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, October 8, 1968, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Galusha
Mr. Hickman
Mr. Kimbrel
Mr. Maisel
Mr. Mitchell
Mr. Morris
Mr. Robertson
Mr. Sherrill

Messrs. Bopp, Clay, Coldwell, and Scanlon, Alternate Members of the Federal Open Market Committee

Messrs. Heflin, Francis, and Swan, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hexter, Assistant General Counsel
Mr. Brill, Economist
Messrs. Axilrod, Hersey, Kareken, Link, Mann, Partee, Solomon, and Taylor, Associate Economists
Mr. Holmes, Manager, System Open Market Account

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, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Messrs. Eastburn, Baughman, Jones, Nelson, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Philadelphia, Chicago, St. Louis, Minneapolis, Kansas City, and Dallas, respectively
Messrs. Bodner and Snellings, Assistant Vice Presidents of the Federal Reserve Banks of New York and Richmond, respectively
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
Mr. Olson, Economist, Federal Reserve Bank of San Francisco

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on September 10, 1968, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on September 10, 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 September 10 through October 2, 1968, and a supplemental report covering the period October 3 through 7, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner said that in September the French had sold the United States another $85 million in gold, bringing the total of such sales to $460 million. That brought the Stabilization Fund's gold holdings up to a very comfortable level and with no large sales in prospect, the Treasury gold stock seemed likely to remain unchanged for some time. There had been virtually no new purchases by sterling area countries in the period since agreement was reached on the sterling balances arrangement.

Mr. Bodner remarked that the gold market itself was generally quieter during September, and with the growing belief that agreement would be reached with the South Africans the price fell about $1.00 to $39.00. Indeed, during the Fund meetings last week the price actually tumbled to $38.30 as a result of one large sale out of the overhang. While the price quickly recovered to the $39.00 level, he thought that momentary decline was indicative of the vulnerability of the present price to any significant sales. Nevertheless, with the failure to reach agreement with South Africa, the price rose to $39.80 yesterday and was just below that level this morning. Volume was small and it seemed likely that for a while at least the market situation would return to something like that of mid-September.

In the foreign exchange markets, Mr. Bodner continued, the atmosphere had improved considerably since the preceding meeting of the Committee and there had been a generally more confident tone during the last couple of weeks. Nevertheless, it was clear that the situation was not too firmly based and the position of early September could quickly recur. After the heavy speculation on a German mark revaluation and the concurrent pressures on the French franc and sterling at the beginning of September, the market began to calm down following the Basle meeting that immediately preceded the last meeting of the Committee. Thereafter, the mark speculation tapered off while the German Federal Bank continued to swap out its spot gains. In total, the Germans took in some $1.8 billion and reshuffled about $1.6 billion back into the Euro-dollar market. In recent days the mark rate had generally been below the ceiling and on a couple of occasions the German Federal Bank was able to sell some dollars. Nevertheless, the market was clearly reluctant to give up the idea of a mark revaluation, although it seemed to have abandoned the notion that it was imminent.

Along with the more balanced trading in marks, Mr. Bodner said, there had been a fairly steady improvement in the position of sterling. The Basle agreement and the sharply improved trade figures for August gave sterling a substantial boost and the Bank of England took the opportunity to reduce the Bank rate by 1/2 of a percentage point to 7 per cent. That move had been generally well received in the market and over the period since the last meeting of the Committee the Bank of England had taken in about $300 million. The report of a $50 million reserve gain in September gave sterling a further lift and the rate had been fairly firm around the $2.39 level. In fact, British reserves actually declined $60 million in September. That mainly reflected losses incurred in the heavy speculative rush into marks early in the month and the cost of repayment of forward market commitments. At the end of September the British began drawing on the new Basle facility and it was anticipated that they would draw the full $600 million to which they were presently entitled by the end of October. All of the money would be used to repay outstanding short-term credits; the U.S. Treasury had already received $150 million against the credits extended to the British in March.

On the other side of the ledger, Mr. Bodner remarked, the French franc remained under pressure. Although the wave of selling diminished considerably in the final week of September, it picked up again last week. Total French losses for September amounted to $528 million, about $90 million more than in August. A portion of that loss undoubtedly reflected the movement out into marks that accompanied the relaxation of exchange controls, but much represented purchases by French banks to cover forward sales to French residents. The Bank of France covered some $336 million of the September losses by drawings on its swap lines, including $216 million in new drawings on the System that brought the total outstanding to $450 million. In addition, the French sold some $205 million in gold during the month. Through September French reserve losses totaled $3.2 billion, of which $1.1 billion was covered through gold sales and $450 million through drawings on the System.

Mr. Bodner reported that the Belgian franc had also been under some pressure during the course of recent weeks, and as the rate had declined close to the floor the Belgian National Bank had drawn a total of $35 million on the swap line with the System. Those drawings represented the first Belgian use of the swap since 1963. Elsewhere the exchanges generally had been quiet. In particular, the Swiss market was very much less active than had been anticipated over the end of the quarter. The Swiss National Bank had expected to see quite substantial inflows of dollars for quarter-end window-dressing purposes but, in fact, had had to take in only $30 million. Those funds were absorbed in the National Bank's dollar position. Subsequently, Swiss Government needs and the acquisition by the National Bank of cover for $50 million that it had provided to the Bank of England under the original sterling balances arrangement opened up leeway for Swiss purchases of $90 million. As a result of those developments, it had been possible to reduce System outstanding swap drawings on the Swiss National Bank to only $40 million rather than--as had been anticipated--adding to the System's Swiss franc indebtedness during the period. Nevertheless, the Swiss franc remained quite firm and it was still anticipated that additional Swiss franc liquidity would be needed by the Swiss banks during the last quarter of the year. Consequently, it would not be surprising to see System indebtedness rise in the near future.

Mr. Maisel asked whether the German Federal Bank was likely to roll over its swaps with the market as they matured.

Mr. Bodner replied that yesterday, when the first maturities had occurred, the Germans had not rolled them over; they had taken in the $138 million involved. The amounts maturing during the next few days would be relatively small, but about $400 million would mature on Friday. It was his impression that the Germans had not yet decided what to do about the Friday maturities and were likely to make their decision on the basis of market developments up to that time.

> By unanimous vote, the System open market transactions in foreign currencies during the period September 10 through October 7, 1968, were approved, ratified, and confirmed.

Mr. Bodner noted that two $50 million swap drawings by the Bank of France would mature for the first time on October 30 and

November 6, respectively. In view of the continued French reserve losses it seemed likely that the Bank of France would request renewal of those drawings; if so, he would recommend such renewals.

Renewal of the two drawings by the Bank of France was noted without objection.

Mr. Bodner indicated that a System drawing of $40 million on the Swiss National Bank would mature for the first time on November 1. As he had mentioned earlier, the System's outstanding commitments in Swiss francs had been reduced recently. While some further progress might be made, it was entirely possible that the drawing in question would not be liquidated prior to maturity. He would recommend in that event that the drawing be renewed for a second three-month term.

Renewal of the System's drawing on the Swiss National Bank was noted without objection.

Mr. Bodner then said that there were two other matters, neither of which required action, that he would bring to the Committee's attention. First, as the members were aware, the fully drawn portion of the swap arrangement with the Belgian National Bank had been eliminated; now, when neither party was making active use of the arrangement it would be entirely on a standby basis, as was the case with all of the System's other swap arrangements. In conjunction with the change, the Belgian National

Bank had asked that an alternative means be found for providing for the payment of interest on swap drawings by them, so that it would no longer be necessary to set up deposits with the Societe Nationale de Credit a l'Industrie as had been done in the past. They had proposed instead that, in the event they initiated a swap drawing, the forward exchange rate governing the repayment of the drawing be set at a premium in favor of the Federal Reserve in order to reflect the interest due to the System, based as usual on the latest tender for three-month U.S. Treasury bills. The suggested procedure was the same as that provided for in the existing swap arrangement with the German Federal Bank. Their suggestion had been accepted and the arrangement modified accordingly.

Secondly, Mr. Bodner observed, the Committee would recall that in March--at the time of the gold crisis--it had authorized the negotiation of increases in some swap lines, with activation to take place in each case upon a determination by the Chairman that the increase in question was in the national interest. Included among the proposed increases was one of $250 million, to a level of $1 billion, it the swap line with the Bank of Italy. At that time the Italians had indicated that they were not in a position to proceed on the matter and had suggested that it be held in abeyance. However, during the Bank and Fund meetings last week, Governor Carli had suggested to Mr. Hayes that the proposed increase in the swap line should now be put into effect.

Chairman Martin observed that Governor Carli's suggestion had been reported to him before today's meeting, and under the Committee's March 14 action he could have made the determination that the increase in the Italian swap line was in the national interest. However, in view of the time that had elapsed since the Committee's action he had considered it desirable to wait until today, to give the members an opportunity to comment. He asked whether there were any objections at this time to the indicated increase in the Italian swap line.

No objections were heard. Chairman Martin then said he was now determining that an increase in the System's swap line with the Bank of Italy, from $750 million to $1 billion equivalent, was in the national interest.

Secretary's Note: As a result of this determination, the table contained in paragraph 2 of the authorization for System foreign currency operations was amended, effective immediately, to read as follows:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	1,000
National Bank of Denmark	100
Bank of England	2,000
Bank of France	700
German Federal Bank	1,000
Bank of Italy	1,000

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	400
Bank of Norway	100
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
System drawings in Swiss francs	600
System drawings in authorized European currencies other than Swiss francs	1,000

Also, on September 24, 1968, under the terms of the Committee's action of July 16, 1968, Chairman Martin had determined that an increase of $650 million, to $1 billion equivalent, in the limit on outstanding System forward commitments to deliver foreign currencies to the Stabilization Fund was in the national interest. Accordingly, paragraph 1C(1) of the authorization for System foreign currency operations was amended, effective September 24, 1968, to read as follows:

Commitments to deliver foreign currencies to the Stabilization Fund, up to $1 billion equivalent.

Chairman Martin then said he might make a few personal observations on the Bank and Fund meetings that had been held in Washington last week. On the whole, he thought the meetings had been quite uneventful. One problem that arose was essentially political; it related to the proposal to hold next year's meetings in Berlin. A decision was put off until the year-end, and he assumed the matter would be resolved satisfactorily.

In connection with the negotiations on gold, the Chairman continued, it was clear that Mr. Robertson's efforts at the July and September meetings in Basle had borne fruit. By and large, there appeared to be a greater degree of adherence to the position set forth in the Washington communique of last March than there had been immediately following the March meeting, and certainly more adherence than at the meeting he had attended in Amsterdam in May. While it had not proved possible to reach an understanding on gold with South Africa, the fact that there was little desire in evidence to back away from the March agreement was a real gain. What would now ensue with respect to gold was not clear; he suspected that little progress would be made until after the U.S. elections. In any case, it would be necessary to continue to wrestle with the question.

Although the dollar was now definitely stronger than a year ago, the Chairman observed, the delegates from other countries were so deeply concerned with their own affairs that they had spent little time discussing the dollar. However, there was a good deal of talk outside of the formal sessions about the possibilities of a revaluation of the mark and a devaluation of the French franc. It was his personal view that the U.S. tax increase and expenditure reduction represented considerable progress, and would supplement monetary policy in laying the groundwork for improvement in the domestic economic situation and the U.S. balance of payments. It was clear that the nation's balance of payments problem would not be solved as long as strong inflationary pressures persisted.

Chairman Martin said he had talked privately with the new French Minister of Finance, Mr. Ortoli, for about an hour, and also--along with Mr. Solomon--had lunched with him at the French Embassy. He had been quite favorably impressed with the Finance Minister, who appeared to be highly aware of the importance of international matters. In the private conversation he (Chairman Martin) had expressed his regret that the French had not participated in the British sterling balances arrangement on even a nominal basis, in light of the need for increased international cooperation. Mr. Ortoli appeared to be more inclined toward international cooperation than his predecessors had been, and as a result there might be a slight shift in France's position. In the Chairman's judgment, the French were not necessarily out of the woods yet, as many people seemed to think. Any recurrence of domestic disorder--at their universities, for example--could easily lead to a new crisis for the franc.

The Chairman remarked that Mr. Ortoli had asked whether the British were likely to succeed in achieving their balance of payments objectives. His reply had been that it was not possible to say at this juncture, but that he thought they had a chance of doing so. Clearly, the British were facing a long hard road. The recent increases in their imports indicated that they had not stopped their domestic inflation. The same kind of inflationary psychology as existed in the United States was evident in Britain; there was a tendency to move quickly on, say, building projects, to avoid the large price increases that were expected. Such a psychology might almost be said to be worldwide.

In sum, Chairman Martin observed, although the meetings themselves had been uneventful he had come away with the feeling that many problems lay ahead. While the position of the dollar had improved, it had been buttressed by one-time events such as the French difficulties and the Russian invasion of Czechoslovakia. He hoped that in the coming period there would not be a revaluation of the mark or a devaluation of the franc, or new concern about sterling. But one could not foretell the nature of the problems to come.

