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 29, 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. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Axilrod, Hersey, Kareken, Link, Mann, Partee, Reynolds, Solomon, and Taylor, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Messrs. Gramley and Williams, Advisers, Division of Research and Statistics, Board of Governors

Mr. Wernick, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Keir, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Bernard, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Messrs. Eisenmenger, Eastburn, Parthemos, Baughman, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Richmond, Chicago, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on October 8, 1968, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on October 8, 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 October 8 through October 23, 1968, and a supplemental report covering the period October 24 through 28, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that conditions in the gold and foreign exchange markets had been generally quiet and uneventful since the preceding meeting of the Committee. The Stabilization Fund had nearly $400 million of gold on hand, which should make it possible to avoid any reduction in the Treasury gold stock for some time to come. Turnover on the London and Zurich gold markets had remained thin, with the price fluctuating around $39. The overhang of gold in the market resulting from central bank sales last winter continued to exert a strongly stabilizing effect. No South African gold had reached the market during the past month or so, but some might do so before the year was out.

On the exchange markets, Mr. Coombs continued, trading in most of the major currencies had been orderly and well balanced, with only minimal flows of dollars into or out of central bank reserves. The present precarious equilibrium was mainly the result of the following developments: the improvement in the British trade figures, coupled with the Basle agreement on the sterling balances; the tapering off of French reserve losses; the subsiding of earlier speculation on a revaluation of the mark; the continuing heavy inflows of foreign capital into the U.S. stock market; and the activity of U.S. commercial banks in pulling in Euro-dollars. The market nevertheless remained cautious and skeptical, and there had been no signs thus far of a reversal of earlier speculative positions taken against sterling and the French franc and in favor of the mark.

The recent experience was in striking contrast to that in earlier speculative episodes involving sterling, when there had been wide swings in payments flows with large outflows from Britain followed by large inflows. Recently, each new favorable development in the British situation had resulted in only modest reserve gains which had faded away within a few days; the French franc had remained at or close to the floor with the longer-term outlook suspect; and the German Federal Bank still had on hand nearly $1.5 billion of forward dollar contacts resulting from its heavy intervention in early September.

Meanwhile, Mr. Coombs observed, the more or less balanced trading in the exchange markets had minimized official recourse to the System's swap lines, and some progress had in fact been made in reducing outstanding debts. In the case of the Bank of France, drafts upon the $700 million swap line had risen to $450 million by mid-September, and Bank of France officials were becoming apprehensive that an expected deterioration in the trade figures over the winter months might bring about further sizable reserve losses. Largely--in his judgment--to economize on the swap line, the Bank of France had decided to execute dollar swaps in the market and had taken in nearly $200 million through such operations in recent weeks. They had devoted $75 million of the funds drawn from the market to paying down their swap debt to the Federal Reserve from $450 million to $375 million, while making roughly proportionate repayments on other central bank debts. He expected that they would offer $30 million of gold to the U.S. Treasury today, and they might devote a part of the proceeds to a further pay-down on their swap debt to the Federal Reserve.

Mr. Coombs noted that the Belgian franc had been under pressure for about a month and that swap drawings by the Belgian National Bank on the Federal Reserve had now risen to $120 million. He gathered from conversations with officials of the National Bank that they were becoming doubtful that recent outflows from Belgium would prove fully reversible in the near-term. Accordingly, they had been considering an early drawing of roughly $100 million on the International Monetary Fund, where they had a strong creditor position. The Belgian officials had been apprehensive, however, that the resultant publicity might result in further pressure on the franc. He had, therefore, suggested to the U.S. Treasury that an alternative solution might be found in a Treasury purchase directly from the National Bank of roughly $100 million of Belgium francs. Such a purchase would be useful, he thought, in enabling the U.S. Treasury to pay down $100 million of its debt to the Fund while simultaneously enabling the National Bank to liquidate an equivalent amount of its debt to the System. He was hopeful that that operation, which would be the first of its kind, would be executed within the next few days.

Finally, Mr. Coombs said, he might mention that the recent sterling balance arrangement negotiated at Basle had allowed the British to draw $600 million on the Bank for International Settlements in compensation for liquidation of official sterling balances in earlier months. The BIS in turn had raised those funds on the Euro-dollar market and local European money markets, without calling upon the central banks and governments underwriting the Basle arrangement. The Bank of England had applied the full amount of the drawing to repayment of debt incurred under the credit packages provided for the British last November and again in March of this year. The repayments, which cleared up roughly half of the debt that had been outstanding under those credit packages since March, included $320 million to the U.S. Treasury and $280 million to European central banks. Still outstanding under the November and March credit packages were debts of $230 million to the U.S. Treasury and $435 million to foreign central banks, the repayment of which was largely if not entirely dependent on a shift to surplus in Britain's balance of payments. In the eyes of the European central banks as well as the Bank of England, repayment of those debts would have priority over repayment of the Bank of England's $400 million swap debt to the Federal Reserve, since the former had been incurred at an earlier date than the latter. In addition, the System was exposed to further possible British drawings on the $1.6 billion still available under the swap line.

Mr. Coombs recalled that at the Committee meeting of June 18, 1968, he had expressed the view that the British might squeak through the rest of this year if they took three major policy measures. One was to extend a dollar guarantee to official holders of sterling. The British had been averse to such a measure at that time, but it proved to be necessary to open the way for the sterling balance credit arrangement that had subsequently been negotiated. Secondly, he had suggested that the huge overhang of debt incurred by the British Government since the end of the last war should somehow be restructured or refunded into longer-term obligations. A third important means proposed for relieving the strain on sterling was for the Bank of England to resume operations in the forward market--say, in the form of market swaps--as an alternative to central bank credit.

Mr. Coombs remarked that the sterling balance credit arrangement seemed not only to have checked any further liquidation but also to have brought about some moderate return flow of official funds to London in recent weeks. As for the second problem, that of refunding or restructuring the heavy overhang of official debt, the sterling balance arrangement had effectively immobilized more than $3 billion. Thus, a great deal had been accomplished by a single stroke. Another $1 billion of debt under the sterling balance credit package of 1966 had also been put on a longer-term basis. More recently, as he had indicated, the Bank of England had funded $600 million of short-term debt owed to the U.S. Treasury and foreign central banks through new borrowings from the BIS.

However, Mr. Coombs said, much remained to be done in that area. As he had indicated, there was now outstanding more than $1 billion of short-term debt to the Federal Reserve, other central banks, and the U.S. Treasury. All of that debt was on a three-month renewable basis, with no take-out in the form of medium-term borrowing from other sources now available. Moreover, Britain faced a heavy schedule of amortization payments on existing medium- or longer-term debt to the Fund and other creditors. Specifically, there were scheduled repayments to the Fund of $100 million in November 1968 and $800 million during 1969; and $200 million of debt to the U.S. and Canadian Governments matured at year-end. Since those debts had fixed maturity dates their repayment would have priority over that of the $1 billion of central bank debt.

Mr. Coombs observed that any such refinancings of British official debt would probably take some time to work out. In the interim, in the absence of a surplus in the British balance of payments, a considerable measure of relief might be attained through forward market operations of the type that the Bank of England had undertaken before and that the French were now engaged in.

Mr. Galusha asked whether the position of the Mexican peso had been adversely affected by the recent unrest in Mexico.

Mr. Coombs replied that Mexico had experienced an outflow of short-term capital in recent weeks, although one of much smaller dimensions than that which had occurred during the 1962 Cuban crisis. It was his understanding that the Bank of Mexico had made a drawing on its swap line with the U.S. Treasury. He had had no indication that they were contemplating a drawing on the System swap line in the near future.

Mr. Hickman referred to Mr. Coombs' comment that there had been no reversal of the earlier flows of funds related to speculation on a revaluation of the German mark, and asked whether it were not true that the mark exchange rate had moved down from its ceiling.

Mr. Coombs replied affirmatively, noting that since the speculation had subsided the German Federal Bank had sold about $150 million on an outright basis. That was a relatively small figure, however, in comparison with their earlier inflows of roughly $1.7 billion.

By unanimous vote, the System open market transactions in foreign currencies during the period October 8 through 28, 1968, were approved, ratified, and confirmed.

Mr. Coombs then noted that all of the System's reciprocal currency arrangements would mature in December. With the exception of the arrangement with the Bank of France, the swap lines had one-year terms. As he had mentioned at the Committee meeting of September 10, he thought the French might propose that their line also be put on a one-year basis. Advice to that effect had not been forthcoming from the Bank of France thus far, but it might be received during the next few weeks. Consequently, he would defer making any recommendation regarding renewal of the French swap line until the next meeting of the Committee. Today he recommended renewal of all of the other swap lines for further periods of one year.

By unanimous vote, renewal for further periods of one year of the following swap arrangements, having the indicated amounts and maturity dates, was approved:

Foreign bank	Amount of agreement (millions of dollars)	Maturity of latest authorized renewal
Austrian National Bank	100	December 2, 1968
National Bank of Belgium	225	December 23, 1968
Bank of Canada	1,000	December 30, 1968
National Bank of Denmark	100	December 2, 1968
Bank of England	2,000	December 2, 1968
German Federal Bank	1,000	December 16, 1968
Bank of Italy	1,000	December 30, 1968
Bank of Japan	1,000	December 2, 1968
Bank of Mexico	130	December 2, 1968
Netherlands Bank	400	December 30, 1968
Bank of Norway	100	December 2, 1968
Bank of Sweden	250	December 2, 1968
Swiss National Bank	600	December 2, 1968
Bank for International Settlements:		
System drawings in Swiss francs	600	December 2, 1968
System drawings in authorized European currencies other than Swiss francs	1,000	December 2, 1968

Mr. Coombs then noted that a $50 million swap drawing by the Bank of England would mature for the first time on December 4, 1968. Also, three drawings by the Bank of France would soon reach the end of their first three-month terms. Those were drawings of $50 million, maturing November 13, 1968; $20 million, maturing November 14; and $4 million, maturing November 15. He recommended renewal of all four drawings, if requested by the foreign central banks involved.

> Renewal of the drawing by the Bank of England and of the three drawings by the Bank of France was noted without objection.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period October 8 through 23, 1968, and a supplemental report covering October 24 through 28, 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:

> In the period since the Committee last met short-term interest rates moved higher and bank credit continued to expand vigorously. At the close of the period both the three-month Treasury bill rate and the bank credit proxy were at or above the upper end of the ranges projected for them in the blue book[1/] three weeks ago. Concern that the strength of the economy might require a firming of monetary policy to resist inflation, Treasury financing activity, and a large volume of new issues in the private capital markets all tended to push rates higher, with a fair amount of congestion developing in the capital markets

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

in the middle of the period. Revived hopes for peace in Vietnam, indications that the Treasury cash position was turning out stronger than had earlier been expected, and an underlying feeling that the economic effects of fiscal restraint would eventually be felt tended to restrain the rise in rates. While the financial markets have remained cautious and rate sensitive, the Treasury's offer of $3 billion June tax-anticipation bills was well received, and its refunding offer has also been accorded a satisfactory, if unenthusiastic, reception.

