it expected that the staff could provide a consistent set of specifications for all of the different variables and that the Manager could make actual conditions conform to those specifications in all respects. He had been wondering whether the Desk itself was satisfied that the feel and tone of the market was about that implied by the directive issued at the preceding meeting. The answer, apparently, was yes; and in his judgment that conclusion was borne out by the levels of money market variables such as the Federal funds rate. In any case, he thought the Desk was in the best position to make a judgment on that question.

Mr. Sherrill remarked that evidently as a result of a change in market psychology various indicators recently had been moving in unexpected directions. He asked whether the Manager thought the situation had about stabilized.

Mr. Holmes replied that he was not sure.

Chairman Martin commented that the subject the Committee had been discussing was an important one. Basically, he agreed with Mr. Mitchell that from the point of view of the outside analyst the Committee had lost some ground recently. In saying that, he was not implying any criticism of the Desk; one had only to recognize how much higher the Federal funds rate would have had to be to prevent the decline in the bill rate in order to appreciate the complexities of the Desk's task. But there was no doubt in his own mind that many observers thought that monetary policy had lost some of its earlier firmness, and that a good many people, including people abroad, were surprised by what had occurred during the last few weeks. He thought that view was more prevalent outside the Federal Reserve System than within it. Presumably there was a variety of causes for the developments that gave rise to that impression, some of which perhaps were beyond the System's control. Nevertheless, the situation was an unfortunate one.

Mr. Brimmer asked whether, in view of the Treasury financing, there was likely to be any scope in the coming period for attempting to recapture the firmness that had existed in the money market prior to the preceding meeting. In that connection he noted that there would be about two weeks between the payment date for the cash financing, on February 20 or 21, and the tentative date for the

Mr. Holmes said he suspected that some time following the payment date would be required to distribute the Treasury's cash offering, which was a large one. Nevertheless, there might be a brief period before the next meeting in which some firming could be accomplished.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period January 9 through February 5, 1968, were approved, ratified, and confirmed.

Chairman Martin then called for the staff economic and financial reports, which at this meeting were in the form of a visual-auditory presentation. Copies of the charts have been placed in the files of the Committee.

Mr. Brill made the following introductory statement:

> This is the morning for our annual critique of the GNP projection underlying the President's budget, and our assessment of the financial developments that would be consistent with it. In evaluating the official economic model, one must distinguish between a critique that accepts the basic assumptions on which the model rests, particularly those as to fiscal policy, and a critique of the assumptions themselves. Ours if the former; our analysis focuses on the economic needs for and consequences of the fiscal restraint requested by the Administration.
>
> Given Congressional attitudes on the President's tax program up to this point, an assumption of fiscal restraint may strike one as far from a maximum likelihood. Nevertheless, there is some virtue in examining a model which rests on this assumption--first, because the possibility of

tax action, while low, is not entirely negligible; and second, because it provides some insights into the extent of demand and price pressures with which monetary restraint may have to contend if the assumed fiscal restraint is not forthcoming. It can serve as a benchmark as, over the next few even-keel weeks, we reformulate the longer-run strategy for monetary policy if we are to have a no-tax world.

Our staff task this year, in evaluating the budget model, is easier than it has been at times in the past, since we find ourselves in broad agreement with the Council on the over-all contours of the GNP expansion that might emerge, given the assumed fiscal program. We do, however, have some differences as to the cost and price implications of the model, even with a tax increase.

Mr. Wernick made the following statement on nonfinancial developments:

The year 1968, as foreseen by the Council, is one of faster expansion than in 1967, even though the assumed tax increase limits private spending. From fourth quarter to fourth quarter, current dollar GNP is expected to rise by about $58 billion this year, or 7 per cent--up from 6 per cent in 1967. In constant dollars, the gain is projected to be 4 per cent this year. Prices (as reflected in the deflator) are expected to rise no faster, on average, than last year. In fact, the pace of inflation is assumed to slow as the year progresses.

Higher taxes act promptly to slow the rate of increase in GNP. Following a strong first quarter, the expansion in GNP begins to moderate. The increase is smallest in the third quarter, when higher taxes and an expected reduction in the rate of inventory accumulation combine to hold down private demands. Real GNP growth is projected to dip to a 2 per cent rate in the third quarter, but a rebound to a 4 per cent growth rate is expected in the final three months.

Fiscal restraint in the Council's model stems mainly from the requested tax increase. The rise scheduled for Federal purchases is close to the rate experienced since early last year, with purchases for defense increasing at about a $1 billion annual rate per quarter. Since much of this increase reflects higher pay and rising prices, the defense budget doesn't imply any significant expansion in the scale of hostilities.

Other Federal expenditures, as measured in the national income accounts, rise sharply early in 1968, due to enlarged social security benefits, and a sharp one-shot jump in grants-in-aid stemming mainly from increases in medicare payments. After midyear, the rise in these outlays is more gradual.

Reflecting continued increases in demands for public services, State and local purchases are projected to advance as rapidly as in the past two years. These purchases directly contribute about $2 billion per quarter, at annual rates, to GNP expansion.

Increased receipts from the 10 per cent surcharge alter Federal budgetary developments materially. Since the tax increase is assumed to be effective January 1 for corporations and April 1 for individuals, receipts rise rapidly in both of the first two quarters of calendar 1968. After midyear, receipts rise about in line with expenditures.

The deficit on a national income accounts basis, therefore, is reduced significantly in the first quarter and still further in the second. In the last half, the projected deficit stays close to the first-half average. If the surcharge were not enacted, the deficit in calendar 1968 would likely stay in the $10-$12 billion range--or about as large as in the fourth quarter of 1967.

In the short-run, the major restrictive influence of higher taxes falls on consumer income and spending. Nonetheless, the outlook foreseen by the Council is by no means bearish. After the initial impact of higher tax rates on disposable income is absorbed in the second quarter, income growth resumes at about the pace of the final six months of 1967. Substantial wage gains and continuing increases in employment after mid-1968 bolster personal income.

With a small decline in the personal savings rate acting to cushion the effects of the tax increase, gains in consumer expenditures in the final three quarters are only moderately below the sharp growth projected for the first quarter. Sales of autos are expected to be somewhat higher than last year by about the margin of sales lost in strikes. Other consumer durable purchases also would strengthen, partly reflecting the higher rate of new home completions.

The Council's expectations about consumer spending may be optimistic in light of recent consumer behavior, but not unduly so. Aside from a small downward adjustment of the savings rate because of the tax increase, no major shift in spending propensities is projected. The savings rate for 1968 is expected to be only a little below last year's average, but well above the average for 1963-66.

Tax action in the Council model is assumed to be accompanied by monetary policies that permit housing to make a further contribution to growth in 1968. Private starts are projected to increase a little more than 10 per cent by year-end, and residential construction expenditures to grow about the same amount. The effects on expenditures of higher prices for construction materials and labor are offset by an anticipated further shift in construction to the more economical multi-family units.

Only a modest stimulus is expected from the change in inventories, and that is confined to the first half. Total nonfarm inventory accumulation has already risen to a \$7-1/2 billion rate last quarter. Part of the further rise in the first half of this year would presumably come from autos and steel. Liquidation of stocks in these industries after midyear reduces the rate of inventory accumulation by about \$4 billion in the last half.

Inventory accumulation in defense industries, meanwhile, would likely slow, with the moderate growth projected for defense spending. By the fourth quarter, no further build-up in defense inventories is indicated. In other industries, the Council's projection seems to imply a gradual rise over the year in the rate of inventory accumulation, associated with the continued gradual rise in sales.

Passage of the surcharge is expected to have a small direct effect on investment incentives. Corporate profits after taxes are projected to show no rise in 1968. But more important in restraining business fixed investment would be the general context of the unfolding economic situation, with only moderate growth projected for government spending and housing, and consumer demands kept under control by rising taxes. The Council, therefore, projects a slow growth rate--5 per cent--in business fixed investment during 1968; with prices rising, less than half of this increase would be real.

Nevertheless, the level of business investment outlays would be high enough to produce an increase of about 5 per cent in total manufacturing capacity. Capacity utilization would therefore change little from the current rate of about 85 per cent, because manufacturing output would be rising at about the same pace as capacity.

The relative slack that characterizes industrial capacity use in the Council's model does not hold true for labor resources. Employment gains in manufacturing are relatively sharp apart from the third quarter--when projected reductions in steel inventories slow manufacturing production.

In nonmanufacturing industries, gains continue to be rapid in trade, services, and State and local governments--requiring 400,000 additional workers per quarter.

The projected increase in total employment over the year exceeds by 200,000 the expansion in the civilian labor force. The unemployment rate, consequently, would decline somewhat further in the first half from an already low level, and then rise a little as the pace of economic advance slowed. For adult men, the rate would remain below 2 per cent.

With labor markets thus remaining tight, and the cost of living still rising, contract settlements in manufacturing would be expected to follow patterns established in autos and other major industries last year. And since the minimum wage has been increased, and recently negotiated contracts provide for large wage gains in many industries, the rise in hourly compensation in manufacturing should be at least as large as in 1967.

A more rapid increase in productivity is expected to accompany rising production this year, in contrast to the unusually small gain in 1967. As a result, the rise in unit labor costs in manufacturing should be smaller in 1968 than last year, but it will still be too large for comfort. Businesses will undoubtedly be searching for opportunities to pass continuing cost increases through to higher prices, even with less than optimal use of plant capacity.

Thus with cost pressures remaining strong, industrial commodity prices seem likely to continue rising through the first half of 1968 at about the annual rate of 3-1/2 per cent in evidence over the past six months. But this rise must slow down before year end, as the pace of economic expansion moderates, to be consistent with the GNP deflator projected by the Council.

Unfortunately, prices of foods, which provided some offset to rising industrial prices from the fall of 1966 until recently, are expected to advance throughout the year, particularly if the Administration's proposals for restricting farm production are realized.

For consumer prices, upward pressures would be widespread, reflecting increasing wholesale prices of food and nonfood commodities and the continued rapid rise in services. However, a slower rise after midyear in consumer as well as wholesale prices is implicit in the Council's projected GNP deflator.

In conclusion, we believe this price outlook is too optimistic. Our own staff analysis of demand and cost factors consistent with the Council's GNP projection suggests that price pressures would be stronger and more widespread than those expected by the Council for the last half of 1968. Fiscal restraint at best would provide only a small start this year to the solution of inflationary problems.

Mr. Gramley commented on financial developments as follows:

Financial markets have been buffeted these past two years by inflation, large Federal borrowing, balance of payments deficits, and shifts in both monetary policy and expectations. Adverse expectations pushed long-term interest rates to giddy heights late last year. But the expectational climate since then has changed markedly, and interest rates have declined.

This recent change in market sentiment does not appear to have been based principally on the expectation of tax legislation, but it could prove to be short-lived if the proposed surcharge is not passed. For even with a tax increase, financial markets are likely to face heavy credit demands during 1968.

The Federal sector, once again, plays a large role in the projection of funds to be raised. The Administration's Budget implies that total Federal borrowing, including PC's and issues of all agencies and Government-sponsored enterprises, will be larger this calendar year than last. The tax increase does reduce the NIA deficit.

But in calendar 1967, tax accruals were nearly $4-1/2 billion less than payments, reflecting acceleration of corporate tax payments. This helped to hold down borrowing last year, but it will not in this calendar year, even though some further acceleration in corporate tax payments is proposed. And loan programs will also be larger in calendar 1968, since net loans were held down last year by exceptionally large debt repayments to the Federal Home Loan Banks. For reasons related to timing and coverage, these loan figures look quite different from those in the Budget, but they are consistent with it.

The half-year pattern for projected Federal borrowing is much different from calendar 1967, when the borrowing rate rose to exceptional levels in the final six months. This year, borrowing will be spread more evenly through the year. After the forthcoming financing, the Treasury will have made a good start in raising the cash needed between now and June 30, and thus with timely tax action, the worst could be behind us. Nonetheless, the Government's demands on the money and capital markets in 1968 would still be substantial.

Private borrowing is also expected to be large, dropping somewhat in the second half along with the projected slower pace of economic activity, but for the year averaging well above 1967 flows. Thus, the total of funds raised by private borrowers and the Federal Government would remain at high levels in 1968--but below the exceptionally high annual rate of late 1967.

The principal contributor to the enlarged private borrowing would be the household sector. Mortgage borrowing of households has already risen considerably from the depressed levels of early 1967, and a further advance is indicated by the projected rise in residential construction. And growth in consumer credit would also increase, with durable goods purchases rising in the Council's projection.