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 September 10 through October 2, 1968, and a supplemental report covering October 3 through 7, 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:

> Since the Committee last met the financial markets have been waiting expectantly for signs that would confirm the anticipated slowdown in the economy. There was some tendency--shortly after that meeting--for interest rates to decline in anticipation of a cut in the prime rate, while a feeling that loan demand would not be especially strong contributed to a rise of bank investments. As the period wore on, however, the failure of the 6 per cent prime rate to become generalized, more strength in a number of economic indicators than had been expected, an exuberant stock market, and the imminence of Treasury financing led to a more cautious appraisal of the likely course of interest rates in the near future. Basically, the market still expects interest rates to move lower over the next few months, but any expectation of a further early easing of monetary policy appears to have evaporated in light of the current performance of the economy. As a result, after backing and filling for much of the period, interest rates have edged higher for a week or so, and as the blue book[1/] notes, this continued upward pressure is likely for the immediate future, barring a change in the economic environment.
>
> The three-month Treasury bill rate, after declining to as low as 5.09 per cent, wound up at 5.28 per cent in yesterday's auction, up slightly from the auction just preceding the last meeting of the Committee; the 6-month bill rate--at 5.36 per cent--was up 8 basis points. Yields on intermediate-term Treasury issues were little changed for the period as a whole, while yields on long-term Treasury bonds rose as both the corporate and municipal bond markets came under considerable pressure towards the close of the period. Government security dealers--assisted by some official purchases--made substantial progress in reducing their holdings of coupon issues maturing in more than one year. Some dealers, however, still have sizable inventories and are vulnerable to

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

any pronounced change in sentiment. Total dealer inventories of coupon issues due in a year or more--at about $700 million--are about $250 million above their level at the corresponding date preceding the last Treasury refunding.

As the written reports indicate, open market operations had to deal with a sharp swing in reserve availability over the period. A seasonal rise in reserves through September 25 was substantially augmented by foreign operations and an unexpectedly sharp decline in Treasury balances at the Federal Reserve Banks. In addition, the introduction of lagged reserve accounting--at a time when deposits were rising seasonally--resulted in average required reserves $500 million less in the two weeks ended September 25 than would have been the case under the old procedures. With the outlook after September 25 indicating a need for a massive reserve injection, the Trading Desk made extensive use of matched-sale purchase agreements to absorb reserves on a temporary basis. These operations included the largest single daily volume the System has ever had--a total of $1,530 million in reserve absorption on September 11, of which $1,330 million were matched agreements, and the largest total outstanding of such agreements, $1,750 million on September 18. Despite the operations, there was some tendency for the money market to be relatively comfortable.

After September 25, the System provided reserves in volume to meet seasonal needs, which were augmented by the rebuilding of Treasury balances at the Reserve Banks back to normal and the lagged increase in required reserves. From September 25 to October 2, the System purchased about $1 billion of Treasury bills, including $371 million from foreign accounts, and $247 million of coupon issues. The purchase of coupon issues was a normal meeting of part of seasonal needs by this technique and had the additional advantage of reducing dealer inventories in advance of the forthcoming Treasury financing. Despite the large reserve supplying operations, the money market was a shade firmer than it had been earlier, but this seemed quite appropriate in light of the continued strong performance of the credit proxy.

It is probably too early to say much about the impact of lagged reserve requirements, the new carry-over privileges, and the one-week settlement period for country banks. While I foresee no special problems, I am not sure that we or the banks have yet learned to work with the new procedures, and some transition will be required. The country banks so far seem to be operating--with respect to excess reserves--in much the same way as they did when they had a two-week settlement period. The money market banks, on the other hand, appear to be taking advantage of the carry-over privileges, alternating weeks of moderate excesses and deficiencies which they carry over to the next week. Interpretation of the reserve figures has become more difficult, since excess reserves in any given week may be needed to meet last week's deficiency or a planned deficiency in the coming week. A further de-emphasis of the free or net borrowed reserve number, however, is not necessarily a bad thing.

While on the subject of reserve accounting, there appears recently to have been an increase in "as-of" adjustments that on balance have tended to add reserves to the banking system and to require revision of previously published figures. The Desk's operations are thus subjected to an added degree of uncertainty. While an increase in such adjustments is not surprising in light of the tremendous volume of financial transfers currently taking place and of staffing problems at commercial banks, and at Reserve Banks as well, I hope that every effort can be made to keep such adjustments to a minimum.

After a respite since the August refunding, Treasury financing will become a major market influence in coming weeks. The Treasury expects to announce the sale of about $3 billion tax-anticipation bills this week and will have to refund November 15 maturities, of which $3.9 billion are held by the public. Since Election Day falls on a date when the books could normally be open in the refunding, the announcement will come on October 23--a week earlier than usual--with the books open on Monday, October 28, if a cash refunding is decided upon and on October 28 through 30 if a rights refunding is used. The Treasury will also have to decide whether to prerefund the $1.6 billion of publicly held 2-1/2 per cent bonds maturing in December, when additional cash financing will also be necessary. While the auction of tax-anticipation bills does not raise any serious problems, the timing of the refunding

> permits only a short period--about a week--before even keel considerations come into play. Depending on the success with which the new issues are distributed there should be an open spot in the calendar in the second half of November, particularly if December maturities are prerefunded. The System holds $6.1 billion of the maturing November issues, and if the Treasury offers an anchor issue and a longer-term option, I would plan to split the System subscription between the two issues in a proportion equivalent to the expected public subscription. The System also holds $169 million of the December maturities and should the Treasury decide on a prerefunding, I would plan to roll this additional amount into the new issues at the same time.

Mr. Brimmer asked Mr. Holmes about the extent to which he thought System operations would have to be conditioned by the Treasury's approaching tax bill financing. He (Mr. Brimmer) felt that banks, who would be allowed to pay for the issue by credits to tax and loan accounts, should be able to underwrite the financing without assistance from the System. On a related point, he thought that the Committee should re-examine its even keel policy with respect to Treasury refundings involving coupon issues in order to determine how the System's role in such financings could be minimized.

Mr. Holmes observed that the tax-and-loan-account privilege should enable banks to underwrite the tax bill financing without special System help. As usual, estimates of required reserves would have to allow for increases in Treasury deposits as banks acquired the new tax bills. He was not sure, however, whether the new two-week lag in required reserves would make the tax-and-loan-account privilege more or less attractive nor how that lag would affect the willingness of banks to underwrite the tax bill financing.

In response to a question by Mr. Daane, Mr. Holmes said that the Treasury's forthcoming refunding operation would be relatively large, as $3.9 billion of publicly held coupon issues would mature in November and the Treasury might also decide to prerefund $1.6 billion of publicly held bonds maturing in December. The Treasury would need to raise some additional cash in December.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period September 10 through October 7, 1968, were approved, ratified, and confirmed.

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

Mr. Wernick made the following statement on economic conditions:

> The flow of current economic information continues to confirm a somewhat stronger performance than seemed likely earlier and we have adjusted our projections accordingly. At the same time, the data continue to suggest that we have moved from a period of exceptionally rapid growth to one of less hectic economic expansion. What is still in doubt is the extent of the slowdown

and whether it will be of sufficient depth and duration to reduce inflationary pressures significantly.

It seems to me, naturally enough, that the staff projection in the green book[1/] presents a reasonable pattern of developments for the remainder of this year. However, our third-quarter projection doesn't reflect the official Commerce estimate, which won't become available until next week. At the moment, the staff projection shows GNP increasing roughly $15 billion in the third quarter and only a little less rapidly in the fourth quarter. Real growth in both quarters falls to about half the 6 per cent annual rate of the first half of this year. For the fourth quarter, growth in final demands is projected to slow considerably but inventories are expected to accumulate somewhat more rapidly.

Recent leveling in industrial output and manufacturing employment and declines in Federal employment tend to confirm the slowing that is taking place in economic expansion. Even leaving steel aside, there has been no growth in manufacturing output or employment since June. This is in sharp contrast to the period from November to June when these series were moving up rapidly.

Much of the renewed optimism in recent months stems from the strong rise in consumer expenditures in the face of higher taxes. However, projections based on a single quarter's change in consumer outlays are hazardous. This is true both for the businessman and the economist. A lesson in point was the sharp slowing in growth for consumer expenditures in the second quarter of this year following the first quarter's record rise. It was this moderation in spending that convinced many of us that the surcharge would intensify a downward trend already in motion.

Gains in consumption in the third quarter, however, may turn out to be less ebullient than was originally suggested by the Commerce sales data. The sharp rise in retail sales in July will be revised downward because of a smaller increase indicated in a new sample, and in August and September sales have shown little further gain. At this juncture, most of the

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

factors usually influencing consumer spending point to a slowing in growth from the high third-quarter rate. Increases in disposable income should be moderate because of the leveling off in employment. Further, another large decline in the saving rate--which provided major support to consumption in the third quarter--seems unlikely. The drop in the saving rate last quarter was equivalent to almost half the growth in consumption--about $6 billion. It is also expected that a small reduction in durable goods sales may occur in the months ahead because of forward buying of automobiles last quarter. Finally, the bite from higher taxes on personal income should become increasingly evident.

While forecasts of consumption and inventory accumulation have been subject to upward revisions these past weeks, the outlook for most other sectors of final demand has not changed materially and they continue to show little vigor and provide little stimulus to over-all economic activity. Together, business fixed investment, residential construction, and Federal purchases of goods and services are expected to provide the smallest quarterly addition to GNP growth this quarter since the Vietnam build-up began.

So far, businessmen do not appear to be lifting their plans for plant and equipment spending. New orders for machinery continue to be sluggish, and private surveys indicate little or no increase in real terms for 1969. Relatively low rates of capacity utilization and the cloudy profit picture continue to be strong negative factors in spending plans. Some edging up in residential construction outlays is anticipated as a result of the recent pick-up in housing starts, but further gains in starts late this year or early next year may be limited by the availability of mortgage funds. The effects of fiscal restraint should become increasingly evident in the economy as defense and other Federal purchases level off in the fourth quarter. One visible consequence of the Budget cuts has been a reduction of 60,000 in Federal civilian employment since June.

However, the labor market has generally remained firm and unemployment has continued at low levels in August and September. Average hourly earnings have been advancing at about the same rapid rate as earlier this year and price pressures have continued strong. After increasing moderately in recent months, industrial prices spurted in September. Steel increases accounted for part of the rise but higher prices were also posted in many other categories. An appreciable rise in industrial prices is likely again this month. But, if some further easing in over-all demands takes place, it seems unlikely that the industrial price upswing could continue at the recent pace. It is worth noting that not all of the steel price rise is holding and the auto price increases this year were well below those put into effect a year ago.

Meanwhile, the rise in consumer prices has moderated somewhat. In fact, if the recent extraordinary jump in mortgage interest charges is excluded and if allowance is made for seasonal changes in food prices, consumer prices have gone up quite a bit less since May than prior to May; but the recent annual rate of advance--about 3-1/2 per cent--is still very high by earlier standards and is likely to be maintained for the remainder of the year.

Conflicting forces are typical when the economy is making a transition to more moderate rates of growth. On the one hand, surprising strength in consumer expenditures has tended to improve business expectations and could lead to upward revisions of business inventory and capital spending plans. On the other hand, the impact of fiscal restraint on Federal and business spending is only now getting under way. And, given the recent volatile behavior of the consumer and signs that retail sales may be losing some of their earlier momentum, it seems too early to discount the probability that the surcharge will in due time take its toll.

If output does remain stronger than shown in our current projection, a fall-off in growth of final sales would result in substantially more accumulation of consumer goods than is now assumed. This would mean more rapid growth in real GNP temporarily, but for the longer run a weaker over-all situation--reminiscent of developments in late 1966. Perhaps it is too early to look for a serious inventory-sales imbalance and it is certainly more judicious, with the limited data now available, to suggest, as the staff does, only a moderate rise in inventory investment in the fourth quarter. But the possibility of a large inventory build-up as an alternative assumption should not be overlooked in the weeks ahead. A substantial involuntary inventory build-up could have implications for slower real growth in the early part of next year. For now, in view of the many cross currents, the uncertainty of the extent of the slowdown under way, and the stubborn persistence of upward price pressures, a period of watchful waiting would seem to be indicated.

In response to a question by Mr. Hickman, Mr. Wernick indicated that the Commerce Department was waiting for additional information in two areas before preparing its third-quarter GNP estimates. The first was the advance monthly retail sales estimate for September, which would be received at the end of this week. According to preliminary weekly figures, retail sales in September were off 1/2 to 1 per cent from their August level. The second was data on trade inventories for August; the first advance monthly report on total business inventories would not be available until early next week. There would not be any September inventory data available until after the third-quarter GNP estimate was released.

Manufacturers' inventories had risen more in August than had been anticipated, Mr. Wernick continued. He suspected that the Commerce Department would attach more weight than the Board staff had to that development and would therefore come up with a higher GNP figure for the third quarter than that projected in the green book.