The increase in short-term interest rates affected bankers' acceptances, commercial and finance company paper, and certificates of deposit as well as Treasury bills. Towards the close of the period some of the New York City banks moved their negotiated rates on three-month CD's to the 6 per cent ceiling, although this was not universal. In yesterday's regular Treasury bill auction an average rate of 5.47 per cent was established for both three-month and six-month Treasury bills, up 19 and 11 basis points from the auction just preceding the last meeting.

Fairly large-scale open market operations were required over the period to deal with large variations in market factors and wide swings in the distribution of reserves between money market and country banks. Day-to-day money market conditions were also strongly influenced by the availability of Euro-dollar deposits and by the banks' continuing adjustment to the new reserve requirement rules. The major money market banks appear to have fallen into a pattern of alternating weeks of carry-over deficiencies and excesses. This pattern, as the blue book notes, has created a fluctuating weekly pattern of excess reserves closely akin to the pattern that existed under the old reserve regulations. In the week ending October 16, for example, when the major banks had carried over deficiencies, substantial injections of reserves were required to counter the very firm money market conditions early in the statement week brought about by the cautious management of bank reserve positions. On the final day of that statement week excess reserves built up early in the week finally caused money market conditions to ease, requiring a substantial absorption of reserves by the System. The reverse pattern prevailed in the statement week ending last Wednesday when it was apparent that a low level of borrowing and relaxed bidding for Federal funds early in the week would result in a reserve shortfall at the end of the statement week. So far it appears that the new reserve requirement regulations have tended to increase, rather than to reduce, the need for open market operations. Country banks have now apparently caught on to the new system and have begun to reduce net excess reserves--implying that somewhat higher net borrowed reserves would be consistent with unchanged money market conditions.

As the written reports note, the credit proxy for October is running at, or slightly above, the upper end of the range projected at the last meeting, while the tentative November estimate--at 9 to 12 per cent--is about double the still more tentative estimate made at that time. Given the concern of most members of the Committee about the recent rate of growth of bank credit, the proviso clause has been marginally in effect, although even keel considerations in the recent past and in the period ahead limit what can be accomplished under that clause.

The Treasury financing will, of course, tend to dominate the financial markets over the next few weeks. The offer of a six-year maturity option--in addition to an 18-month anchor issue--to holders of November and December maturities came as something of a surprise to the market in light of the fairly substantial volume of intermediate-term Treasury issues still available in the market. Nonetheless, the offering appears to have been satisfactorily received, with both issues trading at a premium of 3/32 on a when-issued basis at the close last Friday. A very cautious atmosphere prevailed yesterday with the premium on the when-issued securities declining by 1/32. Unless there are dramatic developments with respect to Vietnam before the books close on the financing tomorrow night, a heavy exchange into the reopened 5-3/4 per cent notes of November 1974 is unlikely, given the lackluster underwriting demand by dealers and commercial banks. The market is very tentatively guessing that the public may take about $1 billion of these notes, but investors are obviously waiting until the last minute to make up their minds. But even this amount would represent a useful bit of debt extension. As you know, the System holds $6.1 billion of the November 15 maturities and $169 million of the December 15 maturities. I plan to split the System subscription between the new 5-5/8 per cent 18-month notes and the reopened 5-3/4 per cent 6-year notes in line with the best guesses tomorrow on the likely public takings of the two issues.

In connection with the financing, the Treasury made public new estimates of its cash position for fiscal 1969 which indicate a substantial improvement from expectations at the time of the August refunding. On the Treasury estimates, no new cash will be needed over the balance of the calendar year--a $2 billion improvement over earlier estimates. A cash offering of June tax bills for payment in early December will, however, be necessary to pick up the attrition in the current refunding, and the Treasury could also anticipate its expected $1 billion January cash need at that time. I should note that neither the Board nor the New York Bank staff is as optimistic as the Treasury about the cash outlook, although our estimates have also improved somewhat. If our estimates turn out to be correct, there could be some problem with management of the Treasury's cash position at the Reserve Banks over the next couple of months. Confirmation of the Treasury's estimates, on the other hand, could have a significant impact on the market, which has also tended to think that the Treasury estimates are over-optimistic. In any event, we are about to pass the seasonal peak of Treasury financing pressure on the markets.

While there may be some further upward pressure on interest rates in the period ahead, there are a number of mitigating circumstances that prevent any firm conviction on this score. Further progress in the Vietnam negotiations, confirmation of the Treasury's estimate of its cash position, and a possible slackening of the corporate and municipal bond calendars--added to investment demand for Treasury bills coming from sellers of rights in the refunding--could tend to stabilize rates or move them lower from the relatively high levels they have reached recently. Basically, however, the market will tend to keep a close eye on economic developments and their implications for monetary policy once the Treasury refunding is out of the way.

Mr. Mitchell asked Mr. Holmes to comment on the time period for which monetary policy actions were likely to be constrained by even keel considerations in coming weeks.

Mr. Holmes replied that for the current Treasury refunding subscription books would close tomorrow and the settlement date would be November 15. He suspected that there would not be a large amount of dealer and bank underwriting of the refunding, and accordingly that there would not be a large overhang of the new issues in the market. However, it was difficult to predict the precise period for which even keel considerations would be important. For example, if there were a bombing pause in Vietnam the new issues would become very attractive and would tend to be put away quickly; but if the Vietnam negotiations took an unfavorable turn or there were other unsettling developments in the news, distribution would be hampered. As he had mentioned, the Treasury probably would come back to the market in late November with an offering of June tax bills for payment in early December.

Mr. Hickman commented that he would have strong reservations about using the time required to distribute newly issued securities as the criterion for the appropriate length of the even keel period. On that basis, one could argue that an even keel should have been maintained ever since the August refunding, since dealers still held large inventories of the securities issued then.

Mr. Holmes replied that he had not meant to suggest that an even keel was required until all of the securities issued in a financing had been distributed. However, it had been customary to allow a reasonable period for distribution, although the period that might be deemed adequate varied from one financing to another depending on the particular circumstances. As he had noted, he did not expect serious problems in connection with the current refunding.

Mr. Mitchell referred to Mr. Hickman's comment about the August financing and noted that dealers had retained large inventories as a matter of choice, not because a long period had been needed for distribution.

Mr. Hickman remarked that he would favor a Committee decision to maintain an even keel through some specific date--he would recommend November 15, the settlement date for the refunding--rather than permitting the length of the even keel period to depend on the progress of the distribution. Moreover, he would not consider the expected offering of a tax bill to require an even keel. Undue concern with Treasury financing operations could have the effect of ruling out changes in monetary policy for much of the remainder of the year.

Mr. Brimmer recalled that about a year ago the staff had prepared a number of memoranda on the subject of even keel, including one written by Messrs. Axilrod and Burns of the Board's staff.[1/] As noted in that memorandum, periods of even keel had typically extended from roughly one week before the announcement date to one week after the payment or settlement date of an exchange or cash refunding involving coupon issues. There had been a few exceptions,

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1/ This memorandum, entitled "The Behavior of Interest Rates, Bank Credit, and Marginal Reserve Measures during 'Even Keel': 1965-Mid-1967" by Stephen H. Axilrod and Joseph E. Burns, was distributed to the Committee on November 9, 1967, and a copy was placed in the Committee's files.

but as a rule even keel seemed to cover a period of several days before the announcement and after the payment date.

Mr. Holmes agreed that that had been the general pattern, adding that there had been some variation depending on specific circumstances.

Chairman Martin commented that it was also his impression that even keel usually lasted 5 to 10 days beyond payment date.

Mr. Mitchell asked Mr. Holmes whether he would view even keel considerations as having priority over a proviso clause calling for some tightening if bank credit was growing faster than projected.

Mr. Holmes replied that in his judgment the Committee would want to give priority to even keel considerations, particularly during the period in which the Treasury was engaged in setting the terms of a refunding and immediately thereafter when the subscription books were open. There might be some room for marginal implementation of a tightening proviso clause during a period of even keel, such as had been true in the interval since the previous meeting of the Committee, but the opportunity for such maneuvering usually was limited.

Mr. Brimmer noted that in his statement Mr. Holmes had indicated that the Desk intended to apportion the System's exchanges in the current Treasury refunding in line with the market's probable takings of the short- and long-term options being offered by the Treasury. While such a procedure for determining the System's exchanges might be appropriate as a general rule, he wondered whether there would be any advantages to departing from it at times when the Committee had special interest rate or other objectives.

Mr. Holmes replied that any given apportionment of the System's exchanges was not likely to influence market interest rates. At the extreme, it was possible that too large an exchange into the longer-term option might have a slightly depressing effect on the market, if some participants concluded that the System might want to sell some of the longer-term securities at a later date. He added that on the basis of current market guesses concerning the probable results of the refunding the System's exchanges might be split between the 18-month note and the 6-year note on about a four-to-one basis.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period October 8 through 28, 1968, were approved, ratified, and confirmed.

Chairman Martin then called for the staff economic and financial reports, supplementing the written reports that had been distributed prior to the meeting, copies of which have been placed in the files of the Committee. At this meeting the staff reports were in the form of a visual-auditory presentation and copies of the charts have been placed in the files of the Committee.

Mr. Bill made the following introductory statement:

It may seem an act of effrontery for the staff to present another long-term projection this morning--in the wake of our massive miss for the third quarter, on the eve of an election which could result in major changes in national economic policy, and in the midst of peace negotiations which--whatever the outcome--will undoubtedly affect significantly the public's demands for real and financial assets. But there are compelling reasons for a slightly--only slightly--chastened staff to stick its neck out again. Whatever the obstacles to foreseeing the future, policy today must be formulated in light of economic prospects relatively far ahead. And in formulating our views of the future, it is imperative to assess carefully the deviations from earlier projections, to distinguish temporary aberrations from developments of longer-lasting significance for the course of economic activity.

Our analysis today reflects a significantly different assessment of the future than that presented to the Committee last spring. The difference is attributable only in part to events in the private economy over the past summer. The principal factor requiring modification of our earlier projection is a revised outlook for Federal spending.

We are now projecting Federal outlays in fiscal 1969 at $2-1/4 billion above the midyear Budget Review, reflecting the exemptions granted by Congress for CCC and Medicaid, together with some additional increase in Vietnam outlays. I must warn the Committee that these estimates are somewhat higher than those of other Governmental agencies, not because of any superior military or diplomatic insights, but because our assessment of order trends and Congressional attitudes--and, frankly, our hunches--lead us to the high side of things. Of course, this assumes no major change in the level of hostilities in Vietnam, a governing assumption in this projection.

For purpose of this exercise, we have also assumed retention of the surtax after midyear 1969--it will be needed, unless Vietnam spending begins to decline.

Our analysis indicates that in light of these changed fiscal assumptions, the economy would need monetary restraint continuing at about the present level of intensity. The projection assumes interest rates staying near current levels, with a resulting moderation in growth of the aggregates between now and mid-1969. For bank credit, the projection implies an annual growth rate of about 7 per cent in the first half of next year--abstracting from projected changes in the Treasury's cash balance.