Total business borrowing, by contrast, is projected to show little increase from the advanced level reached in the second half of 1967. While the gap between business capital expenditures and internal funds is projected to widen in 1968, businesses will not be faced with the market acceleration in tax payments that added to their demands on credit markets last year.

We would, however, expect business demands for funds to concentrate more heavily on the banking system. Bank loans to businesses are projected to rise at over a $10 billion--or 12 per cent--annual rate in the first half, and to slow down thereafter. The pattern of inventory investment projected in the Council model is the main factor here.

Corporate security issues, in contrast, would be expected to decline sharply. No investment boom is projected, and a renewed scramble for liquidity would seem quite unlikely if the surcharge were passed.

In summary, these are the demands for funds that would seem consistent with the projected pattern and growth of GNP underlying the Budget. What volume and distribution of credit supplies would be required to meet these demands on terms that would permit realization of the projected level and structure of GNP--and particularly the further rise in housing?

First of all, the easing of mortgage credit availability needed to promote a further increase in housing starts would necessitate higher growth rates of nonbank savings accounts than we have seen recently. These rates of inflow subsided in the second half of 1967, as yields on market securities rose to heights that attracted individual savings. By December 1967, deposit inflows were down to about a 5 per cent annual rate, and nonbank institutions had become considerably more cautious in their commitments of funds to mortgages.

The projected rise in residential construction, according to our estimates, would require inflows to nonbank savings institutions at about an 8 per cent annual rate. Those larger inflows would result, presumably, from a rechanneling of individual savings away from market securities and toward depositary institutions--a shift that would be unlikely without lower market rates of interest.

Growth in commercial bank time deposits also would be expected to respond to this redistribution in the public's asset acquisitions. For time deposits, the projection is for growth at roughly a 13 per cent annual rate--considerably above the fourth quarter 1967 and much higher than we have seen in the early weeks of this year. The projection assumes that dollar inflows of individuals' savings to banks and nonbank thrift institutions would be about equal. It also assumes that large banks would be motivated by the projected pickup in business loans to bid more aggressively for negotiable CD's than they have been doing these past few weeks.

Growth in the money stock, however, is projected to slow. Fears of a credit crunch seem to have diminished substantially since late last year, and tax action would presumably quiet uncertainties further. Continuation of last year's rapid pace of money expansion appears unlikely, in the context of the Council's GNP model.

These projections for money and time deposits imply an expansion in bank credit at about a 9 per cent annual rate in both halves of 1968. And the reserve expansion needed to support the deposit growth would be a little less than 7 per cent, with the rate of growth fairly uniform through the year.

Some impression of the degree of ease in credit markets implicit in this pattern of credit supplies can be gained by considering the amount of security purchases needed from households to match total credit sources with uses. Households are the most important residual supplier of funds directly to credit markets--purchasing securities in volume only when yields look quite attractive.

Our projection does not suggest credit market conditions as easy as those in the first half of last year, when households liquidated substantial amounts of securities to acquire money and other depositary claims. But it does seem to indicate substantially easier conditions than those prevailing in the last half of 1967 or in 1966.

Interest rates, then, would have to fall considerably further to realize the Council's GNP model, given a tax increase. Our rough guesses as to the dimensions of that decline are for bill rates to fall to the 4 - 4-1/4 per cent range by year end, and corporate new issue rates to recede to levels we have not seen since the spring of 1967. While such a decline might seem to imply excessive monetary ease, it should be recalled that it is projected as occurring in the context of fiscal restraint that moderates GNP growth substantially by the second half of the year.

Mr. Hersey presented the following statement on international developments:

The President's New Year's Day program can be looked at from three or four angles. Its most immediate purpose was to stop the run into gold that started after the sterling devaluation in November. Its purpose for the year 1968 is to ensure a considerable reduction in the balance of payments deficit, which last year enlarged the excess of our reserve liabilities to foreign monetary authorities over our reserve assets by more than $3 billion. Its longer-run purposes are to help promote

The parts of the program that are most clearly defined are intended (1) to swing the U.S. bank credit flow inwards this year, improving the balance by nearly $1 billion, and (2) to reduce the net capital outflow for financing direct investment this year by more than $1 billion--the latter partly by increasing Euro-bond issues by U.S. corporations. Other private capital flows will not be directly much affected by the new program, but will absorb some of the pressure the program puts on foreign financial markets. For example, sales to U.S. investors of new issues of foreign bonds, unusually large last year, may shrink less than they otherwise would have; and foreign purchases of U.S. common stocks, which reached three-quarters of a billion last year, may be reduced.

Impacts of the program on the balances of payments of other countries unfortunately cannot be confined to the surplus countries of continental Western Europe. About a half of the shift in flows from 1967 to 1968 will fall on them--that is, a direct impact of perhaps over $1 billion. The flow of our direct investments in European Schedule C countries, net of our use of Euro-bond funds for direct investments there and elsewhere, will shift from a net U.S. outflow of about $1 billion last year to a small net pull-out from Europe. But several hundred million of the reduction in direct investment flow will fall on Schedule B countries, which include Canada, Britain, and Australia--even if more use is made of Euro-bond financing and even if some licenses are given to exceed the quotas.

We will continue to get repayments of bank credit from continental Europe, and perhaps somewhat more than last year, when nearly half a billion was paid off. But most of the change in bank credit flow will fall on Japan and, in the "rest of the world" group, on Latin America; these areas, taken together, may not have to make net repayments to us like Europe, but they will no longer get much net new money from U.S. banks as they did in 1967.

However, the program's effects ought to stimulate larger borrowing from Europe, not only by U.S. corporations but also by Japanese, Latin Americans, Canadians, and others. Such demands for European funds, together with a continuation of present easy conditions in the key German short-term money market, may, we hope, promote a rapid further development of European capital market and credit facilities. In this way the program may contribute to a needed long-run adjustment:

Europe must take over from us some of the function we have been serving as capital supplier of last resort.

Summarizing, net flows of nonliquid private capital from and to the United States may reasonably be expected to be more favorable in 1968 than in 1967 by $2 billion or better. On the other hand, various Government capital transactions are expected to be less favorable by about half a billion; this reflects the continuing rise in Export-Import Bank lending, and a shift in military export prepayment accounts from buildup to gradual liquidation. No advance redemptions of debt by foreign governments are expected in 1968, in contrast to the years up to 1966. The goods and services balance during 1968 is projected as averaging equal to that of 1967, taking into account the Council's GNP projection and the demand outlook abroad. We allow for some effect of the proposed tax on tourists, but we have not tried to estimate the direct effects and adverse repercussions of an import levy and export rebate.

The deficit on the liquidity basis before special transactions, which was over $4-1/2 billion in 1967, may be about half as large in 1968, somewhere between $2 and $2-1/2 billion. After special transactions, the liquidity deficit as published will have been about $3-1/2 billion last year; we have not tried to estimate this for 1968. On the official reserve transactions basis, the deficit is projected very roughly at $2-1/2 billion in 1968, on an assumption that U.S. banks will make moderate net repayments of their balances due to branches abroad in contrast with net borrowing from branches last year. The over-all picture is not a pretty one, despite the improvement in the private capital account expected this year.

The trouble is that the balance on goods and services this year is unlikely to regain the level, near $5-1/2 billion, that was maintained in the first three quarters of last year. When we recall that net exports of goods and services in the three years 1963-65 averaged a $7 billion rate, we can see that our balance of payments problems are not confined to the capital account--contrary to a common view in Europe. An unexpectedly severe worsening of the current account hit us in the fourth quarter of 1967.

The decline in the trade surplus since 1964 dominates the current account balance. Direct investment income is estimated for the past half-year, and is projected into 1968, at a level nearly $1 billion a year above its 1964-65 average. The items included under "other" current transactions have not changed much on balance, except for last year's drains for travel to Expo '67 and for personal remittances to Israel. The net balance of military expenditures abroad and deliveries on our military export contracts has worsened by about $1 billion since 1964; the projected changes on these military accounts in 1968 are small.

The trade surplus averaged in 1963-65 about $5-1/2 billion. In the first three quarters of last year it ran a little above $4 billion a year, and in the fourth quarter it dropped to a $1-1/2 billion rate. The projection for 1968 is for only partial recovery, to an average that may be short by $2-1/2 billion of what we achieved in our last years of reasonable price stability.

The shrinkage in the trade surplus in the fourth quarter was due almost entirely to a steep jump in imports. We will come back to the import trend in a minute. The projection assumes that exports, which held fairly level last year despite a drop in agricultural exports, will rise rapidly through 1968.

The basis for this optimistic export projection is the evidence we now have that recovery is well under way in Germany--with industrial production in November 6 per cent above the first half of 1967--and recent indications that policies in both Germany and France are and will remain expansionary. Further expansion is expected also in Canada, Japan, and Italy. On the other hand, the outlook for U.S. costs and prices constitutes a bearish factor for our exports.

Turning back to imports: just as the manufacturing capacity-use ratio has recently been proving a poor indicator of domestic price prospects, it has failed to warn us of the recent jump in imports. The projections indicate a still higher ratio of imports to GNP in 1968. It can hardly be doubted that the rising trend of imports, whatever its various causes, has been influenced in some degree by the progressive deterioration over the past two and a half years in international price and cost relationships between us and some of our major competitors.

The relative trends of prices here and in Germany are useful to bear in mind when we consider what are the long-run adjustments for which we are buying time with our new capital control program and with the taxes on tourism and imports that are under consideration--all of which we hope can be temporary. Part of the answer was given earlier: we hope the new program gives a push to the development of

European capital markets and credit facilities. The other part must be that the United States intends to regain a larger surplus on goods and services, by means of lasting adjustments of one sort or another. Apart from an eventual reduction in our military expenditures abroad and further growth in income from our foreign investments, the adjustments that are needed relate to our international competitive position in both export and import trade. From this point of view, the present trend of U.S. prices is disturbing. Unless price inflation in this country is halted, all attempts to restore balance of payments equilibrium will be frustrated.

Mr. Brill concluded the presentation with the following statement:

The President's tax proposal rests squarely on the expectation of economic overheating. Even with the tax hike, current dollar GNP is projected to rise about 7 per cent, and the deflator about 3 per cent. Nonetheless, the question is being raised, once again, as to whether expansive forces in the economy are strong enough to withstand a tax increase.

This question clearly cannot be dismissed out of hand, particularly in view of the recent performance of financial markets, inventory investment, and consumer expenditures. Inventory stockpiling has come sooner and been considerably larger than expected, and growth in consumer purchases substantially smaller. The savings rate last quarter rose to 7-1/2 per cent--a level no one had contemplated.

While there are evident similarities with developments of a year ago, the two situations differ in important respects. The recent inventory buildup has been neither as large nor as generalized as it was late in 1966. Moreover, given the sharp rise in new orders in December, and the sentiments expressed in recent surveys, there is little evidence that businessmen are currently very concerned about excessive stocks. And with large increasesin personal income likely to occur in this and the coming quarter, a significant acceleration in the growth of consumer expenditures seems highly likely. I would underscore that this does not rest on a rise in spending propensities, but would occur even

Some who accept the prospect of rapid expansion in the near term express concern about the prospects for weakness in the second half of this year, with or without the proposed tax increase. It does seem likely that the pace of expansion will slow after midyear, as the Council has projected.

But this slowdown reflects primarily the counterpart of the projected excessive stockpiling of steel and autos in the first half. Given the anticipated growth of Government spending, and given monetary conditions that would permit a continued gradual advance in housing and business fixed investment, there is reason to expect any slowdown would be temporary, even with a tax increase. The tempo of activity should be picking up again before year end. There are, admittedly, risks that a 10 per cent surcharge would prove to be too much restraint, but the principal risks, as we see them, are on the other side.

For while we agree with the Council on the general contours and scale of prospective expansion under conditions of fiscal restraint, we are less sanguine than they about price prospects. Our analysis suggests that cost pressures will continue strong, and despite continued slack in industrial capacity use, we would expect these pressures to be passed through to prices more rapidly and pervasively than the Council does. Restraint now would begin to slow inflation before the year is out, but the full effect of the slowing resulting from the postulated fiscal restraint would not be reflected in the price indeces before 1969. The record leaves little room for optimism about the speed with which inflationary forces can be curbed.

On the international front, too, the major risk lies in the possibility of too little restraint rather than too much. We can look forward this year to some improvement in our payments balance, reflecting the effects of the President's program. But the projected deficit is still much too large. And unless we begin to use the time this program buys to take the steps so essential to better long-run equilibrium in our payments accounts, the key potential benefit of the program will have been lost.