Mr. Keir made the following statement regarding financial developments:

Two types of financial information of significance to monetary policy have become available since the last meeting of the Committee. One type provides support for the view that the over-all economic expansion is moderating. The other highlights the fact that many analysts have now concluded that the extent of the moderation will be substantially less than was generally predicted early in the summer.

In the first category of supporting evidence, recent data on business credit demands are the most significant. Business loan growth at banks dropped off substantially in September, despite the sizable addition to September corporate tax liabilities resulting from the June legislation. While the failure of most major banks to match the 1/2 percentage point cut in the prime rate initiated by the Chase-Manhattan bank does suggest that bankers as a group still hope for a fairly good loan demand this fall, the fact that the prime rate was cut at all--on the threshhold of the autumn period of seasonal loan expansion--is evidence that demand pressures from business borrowers are subsiding.

In capital markets too--although recent and prospective business demands have remained quite large relative to most earlier years--total corporate security issues have been running about one-fourth below the heavy volume sold in the comparable months of 1967 and are also down nearly as much from the large volume sold in the spring and early summer of this year.

Turning to the second category of financial information, changed expectations on the economic outlook have been strongly reflected in the renewed upsurge of prices and trading activity in the stock market and most recently in a tendency for bond yields to rise again. Here the key question for policy is whether these changes reflect a generally more optimistic view of the economy than the one now being presented by the staff, and if so which view is more reasonable. While there are always some forecasters with more optimistic projection models, it seems to me that the recent behavior of stock and bond prices can be partly explained simply as a laying to rest of earlier market concern about the risk of fiscal overkill. Thus, recent market developments are not necessarily inconsistent with the staff forecast, and I believe that the staff outlook is reasonable.

Nevertheless, with attitudes about the likely strength of the fiscal impact substantially modified, participants in the stock market are now looking ahead to more favorable corporate earnings prospects than they had previously thought likely. Institutional investors in particular--many of which had accumulated sizable stores of liquidity during the decline of stock prices earlier in the year--have been moving actively to enlarge stock positions, with consequent sharp upward pressures on stock prices.

In bond markets the large speculative positions carried into the post-Labor Day period were typically taken on the presumption that the Federal Reserve discount rate and the prime rate would both be reduced by at least one-half a percentage point sometime before the end of the year. Now, however, market participants seem to have concluded that the 1/4 percentage point declines already realized are about all that can be expected. In these circumstances corporate and municipal bond underwriters have taken steps to pare inventories. And Government security dealers have lightened positions in order to prepare for the forthcoming Treasury financings.

The resulting upward adjustment in yields has to date kept within fairly reasonable bounds. And without some additional shock to market expectations, the odds would seem to militate against a large further upsurge of rates at this time. With both corporate and municipal demands for funds generally expected to moderate a bit after the turn of the year, and with the Federal Government scheduled to be a very large net repayer of debt during the first half of 1969, many market participants are still anticipating some decline of interest rates in the early months of 1969.

The more moderate business loan growth in September, recent cutbacks in security loans as inventories have been reduced, and the absence of any Treasury cash financing--all contributed to a sharp fall in bank credit expansion during September. In the end-of-month credit series, the September growth rate was about half the 20 per cent annual rate evident earlier in the summer. At the same time, with tax payments to the Federal Government unusually heavy in September, the money supply declined at an annual rate of more than 6 per cent.

Looking ahead to the monthly estimates for October, the staff is projecting only a modest renewal of money supply growth. Total bank credit growth is expected to show a larger increase--an 11.5 per cent annual rate for the proxy--but this is little different from the October rate projected in the last blue book, once allowance is made for the fact that the assumed size of the Treasury cash financing has been increased to $3-1/2 billion. If the Treasury financing is closer to $3 billion, as Mr. Holmes has suggested, the growth estimate would be cut back nearly 1 percentage point. Altogether, the Treasury financing assumption in the blue book accounts for 4-1/2 percentage points or about three-eighths of the estimated growth in the October proxy.

Looking beyond October, there is a good chance that the Treasury can get through the rest of the calendar year with only a small further cash borrowing in early December. This possibility stems partly from the unexpectedly favorable recent inflow of tax receipts, but it also assumes that the Administration makes some progress in implementing the new statutory constraints on Federal spending. If the Treasury does defer new money borrowing beyond November, growth in the credit proxy for that month could drop to a rather low number.

Turning briefly to questions of policy--although an interval of nearly ten days is technically available in which a policy change could be effected before "even keel" considerations take precedence--it would seem more appropriate, in light of the economic and financial conditions now prevailing, to continue the wait-and-see stance adopted by the Committee at its last meeting.

Day-to-day money market conditions have been quite firm recently; in fact they have led some market observers to conclude that policy has already snugged-up a bit over the past couple of weeks. While underwriters and dealers have made fairly good progress in paring the overhang of inventories, at least in the corporate and Government securities markets, positions in some sectors are still relatively large. Moreover, the immediate volume of new corporate and municipal debt offerings is heavy, and the two Treasury financings will follow soon after. Consequently, even with a policy of no-change, some further near-term updrift of rates is likely.

As I have already suggested, with market participants still generally expecting some rate decline after the turn of the year, any further updrift of rates at this time should be pretty well contained within the limits indicated by the blue book, so long as there are no unexpected shocks to market expectations. However, one major premise that still seems to be accepted by most market participants is the assumption that monetary policy will not tighten. Thus, any significant firming of policy at this point could very well trigger a much larger interest rate increase and lead to more aggressive liquidation of inventories. Such a change could lead to important repercussions; for example, adjustments to an overt policy firming now would probably continue to spread into the "even keel" period of Treasury refinancing and complicate the task of pricing new issues. Also, even at recent rate levels, savings flows to thrift institutions--on which the projected 1969 expansion of housing is partly predicated--have shown very little pick-up from the growth rates prevailing during the first half of the year.

Mr. Hersey then made the following statement on international financial developments:

Most people who write or talk about the U.S. balance of payments these days seem to have been seized by a strange euphoria--most people, I should say, outside of present company and outside of the balance of payments staff at Commerce. People seem to think that great progress toward equilibrium either has been made or is about to be made, and this, they seem to think, greatly brightens the prospects for a satisfactory resolution of the gold price problem, for SDR activation, and in general for greater international cooperation and reciprocal responsibility in the adjustment process.

I have a fear that the days of this euphoria are numbered, and I would like to tell you why. I would like first to try to identify for you the sources of the euphoria.

I do not think it comes from careful study of the balance of payments accounts. People do not understand the details of what has sometimes been called ledgermanship, but they are aware of its existence. This may be one reason why people tend not to bother about the statistics in all their complexity. It is true that as compared with 1967 there has been a very moderate net improvement in the liquidity deficit before special transactions--which remains, however, well above a $3 billion annual rate. The net improvement results, as you know, from a worsening in the export surplus, more than offset by an improvement in flows of nonliquid capital--including, for example, the heavy purchases of U.S. common stocks by foreigners of which Mr. Solomon spoke a month ago. In addition, creating a surplus on the official settlements basis, there has been a very large inflow of private liquid funds, especially through U.S. bank branches.

If the euphoria does not come from careful study of these figures, neither does it come wholly from pleasure about the passage of the tax and expenditure package. That was an important event, symbolizing a willingness of two branches of the Government to do something about inflation, the U.S. competitive position, and the export-import balance. But it is widely recognized that inflationary expectations are strong and that prices of services and moveable goods, as well as of buildings and land, are likely to continue rising.

We would not be afflicted with this blanket of euphoria if it were not for some other facts, some very simple facts. First, for four months the Treasury gold stock has not declined. Second, over the past twelve months those central banks which under other circumstances might have wanted to buy gold from us have not added on balance to their excess holdings of dollars but instead have seen those holdings reduced by more than $2 billion.

These are simple facts in their emotional impact--but perhaps not so simple in their causes. The basic causes may be said to have been seven: the flight from sterling, the rush to gold, and the flight from the franc--together with, fourth, the participation of other central banks in assistance operations for sterling and the franc and, fifth, the ability of American banks to attract flight funds into dollars with an assist from, sixth, the Bundesbank's success in repelling hot money by its interest rate and forward exchange rate policies. Finally, seventh, massive U.S. gold sales helped mop up excess dollars. Let me illustrate, using a few figures which I draw from a preliminary updating of an analysis the staff provided in the September green book, appendix B.

The shrinkage in U.S. liabilities to foreign monetary authorities was most rapid in March, the month of the gold crisis, and in May and June, the two months of domestic unrest in France. To summarize a description of the process, I shall take two six-month periods.

In the first six months, October 1967 through March 1968, two major sets of transactions were responsible for holding the rise in our total liabilities to foreign monetary authorities to virtually zero. One was an inflow of nearly $1-1/2 billion of foreign private liquid funds--much of it moving out of sterling, and a good part of it channeled by the borrowing of U.S. banks through their branches. This held down our official settlements deficit to a manageable level. The other was gold sales by the U.S. Treasury of well over $2 billion, which not only mopped up the dollars our deficit had put into foreign hands during these six months, but also closed a circuit in which we advanced reserve funds to the Bank of England to sell to holders of sterling who then bought our gold.

During the same six months ending last March, the seven major continental European central banks sold, net, about $3/4 billion of gold (much of this, indirectly, to people moving out of their own currencies) and advanced about $1 billion to the Bank of England (which helped finance the flight from sterling into dollars). The seven central banks' reserve gains in this period were small enough so that the build-up of their claims on Britain left them practically no net addition to their reserve claims on the United States.

Finally, by buying from us during the six months about $1/2 billion of foreign currency Treasury securities, they were left with a corresponding decrease in their dollar claims on us.

In the second six-month period, or more precisely, in the five months April through August for which we have full data, the dollar reserve claims on the United States of the seven continental countries have shrunk further by about $2 billion. This was the consequence mainly of the massive flight from the franc and the accompanying flow of foreign private liquid funds into the United States--the latter having amounted to $2-3/4 billion in five months, more than $2 billion of which was through the branches of U.S. banks.

The financing of these flows is of interest, particularly as it relates to the shrinkage of European official dollar holdings. The Bank of France's own dollar claims on the United States declined only about $1/2 billion through August. But France has received credit and sold gold not only to us but also to the other European countries. Also, it has drawn from the IMF a large amount which the Fund obtained from the other European countries by GAB borrowings and by sales of gold. All told, their transactions to assist France cost the other continental central banks about 1-1/2 billion of dollars through August, and some more in September, in exchange for which they acquired gold and claims on the Fund and France. In this period, the six countries other than France had a fairly substantial balance of payments surplus on the official settlements basis, but as they put their reserve gains into additional gold and into foreign currency securities of the U.S. Treasury, the net decline in their official dollar claims on the United States from April through August came to just about the $1-1/2 billion involved in assistance to France.

It is this great improvement in the dollar reserve liability position of the United States in relation to Europe that is basically responsible, I believe, for the euphoria now in the atmosphere. I am afraid the days of this euphoria are numbered, because I hope that both the French and the British are coming out of the critical phase of their troubles. If this happens, it means that there will no longer be massive movements of private liquid funds into the dollar out of sterling and the franc. Correspondingly, it means that other continental central banks will no longer be using up their dollars in assisting Britain and France, and indeed before long they may be getting some dollars repaid to them. Besides that, they may be taking in dollars from our deficit.

The present outlook for the various elements of the U.S. balance of payments implies some over-all improvement but still a drain on our net reserve position and/or rise in liquid liabilities to private foreigners totaling probably over $2 billion in 1969. Part of the deficit may be financed by a reduction of our sterling holdings. If the confidence of private business and investors in the pound sterling and the franc begins to be restored there is no chance of our banks drawing in anything like the $3 billion they have pulled through the Euro-dollar market in the past twelve months. I do not recommend that the Committee aim at a level of interest rates in the United States that would foster a continued inflow. The inflow we have had this past year was really a mixed blessing, considering the way it has contributed to over-optimism about the dollar--and, in any case, I do not think it likely that at any tolerable level of interest rates U.S. banks could pull in a very large amount next year if they tried.

What I do urge is that the Committee give full consideration to the long-run problems of checking inflation and halting the deterioration of our international trading position.

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:

There has been mounting evidence over the past few months that the slowdown in business expansion in the third quarter would be nowhere near as sharp as expected. Such new data as have become available in the past week strongly reinforce this conclusion. The strength of retail sales has been especially dramatic, but I have in mind also the disturbingly large surge in manufacturers' inventories, the relatively high level of residential construction, and the continuing very tight labor market. Of course the third quarter is in a sense past history. But I think we must recognize that almost all projections for that period underestimated the basic strength of the economy. And it is not surprising that in this environment we have hardly made even a start toward the much-hoped-for slackening in upward price and wage pressures. It seems to me that inflationary psychology has a pretty strong hold on the public generally.

The booming domestic economy has, of course, disturbing implications for our balance of payments situation. So far there is nothing in domestic developments that would bring about the needed dampening in the demand for imports. Imports have continued to rise across a broad front. Although large special financial transactions are keeping our recorded liquidity deficit at a very comfortable level, the liquidity deficit on an underlying basis may come out at an annual rate of $3-1/4 billion for the third quarter and perhaps almost $4 billion for the full year. This should demonstrate clearly the desperate need for a major improvement in our trade balance, especially as we can hardly count on maintenance of the recent favorable level of aggregate capital flows.