Mr. Partee then presented the following discussion of the outlook for GNP:

As we all know now, it was largely consumer behavior that led to unexpected strength in the economy last quarter. Gains in consumer expenditures were more than half again as large as in the previous quarter, though the rise in personal taxes sharply curtailed growth in disposable income. The savings rate fell from 7.5 to 6.2 per cent, one of the sharpest quarterly declines in almost a decade, adding $7 or $8 billion to consumer spending, and absorbing all of the impact of higher taxes.

It would be premature, nonetheless, to conclude that hopes for slowing the pace of aggregate demand have been lost. We still expect monetary and fiscal restraint to slow economic expansion, with growth in current dollar GNP projected to moderate to about $15 billion in this quarter. Moreover, it is reasonable to anticipate a further slowing in the first half of 1969.

We expect real growth to fall to about a 2 per cent rate by mid-year 1969. Beyond mid-year, the crystal ball becomes exceedingly murky--much depends on the Vietnam conflict, the course of other Federal expenditures, and the status of the surcharge. Our own tentative view suggests that the higher tax rates will need to be maintained unless there is a major slowing in Federal expenditures. For today's purposes, in evaluating consumer and business attitudes in the first half of 1969, therefore, we have assumed the surcharge will be continued.

In the course of fiscal developments assumed here, some--but not all--of the trimming of Federal expenditures expected earlier comes to fruition. A slowing in the expansion of Federal purchases for defense and other goods and services already has become apparent and further increases are projected to be quite small compared to other recent years. Nevertheless, our current estimates are higher than those used in our last chart show. CCC expenditures have been exempted from the spending cuts, and it appears to us that Vietnam and other defense outlays in fiscal 1969 may be about $1 billion above the estimates in the summer budget review.

Insistent demands for education, housing, and other services should push up State and local purchases throughout the next year, though slower growth in Federal grants-in-aid may be a retarding factor. We expect an average rise of over $2 billion per quarter in these expenditures over the next year, about in line with the recent trend.

If the projected course of Federal spending is realized total Federal expenditures as measured in the national income accounts would rise another $6 billion, annual rate, from the third quarter of this year to the second quarter of next--compared with a decline over the same period in our projection last spring. Meanwhile, tax receipts already have jumped sharply and are expected to show a further bulge in the first half of 1969, as large final settlements of 1968 tax obligations and higher social security taxes flow in.

The NIA budget consequently should move to a small surplus by mid-year, providing additional fiscal restraint. As noted, however, the shift in the Federal budget position under our present assumptions would be considerably less than we had estimated earlier.

Housing proved to be a source of much greater strength in the third quarter than generally had been expected. The spring drop in starts appeared to signal some weakening in residential construction. But the underlying demand for housing has been so strong that high rates of interest and reduced inflows of funds to nonbank depositary institutions failed to prevent a rebound in starts during the summer.

Our monetary policy assumptions call for maintenance of credit conditions that would likely be tight enough so that housing starts next year will rise only slightly from the third-quarter average. Scarcities of skilled labor and rapidly rising building costs should also act to dampen any additional upsurge in activity.

The dollar volume of construction, which should move up strongly in the current quarter in response to the recent jump in housing starts, is projected to show only a gradual rise thereafter. This would mean little further gain in real terms, since the dollar increases would mainly reflect rising materials and labor costs, offset in part by a continued shift to multi-family units which are less costly, on average.

Business fixed investment is also projected to continue a moderate advance into 1969. We have assumed about a 6-1/2 per cent rate of increase between the current quarter and the second quarter of next year, which is about the same as in the year 1968. We have just been informed that the new

McGraw-Hill survey, which is still preliminary and confidential until released toward the end of next week, is likely to show about an 8 per cent rise in 1969 as a whole, more than indicated here or in other recent private surveys. The need to offset higher labor and other costs is given by many businesses as the major reason for the step-up in planned investment expenditures.

But current low capacity utilization rates and uncertain profit prospects hardly suggest to us that an investment boom is in the making. Much of the dollar increase planned in fixed investment--even in the new McGraw-Hill survey--reflects anticipated price rises over the next year.

The level of investment in new plant and equipment we have projected would be large enough to increase manufacturing capacity next year by 5 per cent. With manufacturing output rising more slowly than the economy as a whole, the rate of capacity use is projected to decline to about 82 per cent by mid-1969. Growing available capacity could increasingly act to dampen advances in product prices.

Given the moderate growth projected for Federal purchases and for business investment outlays, increases in consumer expenditures in this and the next two quarters seem likely to be well below the large rise we have just experienced. Expected smaller gains in disposable income early next year stem partly from reduced employment growth associated with the moderation in economic expansion. But increased personal tax payments should also act to dampen the rise in disposable income.

Moreover, the slower growth projected for consumer purchases next year occurs despite a slightly lower savings rate. A repetition of the recent unusually large drop seems to us highly unlikely if the surtax is retained, however, so that increases in consumer outlays in the next few quarters should be more in line with the gains in disposable income.

Mr. Wernick commented on the implications of the GNP projections, as follows:

Weaker demands by consumers and others are likely to be concentrated in the goods producing sectors. Business fixed investment, residential construction, and consumer durables expenditures are all projected to show only moderate gains in real terms, and thus little growth should occur in goods output. The industrial production index, consequently, would show little further rise--continuing the trend evident since June of this year. In contrast, services are expected to maintain the strong upward momentum characteristic of the postwar period, providing important underlying support to the economy.

With real goods output leveling off next year and with productivity continuing to rise--although more moderately than this year--industrial employment is projected to edge down. In fact, employment gains in this sector have slowed markedly this year despite the rapid expansion in the total economy.

Non-industrial employment growth has also eased somewhat recently, in part because of a decline in Federal civilian employment. However, demands for manpower in trade, services, and State and local governments seem likely to remain strong. Rising employment in the non-industrial sector should continue to absorb a large proportion of the new entrants into the labor force.

But with industrial employment declining, unemployment is expected to begin rising during the projection period. Unemployment has remained close to 3-1/2 per cent thus far this year, partly reflecting an unexpected reduction in labor force growth. The labor force seems likely to resume a more normal growth pattern, however, and with employment less expansive, the rate of unemployment is projected to rise only slightly above the 4 per cent mark by mid-year, a somewhat lower rate than implied in our last chart show.

Though demands for labor may ease only moderately in the nonfarm economy, the absence of any large minimum wage increase and the relatively few major wage negotiations scheduled for early next year should act to dampen somewhat the large advance in hourly compensation--almost 7 per cent over the past year. However, any easing in wage pressures may be partly offset by smaller productivity gains as GNP growth slows. Consequently, we are projecting that the rise in unit labor costs will moderate only a little to about a 3-1/2 per cent rate in the first half of next year.

With labor and other costs continuing to climb, and demands relatively strong, the recent faster pace of industrial price increases is likely to be sustained for the remainder of this year. But by next year, the slackening in business and consumer demands should be reflected in some easing in industrial price rises, and perhaps a decline in sensitive materials prices.

Consumer price increases have moderated somewhat in recent months. However, service and nonfood commodity prices have continued to advance steadily. But there should be some slowing in the nonfood index in response to smaller increases in industrial prices, and some leveling in food prices in 1969. While services should continue to rise rapidly, the pace may be slowed somewhat by smaller anticipated advances in medical costs. Consequently, the consumer price index should moderate further next year.

On balance, if monetary and fiscal policies follow the course outlined in the projection, it appears that we should begin to make some headway by mid-1969 in slowing excessive rates of expansion in current dollar and real GNP, and thus ease pressures on prices and resources. The 3 per cent rise projected for the price deflator in the first half of 1969, while less than the increase experienced in 1968, is still well above the average of recent years. It seems clear, therefore, that the slower growth rate projected in real GNP for the first half of next year would have to be maintained for a longer period of time, if more substantial progress in halting inflation is to be achieved.

Mr. Gramley presented the following discussion of the financial aspects of the model:

Treasury officials recently suggested that the peak period of Federal demands on the credit markets is behind us. Our financial projection confirms this; even on a seasonally adjusted basis, total Federal borrowing--including issues of FNMA and other agencies no longer in the Budget--is expected to turn negative next spring, following the moderate increase expected for the latter half of this year. While these reduced demands stem mainly from the swing toward surplus in the Budget, projected changes in the Treasury's cash balance--an increase in the current half year and a decline in the next, with parallel movements in bank credit--also partly account for the sharp decline in Federal borrowing requirements.

Private borrowing, on the other hand, would show little change from recent levels, despite some slowdown in GNP expansion. The reduction in the projected total of funds raised, consequently, is almost entirely in response to the drop in Federal financial requirements.

The relative strength maintained in private credit expansion reflects principally the borrowings of households and businesses. The GNP projection implies a decline in aggregate net investment in these two sectors, but their borrowing is projected to hold steady at the levels of the current half year.

The projections thus imply a modest advance in the ratio of borrowing to net investment from the levels seen in 1968, reflecting mainly the increased importance of housing relative to other categories of expenditures. Housing outlays depend relatively more heavily on credit than do other types of investment expenditures. But the projected ratio remains below the 1961-1965 average, when credit market conditions were much easier.

Financing the gradual further rise in the dollar volume of residential construction would keep mortgage borrowing on the increase during the first half of 1969. Much of the advance, however, would entail the financing of multi-family dwelling units which depend less on the traditional specialized sources of mortgage credit.

The securities markets are projected to continue absorbing a high volume of issues--about the same amount as that in prospect for the latter half of this year--but less than the peak rates of the second half of 1967. This projection assumes that corporate security offerings would remain moderate, since liquidity has improved so much that the rush to sell long-term debt and build liquid asset balances is probably behind us. If plant and equipment expenditures prove to be stronger than we anticipated, however, corporate security issues could also be larger.

We are projecting State and local government security issues, included in the total, to remain at near-record levels in response to a continued rise in their capital outlays, and periodic congestion could well develop in this market.

Private demands for short-term credit, on the other hand, would likely recede a bit, given the GNP expenditure flows. Expansion in consumer credit would slow somewhat, as purchases of durables level out and repayments catch up with new extensions. And the relatively modest accumulation of inventories projected would limit the demand for business loans at banks. Thus, banks would not be under much pressure from the demand side in the period ahead.

Given the changed fiscal posture assumed and the underlying strength of private demands, we have postulated that monetary policy would, as a minimum, maintain the current degree of tautness in credit markets. This would require interest rates high enough to keep banks under some pressure. Thus, Treasury bill rates might have to remain in the range of 5-1/4 to 5-1/2 per cent. Considering the moderate projected volume of flotations, corporate Aaa new issue rates would stay in the 6-3/8 to 6-5/8 per cent range. Mortgage rates, on the other hand, might tend higher in response to heavy demands for housing credit and moderate savings inflows to the thrift institutions.

Under current conditions, market forces seem strong enough to sustain interest rates near the projected levels. But maintaining these rate levels in the face of reduced growth in GNP and lower total credit demands next spring could require monetary policy to resist downside market pressures, especially at the short end of the market. The result, consequently, would be significantly lower growth rates of bank deposits and credit during that period.