Passage of the surcharge is--obviously--no certainty. And whether Federal expenditures will follow the path projected here is also open to question--particularly in the face of the changing character of the conflict in Asia. It is perhaps instructive to remind ourselves that the NIA deficit this first quarter is projected to be $6 billion with the proposed tax increase in effect; without the tax, the figure would be about $10-1/2 billion, as indicated in the green book,[1/] and not likely to decrease much over the year. There can be little doubt that failure to enact the Administration's tax proposal will require dependence on monetary policy, once again, as the principal instrument of stabilization policy.

For the moment, of course, Treasury debt management has preempted the center of the financial stage. The staff has assumed that, although market reception of the financing seems likely to be favorable, the Committee would wish to pursue an even keel policy until its next meeting. Given the unusual behavior of some monetary variables in recent weeks, it's not easy to define even keel for the entire complex of financial indicators.

The blue book projects the Federal funds rate in a 4-5/8 to 4-3/4 per cent range under an even keel policy. Assuming a return to more normal money market relationships, we would expect this to be associated with a 3-month bill rate in the 4-3/4 to 5-1/8 per cent range. The bill rate, however, is still possibly subject to some exceptional influences. For example, reinvestment demands arising out of the Treasury financing may reinforce seasonal downward tendencies in the bill rate; on the other hand, emergence of stronger business loan demand might restore upward pressure on CD rates, and through this, on bill rates too.

With money market rates within the ranges specified, we would expect free reserves to average between zero and $100 million--although turning negative on occasion--and member bank borrowings to range between $200 and $300 million.

As for the aggregates, the initial bank underwriting of the Treasury issues and of security dealer positions should keep the proxy expanding in February at about the January rate of 9 per cent. This, by the way, is a pace our longer-run projection suggests as roughly consistent with an economy restrained by fiscal policy. It is undoubtedly too rapid a pace for an economy that has to be harnessed by monetary restraint alone.

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

> It may be too early to inter the tax proposal, however, for from time to time a faint spark of life seems to flicker. In any event, given even keel considerations, burial services must wait until the Committee's next meeting, in the wake of which we may have to resurrect monetary restraint.

The discussion following the presentation revolved mainly around the implications of the analysis for monetary policy in 1968, questions relating to the differences between the Council's and the Board staff's expectations for prices and defense expenditures, and related matters.

Mr. Robertson then said he had an alternative proposal for the second paragraph of the directive that he might present at this point so that the members could consider it, along with the staff's draft, in their comments during the go-around. He was concerned with the need to avoid the sense of relaxation in monetary restraint from the degree of firmness that had prevailed earlier. He thought that might best be accomplished by a second paragraph for the directive reading as follows:

> To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining as firm conditions in the money market as are consistent with maintenance of an "even keel" during the period of the Treasury financing, and hold that firmness thereafter until the next meeting of the Committee.

He would interpret that language as calling for a Federal funds rate around 4-3/4 per cent, dealer loan rates ranging up to about 5 per cent, and marginal reserves fluctuating between plus and minus $50 million, with no attention being paid to the bill rate. As the members no doubt had noted, the paragraph he proposed did not include a proviso clause.

Mr. Brimmer said he also had an alternative second paragraph to offer for consideration. His suggestion was directed at the same general objective as Mr. Robertson's, but it employed more specific language and included a proviso clause. It read as follows:

> To implement this policy, once Treasury financing activity has been completed, System open market operations until the next meeting of the Committee shall be conducted with a view to achieving somewhat firmer conditions in the money market; but operations shall be modified, to the extent permitted by Treasury financing, to moderate any apparently significant deviations of bank credit from current expectations.

He offered that suggestion on the assumption that there might be about a week before the next meeting in which some firming could be accomplished, and in the belief that the Committee should take advantage of that opportunity.

Mr. Hayes remarked that he thought there was merit in the reasoning which underlay the proposals of Messrs. Robertson and Brimmer, but he saw some disadvantages in their specific suggestions. He agreed that it would be desirable to firm money market conditions to the extent consistent with even keel considerations. He did not think any substantial amount of firming could be accomplished in view of the Treasury financing, but perhaps some shading of conditions or the resolution of doubts on the side of firmness would be possible. Perhaps the best approach would be to include a proviso clause calling for such action if bank credit growth was proceeding at the projected 7-10 per cent annual rate, which he would consider to be on the high side. Although there would, of course, be greater scope for firming after the Treasury financing was completed, he would prefer to have the Desk keep the possibility in mind throughout the period rather than wait until after the completion of the financing, as called for by Mr. Brimmer's suggestion. He would not favor a two-way proviso clause, because he did not think the Committee was greatly concerned at this point about the possibility of inadequate growth in bank credit. All things considered, he would prefer a second paragraph along the following lines:

> To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed on average since the preceding meeting of the Committee; but operations shall be modified, to the extent permitted by Treasury financing, if bank credit appears to be expanding as rapidly as is currently projected.

Mr. Daane referred to Mr. Robertson's proposal and said he doubted that it was realistic to expect that there would be much, if any, scope for firming during the Treasury financing. On the other hand, there might well be some greater opportunity to firm after the financing. Accordingly, he questioned the desirability of instructing the Manager to hold only to whatever firmness might be achieved during the even keel period after that period was past.

Mr. Robertson agreed that it was not likely that much firming would be possible during the financing. Any that could be accomplished would be desirable, however, and he would want the Desk to hold at least that degree of firmness in the ensuing period.

With regard to Mr. Brimmer's suggestion, Mr. Hayes said he had always been reluctant to have the Committee take a definite decision before or during a Treasury financing to firm money market conditions as soon as the financing was completed. In general, he thought it was preferable under circumstances like the present to formulate the Committee's instructions in a manner that would permit the Manager to firm if in his judgment certain reserve and credit conditions prevailed after the financing was completed.

Mr. Mitchell remarked that the various suggestions for the directive seemed to reflect a common desire to have conditions as firm in the period ahead as was consistent with Treasury financing activity. He also would be reluctant to instruct the Manager now to undertake firming operations immediately after the financing was completed.

Mr. Brimmer said he thought the Treasury financing should not preclude operations to achieve somewhat firmer conditions in the money market, and the objective of his proposal was to incorporate an instruction in the directive to seek such conditions during the coming period. Perhaps Mr. Hayes' objections to his (Mr. Brimmer's) suggested language could be met by modifying the phrase reading "once Treasury financing activity has been completed."

Chairman Martin commented that Mr. Hayes had made a valid point. Noting that there was likely to be only about one week in the coming period in which any significant action could be taken, the Chairman observed that the Committee might want to wait until its next meeting before deciding whether to call for firmer money market conditions.

Mr. Wayne expressed the view that there was a significant difference between the proposals of Messrs. Hayes and Robertson, on the one hand, and that of Mr. Brimmer, on the other. In his judgment it would be undesirable to issue a directive at this point that called for moving toward firmer conditions, as Mr. Brimmer suggested.

Mr. Robertson commented that there also was a significant difference between his proposal and that of Mr. Hayes. The latter called, in the language before the proviso clause, for maintaining prevailing money market conditions; his proposal called for maintaining as firm conditions as were consistent with even keel.

Mr. Hayes remarked that the proviso clause in his proposal was intended to call for firming to the extent consistent with the Treasury financing if bank credit growth was as rapid as projected by the Board's staff.

Mr. Holmes observed that in his judgment a problem was posed by the fact that the shift in market psychology in recent weeks had resulted in market conditions that seemed easier than they in fact were. Federal funds had been trading predominately at 4-3/4 per cent in recent days and prices of Treasury bonds had moved down. Admittedly, it was hard to sort out the implications of the various indicators, but it was his opinion that on the whole market conditions were quite firm at present.

Mr. Brimmer expressed the hope that the Committee members would focus on that question during the go-around. He was not inclined to agree with Mr. Holmes' evaluation of current market conditions and he gathered that other members also thought conditions were easier than they had expected.

Chairman Martin commented that he would prefer language along the lines of the proposals by Messrs. Robertson and Hayes to that Mr. Brimmer had suggested. He would be concerned about calling now for firming immediately after the Treasury financing.

Mr. Daane said that, as desirable as firmer money market conditions might be under current economic circumstances, he would have some question about any course of action that implied an overt departure from an even keel position.

Mr. Holmes mentioned the possibility of calling in the directive for the maintenance of "firm" conditions in the money market.

Mr. Hayes expressed the view that such a course might be preferable to calling for the maintenance of recently prevailing conditions, as he had suggested earlier. However, he would still favor including the type of proviso clause he had mentioned. As an alternative to his earlier proposal, he would now suggest a second paragraph reading as follows:

> To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market, but operations shall be modified, to the extent permitted by Treasury financing, if bank credit appears to be expanding as rapidly as is currently projected.

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

> The outlook for the economy remains strong. Gross national product is expected to show a very large gain in the first quarter. There are many uncertainties in the longer-term outlook, most notably those arising from the possible implications of recent Far Eastern developments for defense spending. I would on balance expect substantial, but somewhat smaller, increases in economic activity over the balance of the year. So far the pace of the

advance has been tempered by conservative consumer attitudes reflected in the continuance of a very high savings rate. However, even if the savings rate remains relatively high, consumer spending should move up more strongly than in recent quarters, because of the impact on incomes of the December Federal pay rise, the February 1 minimum wage increase, and the March boost in Social Security payments. While some slowdown in housing seems entirely possible in 1968, the precipitate December drop in starts was almost certainly not indicative of any sharp downward trend. With the fading of special first-quarter stimulants in the auto and steel industries, quarterly gains in GNP are likely to be less rapid after the first quarter, but still large enough to sustain major upward pressures on prices, especially if there is no tax increase and if defense spending accelerates. The recent pace of price increases, both retail and wholesale, has been disturbingly high. Even if the tax rise is enacted, a sizable rate of inflation seems to have been built into the economy for 1968.

Despite the relative calm of the gold and exchange markets in the last couple of weeks following the sharp pressures on the Canadian dollar at mid-month, the international financial situation remains uneasy, with the emergence of a major crisis this year always a real possibility. As was true in November and December, the London gold market is an especially vulnerable point in the international financial structure. Of course, the prospective repeal of the gold cover requirement will be helpful in strengthening confidence in the dollar, but it contributes nothing to the solution of our balance of payments problem.

The payments outlook gives little cause for cheer despite the welcome inauguration of the President's vigorous January program. Most disturbing is the recent sharp decline in the U.S. trade surplus, which has not been surprising in the light of the stepped-up pace of the economy and the widely prevalent upward movement of costs and prices. Much of the very sharp rise in imports in November and December may have been due to temporary factors, but it is hard to escape the conclusion that inflationary tendencies will undercut some substantial portion of the balance of payments gains to be expected in 1968 from the President's program. A U.S. Government Balance of Payments Information Committee foresees a liquidity deficit of $1.5 billion this year, but the trade surplus assumed in this connection may well be overestimated. And even if the $1.5 billion deficit were to be realized, it would fall considerably short of the goal announced by the President earlier this year.

There are, of course, major uncertainties in the budgetary prospects. In the first place, the underlying assumptions of no further escalation in Vietnam and no military involvement in Korea leave open to considerable doubt the estimated rise of only $3 billion in cash defense spending. Moreover, nondefense spending is expected to continue rising, despite what I feel has been a real effort to limit spending increases and to make some painful cuts in certain areas. Perhaps some further spending cuts could be made here and there, but on the whole the proposed aggregate of expenditures is not unreasonably high, given the numerous urgent domestic and international needs. Nevertheless, on balance the budget will remain strongly expansionary unless a sizable tax increase is enacted. The obvious conclusion is that the tax rise is most urgently called for in order to limit the budget's stimulating effects, to make more manageable the Treasury's financing program, and to improve our international position through a demonstration of fiscal responsibility--and, over the longer run, through a strenthening of our competitive position.

Last month a good deal of satisfaction was expressed by Committee members with the accumulating evidence of an appreciable slow-down in bank credit expansion since the autumn of 1967; and I shared this feeling. However, this slow-down has not carried through into January, the rise last month probably reflecting the continuing strong expansion of business activity as well as the Treasury's financing during the month. As to February, the blue book estimate of 7-10 per cent would imply a near repetition of the January pace. While the New York Bank staff's estimate of bank credit growth for February is considerably lower, I would not be surprised to see it revised upward substantially over the course of the month if business activity continues its strong advance, and especially in the light of the Treasury's large financing program for February. I would conclude that it is not at all clear that the credit expansion has been slowed sufficiently in view of the persistent inflationary and balance of payments difficulties I have cited.