As we look further toward the months ahead, I still expect some moderation in the pace of business advance. Indeed, the sharp rundown in the rate of consumer saving obviously sets limits on the possibility of a further upward push in consumer spending. Similarly, the high level of inventory spending in August may mean that an additional drag from this area will develop in subsequent months. But all of this is guess-work and our experience with the third-quarter developments should serve as a sharp warning that the improbable can happen. And in any case, even if fiscal restraint does bring the expected slowdown, it seems to me increasingly doubtful that the slowdown will be large enough to bring an adequate easing of price pressures and import demand.

Meanwhile, bank credit has continued to grow at an excessive pace. I am not much comforted by the decline in the growth of the proxy from a 22 per cent annual rate in August to 9 per cent in September. The September gain follows two previous months of rapid increase that could perhaps be explained away, but it does nothing to compensate for that bulge. It is twice as large as the 4 per cent growth rate during the first half of this year. And the projection for October is even higher, at 10 to 13 per cent. After some allowances have been made for "re-intermediation," these figures seem to me clearly too high.

The strength of the economy, the lack of any significant signs of lessening price pressure, the continuing bad foreign trade figures, and the pace of the recent bank credit expansion all suggest that we may have eased too much, or at least prematurely. To put it another way, the effective combined impact of fiscal and monetary policy has been a little too mild, despite passage of the fiscal package last summer. We would do well not to ignore completely the almost universal feeling among bankers--with strong support from the economists--that monetary policy is too easy. Unfortunately, we will shortly face another period of even keel at which time it will be difficult to undertake any firming action. Perhaps such restraints will be less severe, however, in the case of the approaching tax bill financing than during the ensuing large refunding operation.

I think we should take advantage of the small gap between this meeting and the Treasury refunding announcement during which some modest action of a firming nature could be undertaken. It seems to me important that we put a check on credit growth and attempt to bring it back down to a rate of about 6 per cent per annum.

In implementing this policy, I would suggest that the Manager be instructed to achieve somewhat firmer conditions within the limitations set by the Treasury financing, with the Federal funds rate at around 6 per cent rather than on the lower side of 6 per cent. Actually this is not far different from conditions prevailing in the market for the past week, when there has been a shading toward greater firmness than had previously prevailed. I think our earlier concern over short-term interest rates, particularly Treasury bill rates, is no longer warranted, unless of course extreme swings develop. In the wake of the introduction of the lagged reserve arrangements, I do not think it is possible to specify a target in terms of net borrowed reserves, which may tend to run higher in any case, if banks succeed in economizing on their holdings of excess reserves. As for borrowings, I would feel that a range of $500 to $700 million might be appropriate.

As for the directive, I would substitute the following wording for the opening sentence of the first paragraph of the staff draft:1/ "The information reviewed at this meeting suggests that the slowdown in

1/ Appended to this memorandum as Attachment A.

the economic expansion has so far been relatively moderate and less than expected. There has been no significant easing of upward pressures on prices and costs." In my judgment, the first sentence of the staff's draft does not adequately convey the thought that Committee members had not anticipated the recent strong performance of the economy.

With respect to the second paragraph I would prefer the following wording to that of the staff's draft: "To implement this policy, System open market operations shall be conducted with a view to attaining, to the extent permitted by the forthcoming Treasury refunding operation, somewhat firmer conditions in the money and short-term credit markets."

Alternatively, in light of the fact that the tone of the money market has been firmer in the past week, the second paragraph might be worded to call for maintaining about the conditions that have most recently prevailed. Specifically, the paragraph might be worded as follows: "To implement this policy, and taking account of the forthcoming Treasury refunding operation, System open market operations shall be conducted with a view to maintaining about the same conditions that have most recently prevailed in the money and short-term credit markets." However, I would consider this alternative, which might be labeled "B," distinctly less satisfactory than my first proposal, which I might refer to as "A."

Mr. Daane observed that from the blue book and the Manager's comments he had formed the impression that firmer conditions could be expected even in the absence of an overt System effort to achieve them.

Mr. Holmes indicated that he concurred in the judgment expressed in the blue book that short-term interest rates were likely to continue under upward pressure. He would add, however, that the Germans might purchase a large amount of bills later in the week if, as Mr. Bodner had suggested was a possibility, they took in dollars when their market swaps matured. Such purchases could have a marked effect on the atmosphere in the bill market.

Mr. Morris said that before commenting on the directive he would make a few remarks about what he considered to be the very limited time span for which staff projections were regularly shown in the green book and blue book. One of the surprising and disturbing aspects of his initiation into the Federal Reserve had been the discovery that the GNP projections the staff had prepared for the past two meetings of the Committee did not go beyond the fourth quarter of 1968. In his portfolio management work of recent years he had always made use of economic projections extending at least three quarters into the future. Such forecasts had seemed essential to him for proper decision-making even though they were necessarily less accurate than short-range forecasts. A long-term horizon was required in dealing with a market in which current prices typically reflected developments of the recent past and discounted developments expected in the near-term.

Mr. Morris remarked that the Committee had to look beyond the immediate future for a different reason--namely, that its policy actions affected the expenditure stream with a considerable time lag. There was very little the Committee could do today to affect developments in the fourth quarter of this year. The

Committee's job today should be to assess the likely course of the economy in the first half of 1969 and gear its action accordingly. However, the Committee had before it no indication of the staff's view of the outlook for the first and second quarters of 1969 and, if his information was correct, no projection for that time period had been provided since the meeting on May 28. In sum, it seemed to him that the Committee had an inadequate basis for policy formulation.

Mr. Morris noted that he had discussed the matter with Mr. Brill and he (Mr. Morris) appreciated the difficulties the staff would face in attempting to project GNP and flow of funds developments regularly for three quarters ahead. At the same time, he was mindful of the ever-present danger of giving too much emphasis to recent developments. For example, the need for tightening might not be clearly discerned at a time when current economic indicators were not strong but the longer-run outlook was for an excessive rate of economic expansion, as was the case in the summer of 1967. At present, the opposite situation might well exist.

Mr. Morris indicated that the staff at the Boston Reserve Bank was trying to develop its own projection model, with the help of academicians from Harvard and the Massachusetts Institute of Technology. He had found that he needed such a model in August, at the time the Boston Bank's directors were considering discount rate action. Current economic indicators then were generally strong, but in his judgment the expectation of slower economic growth in the first part of 1969 offered an important reason for a discount rate reduction.

Looking to the recent past, it seemed to Mr. Morris that there had been two major swings in market psychology since June. At first there had been excessive concern about the possibility of economic overkill. That concern had dissipated mainly as a consequence of two events--the large increase in retail sales in July and the shift in monetary policy--and subsequently market psychology had swung in the other direction when the belief spread that the fiscal package would be relatively impotent and that expansion in economic activity would be fairly rapid in 1969.

Mr. Morris thought there was likely to be another change in market psychology as the impact of fiscal restraint began to show up in the data. Until recently it had been difficult to find support in current data for the expectation of slower economic growth. However, preliminary August statistics, notably the leading indicators, were beginning to suggest that the economy was losing momentum. For the first time in many months, a substantial majority of the leading indicators declined in August. He recognized that one month's evidence was not conclusive, but he believed that the data for August were compatible with the forecast of slower economic growth in the first half of 1969.

Mr. Morris said he approved the draft directive submitted by the staff. He thought there was a clear need for the one-way proviso shown in the draft, since a very rapid rate of growth in bank credit was projected as a result of continued heavy Treasury deficit financing. Such financing was another indication that the effects of the fiscal restraint package were not yet being reflected in the marketplace. He would agree with Mr. Hayes that under those conditions the Manager should not be overly sensitive to relatively small upward movements in short-term interest rates.

Mr. Coldwell reported that the Eleventh District economy retained its high-level position, although perhaps in tone and flavor it was very slightly weaker than in previous months. Industrial production had remained steady despite further reductions in crude oil output which was now 8 per cent below a year earlier. On the other hand, construction activity seemed to be strengthening and employment was seasonally unchanged. Unemployment had declined as labor force withdrawals of women and teenagers occurred in larger-than-expected numbers. Very tentative estimates of retail trade now appeared to show a slight weakening toward the latter part of September, but the data and the time frame were insufficient to make a judgment that the consumer had now turned toward a slower rate of purchasing. In the District's agricultural sector the data suggested a record physical output but only a small increase in net income. Price levels were down somewhat and costs of production were higher.

In the financial areas of the District, Mr. Coldwell said, bank reserve positions were noticeably easier and the tone of bankers' comments reflected that easing. Moreover, borrowings from the Federal Reserve were now mainly seasonal and the large banks were net sellers of Federal funds. Banking loan totals had advanced, largely on the strength of security loans and, although commercial and industrial loans did increase, there appeared to be some weakening in the demand from that area. In fact, bankers now reported less pressure for loan accommodation and, of course, a substantially easier position in meeting the loan demand.

Demand deposits of District banks were up strongly in line with the increase in Federal Government deposits, Mr. Coldwell continued. However, time deposits rose only slightly, another indication that the banks moved to an easier position. Their demand for CD money was now static and rates had been reduced for the longest maturities to a level of 5-3/4 per cent. In contrast, their loan rates had held and, in consequence, net income of banks as reported for the third quarter was sharply higher.

With respect to nationwide conditions, Mr. Coldwell commented that despite a diligent search he had failed to find significant or material signs of a downturn in the economy other than those expected from the changes in steel and automobile inventories. In his view the developments in employment, unemployment, personal income, and consumer purchasing failed to show an imminent downturn. Even the decline in industrial production could be traced to the steel cycle.

On the other hand, Mr. Coldwell observed, economic common sense suggested that fiscal action of the degree that had been taken should eventually be reflected in a retrenchment in consumer spending. Thus, one continued to search for signs of economic weakness; and perhaps there were some portents of slower growth in the tone of business decisions on capital spending and in the trends of inventories, shipments, and orders.

Mr. Coldwell remarked that the banking industry had already liquefied its position almost as if a downturn were clearly in view. The Committee's easier monetary policy, coupled with the monetization of public debt, had provided reserves even faster than the banks had utilized them. If he had gained any general impression from the recent American Bankers' Association meeting in Chicago it was a feeling of considerable availability of lendable funds at most banks and a marked easing of pressures.

Loan demand appeared to remain uneven but bank investments were rising in most areas. In the meantime, balance of payments developments were still quite worrisome.

In Mr. Coldwell's opinion, therefore, the Committee should give no further encouragement toward easier credit conditions or lower interest rates. As to the directive, he favored the revision of the opening sentence of the staff's draft that Mr. Hayes had suggested. He could accept the staff's wording of the second paragraph if the Desk interpreted that language as calling for working toward the upper end of the ranges of money market conditions given in the blue book[1/] and for resolving doubts on the side of restraint. He hoped that the coming Treasury financings could be used to regain some of the tone of restraint that had been lost over the past two months. He did not suggest a marked or overt return to the restraint of early May but he felt the System was losing its grip on the situation by more than reconstituting reserve positions as the banks used reserves.

Mr. Swan commented that in the Twelfth District the unemployment rate in August had declined by 0.1 of a percentage

---

1/ The blue book passage referred to read as follows: "Assuming a policy which permits member bank borrowings to remain in a $400-$600 million range, the Federal funds rate in the coming three weeks is likely to center around 5-7/8 per cent. . . . The three-month bill rate over the coming period may fluctuate in a 5.10--5.40 per cent range."

point, compared with a decline of 0.2 in the country as a whole, and at 4.6 per cent it remained about one percentage point above the national average. Major District banks continued to be substantial lenders to securities dealers in September, obtaining funds from the inter-bank Federal funds market and through repurchase agreements with nonbank investors. Business loans in September increased a little faster at weekly reporting banks in the District than in the nation as a whole, but the banks did not appear to anticipate more than seasonal gains in the period ahead.

Mr. Swan indicated that share accounts at California savings and loan associations might have increased by slightly more than the amount of interest accruals in September, if the Reserve Bank's very small sample of six institutions was representative. The experience of those institutions suggested a statewide increase totaling around $250 million, of which some $225 million would be net interest accruals. Five of the six institutions in the sample indicated that they were pleased with the smaller than expected outflow in net savings which occurred in the first few days of October. In fact, two of the six reported a net inflow over the first three days of the month.

On the national scene, Mr. Swan continued, the current indications of slowing in economic expansion were hardly sufficient to suggest adequate restraint of inflationary pressures. He still believed that some further moderation in the pace of economic activity would occur later this year and in the first part of 1969. At the moment, however, like Mr. Coldwell he saw no basis for any easing of policy. On the other hand, given the approaching Treasury financing and possible further slowing in economic growth he would not advocate overt tightening at this time.