The most difficult element to project among the monetary and banking quantities is the stock of money. The recent growth in money holdings is not readily explained by past relationships of money demand to income and interest rates. Thus, the income velocity of money since late 1966 has risen considerably less than it had in earlier years, despite additional interest rate incentives to economize on cash.

But during this period the over-all turnover rate of demand deposits has been rocketing upward. This ratio reflects the demand for money to effect transactions not directly related to GNP--such as purely financial transactions--which need to be taken into account in formulating the growth in money consistent with any given GNP pattern.

Our projection of money balances assumes that financial transactions will continue to bolster money demand, but that there will be no repetition of the unusual factors associated with the step-up in such demand in the spring and early summer, when there was a sharp jump in stock market transactions and in delivery delays. Consistent with this assumption is a moderate decline in monetary growth to about a 4-1/4 per cent annual rate in the first half of next year.

Time deposit expansion over the first half is expected to be at about a 9 per cent annual rate, substantially below the recent pace. This reduction is expected to result from both the operation of interest rate incentives, in rechanneling private savings towards securities, and the abatement in corporate demands for liquid assets.

Given these deposit projections, total bank credit growth is expected to moderate in the first half of 1969 to a $21 billion, or 5-1/2 per cent, annual rate. Part of this reduction, however, would reflect the drop in Treasury cash mentioned earlier. Without that drop, the annual growth rate would be $27 billion, or 7 per cent.

With business and consumer loan demands expected to be relatively modest, and bank holdings of Governments expected to decline as Treasury borrowing falls, banks would have somewhat more room to acquire other earning assets. Demand pressures will likely insure attractive mortgage rates, and induce banks to increase their rate of investment in mortgages. In the municipal market also, where rates will be reflecting a continuing heavy supply of new issues, the net volume taken by banks is expected to rise.

The significance of the banks' more active participation in mortgage finance for attaining the projected volume of housing starts becomes more evident when the growth of nonbank savings accounts is considered. The nonbank institutions have done poorly so far this year. Given the relative attractiveness of market securities and the volume of personal savings implied by the projection, this performance is not likely to improve materially. With inflows continuing at about a 6 per cent annual rate, the availability of mortgage credit from these lenders probably will tighten somewhat, since it appears to have been sustained in recent months by expectations of better savings inflows and a willingness, if necessary, to run down liquidity.

These changed deposit flows result in a marked alteration in the shares of funds supplied to credit markets from what we are experiencing in the latter half of this year. The commercial bank share of total funds supplied drops to about 30 per cent--from nearly one-half in the current half year. Nonbank depositary institutions provide a slightly larger share of the total than in 1968, since their deposit inflows remain stable, while the total of funds raised declines. The share of funds supplied by the public--that is, by households, businesses, and State and local governments--rises significantly from the relatively low level in the last half of this year, as savings flows are rechanneled from deposits to market securities.

Mr. Reynolds presented the following discussion of the balance of payments:

There has been some improvement in the U.S. payments position this year, but less than had been hoped. The liquidity deficit before special transactions shrank from a record \$4.8 billion in 1967 to an annual rate of about \$3-1/2 billion in the first nine months of 1968, and probably also for the year as a whole. The published liquidity deficit has, of course, been much smaller, thanks largely to the investment of Canadian and German reserves in nonliquid U.S. assets.

The official settlements balance swung into surplus during the spring and summer, and probably will register a surplus for the year as a whole. But since this swing partly reflected an unsustainable inflow of foreign funds that were fleeing from sterling and the French franc, it cannot be taken as representing a lasting improvement, even though it has contributed greatly to more relaxed market and foreign official attitudes toward the dollar.

This year's payments improvement was the result of a huge favorable shift in private capital flows, which more than offset a marked further deterioration in the balance on goods and services. Early in the year, that balance fell to its lowest point since 1959. It has since recovered somewhat, and is expected to recover further through mid-1969. But it will still be at only half the peak rate reached in 1964, and far below the level needed for sustainable equilibrium.

Since late 1967, merchandise imports and exports have both been increasing, after leveling off earlier. But the expansion has again been very much faster for imports than for exports, and the trade surplus shrank to the vanishing point this spring. In the third quarter the import advance slowed down and exports accelerated, partly as a result of a speed-up in export shipments in anticipation of a longshoremen's strike.

The tendency of merchandise imports to rise more rapidly than domestic expenditures has been evident for many years, but has been particularly striking during the inflationary period since mid-1965. While imports leveled off temporarily during 1967, and are expected to do so again next year if domestic demand pressures subside as projected, the percentage increase for the 4-year period from mid-1965 to mid-1969 will have been nearly twice as large as the increase in GNP. Relative to domestic expenditures, the increase in imports has been especially large for autos, other nonfood consumer goods, and capital equipment.

Merchandise exports leveled off last year, mainly as a result of recessions in Germany and some other European countries. Since mid-1967, activity in Europe has been rising briskly, and the further advance projected into next year should stimulate U.S. exports not only to Europe but also to third countries that will be earning more from Europe. Shipments to Japan are also expected to be rising, following a pause earlier this year.

Nevertheless, the rise in total exports may slow down because agricultural exports will be less buoyant and exports of aircraft, which bulged this year, will be falling off. Thus the trade balance may improve only moderately, to about a $2 billion annual rate compared with an average of more than $5 billion over the years from 1960 through 1965.

As noted earlier, the worsening on current transactions this year was more than outweighed by a huge favorable shift in private capital transactions. To some extent, this shift was the result of new restraints on outflows of U.S. capital. Such outflows, net of funds borrowed through securities issued abroad, diminished from $5 billion in 1967 to an annual rate of only $1-1/2 billion in the first half of 1968, the lowest since the mid-1950's; and these flows are apparently remaining low in the second half. Little change in the net outflow is foreseen for 1969. Direct investors will issue less securities abroad than this year's record amount, and will draw more heavily on the proceeds of earlier issues, with little change in the net outflow of U.S. funds.

The net flow of U.S. bank credit next year may be close to zero. That would represent an unfavorable shift from the reflows of 1968. But there are likely to be offsetting changes in some other flows of U.S. capital, including a reduction in net U.S. purchases of foreign securities.

A second important change in the international capital accounts this year has been the remarkable increase in net foreign purchases of U.S. corporate stocks. Such purchases--aside from official U.K. liquidations--began to be large in mid-1967, and for 1968 they are expected to total more than $1-1/2 billion. Probably it would not be prudent to count on continued inflows at this record rate, especially if U.S. corporate profits and profit prospects begin to look somewhat less buoyant; on the other hand, there does seem to have been a fundamental change in attitudes of foreign investors which could sustain this inflow at a rate that would be high by historical standards. Our projection of something over a $1 billion annual rate for the first half of 1969 is intended to represent a balancing of these views.

A third element of change in the capital accounts--affecting only the official settlements balance--has been the heavy inflow of foreign private liquid funds this year, particularly through the foreign branches of U.S. banks operating in the Euro-dollar market. Through mid-October the outstanding liabilities of U.S. banks to their foreign branches had increased by a startling $3-1/2 billion--nearly 100 per cent. As noted earlier, the ready supply of Euro-dollar deposits owed much to sterling's difficulties and to the French crisis. Also, U.S. corporations borrowed abroad at long term well in advance of need, and placed the proceeds in Euro-dollar deposits. Since these special factors on the supply side are not expected to be present during 1969, the inrush of liquid funds is not expected to persist on balance, although there may continue to be wide short-term fluctuations in outstanding liabilities to branches.

The net result of all these prospective developments is likely to be a moderate further diminution in the deficit on the liquidity basis before special transactions--perhaps to an annual rate range of $2 to $3 billion--as an improvement on current account outweighs a slackening in inflows of foreign nonliquid capital. The official settlements balance, however, will be adversely affected by the subsiding of inflows of liquid funds, and hence is likely to move into deficit, though to an extent that is unpredictable within wide margins. The over-all payments position will be one of deficit on either basis of calculation.

Beyond mid-1969 there will be the danger of renewed deterioration if import expansion accelerates again as domestic activity regains momentum. Thus, even if capital flows continue to be exceptionally favorable, further progress toward equilibrium would still appear to be dependent upon some improvement in the U.S. international competitive position. Assuming no change in exchange rates, this improvement would require a further abatement of domestic inflationary pressures as well as the continuation of buoyant economic conditions abroad.

Mr. Brill concluded the presentation with the following comments:

Summarizing this presentation is not easy. The change in staff outlook since last May is not measured adequately by the difference in the rise of nominal or real GNP projected for next year. In fact, the projected GNP growth is not very different now from what it was last spring. But our earlier outlook was for an economy weakened by an exceptionally severe fiscal bite and needing moderate monetary ease to stimulate flagging private demands. Today's presentation shows an economy in which the fiscal bite is much less severe, and in which private demands are sufficiently strong to require some monetary restraint.

Certainly the initial reaction of consumers to the tax increase was indicative of latent strength in private demands. Growth in consumer spending during the third quarter was exceedingly large--with pre-tax incomes higher and the savings rate dropping far more than we had expected. The vigor of consumer buying has sustained the momentum of economic expansion into the fourth quarter--if for no other reason than that auto manufacturers have been induced to set production schedules at record levels.

The consumer sector cannot, however, be counted on to continue so dynamic a role, and we are projecting a distinctly slower pace of expansion in consumer spending for this quarter. This seems consistent with trends in retail sales--which show progressively smaller monthly gains since July, and the possibility of a small decline in October. We are probably beginning to see the effects of the tax increase in this sector, even though it has come later than anticipated.

The major factor requiring rethinking of economic prospects has been the change in the outlook for fiscal policy. We still expect the high employment budget to swing into surplus early next year. But the swing we are projecting now is much smaller than expected last spring. Since then, budget estimates in a number of categories exempted from the ceiling--including veterans and social security benefits, interest on the debt, CCC support operations and Medicaid--have all been revised upward substantially. And we also are projecting Vietnam outlays a little higher for the fiscal year than our counterparts in other Government agencies. We are aware that our estimates of Federal spending could be overstated, even without a change in the course of the war.

But on the other hand, a major element of private strength--the rise in prospective capital outlays indicated in the latest plant and equipment survey--has not yet been folded into our estimates. This demand for capital goods could bring with it a larger inventory build-up than we have projected, and also more income and consumer spending.

Moreover, if we look beyond the first half of the year, some of the factors restraining consumer demands next winter and spring--particularly the impact of higher social security taxes and retroactive tax payment on 1968 liabilities--would not be limiting disposable incomes later in the year, and another large Federal pay boost is scheduled at midyear. The combination of rising investment outlays and a surge in disposable incomes would threaten resumption of strong inflationary pressures in the latter part of 1969.

Inflationary pressures have been with us so long already that expectations of further cost and price rises are beginning to be fundamental factors in the spending decisions of businesses and consumers. There has been some slowing in the rise of consumer prices, and the figures for September to be released this morning will, superficially, show even more deceleration. But one must use the latest figures cautiously; appropriate adjustments, of the type incorporated in recent green book[1/] analyses, would likely show that little if any further slowing had occurred, and the acceleration and broadening of the industrial price advance in October does not suggest any further easing in price pressures or of inflationary expectations generally. Shock treatment to eradicate these expectations abruptly would run grave risks of economic dislocation, but it is vital to make a clear and visible start on the road to control of inflation.