As for interest rates, they seem to be under much less pressure than a month or two ago, and although the flow of funds into the thrift institutions has slowed significantly, the disintermediation problem is certainly less acute today than it was at the time of our last meeting. There appears to have been a real--but not necessarily long-lasting--change in sentiment in the financial markets. No doubt the less-than-expected loan pressure on the banks and the tendency toward lower short-term rates are partly a result of the continuing very high level of corporate and municipal bond offerings and, perhaps, also a temporary result of the new balance of payments program. But if the economy develops as we expect that it will, aggregate credit demands are likely to be very heavy in 1968. We may well see new upward pressures on interest rates in the coming months, more particularly if tax action suffers further delays.

Were it not for the Treasury financing program, I would urge that we move somewhat further through open market operations to restrict bank credit growth. I would have in mind, for example, that free reserves might range around zero, borrowings might approximate $300 million, and the Federal funds rate might occasionally reach 5 per cent. I would hope that those conditions would tend to move Treasury bill rates above recently prevailing levels. As it is, even keel considerations preclude any appreciable change of policy for two or three weeks at least. I would hope, however, that the Manager would try to maintain as firm a tone as would be consistent with the even keel policy and that doubts would be resolved on the side of firmness. Later in the month, if the Treasury financing has been completed without running into undue difficulties, perhaps a modest start could be made toward a somewhat firmer policy if estimates of the credit proxy at that time point to a February gain of anything close to the January increase. It seems to me that we should try to limit bank credit growth to around 6 per cent in view of the seriousness of our inflationary and international problems.

In view of the earlier discussion of the directive, no further comments on that subject are necessary at this point.

In the last few weeks I have felt increasingly concerned with the accumulating signs of excessive stock market speculation. While the extension of margin requirements to unregulated lenders through Regulation G should have a dampening effect, I think the Board might well consider the possibility of following up this action with an increase in margin requirements from 70 to 80 per cent. The timing of such an action would of course have to give due weight to the exigencies of the Treasury's financing operations.

Mr. Francis said that during the past four weeks, as new data had become available, it had become increasingly clear that monetary developments were continuing to add to excessive demands for goods and services. At the time of the Committee's previous meeting, it had appeared that considerable progress had been made in achieving monetary restraint. Monetary aggregates had grown little in late 1967, and staff projections for January indicated that the new trends would continue. Reserve requirements were increased, presumably another move toward restraint. In fact, a month ago many members of the Committee had begun to believe that monetary action might soon become unduly restrictive.

In retrospect, it appeared to Mr. Francis that the Committee's decisions in late 1967 to move toward restraint had not been realized. Since December expansion in Federal Reserve credit and other factors had more than offset the impact of higher reserve requirements on monetary aggregates. The staff projections of growth in bank credit and the money stock from December to January had been progressively revised upward. For money, the projection had been for no growth, and it was now discovered that money rose at an 8 per cent annual rate, about the trend rate of last year.

Mr. Francis felt that restraint on spending was urgently needed. Excessive demands for goods and services were causing further inflation and imbalances. Since last July prices paid by consumers for commodities other than food had risen at a 4.5 per cent annual rate. Inflationary expectations were fostering high interest rates. Direct Government controls were being extended, with probable misallocation of resources and loss of freedom.

The public interest called for sound fiscal and monetary policies, Mr. Francis continued. Even if the Government adopted some measure of fiscal restraint, growth in Federal Reserve credit, total credit, and money would have to be moderated to obtain a sustainable economic expansion without inflation. The country needed both sound fiscal and sound monetary policies.

Mr. Francis was pessimistic about the probable success of the measures to correct the balance of payments announced by the President on January 1. The country had tried the administrative approach to solving the balance of payments problem in 1963 and 1965. However, imaginative and aggressive businessmen usually found ways of avoiding the restrictions which in turn led to further extension of controls.

Mr. Francis observed that to go all the way to complete and pervasive exchange controls would be contrary to the nation's fundamental beliefs in free markets. But that appeared to be the direction in which the country was traveling. If the U.S. balance of payments was to be corrected its twin causes--domestic inflation and weakness in the international financial structure--had to be directly attacked.

He was sure, Mr. Francis said, that the problem of domestic inflation could be eventually handled by following a more restrictive monetary policy. He believed the best way to handle the problem of a weak international financial mechanism was for the United States to break the link between gold and the dollar. At the same time, of course, efforts should be continued to activate the special drawing rights mechanism that was agreed to at the IMF meeting in Rio de Janeiro last September. The nation's friends around the world, who had been persuaded by the United States to hold dollar balances rather than gold, could be compensated. The cost to the United States of such compensation could be less than the cost of maintaining de facto exchange controls.

As to current monetary policy, Mr. Francis suggested an immediate and substantial move toward monetary restraint. The current situation was sufficiently urgent for the Committee to put aside even keel considerations and other constraints on action. The 6 per cent rate of growth in money over the last six months should be cut in half, and money market conditions should be permitted to find their own level.

It seemed to Mr. Francis that one problem in attaining a proper growth rate of monetary aggregates had been the System's primary reliance on money market conditions as a guide to its short-run operations. Money market conditions reflected changing demands for credit as well as System actions. If the Desk sought to maintain a prescribed set of money market conditions, monetary aggregates might either rise or fall over a broad range depending on the strength of credit demands. Until a complete model was developed which could adequately project short-run changes in credit demands, that system of giving directions to the Account Manager was bound to be subject to misleading results.

Mr. Francis agreed with Mr. Maisel's position, expressed at recent meetings, that heavier reliance should be placed on the aggregate measures in the directives to the Manager. It seemed to him that those measures offered a more reliable guide than such variables as Federal funds rates, other short-term interest rates, or free reserves. The rate of monetary expansion would be better controlled if an aggregate monetary measure were specified in the directive. As the actual figures deviated from the desired levels, adjustments could be made each week in the rate of reserve injections.

Mr. Francis commented that bank credit as used in the proviso clause had deficiencies as a guide to short-run operations. The growth of bank credit was greatly affected by the ability of banks to compete for time deposits. But a routing of saving flows past the banking system because of Regulation Q had little effect on total credit available to borrowers and should not be interpreted as monetary restraint. In his judgment, a preferable measure of the marginal impact of the central bank's actions on economic activity was the growth rate in the money supply. At the present time he suggested a 2 or 3 per cent annual rate of growth for money as a target, and he would delegate authority to the Manager to adapt his procedures each week in the direction required to keep money growing at approximately that pace over a reasonable period of time.

Like others, Mr. Francis said, he found the second paragraph of the staff's draft of the directive unacceptable. The first paragraph developed conclusively, it seemed to him, the compelling need for monetary restraint. The second paragraph struck him as wholly inconsistent with the first, particularly with the sentence reading "In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments."

Mr. Francis commented that the proviso clause as drafted had come to be almost meaningless. Throughout most of the last twelve months staff projections had fallen short of growth in bank credit, and the Committee had found itself operating near the upper limits of the projections. The result had been an easier monetary policy than, he believed, most of the Committee members had expected or desired. He would favor a second paragraph reading as follows:

> To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to achieving firmer conditions in the money market than have prevailed on average since the preceding meeting of the Committee; operations shall be modified, to the extent permitted by Treasury financing, to moderate any tendency for either bank credit or money to expand significantly more than the mid-point of the projected ranges.

Mr. Kimbrel remarked it was hard to find anything but evidence of continued expansion in the latest information on economic conditions in the Sixth District. Both manufacturing and nonmanufacturing employment were increasing. The revival in construction had been strong. The December 1967 construction contract total was up 27 per cent from a year ago, and total contracts during 1967 topped $6 billion for the first time. Improved residential construction accounted for most of the gain, but nonresidential construction contracts in 1967 equalled those of 1966. Some of the improvement in District manufacturing activity could be traced to the construction revival. For example, there had been a pick-up in the lumber, wood products, and furniture industries. Even the improved textile activity could be linked to the increase in housing construction, since manufacturing of tufted carpets is so important in the area.

Manufacturing employment gains had been accompanied by higher average weekly hours and, of course, by higher payrolls, Mr. Kimbrel continued. Unemployment was at 3 per cent or less in 12 of the

District's 18 major labor market areas. Despite the growth of personal income that accompanied those developments, retail sales were sluggish.

Mr. Kimbrel thought the absence of any substantial reductions in savings flows to District savings and loan associations during late 1967 and early 1968 was contributing to optimism about the near future for residential construction. The year 1967 ended with about $3/4 billion more net savings inflow into the associations of District States than in 1966. Net new mortgage lending, at $159 million, did not grow correspondingly, but it spurted sharply in December.

It was also hard for Mr. Kimbrel to find anything in the District banking data to support a view that credit was becoming tighter. The large banks suffered only small losses in large CD's at the end of 1967 and by mid-January had more than recouped the year-end run-offs. Figures through the middle of January suggested that passbook savings and other time deposits at country banks were still increasing. Loans at member banks, after having spurted sharply in December, declined in January, as would be expected; but the drop had been less than in January of most preceding years. Member bank borrowing had been extremely low; and, although a few banks last week came to the window for help in their reserve adjustments, total borrowings were relatively small.

Those developments, of course, were very much like the national ones except for minor variations, Mr. Kimbrel observed. Economic indicators suggested a somewhat greater rate of expansion in the District, and, to some extent, that was also true of District banking data.

No doubt there were many complex causes for the recent softening in rates, Mr. Kimbrel continued. Quite possibly, many of those causes could not have been anticipated or reversed by System action. Moreover, as a newcomer to the deliberations of the Committee, he would be the first to admit that he might not have the complete picture. However, he could not put out of his mind the possibility that the "somewhat firmer conditions" specified at the previous meeting of the Committee had not been maintained. Even a newcomer could recognize that the Treasury financing added a tremendous complication to future policy execution. While he would forego comments on the various suggestions for the directive, he hoped that there would be more evidence in the coming period that the "somewhat firmer conditions" were being maintained.

Mr. Bopp commented that events in recent weeks, although confirming economic strength now, had clouded the outlook for the longer run. On the one hand, continuing upward pressure on prices was testimony to the immediate strength of aggregate demand. On the other hand, the consumer, continuing to save at a high rate, had not been contributing to it. That was reflected in downward revisions in forecasts by the auto industry and a buildup in inventory, some of which might be involuntary.

In the Third District, Mr. Bopp said, developments mirrored the national picture of economic strength. The demand for labor continued strong. Residential, nonresidential, and public construction were all up in December. Steel production increased sharply in January, but part of the rise reflected stockpiling in anticipation of a strike. And some softening in final demand might be indicated by declines in auto registrations and checkbook spending.

Mr. Bopp concluded that the immediate economic picture in the nation and District was one of strong demand--probably too strong. At least during the first half of the year the problem would be one of inflationary pressures. Among his reasons for that expectation were the following: (1) Even if a tax surcharge was passed, the earliest date for it to become effective probably would be sometime in the second quarter. Its impact on actual spending would be still later. (2) Even if defense purchases rose as modestly as indicated in the President's Budget Message--which also seemed unlikely in view of the step-up in Vietnam and the Korean crisis--total Federal expenditures would increase by $10 billion from the fourth quarter of 1967 to the second quarter of 1968. (3) Consumer expenditures would rise substantially just because of projected increases in disposable income. Even modest declines in the rate of consumer saving would swell total expenditures significantly.

Compounding the near-term problems was the balance of payments, Mr. Bopp continued. Normally, during a period of economic overheating, a deterioration in the trade balance was useful because it dampened inflationary pressures. But futher deterioration in the U.S. trade balance, particularly if it was a result of rising domestic prices, could be highly destabilizing to expectations about the dollar. Hopefully, over the longer term the program to deal with the balance of payments would be successful; however, the help that could be expected from that program during the next several months was uncertain. To be sure, elimination of the gold cover against Federal Reserve notes could help immediately, but the near-term problems might still be substantial, depending upon expectations about the U.S. determination to solve the problem.

There were, thus, the here-and-now problems of the balance of payments and over-full total demand with increasing inflationary pressures, Mr. Bopp said. Monetary policy was not powerless to deal with those problems. But measures strong enough to do that would have other short-run repercussions as well as great long-run repercussions. And even if acceptance of the short-run consequences were desirable, he was still sufficiently uncertain about the economy later in the year, when much of the impact of present policy decisions would be felt, to be willing to run the risks. In addition, within the next month or so there should be sufficient clarification of the strength of the economy after mid-year to make possible a more realistic evaluation of the costs and benefits of the various policy alternatives.

On economic grounds, Mr. Bopp said, he would not recommend a major move to tightening. Nevertheless, he would still like to see money market conditions less easy than they had been. To the extent possible within the constraints of even keel, he would favor money market rates tending to the upper ends of the ranges and the bank credit proxy to the lower end of the range specified in the blue book.