Mr. Swan said he had intended to suggest adding the word "somewhat" after the word "moderated" in the first sentence of the opening paragraph of the draft directive, but he now preferred Mr. Hayes' suggested changes in that paragraph. As for the second paragraph, his preference was to retain the staff's draft on the understanding that "prevailing conditions" referred to current conditions rather than to those of two or three weeks ago. Moreover, he would favor instructing the Manager to invoke the proviso clause, to the extent that Treasury financing operations permitted, if growth in bank credit in October appeared to be reaching the lower limit of the 10 to 13 per cent range projected, rather than waiting for it to exceed that range. Like others, he was disturbed about the rate of expansion in bank credit since midyear irrespective of month-to-month changes. Perhaps his policy prescription was not much different from that of Mr. Hayes, but he (Mr. Swan) preferred the approach he had suggested to a specific statement in the directive calling for somewhat firmer conditions.

Mr. Galusha commented that there seemed to be nothing portentous in recent developments in the Ninth District. He wished to point out, however, that the District economy was growing less rapidly than earlier and less rapidly than the national economy. For the last couple of months the unemployment rate in the District had exceeded the national rate.

It was not clear, Mr. Galusha continued, that the slowdown could be traced to the imposition of the income tax surcharge, although consumer spending was no longer increasing at its earlier rate. He wanted to add, however, that he still did not count himself among those who doubted that the surcharge would have an effect. In his own mind it was clear that it would.

Mr. Galusha also noted that Ninth District agriculture had not benefited from the recent increase in the index of farm prices. Some farm prices had increased, but not those of the crops that bulked large in the District. Accordingly, he was not looking for an increase any time soon in farm spending, whether for producer or for consumer durables.

With respect to Committee policy, Mr. Galusha said he was for no change, which meant that he implicitly accepted the possibility of wide short-term swings within the target parameters indicated in the blue book. If an inconsistency in targets became apparent, he believed the Manager should aim at maintaining the bill rate within the specified range of 5.10 to 5.40 per cent.

His reasoning was simple and perhaps too stark, Mr. Galusha continued. He was quite impressed with Mr. Morris' observations about the desirability of basing policy on prospective developments. Given present-day institutions, inflationary pressures increased as the unemployment rate decreased and very quickly became intolerable as the rate decreased below 4 per cent. But if interest rates were to change little from their recent levels, he (Mr. Galusha) thought the unemployment rate would increase. It could rise to 4-1/2 per cent by mid-1969, and average 4 per cent or thereabouts for fiscal 1969. That outlook made it logical to assume that inflationary pressures were likely to become less intense. And unless there was an appreciable change in the economic outlook, an unaltered Committee policy was therefore appropriate.

It seemed to Mr. Galusha that a sharp precipitate shift in economic policy might be expected to send the unemployment rate to 5 per cent by mid-1969 and to produce a net decline in economic activity instead of a slower rate of growth. Such a development would be unfortunate socially as well as economically. He believed that domestically--leaving balance of payments considerations aside--the moderate nature of the System's responses had been appropriate. It might be necessary to swallow a higher rate of unemployment for balance of payments reasons than the Committee had implicitly considered, but the Committee should view the balance of payments as one of the concomitants of economic policy and meet it squarely.

Mr. Galusha observed that circumstances would be different if the surcharge were not scheduled to expire next June. This time the Committee knew there would be fiscal action--either that which occurred as a statutory requirement contained in the tax act of 1968 or as a specific act of Congress to postpone or modify in some way the expiration of the surtax. The better assumption was, he thought, that the surcharge would be allowed to expire. That being so, he believed that the Committee had done about as much as it could. He wished the Committee were able safely to alter permanently the mix of monetary and fiscal policies, or shift to a new lower average level of interest rates. Barring a significant decrease in aggregate demand, it could not aim for lower interest rates, however, until tax rates were "permanently" increased.

Mr. Galusha said he was not sure he understood the difference between Mr. Hayes' alternative B for the second paragraph of the directive and the staff's draft. He assumed there was no substantial difference except that Mr. Hayes' proposal would shift the emphasis toward the tighter end of the ranges discussed in the blue book. He (Mr. Galusha) preferred the wider latitude allowed by the staff draft. He thought, however, that Mr. Hayes' proposed language for the first paragraph of the directive was appropriate.

Mr. Scanlon reported that the over-all view from the Seventh District remained the same--continued strong consumer demand, confident business expectations, essentially full utilization of manpower, and little abatement of upward price pressures. Gains in employment were less in the region than for the nation in recent months, and manufacturing employment was slightly below the level of a year ago in most areas. But there was no appreciable evidence of an easing of labor supplies. Unemployment compensation claims were well below last year's level in September in all District states. In the Chicago area, help-wanted advertising increased sharply in September. Construction workers were in extremely short supply in the District, especially in the large centers. Many projects had been delayed, either by labor shortages or strikes.

Price increases were widespread in September, Mr. Scanlon noted. The fact that auto firms increased prices less than had been expected, the highly competitive markets for steel and most industrial raw materials, and the expected downward trend of agricultural prices were hopeful signs that price inflation, over all, would soon moderate--at least in the wholesale markets.

Steel output in the Chicago and Detroit areas rose somewhat in late September but output for the nation had remained at the recent low, Mr. Scanlon said. Auto industry requirements mainly accounted for the difference. Imports of steel continued very large and along with currently large inventories were exerting downward pressure on prices of most types of steel. It was possible that most of the announced increases in steel prices had been, or would be, eroded.

Mr. Scanlon remarked that auto assemblies in September were somewhat less than originally scheduled because of shortages of components, related in most cases to wildcat strikes, but auto output for October was expected to set a record high for any month. The industry felt the demand for 1969 models appeared to be strong. That would indicate that the high rate of sales in the summer months was not simply a result of price concessions on 1968 models and expected increases of prices on 1969 models, but reflected strong underlying demand.

Observers in the Seventh District reported that consumer demand continued to be strong, Mr. Scanlon said. Over all, it appeared that the recent high level of total retail sales would be at least maintained in the fourth quarter. Retailers' inventories were relatively low. Somewhat contrary to Board staff reports, there was a widespread expectation in the Seventh District--supported by recent surveys--that 1969 would see the start of a new, broadly-based rise in demand for producers' equipment. Outlays to cut costs and reduce labor requirements were likely to predominate. Some people in the Seventh District believed an increase in construction contracts for factory buildings in July and August might be an advance indication of forthcoming increases in plant and equipment spending.

Generally, Mr. Scanlon observed, 1968 had seen homebuilding at high levels in District centers, with Chicago, Milwaukee, and Indianapolis permits up in step with or more than the U.S. gain. For Chicago, 1968 appeared likely to approach the 1955 record high. It seemed a certainty that apartment construction would set a new record, although detached home volume had been below its recent--late 1967--pace. Trade reports suggested that apartment vacancies might be up slightly, but on balance the local market remained strong, with new high-rise apartments renting briskly before completion and rentals continuing under upward pressure. Meanwhile, single-family houses, conspicuously in the suburbs, were selling readily as prices continued to climb.

Mr. Scanlon reported that mortgage funds remained available despite weakness in savings inflows during the third quarter. The rate level had changed little in recent weeks: single-family conventional loan rates currently were quoted in the 6-3/4 to 7 per cent range or fractionally below the "soft 7 per cent" of mid-summer. Lenders were somewhat apprehensive about the durability of the current pace of personal savings and, looking toward early 1969, about the delayed April 15 impact of the under-withholding for the surtax.

Tightness in the market for construction labor was widely believed to be the major current restraint on homebuilding in the District, Mr. Scanlon said. Related was the widespread notion that concern over the uptrend in construction costs sustained buyer and borrower demand for financing despite the high level of mortgage rates and, indeed, constituted a major factor supporting the present rate level.

Mr. Scanlon remarked that District banks showed a rather slow credit growth in September, compared with the national experience, but that might be more a reflection of tight reserve positions than slackening credit demands. Chicago banks were in very deep deficit positions through most of the past month, partly as a result of unduly heavy Treasury withdrawals following the tax date and occasioned by the lack of uniform procedures for handling Treasury deposits by the Reserve Banks. Chicago banks reduced both dealer loans and holdings of securities and purchased unusually large amounts of Federal funds. In the past week, however, the positions of most of those banks had improved markedly as deposits rose.

In Mr. Scanlon's view, rates of change in aggregate reserve, money, and credit series in September were considerably more appropriate to current and prospective economic developments than those in previous months. The resulting interest rates also appeared to be constructive to the Committee's objective of curtailing inflationary pressures. He believed that the Committee should not let up on the slower rates of monetary expansion now that they had been achieved, particularly in view of the apparent failure of the fiscal action to take hold as quickly as expected and the downgrading of its future restrictive impact.

Mr. Scanlon said he would like to see a smaller growth in the credit proxy than that projected in the blue book. He would not worry about some modest upward movement in short-term money rates. He found Mr. Hayes' alternative B satisfactory for the second paragraph of the directive. The staff draft also would be acceptable to him if it was understood that "prevailing conditions" referred to those that had prevailed most recently. He favored Mr. Hayes' suggested revision in the first paragraph.

Mr. Clay commented that there was little evidence of progress in correcting the problems arising from the overexuberance of the current economic upswing. The cost-price inflation problem continued. Qualified labor was extremely scarce, and the unemployment ratio for aggregate labor remained at its low point. The national economy continued to show substantial strength, particularly in the consumer sector. Moreover, the weak foreign trade situation underscored the need for alleviating cost-price pressures.

Economic developments and the severity of the problems facing public economic policy formulation raised serious doubts about the expansiveness of monetary policy, Mr. Clay remarked. The large expansion in bank credit since June was a matter of record. Now the staff projection for October was for an increase at an annual rate in the range of 10 to 13 per cent. A significant proportion--4-1/2 percentage points--of the projected October increase was accounted for by Treasury financing activities, but past experience gave little reason to expect that that segment of the bank credit expansion would be temporary. Even without that portion, bank credit growth would be on the high rather than the low side of what was desirable in view of the cumulative growth since June.

Aggregate economic growth had moderated somewhat, Mr. Clay observed, and there still remained the possibility that the pace of growth would moderate further. Under those circumstances, one would expect some change in monetary policy from that pursued prior to passage of the tax law. Moreover, one would expect policy to continue on the expansive side. It was the degree of credit expansion that raised serious question.

Mr. Clay remarked that moderation of bank credit growth might and probably would put upward pressure on interest rates. That had to be accepted as the trade-off for a slower rate of credit growth. To do otherwise would delay the adjustment in policy necessary for bringing balanced economic growth and alleviating the pressures on resources and prices. Recognizing that the basic problem had not given evidence on being on the way to solution, the risk remained one of accelerating the cost-price inflation and thus aggravating the problems needing correction.

Mr. Clay said that guidelines for the period ahead might include growth in the credit proxy at a rate of 6 to 8 per cent, a Treasury bill rate ranging up to 5-1/2 per cent or slightly above, a Federal funds rate of 5-7/8 to 6-1/8 per cent, and member bank borrowings of $400 to $600 million. He considered appropriate the change suggested by Mr. Hayes in the first paragraph and he also favored Mr. Hayes' proposed alternative A for the second paragraph.

Mr. Heflin commented that Fifth District business activity apparently was continuing the quickening pace reported last month which followed a slight midsummer relaxation. The only exception to the buoyant trend noted by respondents to the Richmond Reserve Bank's District survey was textile mill activity. Textile producers had unusually high stocks of raw cotton, causing depressed cotton prices. Respondents reported an especially high level of construction activity with residential building recovering rapidly. Retail sales, including automobiles, showed no signs of weakness in the District.

On the national scene, Mr. Heflin said, the economic picture had not changed greatly since the Committee's previous meeting. Although the economy appeared to be expanding at a slower rate than earlier in the year, it continued to move ahead at an unexpectedly strong pace, as was evidenced by recent statistics and by the frequent upward revisions of third-quarter GNP estimates. Business fixed investment expenditures and residential construction outlays were somewhat stronger in the third quarter than had been expected, but of course the real surprise was the growth in consumer spending.

It seemed to him, Mr. Heflin said, that the course of economic developments over the next few months would be determined in large measure by the behavior of the unpredictable consumer. Consumer outlays in the fourth quarter as projected in the green book would represent a movement toward a desirable cooling off of the economy. On the other hand, there was always the danger, pointed out in the staff's report last month, that the strength of consumer demand would persist long enough to cause businessmen to revise their estimates and thus lead to a rapid buildup of inventories. The anticipated moderation in the growth of personal income and the possibility that consumers might try to restore the saving rate to something approaching its level earlier in the year might well lead to a slowdown in the growth of consumer spending. But a question of timing was involved here, and on the basis of what he had seen so far he would not expect any significant moderation in consumer spending before the first quarter of next year.

Conditions in financial markets seemed to reflect the high degree of uncertainty as to the future course of economic activity, Mr. Heflin observed. The controversy surrounding the recent reduction in prime rates and the emergence of a split rate only served to emphasize the extent to which opinions differed as to the current state of the economy and the strength of loan demand. At any rate, the markets seemed to be in a very cautious mood at the moment, awaiting some clear-cut evidence of a change in the direction of the economy.