Much the same conclusion can be derived from the analysis of our international payments situation. Our trade balance has deteriorated badly over the past several years, and the improvement we can realistically expect over the next several quarters will still leave us far below the

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

rate needed to sustain equilibrium in our over-all payments accounts. The modest improvement projected is perhaps the minimum necessary to hold in place existing international financial arrangements.

The appropriate course of monetary policy, it would seem to us, would be to validate the degree of fiscal restraint we are getting and to ensure that an appropriate slowing in GNP growth does occur. As was noted earlier, we believe that maintaining interest rates at around current levels would serve to hold down credit expansion and GNP growth in the first half of next year to projected rates. Such a policy could cool off the resurgence in housing activity, since traditional lenders in this area seem currently to be acting in anticipation of lower interest rates and much larger savings inflows.

The task of maintaining this degree of restraint through early 1969 would thus not be easy, in the context of downward pressures on bill rates arising from the reduction in Federal borrowing, and in a climate of reduced GNP growth and an upward creep in the unemployment rate.

In the near-term, however, it should not be too difficult to maintain market rates in the desired range--barring, of course, a decisive change in the Vietnam situation, from which we have abstracted in this projection and in the blue book. Seasonal upward pressures on bill rates, and the general market atmosphere of uncertainty about the war, the election, the economy, and monetary policy, are likely to keep market rates from any significant move in either direction. Even keel considerations suggest keeping the Federal funds rate within the range in which it has fluctuated recently, averaging around 5-7/8 per cent. This would probably result in a 3-month bill rate ranging from 5-1/4 to a bit over 5-1/2 per cent. Associated with these rate levels would likely be a level of member bank borrowings in the $400 to $600 million range, and a credit proxy that shows little net change from month-end to month-end, but with an average for the month that would be from 9 to 12 per cent (annual rate) over the October average.

Perhaps an even keel instruction is appropriate at this juncture for more reason than Treasury financing operations alone. Before this Committee meets again, markets will have had to cope with election results and further peace

> negotiations. Since any of the possible outcomes of either event will take time to assess--at least for their longer-run implications for the economy and financial flows--we are probably best advised to sit tight.

Mr. Hickman noted that one assumption underlying the projection was that the surtax would be continued after mid-1969. He asked how the projection for the first half of 1969 might differ if it were assumed that the surtax would be permitted to expire on June 30.

In reply, Mr. Brill said that advance public knowledge that the surtax would be allowed to expire at midyear probably would result in a stronger second quarter, with some of the spending that otherwise would have occurred in the second half brought forward into the earlier part of the year. He added that a preliminary analysis by the staff of prospects for the second half of 1969 suggested so much strength even with the surtax that, under the other assumptions of the projection, it seemed quite clear that the surtax would be needed. It was for that reason that its retention had been assumed in the first-half projection presented today.

Mr. Hickman then remarked that it probably would be desirable for the staff to re-examine the assumptions underlying the model shortly, when the elections would be over and the situation with respect to Vietnam probably would be clearer.

Mr. Mitchell noted that the staff described the policy course it recommended--maintaining about the prevailing level of interest rates--as one of monetary restraint. He wondered whether borrowers would not become accustomed to the present level of interest rates, so that that level would not involve very much restraint. It seemed to him that a higher level of rates might be needed in order to get as much restraint as the staff's analysis suggested would be desirable.

Mr. Brill replied that in its projections the staff had tried to take into account possible shifts in the responses of spenders to existing monetary conditions. In the housing area, at least, such shifts were likely to work in the direction of damping activity. Residential construction had been high recently partly because of the basic strength of underlying demand for housing, but also because nonbank lenders were, in a sense, mortgaging their future by extending mortgage credit at a higher pace than appeared to be supportable by inflows of funds at recent rates. Accordingly, the availability of mortgage credit from nonbank lenders was projected to tighten somewhat if prevailing monetary conditions were maintained.

Mr. Hayes noted that for much of the recent period staff projections of bank credit had tended to underestimate growth. The projection in today's model for bank credit growth at a rate of about 5-1/2 per cent in the first half of 1969--and the associated projection for time deposit growth at a rate of about 9 per cent--struck him as highly conservative. He wondered whether those projections were not overly optimistic with respect to the amount of slowing in prospect.

Mr. Brill commented that not all of the staff members who had worked on the model concurred in the view that time deposit growth would slow as much as indicated if prevailing interest rate levels were maintained. The projected slowing was based in part on the notion that with corporate liquidity demands largely satisfied corporations would not be borrowing heavily in capital markets and investing the proceeds in CD's. Apart from the fact that there was some disagreement within the staff, the projection might well have to be reconsidered to allow for the implications of the McGraw-Hill survey results. If there were indications that plant and equipment spending would be much stronger than assumed in the model, the projections of both corporate security offerings and time deposit growth in the first half of 1969 perhaps would have to be revised upward.

Mr. Maisel referred to Mr. Gramley's comment that if the expected decline in the Treasury's seasonally adjusted cash balance was discounted the growth rate projected for bank credit in the first half of 1969 would be 7 rather than 5-1/2 per cent. He asked whether a corresponding adjustment for the second half of 1968, when seasonally adjusted Treasury balances were rising, would not result in a lower projection of bank credit growth for that period.

Mr. Gramley replied affirmatively, noting that the two adjustments would be of roughly the same order of magnitude; the increase in the projected Treasury balance, seasonally adjusted, from June 30 to December 31, 1968 was about $8 billion, and the decline projected for the following half year was about $6 billion. He added that the bank credit figures under discussion were the end-of-month series and that, while the effects of such adjustments on the bank credit proxy series would be similar in direction, they would be much smaller in magnitude. For example, the annual rate of change in the bank credit proxy for the second half of 1968--measured in terms of the relation between daily-average member bank deposits in June and December--would be reduced by only a small amount--perhaps 1/4 of a percentage point--if the change in average Treasury balances between those two months was discounted.

In reply to a question by Mr. Hickman, Mr. Gramley said that for the first half of 1969 the projection for the bank credit proxy after discounting the expected change in Treasury balances would be about the same as for the end-of-month series, or 7 per cent.

Mr. Hickman then remarked that growth in bank credit obviously would have to slacken considerably from the rates recently experienced and projected for November if the real economy was to perform in the manner portrayed by the model. He was inclined to agree that growth at about a 7 per cent annual rate would be appropriate, but he was not at all sure that such slowing would be consistent with maintenance of interest rates at current levels. In his judgment the Committee should be prepared to pay whatever price was required in terms of higher interest rates in order to slow bank credit growth to about a 7 per cent rate.

Mr. Brill commented that the staff had not intended to imply that 7 per cent was the right growth rate for bank credit in the first half of 1969 and that the Committee should do whatever was necessary to achieve that rate. Rather, the staff was indicating that maintenance of the current level of interest rates was likely to be consistent with a 7 per cent growth rate for bank credit. Also, in the staff's judgment--which of course could be wrong--the current level of interest rates was likely to lead to some pinch on thrift institutions; it probably would keep inflows down to a level that would make them scramble for funds to make good on commitments, which had been at a rapid pace recently. Admittedly, not much of a financial pinch was implied for other sectors of the economy, but nevertheless the model suggested that real growth would slow to about a 2 per cent rate in the first half of 1969.

Chairman Martin remarked that the staff obviously had worked hard in preparing today's presentation and in his judgment they had done an excellent job. Of course, the projections were intended simply as guides to possible developments and not as literal predictions of the future.

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

> The business picture continues to be unexpectedly strong. We still lack any really convincing evidence of a substantial slowdown. While I would expect gains in GNP for the current quarter and for the first half of next year to be smaller than in the third quarter, the economy will probably be operating at a somewhat higher level in relation to resource availability over the next three quarters than we had expected. With this outlook prospects have greatly diminished for a significant slowdown in the rate of price increases over the coming months. What little can be seen of the last half of 1969 is even less encouraging as regards the outlook for price stability. Price pressures are likely to intensify again in that period--and especially so if the tax surcharge is allowed to expire. In sum, there is a probability now that the fiscal package, while bringing some slowdown, will not put enough of a real check to the inflationary pressures and inflationary psychology that are now so firmly imbedded in the economy.
>
> We have discussed so often the highly disturbing state of our underlying balance of payments that it seems unnecessary to dwell on the figures today. But it is obvious that with this deficit running around $3-1/2 billion for the full year and with no clear prospect of a major change for the better next year, the present happy state of the exchange markets could take a serious turn for the worse at some time over the coming months. Very high imports have of course been the most damaging

factor in our trade balance, but there is beginning to be some evidence of damage to our competitive position as an exporter. As we look ahead, it seems inevitable that the foreign credit restraint program with respect to banks and other financial institutions will inevitably show deterioration from the strong net inflow of 1968. It is also problematical whether U.S. stock purchases by foreign investors can be maintained at the very high level prevailing through most of this year.

It seems to me that bank credit is still growing at an excessive rate, given the inflationary pressures in the economy. I find it very hard to justify a 12 per cent credit proxy growth rate in October following a 13 per cent rate in the third quarter--about three times the rate of growth of the proxy during the first half of the year. The October rate remains high even after adjusting for liabilities of U.S. banks to their foreign branches. The present 9 to 12 per cent projection for November is discouraging. I am impressed by the fact that throughout recent months most early projections have underestimated the actual growth of the proxy by wide margins. While the money supply proper is to my mind a somewhat less significant indicator, the recent resumption of sizable increases in the projections seems unfortunate.

I am quite mindful of the fact that we are in the midst of a large Treasury refunding operation which calls for maintenance of an even keel policy until some time around the middle of next month. Thus, an overt policy change is out of the question at this time. However, this does not preclude our instructing the Manager to maintain maximum firmness consistent with the Treasury financing requirements, which might involve member bank borrowings in the upper part of the $400 million to $600 million range recently prevailing, and a Federal funds rate of from 5-7/8 per cent to 6-1/8 per cent. It would also involve resolving doubts on the side of firmness. The difficulty in maintaining steady money market conditions while banks are learning to manage their reserve positions under the new accounting procedures makes it desirable to widen the range of the Federal funds target; and since net borrowed reserves have less meaning than before, this measure should be further de-emphasized as a target variable. I see no reason why movements in the bill rate should have any important influence on open market operations in the period ahead.

As for the directive, the first paragraph of the staff's draft[1/] seems quite appropriate, except that I would change the statement regarding the money supply to read: "The money supply, after moderate growth on balance during the third quarter, has increased more rapidly in recent weeks." In my view this language would be more accurate, since the increase in the average level of the money supply in the three months from July through September works out to an annual growth rate of more than 4 per cent. I would also accept the first part of the second paragraph, and I would urge that we retain a one-way proviso in view of my concern, which I believe is rather widely shared, over the continuing tendency for bank credit to grow faster than we would like. In fact, given the present October-November projections, I would strengthen the proviso clause to read: "provided, however, that operations shall be modified, to the extent permitted by Treasury financing, if bank credit appears to be expanding as rapidly as currently projected."