Mr. Hickman remarked that the economy continued to expand rapidly from the strike-depressed levels of early fall. With the strike adjustments about over, the economy was now pretty much on its own. The basic question for the future was the ultimate strength of final demand. There was increasing evidence that the gain in GNP this quarter might not be quite as large as expected earlier, since consumer spending remained sluggish and inventory building was moderating. In fact, unless consumer psychology improved promptly, and the savings rate declined, the growth of GNP in the first quarter might not be much different from the fourth quarter of 1967.

A meeting of Fourth District business economists was held at the Cleveland Bank on January 19, Mr. Hickman noted. The dominant theme of the meeting was the high degree of uncertainty associated with key variables that would ultimately shape the contours of the economy in 1968. Those included such factors as the mix of fiscal and monetary policy, the stubbornly high savings rate, the uncertain trend of Federal spending for defense and other purposes, the upward movement of prices, and the interaction of those and other variables on spending and investing decisions.

Despite such uncertainties, Mr. Hickman continued, the group forecast, prepared in early January, remained highly optimistic for the near term. The median forecasts of the production index and gross national product were considerably higher than last fall, with a strong upward thrust in the first half and a more moderate advance in the second half. For 1968 as a whole, industrial production was expected to average 165, a 4-1/2 per cent increase over 1967; and GNP was expected to amount to $845 billion, a 7-1/2 per cent advance, with an undesirably large portion of the GNP increase accounted for by rising prices. The quarterly increments of GNP expected during the year were $19 billion, $16 billion, $10 billion, and $13 billion, for the respective quarters. Those estimates, incidentally, were not very different from those of the Council of Economic Advisers.

Turning to monetary policy, Mr. Hickman expressed the view that in the current environment there was little reason for the Committee to depart from the policy set forth in its last two directives. Indeed, in view of the Treasury's financing calendar the Committee would not want to change course in any event. Nevertheless, he was disturbed by the discrepancy between the intent and the event. Specifically, the high rates of growth in reserves, money, and bank credit now estimated for January exceeded what he had hoped, at the time of the previous meeting, would be achieved. Partly as a consequence, conditions in the money market had been easier than would be consistent with the policy the Committee had adopted in December and January. As a result, he was in a quandary as to what "even keel" meant today. If it meant a return to the growth rates of money and credit that actually obtained in November and December and that were estimated earlier for January, then he supported even keel. If it meant continuation of the excessive rates of growth in money and credit now estimated for January, then he felt the Committee should move to a more restrictive policy. He would accept Mr. Hayes' modification of the staff directive.

Mr. Sherrill remarked that he shared the sense of disappointment that monetary policy appeared to have eased in the recent period; indeed, he had the uncomfortable feeling that the easing may have been more than a matter of appearances. Since it had occurred, however, he would want to take full advantage of it in connection with the current Treasury financing. In his judgment, it would be a great mistake for the Committee to follow any policy course that would tend to hold down the volume of eligible issues exchanged in the prerefunding, since the Treasury might be faced with large financing needs later in the year.

Mr. Sherrill favored Mr. Hayes' proposal for the proviso clause of the directive, with the thought that the Manager might find it appropriate to implement the clause toward the end of the period before the next meeting. In his judgment the most effective course at this stage would be to concentrate on changes in the bank credit proxy, in an effort to keep its growth rate closer to the 7 per cent end of the projected range than to the 10 per cent end. He would use money market variables mainly as guides to the degree that bank credit growth could be moderated without disruptive effects. But such observations might be more appropriate at the next meeting, since there was likely to be very little time for implementing the proviso clause in the period before that meeting.

Evidently it was necessary that the recovery of housing continue in 1968 if the GNP projections for the year were to be realized, Mr. Sherrill said. To minimize the risk of disintermediation in the period ahead, he would not want the Treasury bill rate to go above 5-1/4 per cent. He would not be disturbed by a Federal funds rate as high as 5 per cent for a short time if that did not result in a bill rate above 5-1/4 per cent. As to the directive, the staff's draft of the first paragraph was acceptable. He favored Mr. Hayes' proposal for the second paragraph.

Mr. Brimmer said he disagreed with an inference he drew from Mr. Francis' remarks to the effect that the use of domestic economic policy was a feasible alternative to the new balance of payments program, in the sense that the degree of improvement sought through the program could be achieved by domestic policy alone. The question of how far domestic policy could be relied on for the purpose had been carefully considered within the Government, and it had been concluded that there was a clear need for other measures. One of the outstanding features of the recent WP-3 meeting was the recognition by the participants that the new program was required because the United States could not accept the degree of domestic deflation that would have been necessary, in the absence of the program, to achieve the balance of payments improvement sought.

Mr. Francis remarked that he had not meant to imply that the balance of payments program was useless. His point was that he did not think it would be as effective as was hoped.

Mr. Brimmer then noted that as a member of the President's task force concerned with encouraging travel of foreigners to the United States, he regretted having to report that he was pessimistic about the prospects for significant help to the payments balance in that area. It seemed clear that the tax measures the President had recently recommended in connection with foreign travel by Americans were needed.

Turning to the directive, Mr. Brimmer said that of Mr. Hayes' two suggestions for the second paragraph he preferred the later one. Specifically, he favored achieving somewhat firmer money market conditions than had prevailed since the Committee last met. He did not agree with the implications of the staff's draft that the average conditions prevailing since the preceding meeting were as firm as the Committee had intended; and he gathered that Mr. Hayes shared that view, since the latter's second proposal called for maintaining firm, rather than recently prevailing, conditions. He could accept Mr. Hayes' second version if it meant that the Manager should get an effort under way to achieve some further firming, if feasible, after the Treasury financing was completed.

Mr. Hayes remarked that the objective of his second version was to call for firm conditions in any event, but to move toward a little greater firmness if the financing permitted and if bank credit growth was as rapid as projected.

Mr. Brimmer said he would favor having the Desk take every opportunity available to attain greater firmness than existed today. It had been his impression in the recent period that the Desk had perhaps not taken advantage of all the opportunities to maintain as firm conditions as were intended.

Mr. Hayes said he was not convinced that the Desk had permitted conditions to become less firm than intended. As Mr. Brill had pointed out, the Committee could not expect every variable to come out at the level it desired; if money market conditions were not to be too tight in some respects they might often have to be easier than desired in other respects. On the whole, he thought the Desk had performed fairly well under difficult circumstances. Nevertheless, he agreed with the general view today that policy should be as firm as was consistent with the Treasury financing.

Mr. Maisel said he preferred Mr. Hayes' later version of the second paragraph of the directive, except that he would include the same two-way proviso clause that was contained in the previous directive, as originally suggested today by Mr. Brimmer.

Mr. Maisel was disturbed by the discussion thus far, in that it seemed to revolve around the type of directive language and the type of policy decision that he thought the Committee should attempt to avoid if possible. Specifically, he was disturbed by the use of the word "firm" and by the avoidance of a specification of policy objectives in terms of monetary flows. The problem with "firm" was that it was a relative term; as had been brought out, it had to be interpreted in terms of relations to market expectations. Even if the Committee agreed on an interpretation, the question remained of what would happen as a result of reacting or not reacting in terms of monetary flows.

Mr. Maisel thought that, while the Committee should not be swayed by the simple concept of money supply, it should recognize the value of the debate over the theory. The Committee should make up its mind as to where it hoped to go over a considerable period in advance and should not shift frequently unless economic conditions, not market expectations, appeared to be changing. He was glad that Mr. Francis agreed with that concept, but he (Mr. Maisel) would want to work further on specifics. He thought that the Committee should set goals in terms of expansion of total reserves or of bank credit and shift those goals only for sound reasons.

In the current situation, Mr. Maisel continued, the Committee should aim at a non-inflationary normal expansion of bank credit. On the basis of the data presented in the chart show today, he would define that as an expansion in total reserves at an annual rate of about 6 per cent, with total deposits expanding at a rate in the vicinity of 8 per cent. He would set such a goal for this and the next quarter and would revise it only if there were a very drastic change in the economic outlook.

Mr. Maisel found a target specified in terms of deposit growth more persuasive than one drawn up in the far looser terms of either further unspecified firming or tightening, or higher interest rates. If the Committee tightened or firmed, what was it tightening against? And for what purpose? He assumed it was not interested in raising interest rates _per se_. Rates remained near record levels. They reflected the result of both the demand and supply of funds. That was why he would reject interest rates as a goal. At the same time, since a non-inflationary policy was desirable, he would not be concerned about the level of interest rates which might at this time be brought about by an increase in market demand.

On the other hand, Mr. Maisel continued, if the Committee tightened against a lack of demand for funds, it could find that it was decreasing the level of reserves and credit rapidly. Some might feel that a proper objective should be to reduce all credit flows as much as possible without raising rates faster than a certain number of basis points per month. If the purpose of firming was to have flows of credit fall and rates rise, he would think the amount desired should be specified or at least indicated. It was far easier to analyze the implications of growth in total deposits at an annual rate of 6, 8, or 10 per cent than it was to debate what "firmness" meant--as had been seen today.

Mr. Maisel went on to say that to use the term "firm" and to include a one-way proviso clause in the directive would seem to indicate that the Committee was not concerned with the possible limits of the downward push of monetary policy on the economy; that it simply wanted to hold credit down as much as possible. He thought that, before the Committee adopted Mr. Hayes' proposed proviso, it should ask what it meant and where it was expected to lead. He was not clear as to what Mr. Hayes' proviso would allow in terms of minimum credit flows.

Mr. Maisel remarked that the CEA forecast--while outlining an economy that was too high for the current period--did not picture an unduly exuberant economy for the following three quarters. At the same time the Board's staff estimated that that type of demand was consistent with the type of monetary flows he had chosen as a proper goal. What were the implications of choosing the amount of credit created as the Committee's goal? If the economy expanded more rapidly than projected, or if there was no tax surcharge, then maintaining the expansion of credit within those limits would help to restrain any inflationary pressures. On the other hand, if demand failed to appear, those credit flows would mean that lower interest rates would result and monetary policy would be tending to increase demand.

Mr. Maisel said he had been concerned that the Committee was getting faster flows through the middle of January than he thought had been agreed upon, and he would have allowed greater tightness in that period. However, he accepted the Manager's statement that conditions were once more on track. Since the beginning of November, which included a full quarter, he thought the Committee's policy had been close to correct. Total reserves had expanded at an annual rate between 6 and 7 per cent. Member bank deposits and the money supply broadly defined had gone up a good deal less than that. He would like to see those types of flows continued at the levels projected by the staff. While the staff believed such flows were consistent with the current policy directive, they could not be certain. That was why he would like to see a two-way proviso clause, calling for action to halt major changes in flows in either direction.

Mr. Hayes referred to Mr. Maisel's comment about the avoidance of specification of objectives in terms of monetary flows, and observed that he (Mr. Hayes) had expressed a view on that subject in his earlier remarks. The Committee, he noted, was setting policy today for only the next four weeks. As he had indicated, it seemed to him that an annual rate of growth for the bank credit proxy in February of 7 to 10 per cent was on the high side; he would prefer a rate in the neighborhood of 6 per cent. He did not think a two-way proviso clause was needed because the risk of inadequate credit growth was minimal in the relatively short period to which the directive would apply. He preferred the type of proviso clause he had suggested because it involved a firmer posture than Mr. Brimmer's proposed clause; that is, it would be implemented if bank credit growth was at the rate projected, whereas Mr. Brimmer's clause would not be implemented unless growth was significantly in excess of that rate.

Mr. Daane said that to him events in the recent period had once again reflected the truism that developments in financial markets were often beyond the practical control of the Committee. It was unfortunate if those developments had misled the market or the public in general regarding the posture of monetary policy, but he did not believe they could be attributed to the Desk's operations. As he had mentioned earlier, he felt that the Committee could not expect the Manager to make all of the financial variables conform to its desires.

Having said that, Mr. Daane continued, he would add that he agreed with the intent of the directive proposals offered by Messrs. Robertson, Brimmer, and Hayes--namely, to attain a sense of firmness, insofar as that was feasible within the limitations set by even keel considerations. Of the various proposals, he favored Mr. Hayes' second formulation.

In a concluding comment, Mr. Daane referred to Mr. Francis' remarks about the importance of continuing to press ahead toward activation of the Special Drawing Rights mechanism. He could report that the work of the Executive Board of the IMF on the preparation of the necessary amendment to the IMF Articles of Agreement was proceeding on schedule. The schedule called for completion of that work by March 31, 1968, at which point the process of ratification by member countries could begin. The Deputies of the Group of Ten had met in Paris on that day after the recent WP-3 meeting to consider some of the key issues. In short, the work was going forward.