As far as policy was concerned, Mr. Heflin said, he did not believe that either the general economic situation or conditions in the financial markets called for any change at this time. He was pleased to see that the money supply had remained virtually stable in recent weeks and that it was expected to grow very little in the period just ahead. He would prefer to hold the growth in bank credit in October somewhat below the 10 to 13 per cent range projected in the blue book.

Mr. Heflin said he found appropriate the changes suggested by Mr. Hayes in the first paragraph of the directive but preferred the language proposed by the staff for the second paragraph.

Mr. Mitchell remarked that he would endorse the staff's draft of the directive and the staff's analysis, except for Mr. Hersey's presentation which he found difficult to assimilate and to agree with. It seemed to him that an analyst, whether an economist or political scientist, would have been able to say that the situation in France before the recent crisis was unsustainable. It also seemed to him that the Russian threat to political stability in Western Europe was a fact that sophisticated investors would have been taking into consideration. Accordingly, neither the developments in France nor in Czechoslovakia should have occasioned much surprise, and any euphoria about the consequences of those developments for the position of the dollar could be considered to be warranted. At the same time, he personally was not euphoric about the prospects for the U.S. trade balance.

Mr. Mitchell referred to Mr. Morris' suggestion that the staff prepare longer-term projections than it now did on a regular basis. He thought such a procedure would be desirable if feasible, but was not sure it was feasible. On the subject of policy lags, he thought Mr. Morris had overlooked one channel--expectations--through which monetary policy actions could very quickly have significant effects of a type that might be difficult to reverse. For example, the behavior of savings and loan associations with respect to mortgage commitments might change swiftly if they came to believe that there had been an overt shift in monetary policy.

As a matter of general practice, Mr. Mitchell continued, he thought the Committee should not make frequent small shifts in policy; rather, it should maintain an existing policy until it was convinced that it was inappropriate. The immediate economic situation did not suggest to him that the Committee's present policy stance was outmoded. If the longer-run outlook suggested any policy change, it would be in the direction of easing, particularly since most of the effects of the tax increase and expenditure cuts had yet to appear. At the moment, however, he would favor no change in policy--not because he thought the longer-range forecasts of slower growth were not becoming more probable but because it seemed desirable to hedge for the time being.

As he had indicated, Mr. Mitchell said, he favored the staff's draft directive. Mr. Hayes' suggested changes, including that in the first paragraph, struck him as undesirable. Present estimates indicated that GNP growth had been slowed from $21.7 billion in the second quarter to about $15 billion in the third. That, in his judgment, was a significant change, and it justified the language of the first sentence of the staff's draft.

Mr. Daane noted, apropos Mr. Mitchell's final comment, that the green book estimates also showed third-quarter growth in real GNP at a rate only about half the 6 per cent rate of the second quarter. Accordingly, he agreed that it would not be appropriate for the directive to say, as Mr. Hayes had suggested, that "the slowdown in economic expansion has so far been relatively moderate." However, he agreed with Mr. Hayes that the growth rate now indicated for the third quarter was higher than had been expected. Thus, he thought it would be appropriate to add the words "although less than expected," after the statement in the staff's draft that "economic expansion has moderated."

For the second paragraph, Mr. Daane continued, he would favor retaining the language of the staff's draft on the understanding that the words "prevailing conditions" would be interpreted to mean current conditions, which were somewhat firmer than those of recent weeks. He did not think the Committee should push positively for greater restraint at this juncture, but within the margin the Committee normally allowed the Manager he would want any errors to be on the side of restraint. It would be necessary, of course, to take account of the Treasury's November refunding. The size of that operation, particularly if the Treasury decided to prerefund December maturities, argued for maintaining an even keel after about the third week of October.

Mr. Daane said he had a good deal of sympathy with Mr. Morris' comment that the Committee would find longer-run projections valuable, although he shared Mr. Mitchell's view that monetary policy actions could have significant consequences almost immediately.

But the main risk he thought the Committee faced was not so much that of failing to look far enough into the future; it was the risk of placing undue emphasis on the past. At the moment, all members were highly conscious of the rapid growth in bank credit this summer and of the large increases in the money supply a little earlier. While those increases could not be explained away in their entirety, they did reflect some special factors. In any case, it was important for the Committee to look forward rather than back.

Mr. Maisel said he shared the concern about possible over-emphasis on short-run changes in the available figures. He was also concerned about a risk that policy could be whipsawed if there were frequent shifts in the focus of attention for policy decisions from one variable to another. For example, the money supply grew substantially in the second quarter but its average rate of increase since June had been rather low. The bank credit proxy had been increasing rapidly in recent months, but its growth had been slow in the spring, when banks had experienced a rather large runoff of CD's. If one focused first on bank credit and then on money supply, monetary policy would appear to have been quite restrictive over the past six months while the opposite would appear true if the emphasis was reversed.

As he had indicated in the past, Mr. Maisel continued, he thought the Committee should focus on total deposits of banks and major thrift institutions. Such deposits had been increasing more or less steadily in recent months at an annual rate a little under 8 per cent. That rate was probably slightly lower than desirable; the staff projections presented at the May meeting of the Committee had suggested that growth at an 8 or 8-1/2 per cent rate in the second half of 1968 would be appropriate. In any case, if one accepted the growth rate of the total deposit series as a proper measure of monetary policy for this period, then there were few grounds for concern in the recent behavior of the aggregates. At the same time, he did not feel the somewhat lower interest rates in the past four months indicated any real policy change. Since the fiscal legislation was enacted interest rates had declined considerably less on balance than might have been expected in light of the sharp cutback in expected Treasury financing needs. While the System was still financing past fiscal policies, the market should be expected to react to the recognition that the Treasury deficit would be $20 billion less in fiscal 1969.

In sum, Mr. Maisel observed, he thought the Committee should not be unduly influenced by the last few figures for individual aggregates, and that it should maintain its present policy which the blue book indicated would lead to a slow growth in M_1 and, considering the Treasury financing, no unusual growth in M_2 or M_3. He favored the staff's draft of the second paragraph of the directive.

He was disturbed by the suggestion that the Manager should permit market conditions to become a little tighter under a directive that did not specifically call for firmer conditions. If the Committee wanted to change policy, he thought it should say so explicitly in the directive. If, on the other hand, as he hoped, a majority of the members did not want to change policy, the Manager should be careful to avoid giving the market the impression that a change had been decided on.

With respect to the first paragraph of the directive, Mr. Maisel remarked that he would favor adding the word "somewhat" after the statement in the opening sentence that economic expansion had moderated. He would not want to say that the moderation had been less than expected since it would not be clear whose expectations were meant or when they had been held. In the latter connection, he noted that while the latest projection for GNP growth in the third quarter was considerably higher than those given in recent green books, it was very close to the projection in the green book prepared for the June 18 meeting.

Mr. Brimmer remarked that he had found Mr. Morris' comments about longer-run projections highly perceptive, and he hoped the Boston Bank's projection work would be successful. At the same time, he was not persuaded that it would be useful for the staff to attempt to prepare highly detailed projections for three or four quarters ahead on a regular basis. In any case, it was his impression that in formulating their views on policy most members of the Committee did give weight to likely developments in the economy over the coming six to nine months.

Mr. Brimmer said he personally was impressed with the impact of the policy measures taken although, like others, he had been somewhat disappointed by the lag in the response to the tax increase, especially on the part of consumers. He had no doubt, however, that a slowdown in the rate of growth of consumer spending would come about; and for that reason he thought the Committee should stay on its present policy course. He shared Mr. Galusha's expectation that the tax increase would be permitted to expire in mid-1969, and accordingly thought the Committee should be careful not to create excessive liquidity in the interim.

With respect to the directive, Mr. Brimmer continued, he agreed that there were problems with Mr. Hayes' proposed reformulation of the opening sentence. Unlike Mr. Maisel, however, he thought it would be appropriate to indicate that GNP growth in the third quarter was greater than the Committee had expected. Despite the staff's June projections, in recent months the Committee had anticipated a greater response to the tax increase than had occurred. If the opening sentence were to be changed, he would favor the following language: "The information reviewed at this meeting suggests that over-all economic expansion has slowed from its very rapid pace earlier in the year, but the degree of moderation has been somewhat less than expected. There has been no significant easing of upward pressures on prices and costs."

Turning to the second paragraph of the directive, Mr. Brimmer remarked that if the Committee wanted to seek firmer conditions he would hope it would choose Mr. Hayes' alternative A rather than B. To his mind, the latter could be read to imply the same policy course as the staff's draft, and he would not want to rely on a subtle difference in wording to effectuate a policy change. He personally did not favor such a change, and accordingly preferred the staff's draft. As to money market targets, he assumed that there would be somewhat greater pressure on the Federal funds rate in the coming period. He noted that the blue book had suggested a $400 to $600 million range for borrowings, and that Mr. Hayes had proposed a $500 to $700 million range. Since the difference was not great he would not pursue the matter.

Mr. Brimmer said he was concerned about the effect of the Treasury refunding on System operations. He recognized that the refunding would be a large one, particularly if the Treasury pre-refunded December maturities, and he doubted very much whether the Committee could afford not to be helpful. He hoped, however, that it would prove possible to provide the minimum amount of reserves consistent with that objective so as to avoid a large increase in bank credit.

Mr. Sherrill remarked that he was well satisfied with the situation in which the Committee found itself at present, which was better than might have been expected in view of the uncertainties that had been prevailing for some time. He preferred the staff's draft of the directive to the alternatives that had been proposed today. For the most part, the differences between the target ranges specified in the blue book--which were relatively wide--and those suggested by some members did not seem to him to be highly significant. The only area of substantial difference involved bank credit, for which a lower growth rate in October had been proposed than the 10 to 13 per cent range given in the blue book. But the blue book indicated that Treasury financing accounted for a good part of the projected increase. Since the period of heavy Treasury financing was about to end, he thought it was reasonable to discount the contribution of such financing to bank credit growth. If that were done, bank credit would be expected to increase in October at the relatively moderate rate of 5-1/2 to 8-1/2 per cent.

Mr. Sherrill said that while he would not attach great weight to bank credit growth at the moment he did consider the three-month bill rate to be important. The range of 5.10 to 5.40 per cent given in the blue book struck him as appropriate.

Mr. Hickman reported that economic activity in the third quarter was unexpectedly strong and prices advanced further. The recent price situation, in fact, was especially disquieting: wholesale industrial prices had accelerated in September and the GNP deflator had accelerated in the third quarter. There was some evidence that the pace of economic activity had slowed down as the third quarter unfolded, although over-all growth was greater than expected.

Mr. Hickman noted that about forty Fourth District business economists had met at the Cleveland Reserve Bank on September 30 to discuss the economic outlook. Their median GNP forecast revealed no basic change in the general contour projected at their previous meeting in May--namely, moderation in the pace of economy activity in the second half of 1968 and early 1969, and recovery in the second quarter. Beginning with the fourth quarter of 1968, quarterly changes in the median forecast for GNP were $11.5 billion, $9.5 billion, and $14 billion, respectively. The GNP changes forecast by the group were generally similar to those projected last May. The group expected that the economy would advance at an accelerated rate during the second half of 1969.

A major concern expressed at the meeting of business economists, Mr. Hickman said, was whether any politically acceptable fiscal-monetary policy mix could be designed and implemented that would cool off price inflation so long as the Vietnam War continued.

Their doubts seemed to reflect the pervasive inflationary psychology embedded in the attitudes of consumers and businessmen. Corroboration for that point of view was found in the results of successive Census surveys of consumer buying intentions, and also in surveys of Fourth District manufacturers, where further price advances had been consistently anticipated for several months. Moreover, Dun and Bradstreet's recent survey of businessmen's expectations for the fourth quarter revealed that the proportion expecting increased selling prices was very high; in fact, virtually the highest since the Korean War surge of 1951.

Against that background, Mr. Hickman was pleased to see some moderation in the rate of growth of bank credit in September, and he hoped that still further moderation would be achieved. He would favor aiming for a rate of growth in the bank credit proxy in October no higher than 6 to 8 per cent, including Euro-dollars, with a strong preference for the lower end of that range. He could not support the staff directive, which called for no change in policy, since it would permit bank credit expansion of 8-1/2 to 11-1/2 per cent, including Euro-dollars. That range, even if achieved, would exceed the long-term growth rate of real GNP, and would therefore be inflationary. Moreover, if recent experience was a guide, the reality was apt to exceed the projection. He thought it was a time to snug up a bit, and would dissent from both the staff's draft directive and from Mr. Hayes' alternative B. He would, however, vote for Mr. Hayes' alternative A.

Mr. Bopp commented that framing monetary policy during the past several months had been particularly difficult because of the problem of reconciling anticipations of economic weakness with the actualities of immediate economic strength. And the dilemma continued. The actuality, as he saw it, was that growth in the economy had moderated during the third quarter but not sufficiently to counter inflationary pressures built up earlier. Although the latest increase in consumer prices was less feverish than in preceding months, it was nonetheless too large. The fact that the pattern of relative stability in prices of industrial commodities had been broken was evidence that cost pressures were still finding their way into price increases.