Over recent years there have been many occasions when System representatives have strongly denied any claim to infallibility in our judgments. I think, however, there have been few instances when we were prepared to point to a specific action as having been a mistake. While I am not advocating any unnecessary public emphasis on such errors as we may have made since early summer, I do believe that we should admit to ourselves that we probably did ease credit conditions too much and too soon. This does not mean, however, that it is either practicable or desirable to reverse all of the measures taken since late in the second quarter of the year. It does mean, in my judgment, that we should recognize that inflation is a far greater risk to the economy under present conditions than recession and that we should be prepared to examine the policy implications of this fact very carefully over the coming weeks and months.

Mr. Francis observed that total demand for goods and services had continued to rise excessively, adding to inflationary pressures and contributing to deterioration of the nation's balance of trade.

1/ Appended to this memorandum as Attachment A.

Recent growth in private spending reflected primarily the lagged response to monetary and fiscal actions taken before midyear. Stabilization actions since June were likely to have most of their impact later this year and early next year.

Some commentators had indicated a belief that monetary influence had eased in recent months, Mr. Francis said. Total commercial bank credit had increased at a 15 per cent annual rate in the last three months compared with an 8 per cent rate in the previous six months. Money plus time deposits had gone up at an 11 per cent rate in the last three months compared with a 7 per cent rate in the preceding six months. In his opinion, those developments should not be interpreted as evidence that monetary influence had been more expansionary since midyear. Those accelerations of growth had been due chiefly to commercial bank reintermediation rather than to increased monetary expansion. The reintermediation, resulting from a drop of market interest rates relative to Regulation Q ceilings, reversed the disintermediation of last spring, with banks regaining their role in the flow of savings into investment.

Mr. Francis believed that monetary influence on total demand since midyear was probably better measured by the trends of demand deposits, the money supply, and the monetary base rather than by bank credit. In the past three months the money supply had risen at about a 2 per cent annual rate compared with a 7 per cent annual rate in the first half of the year. The recent slower growth rate of money had reflected three developments: (1) a slower rate of injection of Federal Reserve credit and of growth in the monetary base, (2) a buildup of Treasury deposits from unusually low levels last July, and (3) a utilization of reserves to support a substantial bank reintermediation by means of time deposits. He believed the moderated rate of monetary expansion had been quite appropriate for the objective of slowing the growth of aggregate demand for goods and services and reducing inflationary pressures.

A perspective of economic prospects over a period of six to nine months appealed to Mr. Francis since there was a high probability that monetary actions adopted now would operate with a lag. In his opinion, the immediate consideration should be to agree upon a desired rate of growth of total spending for the first half of 1969 and then to decide what current policy appeared most conducive to that end.

Mr. Francis suggested a 5 to 6 per cent compounded rate of growth in nominal total demand as the target for the first half of 1969. That desired growth in total spending was about the same as this morning's staff projections. Such moderation of demand growth from the recent 9 per cent rate would reduce inflationary pressures.

However, because of past excesses and lags in price adjustments, over-all prices would still increase. Hopefully, the Committee could reduce the annual rate of rise to about 3 per cent in the first half of 1969 as was projected this morning. Real product, which had been increasing at an unsustainable 5 per cent or greater rate, might be expected to fall to roughly a 2 to 3 per cent rate, which might be less than the attainable longer-run trend. Such a cutback in real output growth seemed, however, to be a necessary price to pay for reducing the strong inflationary pressures.

Over the longer run, Mr. Francis said, as price inflation moderated, total spending might be reduced gradually to a 5 per cent rate, which would possibly accommodate a 4 per cent rate of growth of real output and not much more than a 1 per cent a year rise in prices.

It was Mr. Francis' opinion that a 5 to 6 per cent rate of growth in nominal GNP in the first half of 1969 would not be assured if money were allowed to grow at a 7 to 9 per cent rate in the near future as projected in the blue book. His analysis indicated that that desired GNP growth might best be promoted by a 2 to 4 per cent rate of growth in money during the remainder of this year. That rate of growth in money might be fostered by a 3 to 4 per cent rate of growth in the monetary base.

Mr. Kimbrel commented that in his day-to-day contacts with bankers and businessmen throughout the Sixth District, he found it harder and harder to explain the present policy position of the Federal Reserve. Few of them, of course, recognized the complexities and often conflicting forces that the System had faced. He pointed out to them the complications imposed by Treasury financings and the troubles that might have developed had expectations for easing been shattered after the passage of the fiscal restraint package. He also pointed out the disintermediation problems that had been avoided and asked them to be a little patient for the slowdown that was bound to come, and the need to avoid "overkill." Nevertheless, they continued to say they were bewildered by what they considered to be the failure of the System to react to inflationary pressures.

Mr. Kimbrel remarked that the one view held in common by those attending one of the Atlanta Bank's recent regular conferences of leading businessmen was the expectation of continuing inflation. Their plans were based upon their belief that inflationary pressures were growing. The strong consumer spending of the third quarter, they believed, proved that consumers were catching the fever and they looked for a further reduction in the saving rate. They could see no relief to rising costs, especially labor costs. Construction programs were being accelerated; they would want more funds; and they had no alternative to raising prices.

Mr. Kimbrel said he realized, of course, that the people he talked with might not be representative of businessmen generally. Moreover, he knew the consensus of businessmen might at times be a completely unreliable guide. However, the latest economic and financial information from the Sixth District did little to challenge their conclusions.

Mr. Kimbrel noted that businessmen interpreted the uneasy state of the labor market as leading inevitably to higher labor costs. Although the longshoremen's strike, which could have affected the Gulf Coast region of the District, was averted by invoking the Taft-Hartley Act, several minor labor disputes were reported in September and the first half of October. In Atlanta, Atlantic Steel's 1,160 workers had been on strike since September 15; Humble Oil (Baton Rouge) had a two-day strike involving 1,700; and there were several minor disputes involving about 1,200 workers.

Construction continued to make gains, Mr. Kimbrel said, with the greatest strength in the larger cities and Florida. A possibility of some future decline in plant and equipment spending, however, was suggested by the tabulation of announcements of major new or expanded manufacturing plants in the Sixth District states. For the third quarter, the projected cost totaled $417 million, down sharply from $963 million in the second quarter and from $739 million in the third quarter of 1967.

About the only encouraging news to Mr. Kimbrel, so far as prices were concerned, was that orange prices were expected to be down because of a 30 per cent increase in the crop this year. Hurricane Gladys, incidentally, had done little damage to agriculture in Florida although other damage in the Tampa Bay area totaled between $5 and $6 million.

Mr. Kimbrel remarked that monetary policy apparently had not seriously limited lending and investing by Sixth District member banks. They reported a further expansion in loans during the four weeks ended October 16. Loan growth had been especially strong at the smaller banks. A spot check of leading banks suggested a continuing strong demand for instalment loans to buy consumer durables.

At the time of the Committee's previous meeting, Mr. Kimbrel said, he had believed that some evidence of the System's concern was needed to dampen prevailing expectations of continuing inflation. That continued to be his view. Treasury financing, of course, might force an even keel policy during most of the time between now and the next meeting. However, he believed the directive should contain some indication of the Committee's increasing concern over inflationary expectations and a decision to bring about somewhat firmer conditions, to the extent consistent with Treasury financing. After the Treasury financing was completed, that might involve fluctuations in bill rates up to or above the 5.60 per cent upper limit indicated by the blue book and a rate of bank credit expansion near or below the lower end of the 9 to 12 per cent range specified. He would prefer to have member bank borrowings in a range of $500 to $700 million and the Federal funds rate around the 6 per cent level.

As for the wording of the directive, Mr. Kimbrel thought the changes suggested by Mr. Hayes more nearly incorporated his own views. By its next meeting the Committee might be able to assess more accurately the effects that current events had had on expectations.

Mr. Bopp noted that two interrelated questions had dominated the Committee's deliberations during the past several meetings. One had to do with the likely strength of economic activity during the rest of 1968 and the first half of 1969. The other was the acceptable trade-off among policy objectives. The Committee up to now had decided on both grounds that open market policy should not move decisively to reduce the degree of monetary and credit expansion being experienced. However, developments during the third quarter suggested a reconsideration of that position.

With respect to the first question, Mr. Bopp observed that the Committee had had further confirmation since its previous meeting of the economy's near-term strength. As the green book pointed out, growth in GNP, even though slower than in the second quarter, exceeded earlier forecasts. It was true that a further sharp decline in the saving rate was unlikely, and that consumer expenditures should exhibit more moderation in the months ahead. Nevertheless, other elements in the picture were the strong demand for housing, over-all sales-inventory ratios, and a step-up in the pace of spending by State and local governments.

With respect to the acceptable trade-off among objectives, Mr. Bopp concluded that the pace of economic activity might not slow sufficiently to prevent a new round of inflation without an assist from monetary policy. His chief concern was the accumulating increases in the money and credit aggregates. Although money market conditions had fluctuated during the past three weeks, they had ended up about where they were at the time of the previous meeting. But the cost of that had been growth in the credit proxy near the upper end of the range projected in the last blue book. In terms of average growth rates since midyear, increases in the credit proxy and the money supply also had been too high.

Consequently, Mr. Bopp concluded, if evidence of more substantial moderation in the growth of the economy did not develop shortly, the Committee might have to apply the brakes sharply, with all the risks that that would entail. He would take some risks even with even keel if needed to slow down growth in the money and credit aggregates to more acceptable levels. Should peace expectations revive, he would resist any tendency for rates to decline.

Mr. Hickman noted that there appeared to have been little change in the current economic situation or in the outlook since the Committee's last meeting. Business activity had moderated, but inflation remained the most important threat to economic stabilization.

In view of the large-scale Treasury financing now under way the present obviously was not the time to make an overt change in policy, Mr. Hickman said. He felt, however, that the Committee should maintain as firm a rein as possible on the reserve base and bank credit during the period of the refunding. The 11-1/2 per cent rate of expansion in the bank credit proxy projected for October was too high; the Committee could not hope to curb inflation with growth rates of that magnitude. That view was confirmed by the projections in this morning's chart show--a presentation which, incidentally, he thought was excellent.

Mr. Hickman said he would therefore prefer to hold bank participation in the refunding to a minimum, and would encourage bank and nonbank dealers to sell off their inventories of new issues as soon as possible after the refunding. As a target, he recommended that open market operations be conducted so as to assure that bank credit, on average, did not expand by more than 6 to 8 per cent, at a seasonally adjusted annual rate. Since that goal was not consistent with the second paragraph of the staff's draft directive, he would prefer Mr. Hayes' suggested language for that paragraph. Perhaps the intent to slow the rate of credit growth would be clearer if Mr. Hayes' proposed proviso was revised to read, "provided, however, that operations shall be modified, to the extent permitted by the Treasury financing, if bank credit continues to expand at its recent rate."