Mr. Mitchell said he would favor a revision of the opening sentence of the first paragraph of the staff's draft directive, both to clarify the statement regarding recent economic activity and to indicate that the Committee's policy decision today was based on projections. Specifically, he suggested replacing that sentence with language reading as follows:

> The information reviewed at this meeting indicates that the recent expansion in over-all economic activity has been characterized by substantial inventory accumulation and some sluggishness in final demand. Nonetheless, the prospects are for an acceleration in final demand emanating from rapidly rising disposable income. Both

> industrial and consumer prices are rising at a substantial rate, and prospects are for persisting inflationary pressures in the period ahead.

Mr. Hayes asked whether the staff would consider Mr. Mitchell's proposed language consistent with the analysis in their chart presentation this morning. He was not sure that it was.

Mr. Brill said he had some question about the use of the word "recent" in the first sentence. It might have been appropriate to include language along the lines Mr. Mitchell suggested in the directive issued on January 9, when it would have been clear that the time period referred to was late 1967. At present, however, "recent" presumably would be taken to include January 1968 and the appropriateness of the statement to developments in that month was more doubtful. The business statistics thus far available for January were highly incomplete but some fragments suggested that visible signs of strength were reemerging. If, for example, the indications of the weekly figures on retail sales were borne out by the monthly report, consumer spending would be found to have risen substantially. The problem he saw with Mr. Mitchell's proposed language might be met by broadening the time reference to "recent months."

Mr. Mitchell said that that amendment to his proposal was agreeable to him. He went on to note that he had been pleased to hear the comments of some of the preceding speakers about the desirability of placing greater emphasis on the monetary aggregates as targets for policy. Such statements reminded him--and no doubt Messrs. Ellis and Swan also--of the proposals for revising the format of the directive they had made in response to a Committee request in the spring of 1964. Those who favored greater reliance on aggregative targets did not necessarily agree on the particular aggregate that was best for the purpose; he had his own preferences, and Messrs. Maisel and Francis had theirs. Such differences of view were one reason the Committee might find it difficult to avoid the problem of over-determination in setting its objectives.

Mr. Mitchell remarked that the staff's development of the blue book in its present form in the autumn of 1965 represented a great step forward, and further progress had been made since. It would be most helpful to the Committee now if the staff would attempt to come to grips with the problem of developing more specific instructions to the Manager. A case in point was the present proposal to call for "firm" money market conditions without indicating how the term was to be interpreted. As a general rule, he would not favor use of that term without definition. However, he was willing to have such an instruction in today's directive because he thought the Manager understood the Committee's intent; in other words, he would accept Mr. Hayes' later proposal for the second paragraph. He would assume that as a consequence of the proviso clause in

Mr. Hayes' proposed paragraph the statistics would begin to reflect some tightening after the Treasury financing was completed; and in that connection he thought the refunding and prerefunding were more important from the Committee's standpoint than the subsequent cash financing. He saw no need for a two-way proviso to guard against a decline in bank credit. He did not expect such a decline, but if it occurred the Committee could hold an interim meeting to reconsider its policy.

Mr. Maisel remarked that his main objection to the one-way proviso was that it was not clear where it would lead. Fundamentally, he thought the Committee should express its policy decisions in terms comparable with desired aggregate growth rates for a longer period than four weeks.

Mr. Mitchell said he found a one-way proviso acceptable for today's directive. He assumed that any action the Manager took to implement it would be moderate in nature and consistent with the Committee's discussion.

Chairman Martin noted that none of the speakers thus far in the go-around had expressed a preference for Mr. Robertson's proposal for the second paragraph of the directive. He asked whether the members saw some specific problems with that proposal.

Mr. Hayes said he objected to the final clause of Mr. Robertson's suggested language because it called for holding the degree of firmness maintained during the Treasury financing after the financing was completed. He would prefer to leave a little leeway for the Manager to modify operations at any time in the coming period, if that appeared called for by the rate of bank credit growth and was feasible in light of the financing.

Mr. Daane remarked that while he was sympathetic with the spirit of Mr. Robertson's proposal he thought the same general purpose would be served more satisfactorily by Mr. Hayes' suggested language.

Mr. Sherrill said his objection to Mr. Robertson's proposal was that, since the price of the recent easing had already been paid, he thought full advantage should be taken of it in connection with the Treasury financing.

The go-around then resumed with remarks by Mr. Wayne, who reported that the pace of business advance in the Fifth District appeared to have slowed somewhat in recent weeks. The slackening, however, might be of no more than normal seasonal proportions. The seasonal decline in business loans at the District's larger banks had been considerably less than at large banks in the nation as a whole.

Mr. Wayne then observed that the opening sentence of the blue book deserved emphasis. That sentence read: "Key monetary variables have behaved in disparate ways since the last meeting of the Committee--some in line with expectations, some at the outer edge of expectations, and some unexpectedly." That was a sobering statement but it did define the circumstances under which the Committee frequently had to function.

As for the national economy, Mr. Wayne found himself in general agreement with Mr. Hayes' remarks today. Over all, he saw little reason to modify the green book's projections of GNP growth. To him, that fact implied a rather clear need for additional restraint, although he remained convinced at this stage that no credit policy action could serve as an adequate substitute for the fiscal restraint that was so obviously required. Nonetheless, in view of the will-of-the-wisp chances of the proposed surcharge, he did not see how the Committee could refrain from taking whatever action it could to hold growth in aggregate demand to sustainable levels.

For his part, Mr. Wayne said, he would not interpret a move to offset the recent easing in credit markets--whether apparent or real--as inconsistent with even keel considerations, and he would favor such a move. As he analyzed the latest data, that would imply free reserve averages in the lower range of the weekly figures for January, or perhaps even occasionally lower, with the Federal funds rate occasionally reaching 5 per cent. As to the directive, he favored the revised second paragraph proposed by Mr. Hayes. The amendments to the opening lines of the first paragraph proposed by Mr. Mitchell were also acceptable to him.

The meeting then recessed for lunch and reconvened at 1:45 p.m. with the same attendance as at the morning session.

Mr. Clay commented that Treasury financing activities would be a limiting factor on open market operations for the period immediately ahead. Looking at public policy requirements more broadly, it was apparent that price inflation continued to be a major problem for this country in terms of both its domestic and its international situations. Moreover, it was difficult to find much if any encouraging evidence pointing toward a resolution of the price inflation problem.

Mr. Clay observed that the expansion in final demand for goods and services had been somewhat less than anticipated, as the savings rate had been very high, but the demands on the economy continued to grow. Even with the present rate of economic activity, unemployment generally was relatively low, qualified manpower was extremely scarce, and wages and prices were advancing at a disturbing pace. Moreover, recent military developments put one on notice that Federal Government outlays might expand substantially beyond the levels presently projected.

Mr. Clay thought the Committee was highly conscious of the limitations of monetary policy and the need for appropriate action in other areas, notably on the fiscal front, and appropriately so. It also needed to be on guard against relaxing restraint on the monetary front. During periods of successive Treasury financing activities, with closely spaced periods of "even keel" monetary policy, there was a risk of more bank credit expansion than the general state of the economy warranted. Limiting bank credit expansion presumably involved some trade-off in the level of interest rates, but that needed to be done so far as Treasury financing permitted.

The draft policy directive, with Mr. Hayes' later proposal for the second paragraph, appeared to Mr. Clay to be in line with the even keel approach to monetary policy that the Treasury financing called for. It was to be hoped that bank credit expansion would be smaller than indicated by staff projections.

Mr. Scanlon said that in the interest of time he would summarize the remarks he had prepared on business developments in the Seventh District, and submit the full text for the record. He then summarized the following remarks:

> A number of cross currents are evident in business prospects in the Seventh District, but the evidence, on balance, still indicates sufficient pressure on resources to maintain an excessive degree of inflation.
>
> Concern over continuation of the uptrend in residential construction has been relieved by evidence of relatively favorable inflows of funds to financial intermediaries. Inflows of savings to S&Ls were much better in December and January than had been expected and some firms found that funds accumulated to meet threatened outflows have not been needed for that purpose. Construction contracts for new housing were

very high again in December. For the fourth quarter, contracts in this region were 7 per cent above the same period of 1965, although contracts for the U.S. were up only slightly. Total construction contracts for the region were up 9 per cent from the fourth quarter of 1965, compared with a gain of 13 per cent for the U.S.

Production of steel in the District is close to capacity. Estimates from the industry suggest about 7 million tons of steel will be added to inventory by August 1, with most of this liquidated in the remainder of the year. Imports are expected to rise to about 14 million tons, up from 11 million last year. The steel industry will continue to press hard for additional protection, and it is to be expected that other industries will join the parade unless domestic inflation is quickly curbed.

There are a number of less bullish indicators. There appears to be some easing of demand for consumer durables, possibly reflecting temporary impact of recent developments in the Far East. Recent sales trends for autos have been disappointing to both manufacturers and dealers. Despite very mild weather, in contrast to last year's storms, auto deliveries have not exceeded last year's levels. Auto production had been projected at more than 2.5 million units in the first quarter, near the record high in the same period three years ago. But even if sales of domestic cars were at the relatively strong 1.9 million units, inventories would rise to about 1.8 million (a new high) by April 1. Output of new cars in the current quarter therefore probably will be at least 200,000 less than the 2.5 million indicated earlier.

Recent orders for farm and construction machinery and trucks indicate little rise in physical production of these goods in 1968.

Insured unemployment is above the low level of a year ago in all District states, with most of the layoffs reflecting reduced labor requirements in capital goods industries. Nevertheless, more than half of the major labor markets in the area are classified as having "low unemployment," compared to one-third for the nation.

With respect to banking Midwest bankers expect the demand for agricultural loans to strengthen further. Difficulties in harvesting and marketing the very large 1967 corn crop continue to boost credit demands.

> The volume of new farm mortgage loans is continuing to decline as the insurance companies shift funds to more profitable loans on urban properties and the Federal Land Banks restrict their lending. Usury laws have played an important role in reducing the availability of funds for farm mortgages in some States, especially funds from insurance companies.

Mr. Scanlon went on to say that the banking situation, in general, appeared little changed from a month ago, with the basic trends still clouded by what appeared to be seasonal forces. While business loans still had not grown in line with earlier expectations, they could hardly be considered weak. Some banks continued to foresee strong demands ahead and reported an active demand for new commitments.

Seventh District major banks had continued to maintain quite comfortable positions, Mr. Scanlon observed. They had not been aggressive on CD's, but total CD outstandings had risen over the past month even in the face of heavy maturities. Their holdings of Governments and municipals had increased also. On the whole, they appeared to be in a very strong position to accommodate any increase in loan demand, perhaps to a greater extent than the Committee would like to see.

In the policy area, Mr. Scanlon said, as the blue book indicated the atmosphere in some of the financial markets had become more relaxed than had been anticipated. That had occurred in a period when the Committee had desired, as a minimum, to retain the firmer conditions that had developed following the discount rate increase. Data tabulated in the blue book showed that growth rates in many of the monetary aggregates in January were similar to those of last year when policy was intentionally expansive.

Mr. Scanlon believed that, through no fault of the Manager, developments did not quite accord with the Committee's desires; the tautness the Committee had sought to maintain at its last meeting had not been retained--at least in the eyes of many people in the financial community. He made that statement despite the fact that he had participated in the morning conference call during the period since the previous meeting and had expressed concurrence in open market operations from day to day. The outcome was a consequence of the manner in which the Committee had formulated its instructions to the Manager--in the framework of the Federal funds rate, free reserves, and member bank borrowings, rather than in terms of achieving some approximate change in total reserves or some other aggregate financial series provided that money market conditions did not fluctuate outside a specified range. While he had become increasingly skeptical of the viability of the Committee's directive in its present form, he recognized that today was not the time to make a major change in the form of directive even if the Committee were so inclined.

The problem he saw with the staff's draft directive today, Mr. Scanlon said, was similar to that noted by others. Although it was acknowledged that some markets had become more relaxed than was anticipated, and although evidence had been presented of very rapid growth since the previous meeting in most financial series, the draft called for maintaining recently prevailing money market conditions; and furthermore, it included a proviso clause that would not become operative unless bank credit appeared to be expanding significantly more than currently expected. A growth rate in the range projected--7 to 10 per cent--was higher than he thought desirable.

Mr. Scanlon said he was not as disturbed by the wording of Mr. Robertson's suggested second paragraph as some other members were. On balance, however, he favored the second paragraph proposed by Mr. Hayes.