Mr. Bopp was impressed that, despite the surtax, the depressing impact of inventory adjustments, and some moderation in Federal Government spending, increases in consumer spending had been strong enough to sustain growth in the third quarter. The vigor of retail sales had helped to erode the high levels of inventories accumulated earlier this year. As a result, although further adjustments in business inventories--mainly steel--might take place this quarter, present inventory-sales ratios were such that the drag of the adjustment would be less than many had expected.

Although current strength was undeniable, Mr. Bopp continued, future strength was still very much a matter of debate. However, a survey that the Philadelphia Reserve Bank had made in late August provided some clues about one important sector of the economy. A questionnaire was sent to treasurers of the nation's 500 largest manufacturing and 150 largest non-manufacturing corporations. About 60 per cent responded. A majority of the treasurers looked for a slowing down in the economy but no recession. In spite of the numbers forecasting slowing in the economy, the outlook for profits was more favorable than might have been expected. Thus, the treasurers expected after-tax profits to remain at 1968's record level. That was all the more surprising in view of their general belief that the surcharge would be extended and that costs would increase further. One explanation was that the slowdown anticipated was relatively modest and that prices would continue to rise. The respondents planned only modest increases in plant and equipment expenditures in 1969 and foresaw no difficulties in financing them.

Mr. Bopp commented that the Reserve Bank's September survey of large manufacturing firms in the District indicated that only 26 per cent expected general business conditions would have weakened six months from now. A majority expected cost-push inflation to continue for the next six months and only 12 per cent anticipated a decline in capital expenditures.

Even though both surveys indicated uncertainty about the vigor of the economy in 1969, Mr. Bopp continued, neither indicated fear of a recession. His own conclusion was that on the basis of neither anticipations nor current economic indicators were there grounds for believing that the adjustment had gone or was likely to go too far. He continued to believe that inflation was still the most important problem and that, in spite of the policy directive of no change during recent months, growth in the money and credit aggregates had fueled the flames.

Mr. Bopp noted the blue book was now forecasting a 10 to 13 per cent annual rate of growth for the credit proxy in October. In his judgment that was too high, even allowing for the impact of the upcoming Treasury financing. In view of the fact that the growth of the proxy had been consistently underestimated during the past few months, he was not much comforted by the forecast of a slowdown for November. He recommended that policy during the next three weeks should be to slow down growth in the credit proxy below the lower limit of the blue book range. That probably would involve a back-up in rates, which he thought the Committee should accept.

Mr. Kimbrel observed that with what had already been said today, there was little chance that his observations from the Sixth District would suggest any importantly varying viewpoint. He would like to place himself among those who had expressed misgivings over the high rate at which reserves had been supplied in the past three months.

Neither was there much to say about the Sixth District if expectations about the future, rather than what seemed to be going on now, was to form the basis for policy, Mr. Kimbrel remarked. All major sectors of the Sixth District's economy continued to show signs of strength. Consumers had received higher incomes and increased their spending, while construction contract volume was the highest on record for a single month. At banks, deposits rose substantially in September, and loan growth was the greatest since April.

In brief, Mr. Kimbrel said, there was nothing to report from the Sixth District to suggest that a less restrictive policy was appropriate. Such a policy could be justified only on the expectation that conditions had deteriorated markedly since the period to which the data related or were going to deteriorate significantly in the near future.

As a matter of fact, Mr. Kimbrel remarked, he believed the Committee had not intended to supply reserves as liberally as it had in the period of July through September, and that its policy had not been as restrictive as intended. In part, the Committee had been a victim of Treasury financing; but in part, he thought, the reserve growth had resulted from focusing on short-term money market rates. Although the Desk had conscientiously followed the Committee's instructions, more attention might have to be paid to measures of reserve availability if the Committee was not to end up with a policy that turned out to be more expansive than it intended.

For the present, the wording suggested by Mr. Daane in the first paragraph of the directive appealed to Mr. Kimbrel. Alternative B of Mr. Hayes' suggestions for the second paragraph was acceptable to him if it were understood that the Desk would be mindful of the emphasis placed on the conditions that had prevailed most recently. He would hope also that the Desk would resolve any deviation from projections on the side of modest firmness.

Mr. Francis commented that as the fourth quarter began it was evident that total demand for goods and services had continued to rise excessively and that an unacceptable rate of inflation persisted. He believed that appropriate moderation in the growth of total demand would not be achieved in this quarter or even early in 1969 unless monetary expansion was limited to moderate rates.

Some of his Reserve Bank's recent research indicated to Mr. Francis that the continued rapid growth of GNP in the third quarter could be attributed to the lagged effects of rapid monetary expansion and continued fiscal stimulus during the first half of this year. That research also indicated that fourth-quarter growth in GNP would continue to be strong in response to that earlier stimulus. The major effects of last summer's shift toward fiscal restraint, combined with any monetary restraint achieved in the present half year, most likely would not be manifested earlier than in the first half of 1969.

Given those lags between actions and effects on the economy, Mr. Francis thought there probably was little that monetary policy could do currently to influence total demand in the fourth quarter. The Committee should not take actions conducive to achieving desired growth of total spending in early 1969.

Mr. Francis said that creation of monetary assets during the past twenty months at a rate significantly faster than the rate of productivity growth in the economy had led to an excess demand for goods and services. The result had been inflation. In fiscal 1968, when the Treasury had incurred a cash deficit of about $25 billion, System holdings of securities had increased by about $5.5 billion and the money stock had increased by more than $11 billion. Since a large part of the deficit had been financed by monetary creation rather than by private saving, the growth of total demand had been much greater than the growth of supply of goods and services.

Now that the Treasury cash deficit and borrowing requirements were projected to be far smaller in fiscal 1969 than in fiscal

1968, Mr. Francis thought the Committee had an opportunity to keep the rate of monetary expansion properly below the rate in fiscal 1968. It should not feel compelled by Treasury financing requirements to provide Federal Reserve credit at the excessively rapid rates of calendar 1967 and the first half of 1968.

Consequently, Mr. Francis recommended that the Committee direct the Desk to conduct operations in such a manner as to maintain the growth rates of Federal Reserve credit, the money stock, and the monetary base at about one-half the rates that had been observed so far this year. Such action would be intended to reduce growth in total demand to a 5 to 6 per cent annual rate by next spring.

Mr. Francis noted that the money stock had shown little net change since mid-July. That period was too short to have the desired moderating effect on total demand. Therefore he favored adoption of the no change directive if that would be interpreted to mean a 1 to 4 per cent annual rate of growth of money in October, as the staff had projected in the blue book.

Mr. Robertson then made the following statement:

> At our last meeting, several members of the Committee (myself included) advocated our being patient a little longer in order to give some of the disconcertingly strong business and financial indicators a chance to "settle down". The evidence before us today, as I read it, indicates that there has been a little of that hoped-for "settling down"--but only a little.

> Consumer demand still is apparently quite strong, but other elements of final demand seem a bit softer. Projected GNP growth for the third and fourth quarters is greater than some mid-summer estimates, but nonetheless considerably below the excessive first-half pace. The big bulges in bank credit and money supply this summer seem to be in process of digestion. This is particularly so with regard to money supply, but also bank credit seems to be behaving more moderately, at least in the intervals between Treasury financings.
>
> In these circumstances, I would be prepared to continue on our present policy course a while longer. This would involve keeping member bank borrowing and the Federal funds rate in about their recent ranges ($400 - $600 million and 5-3/4 - 6 per cent, respectively). I recognize that other short-term and long-term interest rates might very well increase somewhat under this policy, for reasons already outlined in the blue book. That is quite all right with me. I do not want to see Federal Reserve policy so interest-rate-oriented that it has to be adjusted to counter every general rate movement generated by market forces. I regard the flows of aggregate reserves, money, and credit as being just as significant as interest rates; and I think in most cases our best policy course is suggested by the combined weight of both interest rate and monetary aggregate movements.
>
> With these views, I would be prepared to vote for the shortened directive proposed by the staff. I can even bring myself to vote for the one-way proviso as drafted this time, since it is so clearly tied in with the possible effects of the Treasury financing, even though I continue to feel that it is generally preferable to keep the proviso in two-way form.

Mr. Robertson added that of the various changes in the staff's draft of the directive that had been suggested today, only one seemed to him to represent an improvement. That was the suggestion to add the word "somewhat" after the statement in the opening sentence that economic expansion had moderated.

Chairman Martin recalled that at the previous meeting he had expressed the view that the stance of monetary policy was about right. While there were risks in complacency, he was even more inclined to that view today. During the past weekend he had carefully reviewed developments in the period since the Committee's meeting in mid-August in an effort to evaluate the System's performance. He was not sure that enough time had elapsed for a proper evaluation, but it was his impression that monetary policy had been about as effective as could have been reasonably expected.

As he had noted on earlier occasions, Chairman Martin observed, the market psychology that had developed when fiscal legislation was enacted in late June had posed a major problem for the System. In his judgment some adjustment of interest rates had been necessary to deal with that psychological reaction; otherwise, market forces would have led to developments that no one would have desired.

At present, the Chairman said, he would favor holding to a stable policy. A move toward firming now, on the eve of a Treasury refunding, was likely to be misconstrued and to set in motion a train of events that could be difficult to cope with. In the absence of a clear need for a policy change, the less the Committee did by way of overt action at this time the better it would be. As to the directive, while he would have no objection to some small changes in the staff's draft, he was inclined to accept the draft as written.

Mr. Brimmer said he also preferred the staff's draft. The alternative language he had suggested earlier was his second choice; it reflected an effort to work out a compromise between the staff's draft and a previous proposal for revision.

Mr. Daane remarked that he still saw some advantage in his own proposal to insert the words "although less than expected" after the statement that economic expansion had moderated. It was clear to him that the strength of the economy in the third quarter had been underestimated, and he thought there was some merit in recording the fact that the Committee's expectations had been somewhat less than perfect. However, he was prepared to accept the staff's draft without change.

Chairman Martin commented that he had been impressed with Mr. Maisel's observation that expectations had differed at different times and among individual members.

Mr. Hayes said he could accept either Mr. Daane's or Mr. Brimmer's proposed wording in the first paragraph. He thought it was correct to say that the slowing had been less than expected almost regardless of whose expectations one had in view, both within the System and among knowledgeable people outside, and he saw no disadvantage in recognizing that fact.

Mr. Brimmer remarked that while he had not checked all recent issues of the green book he recalled that one issue during the summer had shown a third-quarter projection for GNP growth as low as $10 billion, in contrast to the $14.6 billion increase shown in the latest issue.

Mr. Maisel said the point he considered important was that the Committee should not focus on developments in any one quarter taken alone. In both the second and third quarters there had been repeated revisions in the figures, particularly for consumer expenditures and business inventories. Much of the consumer spending that had originally been expected in the second quarter had occurred in the third; totals for the two quarters together were about in line with expectations.

Chairman Martin observed that projections of growth often seemed to be understated in periods of economic strength. For example, he recalled that around mid-year GNP growth in the second quarter was generally estimated at about $18 billion, but the present estimate was $21.7 billion.

Turning back to the directive, the Chairman noted that Mr. Holland had handed him a suggestion for the first sentence that might be satisfactory to the Committee--namely, to insert the words, "although less than projected" after the statement that economic expansion had moderated.

Mr. Daane asked how the Manager would interpret the language of the staff's draft of the second paragraph in connection with a possible uptick in interest rates. Specifically, would the Desk allow such an uptick if it developed?

Mr. Holmes replied affirmatively.

Mr. Hayes observed that there had been a noticeable change in market indicators, such as the Federal funds rate, during the past week. He asked whether the Manager would interpret the term "prevailing conditions" in the staff's draft of the second paragraph to mean the conditions prevailing most recently or those that had prevailed earlier.

Mr. Holmes noted that the funds rate had averaged close to 6 per cent during the past week, whereas earlier in the period it had averaged around 5-3/4 per cent. On the basis of the discussion today, he thought the Committee would prefer to have the funds rate average above 5-3/4 but below 6 per cent; the blue book suggested a level around 5-7/8 per cent. He assumed the Committee would accept a tolerance of about 1/8 point or so, depending on developments with respect to other indicators. In particular, it was his understanding that the Committee would not object to a funds rate of 6 per cent for several days in a row, as had occurred during the past week.

Mr. Mitchell said he thought the Committee did not contemplate any change in the target level for the funds rate. He personally would have no objection to fluctuations up to 6 per cent so long as there also were fluctuations in the other direction.

Chairman Martin remarked that he thought the Committee would want to give the Manager a reasonable degree of latitude. The Chairman then suggested that the Committee vote on a directive consisting of the staff's draft with the revision in the first paragraph that Mr. Holland had suggested. Any members who favored an overt change in policy presumably would cast a negative vote.

Mr. Hayes said he planned to vote negatively on the proposed directive, with some regret. He could not vote affirmatively if the language of the second paragraph were to be interpreted to call for money market conditions like those prevailing on average during the past four weeks. He had hoped it would be possible to reach agreement on at least a slight firming beyond that average, recognizing that not much additional firming could be accomplished in the coming period in view of the forthcoming Treasury refunding. He did not feel complacent about the present posture of monetary policy in light of the strength of inflationary pressures; in his judgment, the Committee had permitted bank credit to expand too fast.