Mr. Sherrill remarked that since the current situation clearly called for maintaining an even keel he would address himself to longer-run considerations. He still held to the view that he had expressed at a recent Committee meeting--namely, that inflation represented the main long-run problem and that monetary policy should be geared accordingly. Nevertheless, he thought it would be unfortunate if policy were firmed at this time, just when the economy appeared to be on the verge of a slowdown--to about a 2 per cent annual rate of real growth in the first half of 1969, according to the staff's projections. The presentation this morning had reinforced his view that the current posture of policy was about that required to achieve the needed slowing of the expansion, and so he would not want to firm policy.

Mr. Sherrill said he favored the staff's draft directive without change. The language of that draft, together with the associated specifications in the blue book, might be taken to imply some slight increase in the degree of restraint but so little that he found it acceptable.

Mr. Brimmer remarked that he shared Mr. Sherrill's view that the directive as drafted by the staff was satisfactory. If an even keel were maintained for the usual period--that is, for a week or so beyond the mid-November settlement date of the current refunding--the period would extend to within a few days of the Committee meeting scheduled for November 26. That meeting date would thus be an appropriate time to review policy.

Mr. Brimmer added that he would not favor the kind of proviso clause suggested today by Messrs. Hayes and Hickman. In his view, the Committee should avoid issuing a directive that placed the burden for a change in policy on the Manager. In any event, he (Mr. Brimmer) did not favor a policy change at this time.

Mr. Maisel said he agreed with Mr. Francis that a 5 to 6 per cent rate of growth in current dollar GNP in the first half of 1969 was an appropriate goal. Given that goal, the problem became one of deciding what Committee policy was best suited to achieve it. At the moment, he was willing to go along with the staff expectation that maintenance of the current posture of monetary policy would lead to the desired rate of growth in GNP.

It would be a mistake, Mr. Maisel continued, for the Committee to be unduly concerned about short-run fluctuations in monetary variables. Growth in member bank reserves in October was now estimated to have been much smaller than the staff had indicated at the time of the previous meeting of the Committee. While growth in the bank credit proxy in October was now estimated at about the upper end of the range projected earlier, that apparently was a consequence of changes in the Treasury balance. In his judgment, monetary policy should be based on the longer-run outlook; the proviso clause should not be used to vary policy on the basis of week-to-week changes in bank credit. He thought it would be dangerous if as a result of minor fluctuations in the statistics money market conditions were changed sufficiently to change market expectations.

Mr. Daane said he had very little to add today regarding policy and would accept the staff's draft directive. It seemed clear to him that the Committee had to follow an even keel policy in view of the Treasury's present financing and, more particularly, in view of the nature of that financing. He was not certain in his own mind as to whether an overt change in policy would be desirable even if even keel considerations could be laid aside. However, he did not believe the Committee could lay such considerations aside without raising the pre-Treasury-System Accord--or perhaps he should say also the pre-Ad Hoc Committee report--spectre in the area of fundamental System-Treasury and market relationships--namely, the risk on some occasions of having to choose between permitting a Treasury offering to fail or engaging in massive System underwriting operations.

In sum, Mr. Daane continued, while he shared the frustrations regarding even keel constraints evidenced in the questions and comments of others this morning, he thought there was another side to the matter. Before today's meeting he had reviewed the staff memoranda of last fall to which Mr. Brimmer had referred. In the summary memorandum entitled "Even keel policy" the staff had recognized the desirability of maximum flexibility within the framework of even keel considerations, as he (Mr. Daane) was sure all members of the Committee did. But it had then reached the following judgment: "Nonetheless, on the basis of its experience and study to date, the staff believes that any more significant deviation from the policy of 'even keel' as it has evolved since the Treasury-Reserve accord risks the disruption of basic relationships with both the Treasury and the market that could jeopardize, rather than enhance, the possibilities of greater freedom for monetary policy." He agreed with that judgment and thought the Committee members should keep it in mind despite any feelings of frustration they might have regarding even keel constraints.

Mr. Daane then said he would like to add some comments--perhaps gratuitous, but in his view essential--relating to Mr. Brimmer's speech of yesterday on "Federal Reserve Discount Policy in Perspective." He was sure Mr. Brimmer had intended his statement to be taken only as an expression of his personal views, but in his (Mr. Daane's) judgment--which he thought was supported by reports on the speech in today's press--it was subject to misinterpretation. For his own part, he doubted the wisdom of exposing strong, personal, within-System differences of view on important policy matters via the public speech-making route. Accordingly, he would try to resist the temptation to rush out with a speech on the subject of "Federal Reserve Discount Policy in the Perspective of Another Board Member," or perhaps "Federal Reserve Discount Policy in Proper Perspective." However, within the Federal Reserve family--of which he had been a part for roughly 30 years--he wanted to make it crystal clear that he did not agree with Mr. Brimmer's comments with respect to greater uniformity in rate setting in the interest of a consistent monetary policy, to the rate changes themselves, or to the assured complementary, or even supportive, relationship of the proposed discount mechanism to open market operations. Nor did he share Mr. Brimmer's assessment of the historical experience.

To clarify his views, Mr. Daane remarked, he thought in sum that the System had had a consistent monetary policy with, and in some instances because of, the rate setting procedures (time lags in themselves did not demonstrate inconsistency); he was not sure that rate changes as frequent as every other week or so would prove to be an unalloyed blessing; and he was not certain, in advance of a testing period, that the proposed mechanism would prove to be so complementary or supportive of open market operations.

Mr. Brimmer remarked that in light of the comments Mr. Daane had just made he thought it would be desirable to have the text of the speech he had delivered yesterday included in the record prepared for today's meeting.[1/]

Mr. Mitchell commented that while he was not wholly comfortable with the present posture of monetary policy, he thought there was no choice but to live with it at this time. That view did not stem entirely from the constraints imposed by the Treasury financing; the many uncertainties of the moment--including those relating to military expenditures in Vietnam, business and consumer spending, and the outcome of the national elections--would have led him to favor no change in policy today even in the absence of even keel considerations.

1/ A copy of Mr. Brimmer's speech is appended to this memorandum as Attachment B.

Mr. Mitchell added that he found the staff draft of the directive acceptable, although he would not object to the changes in the first paragraph proposed by Mr. Hayes. With respect to the second paragraph, he was not sure he understood Mr. Hayes' suggestion for the proviso clause.

Mr. Hayes noted that the proviso clause he had proposed called for modifying operations within the constraint of Treasury financing if the current bank credit projections were realized. The Committee had included such a proviso in the directive it had issued at its meeting in February of this year; indeed, the specific language he was proposing today was almost the same as the language used then.[1/]

Mr. Maisel commented that at its meeting in February the Committee had been virtually unanimous in the view that some firming in money market conditions was desirable if and when the Treasury financing permitted. As he recalled the matter, the Committee had chosen the directive language to which Mr. Hayes had referred in preference to a number of alternatives, including one calling for firming after the Treasury's February financing

1/ The second paragraph of the directive issued at the February 6, 1968 meeting of the Committee read as follows: "To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market, and operations shall be modified to the extent permitted by Treasury financing if bank credit appears to be expanding as rapidly as is currently projected."

was completed. He (Mr. Maisel) now believed that it had been a mistake to issue the type of directive actually adopted in February. It seemed to him that if the Committee wanted to change policy it should say so specifically in the directive.

Mr. Hayes remarked that he was not advocating an overt policy change; under the language he had proposed operations would not be modified unless the bank credit projections were borne out and the Treasury financing permitted. To his mind that was significantly different from language calling for a change in policy, since one could not know in advance how bank credit would perform.

Mr. Mitchell then said that he would prefer the type of proviso clause included in the staff's draft. He suspected, however, that even keel considerations would preclude its implementation in the period ahead.

Mr. Heflin reported that business activity in the Fifth District continued to turn in a generally strong performance. Some signs of weakness had cropped up in parts of the textile industry and farm income prospects had been dimmed considerably as a result of severe drought conditions. But most sectors of the District economy appeared to be moving ahead at about the same brisk pace that had characterized the national economy in the third quarter.

At the national level, Mr. Heflin continued, the latest Commerce figures--even allowing for some downward revision later--left little doubt that to date, at least, the June fiscal package had been much less restrictive than anticipated. Coming in the face of the tax increase, the large third-quarter gain in private final sales was especially impressive. It seemed to underscore the extent to which an unwholesome inflationary psychology had come to dominate business and consumer decisions. As he viewed the situation, that inflationary psychology constituted perhaps the most important problem that policy would be confronting over the next few months. While he realized that much of the recent rapid growth in bank credit had been associated with Treasury financing, he was troubled by a suspicion that the publicity it had received might have contributed to inflationary expectations.

For the present, Mr. Heflin said, even keel considerations and the upcoming election would appear to preclude any overt move on the Committee's part. Accordingly, he would favor no change in policy and would support the directive as drafted by the staff. Yet, in the interest of helping to dampen inflationary expectations, he would hope that bank credit growth in November could be held to the lower end of the range projected in the blue book. It seemed to him that over the next few weeks significant shifts in the patterns of market expectations might well be experienced, and the shifts could introduce downward pressure on the whole structure of market rates. If such a development should occur, he thought it would be desirable for the Desk to cushion the decline in rates by undertaking to supply reserves at a somewhat less generous pace than was usual for this time of year. He believed such a course would be consistent with even keel.

Mr. Clay remarked that the degree of monetary expansion continued to be of serious concern. It was not simply a matter of looking back at the large credit growth of the third quarter. It also involved a consideration of the credit growth of the fourth quarter, including October and the projection ahead. What was sought was balanced economic growth along with stable prices. It was desired to accomplish that in a gradual and orderly way. Thus it was the Committee's goal to avoid such monetary-fiscal restraint as would produce recession, but it also was the Committee's goal to solve the price inflation problem.

The evidence to date was not encouraging with respect to the pressure on resources and the course of costs and prices, Mr. Clay said. Inflationary pressures were strongly entrenched and appeared to be quite intractable. Yet it was fair to say that the solution of the price inflation problem was basic to the attainment of balance both in the domestic economy and the country's international payments.

Mr. Clay noted that at present the Treasury was involved in an exchange offering, for which the Committee was considering an even keel posture in its operations. However, in view of the fact that the financing was an exchange rather than a cash offering and that subscription books closed tomorrow, the financing would not appear to involve the same constraint on the Committee's actions as on some other occasions.

In Mr. Clay's view, appropriate guidelines for the period ahead, given the state of the economy, would include growth in the credit proxy at a 6 to 8 per cent annual rate, a Treasury bill rate ranging up to 5.65 per cent or slightly above, Federal funds trading in a 5-3/4 to 6-1/4 per cent range, and member bank borrowings of $400 to $700 million. The immediate Treasury financing might temper the attainment of such goals, but the even keel posture should be limited so far as possible.