Mr. Galusha reported that the Ninth District economic outlook was what it had been--in a word, bullish. The Minneapolis Reserve Bank's most recent survey of District manufacturers, conducted at year end, showed that they were decidedly optimistic about the future; most were expecting their sales to increase substantially, at least through the third quarter of 1968, and quite a few reported wanting more inventories--although whether of just steel he did not know. Rather surprisingly, though, some

District manufacturers--more than in the previous survey--reported having enough plant and equipment.

Whatever the future might bring, Mr. Galusha continued, District farmer and ranchers were hurting still. For the nation, cash farm receipts were about 2 per cent lower in the fourth quarter of 1967 than in the fourth quarter of 1966. For the District, cash receipts were 6 per cent lower; the widely noted increases in prices of fruits, vegetables, and cotton did not help District farmers and ranchers.

Mr. Galusha said he took it that this was a time for looking ahead, not just to the next meeting of the Committee but to the end of the year. There was no need for him to go into the details of his Bank's forecast, however, since it was very much like that provided this morning by Mr. Brill and his colleagues in the chart show--a presentation, incidentally, that he had considered outstanding.

He realized, Mr. Galusha continued, that for the purposes of the chart show the staff had had to base their analysis on the revealed Administration numbers, notwithstanding their private fears. Not having that stricture on his contribution today, he would like to state categorically he did not believe the 1969 budget total was a credible basis for estimating Federal purchases for 1968. There were at least three reasons for believing they would be increased:

(1) Military and aid obligations in Southeast Asia and elsewhere. The U.S. obviously was faced with a requirement to build inventories of military and human resources to cope with probing efforts like the Pueblo incident.

(2) Civil disorder and its attendant problems. There was absolutely no reason to believe that minority groups and urban activists were going to accept the shift downward in national priorities accorded them by Congress. That statement did not go to the merits of their case, but only to a simple reaction to the obvious.

(3) Much had been made of the budget total and its apparent compliance with Congressman Mills' imperative except for the military, Government pay, and social security components. Obscured had been the reshuffling of programs within the budget--designed, he feared, to shift the burden of restoration of the cutbacks to Congress.

And, Mr. Galusha observed, he was no more sanguine about a tax increase this spring than he was last October.

Looking ahead, then, Mr. Galusha continued, economic conditions dictating increased monetary restraint seemed more likely than conditions dictating increased monetary ease. That made him wonder whether the Board ought not seize the present opportunity--if opportunity it was--to increase the interest rate ceiling on large-denomination CD's. Some had argued that, in some circumstances anyway, it did no good to increase rate ceilings. Market expectations were altered by the increase, so in the end there was no widening of the spread between ceiling and market rates. Perhaps that was right, although he had his doubts. The point, though, was that there was not likely to be a better time than the present to increase the large-denomination CD rate ceiling. With market expectations what they were, now would seem to be a good time for increasing the ceiling.

Perhaps, Mr. Galusha said, it would be too risky to increase that rate ceiling while the Treasury was in the market. But should the end of February find money markets as they were presently, then the Board might well seize the opportunity to increase the large-denomination CD ceiling. Before too many months had passed, the Committee might find itself wanting to increase market rates to levels where, with the present ceiling, banks would again be too sorely pressed.

Mr. Galusha granted that by increasing the large-denomination CD rate ceiling now, or soon, the Board might make banks more willing to lend. The fear of a "crunch" would be decreased somewhat; but in the current market, demand factors seemed to be more important than supply. The suspected surge in loan demand was still ahead, and both the blue book and the Minneapolis Reserve Bank's own survey indicated that banks were profit-oriented when confronted with the current relationships between money market conditions and loan demand. They were not about to add expensive CD's for the sake of the footings. And what the System would be "buying" by increasing the large-denomination CD rate ceiling was the ability to increase monetary restraint later on, without severely disrupting financial markets. While this was, strictly speaking, a matter for the Board's determination, he was sure the Board would grant that the level of ceiling rates bore very importantly on Committee decisions.

In conclusion, Mr. Galusha noted that the Manager had asked for expressions of view regarding the appropriateness of the expected rate of bank credit growth. He would much prefer, if possible, to have a growth rate at the lower end of the 7 to 10 per cent range projected.

Mr. Swan said he would limit his comments on recent economic developments in the Twelfth District to the observation that in December the unemployment rate had not decreased in the District, as it had in the country as a whole. Total employment had remained virtually unchanged and the unemployment rate had edged up from 4.6 to 4.7 per cent. January employment data were not yet available for the District.

As to policy, Mr. Swan shared the feeling of those who thought that a move toward somewhat less ease would be appropriate at this point were it not for the Treasury financing operations ahead. He also shared the view that it would be desirable to do what could be done in that direction within the constraint of the Treasury financing. He would subscribe to the change Mr. Mitchell had suggested in the opening sentence of the first paragraph of the directive. In the second paragraph he would prefer not to call for maintaining "firm" conditions, as in Mr. Hayes' later proposal, without any specific reference points. The problems with the word "firm" were evident from the discussion this morning as to whether firm conditions had been maintained recently. He would prefer the second paragraph Mr. Hayes had originally proposed, although that language might be strengthened by calling for operations with a view to maintaining "at least the same" conditions in the money market as had prevailed on average since the preceding meeting.

With respect to the proviso clause, Mr. Swan said he shared the concerns that had been expressed with respect to future movements of the credit proxy, both in the four weeks ahead and over the longer run. He would accept Mr. Hayes' proposed proviso clause on the understanding that an effort would be made to moderate growth only to a rate approaching the lower end of the 7 - 10 per cent range projected or perhaps, as Mr. Hayes had suggested, to a 6 per cent rate. He would prefer to introduce the proviso clause with the word "and" rather than "but."

Mr. Coldwell commented that economic conditions in the Eleventh District were generally good. Defense industry activity was pushing up production and employment. Petroleum output was rising with heating oil demand. Agriculture was in a slack season, but the heavy quantity of moisture prevailing in the whole area was laying an important moisture base for spring crops. Construction contract awards were strong, and there was a shortage of good residential units for sale in large cities. Employment, led by manufacturing, was up more than seasonally and the level of unemployment was low. Evidences of weakness in the District economy were confined largely to the consequences of the copper strike and to sluggish retail sales.

As to financial conditions, Mr. Coldwell said bankers reported that they had funds available for lending. Loan demand was steady to weak, although there had been some evidence of expansion in business loans. Growth in bank CD's had been sharp, but now banks were less interested in attracting CD money because of the availability of funds for lending, and they were buying a smaller volume of Federal funds than before.

With respect to the national economy, Mr. Coldwell continued, one of the questions he had with regard to the staff's GNP projections was the assumption that consumer spending would rise in pace with the expected increase in disposable income. It seemed to him that consumers were beset by uncertainties, and that they might ride out the first quarter while awaiting further information on the trend of hostilities in the Far East, the likelihood of a tax increase, and the financial situation at home and abroad.

As to policy, Mr. Coldwell was concerned about the recent rates of bank credit and money supply expansion. He would prefer a slower pace of growth, perhaps in the range of 4 to 5 per cent, at annual rates. He hoped it would be possible to avoid giving the market the impression of easing, whether that impression was accurate or not, because of the importance of expectations.

Mr. Coldwell suggested that the last sentence of the first paragraph of the directive be revised to indicate that it was the Committee's policy to foster financial conditions conducive to slowing the growth of bank credit and money supply. For the second paragraph he favored Mr. Hayes' later version, except that he would revise the proviso clause to read "and operations shall be modified toward greater restraint, to the extent permitted by Treasury financing, if bank credit appears to be expanding as rapidly as the minimum rate currently projected."

Mr. Ellis said he would characterize New England's economy as involving "high level activity with mixed trends." Through the last six months of 1967 the regional economy advanced but at an irregular pace. Gains were registered in employment, hours worked, and personal incomes. But manufacturing employment had remained virtually stable as several large nondurable goods industries, textile and shoes especially, had taken up some slack provided by primary metals (copper), non-electrical machinery, transportation equipment, and instruments.

In the absence of expansion in those durable goods industries, it was surprising to Mr. Ellis to observe substantial growth rates in their financial counterparts. For example, business loans at District weekly reporting banks showed an 11 per cent year-to-year growth, compared with about 6.5 per cent recorded for the nation on the same basis. Their demand deposits were up 11.4 per cent and time deposits were up 27.5 per cent over the same period.

Mr. Ellis reported that the net drain from Boston mutual savings banks in January was substantially less than in prior years. That was partly traceable to a shift to daily from quarterly interest payments. Outside of Boston, savings banks experienced a net deposit gain, continuing the fourth-quarter experience. In the city the conventional residential mortgage rate (with 30 per cent downpayment) edged up to 6-3/4 per cent, but it held to 6-1/2 per cent elsewhere. Reports from the region's life insurance companies showed no renewal of policy lending and a December level of new mortgage commitments on a par with the record November experience.

Mr. Ellis then said that he would like to encourage Mr. Maisel in his effort to add understanding to the Committee's procedures in formulating policy. Mr. Maisel's remarks raised three questions, having to do with the length of the time period for which policy was formulated; the subject of specification--that is, the variables in terms of which policy goals were formulated in the directive; and the subject of quantification--that is, whether the goals were stated in numerical or other terms. He (Mr. Ellis) would comment on each of those questions in turn, although he approached the subject with some reluctance because the 1964 efforts in this area by Messrs. Mitchell, Swan, and himself had brought only limited results.

As to the time period for policy formulation, Mr. Ellis continued, Mr. Maisel had suggested that it should be longer than the three- or four- week intervals between meetings. The Committee had traditionally taken the view that it should establish policy at a meeting only for the period until its next meeting. But the individual members did have views on the longer-run outlook; otherwise they would have no basis for their judgments on policy. The green book format introduced a little over a year ago--with the opening section focused on the outlook and with GNP projections provided for a quarter or two ahead--was helpful to the Committee in that connection, as were chart shows such as that presented today. Today's presentation was a good effort, but he would urge the staff to do better still and accept responsibility for the projections. The staff had presented the Council of Economic Advisers' projections this morning while saying, in effect, that it did not accept the Council's assumptions on prices. The staff would do the Committee a service if it not only identified the areas in which it disagreed with the Council but also presented alternative projections based on the assumptions it considered appropriate. With the unrealistic assumptions in the model presented today, the chart show might be described as a "fantasy in technicolor." In that connection he might note that in the Congressional hearings on the Council's Report Chairman Ackley had said, in effect, that without both a tax increase and responsible wage and price policies, the annual rate of advance of the GNP deflator could accelerate to 4 per cent. He (Mr. Ellis) thought such acceleration was the more reasonable expectation.

Mr. Ellis remarked that the chart show did have implications that were important for longer-range, as well as for short-range, policy formulation. With respect to the longer run, the consumer--with rebuilt liquidity and with an already high saving rate--was expected to receive substantial increments to income. Thus, consumer expenditures should be expected to swell. The Administration had proposed a tax increase which, even if fully and promptly enacted, would reduce the prospective deficit only to $8 billion on the new basis. If it were not for the threat of a $20 billion deficit, attention would be riveted on measures to eliminate the $8 billion deficit--which was itself a violation of economic prudence in the present full employment, cost-price inflationary crisis. And, as had already been noted this morning, a weakening trade balance as a result of domestic price increases threatened to cancel out the desired effects of the controls on foreign investment and lending under the new balance of payments program.

The short-range policy considerations were related to the problems of specification and quantification, Mr. Ellis said. As to the former, the Committee had not been able to reach agreement in 1964, when he and Messrs. Mitchell and Swan had made proposals for a new directive format, because of differences of views on the nature of the linkages between developments in the monetary and real sectors of the economy and between System actions and monetary developments. A substantial research program had been launched to help narrow those differences. He would like to think that some progress had been made and that more would be made. But the experience in the period since the previous meeting was that, although the Manager had held roughly on course with respect to the Federal funds rate, free reserves, and member bank borrowings, the outcome for the aggregates for which the Committee had hoped had not materialized. The Committee certainly could not blame the Manager for that; rather, it should blame its own failure to specify its goals properly. The same problem faced the Committee today. Mr. Hayes' proposal for the second paragraph said that "operations should be modified . . . if bank credit appears to be expanding as rapidly as is currently projected," but it did not say _how_ operations should be modified in that event. Presumably, the intention was to imply "toward greater restraint." If that was what the Committee intended, he saw no reason for not saying so in the directive, as Mr. Coldwell had suggested.