Mr. Hickman said he would dissent from the proposed directive for essentially the same reasons as Mr. Hayes.

Mr. Daane observed that he planned to vote for the proposed directive, on the understanding that it did not call for resistance to upward movements in the bill rate within the range given in the blue book.

Mr. Galusha said he would cast an affirmative vote on the understanding that the money market conditions to be maintained were those specified in the blue book.

With Messrs. Hayes, Hickman, and Kimbrel dissenting, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The information reviewed at this meeting suggests that over-all economic expansion has moderated, although less than projected, from its very rapid pace earlier in the year, but upward pressures on prices and costs are persisting. Most market interest rates have changed little on balance in recent weeks. Bank credit and time and savings deposits expanded rapidly this summer, but the money supply has shown no net growth since July after rising substantially for several months. The earlier improvement in the U.S. balance of payments was not maintained in August and September, according to preliminary indications, and the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the forthcoming Treasury refunding operation, if bank credit expansion appears to be significantly exceeding current projections.

Chairman Martin then proposed that the Committee consider two of the policy papers from the Steering Committee of the U.S.

Government Securities Market Study that had been distributed on July 22, 1968--the papers entitled Policy Issues #7, Official Relationship to the Market, and Policy Issues #8, Use of Federal Reserve Resources to Finance Dealers.[1/] He asked Mr. Axilrod to comment on the first of the papers.

Mr. Axilrod observed that policy paper #7 considered proposals for a move toward a better defined official relationship to the market and for the formation of a dealer association to encourage more self-regulation in the U.S. Government securities market. The Steering Committee was recommending that the Treasury and the Federal Open Market Committee endorse the general conclusions of the policy paper[2/] and approve the specific recommendation to

1/ Copies of these documents have been placed in the files of the Committee.

2/ The main conclusions were as follows: "(1) In view of the fact that the present official relationship to the market has worked quite well, it would appear desirable to continue, clarify and develop this relationship rather than construct a new one; (2) The Treasury and the FOMC should reiterate publicly their direct and continuing interest in the proper functioning of the market and should also indicate that day-to-day operating responsibilities in this regard remain entrusted to the Manager of the System Open Market Account, in consultation with appropriate senior staff officials at the Treasury and the Board of Governors; and (3) The Manager, in consultation with senior staff officials at the Treasury and Board of Governors, has the responsibility for informing the Treasury and the Federal Reserve of any undesirable individual dealer activity or of any undesirable activity which appears to be developing more generally." It was also recommended that the Secretariat of the current study be continued on a permanent basis, and that the present tripartite Treasury-Federal
(continued on next page)

continue on a permanent basis the Secretariat for the current study of the U.S. Government securities market. The Secretariat, which was comprised of senior staff representatives from the Treasury, the Board of Governors, and the Federal Reserve Bank of New York, would be charged with continuing study of the operations and functioning of the U.S. Government securities market and would submit periodic reports to the Treasury and Federal Open Market Committee, as warranted. The Secretariat would constitute a body which the dealers could recognize as specifically charged with observing the market, and with which they could consult on appropriate occasions.

Mr. Swan commented that it seemed desirable to continue the Secretariat in the function outlined in the policy paper. It was not clear to him, however, whether the Steering Committee was also recommending official sponsorship of a dealer association.

Mr. Holmes indicated that the Steering Committee had concluded that the System and the Treasury should not actively sponsor but should welcome the establishment of a dealer association if the initiative came from the outside.

1/ (continued from preceeding page)
Reserve Committee that oversaw statistical reports be disbanded and reconstituted at a more operational level. Finally, it was noted that over the longer run some form of dealer organization might perform a useful function, provided that it could be organized in full conformity with anti-trust laws.

Mr. Brimmer said it was his impression from the policy paper that the formation of a dealer association by the dealers themselves was not likely. Some dealers apparently had taken steps in that direction but for various reasons they had not been successful.

In the discussion which followed, several members endorsed the Steering Committee's position on this issue, and it was agreed that the published report should make clear that it was not intended to provide official sponsorship of a dealer association.

Chairman Martin asked whether there were any further comments on the recommendation to establish the Secretariat on a permanent basis, and none was heard.

> It was agreed that the Secretariat for the current Treasury-Federal Reserve study of the U.S. Government securities market should be continued on a permanent basis, with responsibility for continuing study of the operations and functioning of the U.S. Government securities market.

The Chairman then asked Mr. Holmes to comment on policy paper #8, dealing with the use of Federal Reserve resources to finance dealers.

Mr. Holmes observed that that policy paper dealt with some of the most difficult questions that the Steering Committee had considered. The basic problem arose from the fact that Government securities dealers were part of the monetary mechanism and they could not, and should not, be insulated from the effects of tight money. On the other hand, in periods of tight money there were, at times, undesirable discontinuities in the availability of funds to dealers--when, for example, several large banks decided on a given day to reduce or to cut off their overnight dealer loan accommodations. Under such circumstances, since sharp changes in the cost and availability of loans to dealers could seriously impair their ability and willingness to make markets, some additional temporary financing by the System might be warranted. The appropriate timing and magnitude of any such financing help would necessarily be a matter of judgment, since pressure on the dealers was an integral element in the implementation of a tight monetary policy.

The Steering Committee had concluded, Mr. Holmes continued, that some official assistance in dealer financing could help at times to assure the satisfactory performance of the market without impeding the market's role in transmitting monetary policy. Accordingly, the Steering Committee was suggesting two possible approaches which the Federal Open Market Committee or--as appropriate--the Board of Governors or the Reserve Banks might consider in order to achieve that objective. The first approach, which might be used in periods of considerable stress or near-emergency, would be to assign lines of credit to nonbank dealers within which repurchase agreements could be made at the dealers' initiative. It would be understood that such dealer accommodations would be for relatively short periods of time and that the dealers would be expected to make necessary adjustments in the size of their positions or find other sources of financing. The criteria to be used in setting the lines of credit would include the net worth and the market performance of the dealer firms.

The second approach suggested by the Steering Committee, Mr. Holmes said, would be to give special consideration at the discount window to banks that were engaged in residual lending to dealers or that were seeking to finance temporarily enlarged positions in their own dealer departments. That approach might apply in more routine periods of monetary restraint. To the extent that it resulted in assistance to nonbank dealers, it would tend to reduce the need for the special RP facility. Indeed, the need to activate that facility might seldom arise, but its availability would tend to encourage the dealers to continue making markets under difficult circumstances.

Mr. Bopp indicated that he had serious reservations about providing special assistance to dealers, partly in light of Senator Proxmire's recent letter[1/] to Mr. Mitchell. The second paragraph of the letter underscored the concern of some members of Congress

---

1/ A copy of this letter, dated September 20, 1968, has been placed in the Committee's files.

about the competitive implications of the proposals for expanded use of the discount window and particularly their impact upon thrift institutions. It was true that the Steering Committee's suggestions did not deal exclusively with possible dealer financing assistance through the discount window, and it might well be that the procedures suggested were desirable on technical grounds. Nevertheless, he thought there was considerable question about the appropriateness of implementing the Steering Committee's suggestions under current circumstances, especially at a time when dealer positions were at historically high levels.

Mr. Mitchell noted that the Steering Committee's suggestions related to direct and indirect emergency assistance for dealers. He did not think that Senator Proxmire had emergency accommodations in mind, and in any case it was settled System policy to provide some form of assistance in emergency situations.

Mr. Daane commented that major money market banks were residual lenders to dealers. Implementation of the Steering Committee's suggestions would encourage such banks to continue performing that function under difficult circumstances.

Mr. Maisel remarked that one possibility would be for the System to accommodate emergency financing needs of dealers under the emergency credit provisions of the revised discount window mechanism, once they went into effect. However, he would make such accommodations available only through banks and at a substantial penalty rate, rather than at a rate only slightly above the regular discount rate. That penalty rate might be in the nature of the "super hell" rate used by the Bank of France; by way of illustration, it might be set at 10 per cent. Such an approach would assure the dealers of emergency financing assistance but would compel them to make prompt adjustments in their positions or to find other financing. He would have reservations about providing direct financing assistance to the nonbank dealers at their initiative. He thought such financing help would be inconsistent with the System's usual policy, as expressed in a draft of a letter to Mr. Patman distributed to Board members yesterday,[1/] of not accommodating through the discount window any borrower who did not hold deposits with the Federal Reserve, except under conditions of severe liquidity crisis.

Mr. Brimmer suggested that a decision on the present policy issue might be delayed until the question of the new discount mechanism was resolved. Senator Proxmire had in effect been given assurances that the System would not make any major changes in the discount mechanism until Congress had had a change to study the proposed changes at its next session. The letter to Mr. Patman noted that the System had a responsibility, as a lender of last

1/ Copies of this draft letter, dated October 7, 1968, and the final letter sent to Mr. Patman on October 9, 1968, have been placed in the files of the Committee.

resort, to various types of financial institutions. The dealers, however, fell in a different category from savings institutions. It was his hope that special lending facilities might be arranged for them at some future date, but he would prefer not to do so now.

Mr. Holmes commented that the Steering Committee was addressing itself mainly to a practical problem of a type that sometimes arose rather than to a basic matter of policy. For example, if the reserve position of a major bank suddenly tightened in the middle of a Treasury financing, the bank might borrow at the discount window instead of sharply cutting back its loans to dealers. However, not all large banks regarded borrowing for that purpose as appropriate and the attitudes of System discount officers toward such borrowing were not necessarily uniform. The Steering Committee felt it would be helpful to have an official statement to the effect that it was appropriate on occasion for banks performing a residual dealer lending function to engage in limited short-term borrowing at the discount window. No real policy change would be involved in such a statement. Similarly, on occasions when dealer financing was unavailable elsewhere and dealer financing costs were under substantial upward pressure, the Desk had found it necessary to make repurchase agreements with the dealers in order to carry out the Committee's instructions concerning money market conditions. In his judgment, to make RP's at the dealers' initiative under near-emergency conditions would not involve a fundamental change.

Mr. Axilrod remarked that the Committee might want to consider an approach under which it was agreed--in the language of the policy paper--that "some official assistance in dealer financing can help to assure the satisfactory performance of the market without impeding the market's role in transmitting monetary policy." If the Committee decided to endorse the proposed approach in principle, the published report of the U.S. Government securities market study might include such a statement along with an indication that the official assistance might involve flexible use of the discount window and of RP's. The report need not spell out in detail the manner or circumstances in which such assistance would be provided.

After further discussion, Chairman Martin suggested that the staff be asked to prepare, for further consideration, draft text of the final report along the lines Mr. Axilrod had suggested. He thought it would be desirable, if possible, to publish the report of the U.S. Government securities market study before the end of the year.

Chairman Martin then noted that at its previous meeting the Committee had considered a proposal to lend securities from the System Account to dealers in U.S. Government securities and to banks participating in a Federal Reserve Bank securities clearing arrangement. After giving further consideration to Mr. Hackley's opinion that the Reserve Banks did not now have authority to lend Government securities in the manner proposed--an opinion which evidently was shared by counsels at certain Reserve Banks--he (Chairman Martin) proposed that the matter be laid aside at this point and not treated in the published report on the current study of the U.S. Government securities market. The matter could be reviewed again after the turn of the year with the Secretary of the Treasury of the new Administration that would then be in office.

There were no objections to the Chairman's proposal.

Chairman Martin then noted that Mr. Maisel had suggested to him that it would be desirable to have a fresh examination of the adequacy of the Committee's current economic policy directive. As the members would recall, a group consisting of Messrs. Mitchell, Ellis, and Swan had made a study of the directive in 1964 and had advanced certain recommendations that the Committee had considered at length.

In his judgment, the Chairman said, a new study of the problem would be useful. If there were no objections, he would propose that it be undertaken by a group consisting of Mr. Maisel as chairman, Mr. Morris, and Mr. Swan. Mr. Swan would be in a position to provide continuity with the work of the earlier group.

No objections were raised to the Chairman's proposal.

It was agreed that the next meeting of the Committee would be held on October 29, 1968, at 9:30 a.m. The Chairman noted that the staff reports at that meeting would be in the form of a chart presentation involving a long-range economic projection. To allow time for a full discussion, the members might make their personal plans with the possibility in mind that the meeting could continue into the afternoon.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

October 7, 1968

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 8, 1968

The information reviewed at this meeting suggested that over-all economic expansion has moderated from its very rapid pace earlier in the year but upward pressures on prices and costs are persisting. Most market interest rates have changed little on balance in recent weeks. Bank credit and time and savings deposits expanded rapidly this summer, but the money supply has shown no net growth since July after rising substantially for several months. The earlier improvement in the U.S. balance of payments was not maintained in August and September, according to preliminary indications, and the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committe to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the forthcoming Treasury refunding operation, if bank credit expansion appears to be significantly exceeding current projections.