With respect to quantification, Mr. Ellis continued, the fact that the Committee was concerned with the risk of over-determination resulted in the use of ranges in the projections that were broad enough to satisfy all. Moreover, the staffs of the Board and the New York Bank currently had differing projections, and Mr. Hayes' proposed proviso clause in itself did not make clear which was intended. He saw no purpose in making the reader look elsewhere for an explanation of the directive's meaning. If the Committee wanted a clear directive, it should incorporate in it the relevant projection in numerical terms. He agreed that the staff had made great progress in developing the present blue book, but he did not agree that cross-references to the blue book should be required.

Mr. Ellis recalled that Mr. Holmes had asked whether the projected 7 - 10 per cent growth rate in bank credit in February seemed about right or appeared excessive. He wanted to be recorded as believing that the 9 per cent annual rate of growth experienced in January, and the 7 - 10 per cent rate projected for February, were higher than desirable in an economy that was characterized as inflationary. He thought a 5 - 6 per cent growth rate would be more in accordance with the economy's needs under present circumstances.

In conclusion, Mr. Ellis urged the Committee to adopt Mr. Hayes' later proposal for the second paragraph, with the amendments suggested by Mr. Coldwell. He would like to see the Committee make the kinds of changes in its directive that he had discussed under the headings of specification and quantification, but he realized that that was not part of present practice.

Mr. Mitchell commented that while he agreed with Mr. Ellis' general observations he thought that some of the latter's specific comments were not quite fair. Everyone present today knew that the projections referred to in Mr. Hayes' suggested proviso clause were those contained in the blue book. They also knew what type of action was to be taken in implementing the proviso clause without having it spelled out in the manner Mr. Coldwell had suggested; and they knew what the limits on such action were in the short run, as precisely as that could be known under the circumstances. Accordingly, what Mr. Ellis was really urging was that such information should be transmitted to the public by means of the Committee's formal directive. He (Mr. Mitchell) did not know what view the staff would take of that proposal but he doubted that, if he were a member of the staff, he would be sufficiently confident of the projections to want them incorporated in the directive in numerical form. Assuming the Committee itself was clear on the intended interpretation, it might be preferable not to make the directive unduly specific.

Mr. Daane remarked that the Committee should not lose sight of the fact that the Manager attended its meetings and that the Committee members spoke in terms as specific as they chose in the course of the discussion. Like Mr. Mitchell, he thought the directive might best be written in more general terms, as long as the Committee was agreed on how it should be implemented. However, he would have no objection to Mr. Coldwell's suggestion that the phrase "toward greater restraint" be added after the words "operations shall be modified."

Mr. Wayne said he had vigorously opposed quantification in the directive in the past and he still opposed it. If the Committee adopted the procedure Mr. Ellis had suggested it would be incorporating in its formal directive a precise statement of goals that it could not possibly hope to achieve on a regular basis, and it would be exposing itself unnecessarily to hostile critics. In his judgment the work of Messrs. Ellis, Mitchell, and Swan a few years ago had been quite helpful in stimulating improvement in the Committee's procedures, and real progress had been made. For example, in its present format the blue book greatly facilitated communication regarding targets among the members of the Committee and between the Committee and the Manager. But even now the Committee was struggling with the problems posed by the fact that it made its directives public 90 days after adoption, even though they were written in terms that some considered vague. Such problems would be dwarfed by those that would arise if the directives released were written in highly specific terms.

Mr. Maisel said that while he would have no objection to adding the phrase "toward greater restraint" to the proviso clause, as Mr. Coldwell had suggested, he thought it was reasonable to omit from the directive itself specific statements of the expectations for bank credit growth such as were contained in the blue book. As he saw the matter, however, there were two problems. First, the value of the projections contained in the blue book was limited by the fact that they applied to the relatively short period of about a month, and no information was given regarding the longer-run trends for a quarter or two with which the movements expected in the short run were likely to be consistent. That problem was magnified by the fact that the short-run fluctuations often were dominated by Treasury financings. Secondly, when the Committee told the Manager to maintain "firm" conditions it was issuing an instruction which he would consider insufficiently clear.

Mr. Mitchell agreed that an instruction to maintain firm conditions, taken by itself, was less clear than would be desirable. However, it was difficult to find a better way to describe the Committee's intentions for the coming period. As he had indicated, he was willing to go along with such an instruction today on the assumption that the Manager understood the Committee's intent.

Mr. Robertson then observed that his contribution to the go-around today would be quite brief. He shared the view that money market conditions should be as firm as they could be in light of the Treasury financing.

Chairman Martin expressed the view that today's meeting had been an unusually good one. He thought the Committee should plan on periodically holding meetings in which a chart presentation by the staff was followed by discussion continuing into the afternoon if necessary.

The Chairman agreed that the Committee had made progress in connection with its directive and its technical procedures in general. In his opinion the work that Messrs. Ellis, Mitchell, and

Mr. Swan had done a few years ago had been invaluable. However, he personally thought that the present directive format could be improved upon and that the Committee should continue to work on it. At the same time, he would not advocate having the members plan on completely re-writing the staff's draft directive in the course of each meeting; the group was simply too large to perform effectively as a drafting body. As he had said in the past, words meant different things to different people. From time to time he had found statements in the staff's drafts that he might have put in a slightly different way but had nevertheless concluded that the staff's phrasing was acceptable.

It was a fundamental fact, Chairman Martin continued, that the Committee often had to deal with problems that arose from errors of the past. That had been evident, for example, in the period following the Treasury-Federal Reserve accord, when it had been necessary to cope for a long time with the consequences of the earlier mistaken policy. Today, the Committee members were close to unanimity in the view that they would have preferred a firmer monetary posture than had prevailed in the recent period. He was pleased that the members had expressed such views frankly and at the same time had not criticized the Manager, since the latter had not been at fault. The Committee should encourage the forthright expression of views at its meetings and of any modifications of initial views as a result of the positions taken by others.

Chairman Martin observed that the Committee had faced a serious problem at the end of last summer. At that time monetary policy had been easier than was desirable in terms of the logic of the economic situation, but he and other members had felt then that a shift to a firmer policy was inappropriate since Congress was actively considering a tax increase and System testimony on that subject was about to be taken. However, after the devaluation of the pound the discount rate was increased and reserve requirements were raised against demand deposits. Those actions, together with the change in open market policy made in December, brought monetary policy into a proper posture in light of the lack of action by Congress on the tax bill. At that stage he had been quite satisfied with monetary policy, as he had indicated at the preceding meeting. Subsequently, he became dissatisfied as a result of developments that were beyond the control of the Desk. Perhaps the Committee should have held an interim meeting in January, by telephone conference or in Washington, to reconsider its directive in light of those developments. Or perhaps the Committee should have formulated its instructions differently. On the other hand, an attempt to issue more specific instructions could fragment the Committee and could result in considerable public misunderstanding.

The Chairman noted that a question had been raised in the discussion of the chart show today about the plausibility of the Council's projections for defense expenditures. Problems in assessing the future course of defense spending had been a source of difficulty in policy-making for the past several years. It was not possible to get definite figures in that area, but the nature of the risks was obvious. In his judgment it could no longer be said that people today were living in a peaceful world; there had been a gradual but large-scale shift to a war economy. In addition to the hostilities in Vietnam and the recent troubles in Korea, there were great risks, he thought, of another outbreak of fighting in the Middle East. The six-day war last June had seemed to settle the problems in that area, but in fact it had not.

Chairman Martin said he thought it was important to continue to press for a tax increase, however questionable the prospects were. Recently he had been asked whether he thought the slowdown in activity projected for the second half of 1968 had any implications for the desirability of higher taxes. He had replied that while the problem of a slowdown might have to be faced as the second half approached, a tax increase was required now to reduce the large deficits in the balance of payments and in the Federal budget to more manageable levels. Those deficits had to be brought under control in a time of prosperity since there would be little chance for doing so in a period of slack activity. If every opportunity to bring the country's international payments and the Federal budget into closer balance was passed up the two deficits could undermine the economy. Whatever the risks of finding a few months hence that there had been too much economic restraint, the risks of inaction now were greater.

The Chairman went on to say that the Committee was more or less in accord on policy today, with most members favoring some version of Mr. Hayes' later proposal for the second paragraph of the directive. As he had implied earlier, he had seen merit in Mr. Robertson's proposal, but he thought some valid objections had been made to it. Moreover, he had been advised that in the past the Committee had not used the term "even keel" in its directives. Some members had commented that the phrase "firm conditions in the money market" in Mr. Hayes' proposed paragraph was unclear. It was true that one's judgments regarding the firmness of conditions could be affected by factors not subject to precise measurement, such as the nature of attitudes in the market. Nevertheless, he thought that money market conditions had not been firm in the last few weeks and that it was desirable to include the word in today's directive.

Chairman Martin then noted that some members had concurred in Mr. Coldwell's suggestion that the words "toward greater restraint" be added after "and operations shall be modified" in Mr. Hayes' proposed paragraph. He asked whether the Committee as a whole agreed to that change.

Mr. Hayes remarked that he did not feel strongly on the matter, and would be prepared to accept the suggestion. However, he had a slight preference for omitting those words, which were clearly implied in any event.

A number of other members concurred with Mr. Hayes, and it was agreed that the words in question should not be added.

Mr. Francis asked whether, if the Committee adopted Mr. Hayes' proposed language, it would intend to have the proviso clause implemented if bank credit appeared to be expanding at a 7 per cent or a 10 per cent annual rate.

Mr. Brill noted that the staff had projected bank credit growth in February in a range of 7 to 10 per cent on the assumption that the set of money market conditions specified on pages 5-6 of the blue book would be maintained.[1/] If in using the word "firm" the Committee had some different money market conditions in mind the projected range for bank credit growth presumably would be affected.

1/ The blue book passage referred to read as follows: "This projection assumes that money market conditions will be about as have prevailed on average since the preceding meeting of the Committee--namely, member bank borrowings in a $200 - $300 million range; the Federal funds rate in a 4-5/8--4-3/4 per cent range; new dealer loan rates in New York frequently 4-7/8--5 per cent; and net free reserves averaging in a zero to $100 million range, but becoming negative at times. Under these conditions, the 3-month bill rate may be in a 4-3/4--5-1/8 per cent range."

Mr. Hayes said he understood that it was the Committee's intent to have the proviso clause implemented--assuming the Treasury financing permitted--if bank credit appeared to be expanding at an annual rate of 7 per cent or more. Other members concurred in Mr. Hayes' observation.

Chairman Martin remarked that the Manager would have adequate latitude under the proposed second paragraph.

The Chairman then said that while certain suggestions had been made for changes in the first paragraph he thought the staff's original draft was acceptable. No disagreement with that observation was voiced.

> 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 information reviewed at this meeting indicates that over-all economic activity has been expanding rapidly, with both industrial and consumer prices rising at a substantial rate, and that prospects are for continuing rapid growth and persisting inflationary pressures in the period ahead. The imbalance in U.S. international transactions worsened further in late 1967, primarily because of a sharp reduction in the surplus on merchandise trade. Although day-to-day money market rates have remained firm, rates on other short-term instruments have declined recently; meanwhile, long-term bond yields have flucuated irregularly below the peaks reached late last year. Growth in bank credit resumed in January, reflecting both loan expansion around the year end and Treasury financing. The money supply expanded sharply following earlier slackening,

> but flows into time and savings accounts at bank and nonbank financial intermediaries have continued to moderate. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market, and operations shall be modified to the extent permitted by Treasury financing if bank credit appears to be expanding as rapidly as is currently projected.

It was agreed that the next meeting of the Committee, which would be the annual organizational meeting, would be held on Tuesday, March 5, 1968, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

February 5, 1968

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on February 6, 1968

The information reviewed at this meeting indicates that over-all economic activity has been expanding rapidly, with both industrial and consumer prices rising at a substantial rate, and that prospects are for continuing rapid growth and persisting inflationary pressures in the period ahead. The imbalance in U.S. international transactions worsened further in late 1967, primarily because of a sharp reduction in the surplus on merchandise trade. Although day-to-day money market rates have remained firm, rates on other short-term instruments have declined recently; meanwhile, long-term bond yields have fluctuated irregularly below the peaks reached late last year. Growth in bank credit resumed in January, reflecting both loan expansion around the year end and Treasury financing. The money supply expanded sharply following earlier slackening, but flows into time and savings accounts at bank and nonbank financial intermediaries have continued to moderate. In this situation, it is the policy of the Federal Open Market Committee to foster finanical conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed on average since the preceding meeting of the Committee; but operations shall be modified, to the extent permitted by Treasury financing, to moderate any apparent tendency for bank credit to expand significantly more than currently expected.