Mr. Scanlon said that in the interest of time he would summarize the comments he had prepared on recent economic developments in the Seventh District and submit the full statement for inclusion in the record. He then summarized the following statement:

> Economic activity in the Seventh District continues at high levels and is expected to rise further.
>
> The main dampening influence on activity in the District has been the adjustment of steel inventories. The steel industry apparently has now turned the corner. Orders were at a low in August and output at a low in September. The increase in orders represents largely

the need to replenish stocks of certain types of steel depleted by heavier than expected production of various products containing steel. Lead times are very short; almost all orders are filled within a few weeks. Implementation of the heavy fourth-quarter production schedules for motor vehicles could result in an appreciable rise in output of steel before year-end. Meanwhile demand for structural steel has continued relatively strong.

The reception of 1969 model autos has been excellent. Production schedules for the fourth quarter have been revised upward to a record high for the period. Overtime work in the industry is the largest in several years. Inventories of passenger cars, although well over a million, are not considered excessive in view of strong sales trends.

Demand continues weak for some types of farm and construction machinery. Cutbacks in employment by a large Milwaukee area employer produced a revealing commentary on local labor market conditions. Attempts of other employers in the area to recruit workers laid off revealed that those released had found other jobs very quickly. Available evidence is that demand for workers in Milwaukee is not as strong as in Chicago or Indianapolis.

The construction outlook is very strong for all major types. In the Chicago area permits for new residential units have been higher than a year earlier in each of the last 18 months. For three successive months, July through September, permits granted for apartments established new postwar highs. A nationwide survey of the availability of skilled construction workers indicates that shortages have worsened in recent months. Chicago, Detroit, and Indianapolis are listed among the centers reporting the most persistent shortages.

Banking figures indicate a greater than seasonal increase in loan demand in the U.S., with business, consumer, and mortgage credit rising markedly faster than a year ago. But at District banks business loan demand, except for retailers, appears much less vigorous than for the country as a whole. Borrowing by metals manufacturers is off sharply.

Large banks in Chicago and Detroit continue to report unusually deep deficit reserve positions despite some liquidation of securities and acquisition of CD money since the September tax date. Their needs reflect still heavy positions in both Treasury and municipal securities. At the four banks that account for the major part of the basic deficit, investments are more than $1 billion higher than a year ago--about twice the gain in their deposits. They have managed to cover their positions largely in the Federal funds market. Their Euro-dollar liabilities exceed $1 billion.

Mr. Scanlon then noted that rates of growth in aggregate reserve, money, and credit measures had accelerated again in October after slowing somewhat in September. Those measures had expanded at rates either close to or in excess of the top of the ranges expected at the Committee's previous meeting. In view of current and prospective business developments, those rates continued to be too rapid if monetary policy was to make a positive contribution to lessening inflationary pressures.

Mr. Scanlon said he could appreciate the problems of the Manager since the last meeting. The sharp spurt in short-term interest rates and continued rapid growth of reserves, money, and credit indicated strong demands for money and credit, stronger than the Committee had anticipated. Current staff projections indicated continuation of that condition.

It appeared, Mr. Scanlon said, that the Committee might either permit rates to drift up further or provide enough reserves to stabilize rates in the short run. He preferred the former policy. He recognized that that might not be feasible in view of the Treasury financing, but he would urge resistance to reserve expansion insofar as that could be done within the constraint of even keel. If the Committee was to provide meaningful support to fiscal policy and make its major contribution to stability at this time, he believed it should reduce the annual rate of growth in total reserves to near 3 per cent and in bank credit to no more than 8 per cent.

On the directive, Mr. Scanlon said that he also questioned the accuracy of the staff's draft statement on the money supply in the first paragraph. He supposed that "summer" had a different connotation in Chicago than it did in Washington. The pertinent reference really was to the September figure. Accordingly, he would prefer a statement reading "The money supply, after declining somewhat in September, resumed a rapid pace of growth." He would amend the second paragraph in the manner Mr. Hayes had suggested.

Mr. Galusha said that he also would summarize his prepared statement on District conditions and submit the full text for the record. He then summarized the following statement:

> It is now somewhat clearer than it was that in the Ninth District the pace of economic advance has slowed; which to those who, like I, believe the economy is responding however slowly to the change in fiscal policy, may provide a bellwether as credible as that small county in Vermont that presages the turn of the election. Total wage and salary employment, seasonally adjusted, increased not at all in September. The manufacturing sub-total did increase, but by the standard of recent months relatively little; and the trade, service, and government sub-totals decreased. This suggests a further increase in the District unemployment, although at this point we cannot be sure what the rate for September was.
>
> The trend of unemployment seems to confirm sales projections of District manufacturers made earlier this year. If these projections are correct, the pace of economic advance is not going to quicken again in the near future.

> I would add here that the agricultural outlook has not changed for the better. Livestock producers may do a little better in coming months than they did last year. But crop producers will not, nor will livestock and crop producers together. Retailers in rural areas cannot expect good times again, at least for a while.
>
> Loans of District weekly reporting banks, seasonally adjusted, increased sharply in the first half of October. With the pace of economic advance having slowed, this is a little surprising, and I do not have a good explanation to offer you. It could be that there has been a substantial warehousing of mortgages. I have noted with interest the failure of liabilities of District savings and loan associations, seasonally adjusted, to increase, and of their mortgage commitments to decrease.

Mr. Galusha added that the tendency for commitments to outpace funds was also observable in the nation as a whole, and it gave him pause. The Board staff had changed its outlook quite considerably and he was not yet convinced that the change--particularly of their inventory numbers--was in order; but certainly the time sequence had been shifted forward from the May forecast.

Mr. Galusha remarked that there was enough difference among good economists to make one wary of permitting the kind of basic change in expectations for the construction industry that a continued run-up in short-term rates might well trigger. A three-month bill rate above 5.50 per cent for any period of time was fairly certain to drag some long-term rates up with it and set off a change in expectations. Moderation and the avoidance of any action that might be construed as a shift in policy should be the Committee's stance.

It seemed to Mr. Galusha that the revised wording of the proviso suggested by Mr. Hayes would involve an overt shift in policy even though the Treasury financing might limit its implementation to the last part of the coming period. He did not think that would be an appropriate use of the proviso clause, especially in a period of essentially even keel. In general, he thought the Committee's primary instruction should be formulated on the assumption that the expectations for bank credit would be realized, and the proviso clause should be used to specify an alternative instruction in the event that that assumption proved false. In any case, a decision to change policy--which he would not favor at this time--should be reflected in the language of the primary instruction and not in the proviso clause. He supported the staff's draft of the directive.

Mr. Galusha added that the speech given yesterday by Mr. Brimmer pointed up to him the need to establish a forum, presumably in this room and among those present today, for free discussion of matters relating to the structure of the System. He agreed with Mr. Brimmer that some areas needed study; it was important to re-examine periodically the relationships among System components and to make changes where changes were needed. But he did not think that such discussions should occur on the public platform--not, at least, until after the System's own introspective exercises, in which all had participated, had been completed.

Mr. Swan remarked that two recent developments in the Twelfth District seemed worthy of comment. First, District banks had sharply increased their investments in municipal securities in recent months. In part the increase reflected a surge of new issues in California before the November elections; a proposition on the ballot would, if passed, severely restrict future borrowing activity by local governments. Since much of the recent borrowing was in advance of need, the volume of new municipal issues in California should be substantially reduced over the remainder of the year whether or not the proposition was approved by the voters.

Secondly, Mr. Swan said, on the basis of information from a number of California savings and loan associations, it appeared that inflows to such associations in October would be at least equal to, and perhaps larger than, the inflows of October 1967. In contrast, September inflows had been weaker than a year ago. While the sample of reporting associations was admittedly a small one, it had provided an accurate guide to September developments.

With respect to policy, Mr. Swan thought that the present was not the appropriate time to make an overt change. Like Mr. Mitchell, he had in mind not only even keel considerations but also the various domestic and international uncertainties presently existing. Accordingly, he could accept the basic intent of the directive as drafted by the staff, although he had some language changes to propose.

In the first paragraph, Mr. Swan continued, he would recommend deletion of the phrase "although less than projected" following the statement in the opening sentence that economic expansion had moderated somewhat. That phrase had been included in the previous directive, and he did not think it was necessary or desirable to repeat it. Also, there was a statement in the first paragraph regarding bank time and savings deposits and savings inflows to "thrift institutions". Since it could be argued that the savings departments of banks were "thrift" institutions, it might be preferable to substitute the words "nonbank savings institutions" for "thrift institutions."

Turning to the second paragraph, Mr. Swan said he did not favor the type of proviso clause Mr. Hayes had suggested, partly because the Treasury financing would leave little room for its implementation and partly because it raised the question of whether or not the Committee intended to make an overt change in policy. But because he shared the concern about the rapid rate of bank credit growth he thought it would be desirable to omit the word "significantly" from the phrase "if bank credit expansion appears to be significantly exceeding current projections."

Mr. Mitchell agreed that it would be desirable to delete the word "significantly."

Mr. Coldwell observed that economic conditions in the Eleventh District continued about as he had reported at the previous Committee meeting. There was still a mix of declines in industrial production and crude oil output, a steady level of employment, gains in construction, but a slower rate of gain in retail trade. Agricultural conditions centered upon harvesting of major crops and seeding of winter small grains. Cotton output appeared to be less than demand and farmers were contemplating a withholding to obtain higher prices. Financial conditions still reflected advancing loan levels, rising investments, and a relatively easy reserve position at most banks. The atmosphere of pressure had almost completely disappeared, with borrowings from the Federal Reserve declining, although purchases of Federal funds had risen.

Nationally, Mr. Coldwell said, there might be a slightly slower rate of growth but the decline had not been enough to cool the inflationary pressures of rising costs and prices. In fact, it was still questionable as to whether the tempering forces of fiscal restraint, steel adjustments, and relatively high interest rates would be offset by the inflationary expectations stemming from further wage and price increases and their impact upon future costs. While he found the staff's latest GNP projections much more acceptable than those presented earlier, they still indicated little progress in dealing with the problem of inflation.

Financially, it appeared to Mr. Coldwell that the unrest and pattern of reserve adjustments originating in the new reserve settlement arrangements had developed as a few had predicted. Certainly the gyrations in Federal funds, excess reserves, and net borrowed reserves posed a real question as to the degree of restraint monetary policies were achieving under present market conditions. It was important that the Committee continually remind itself that maintenance of a given level of net borrowed reserves was not a neutral stance but instead was expansionary through reconstitution of reserves used by the banks.

Mr. Coldwell agreed that the Committee had to take the Treasury refunding into account in deciding on policy today, but noted that there still were shades of difference in an even keel posture. He would prefer to instruct the Manager to hold the present levels of money market indicators while resolving doubts on the side of restraint and permitting short-term interest rates to advance further, rather than instructing him to provide the reserves at a rate that might result in increases in the bank credit proxy or the money supply approaching those projected in the blue book. Whatever the members' individual preferences for policy indicators, it seemed to him that the Committee should not permit continued expansion in bank credit or the money supply at rates like those recorded over the past three months.

Accordingly, Mr. Coldwell said, he would favor revising the concluding phrase of the proviso clause in the staff's draft directive to read "if bank credit expansion appears to be approaching the upper end of the range of current projections." Alternatively, he could accept Mr. Swan's proposal to delete the word "significantly" from the proviso clause in the staff's draft.

Mr. Morris said he wanted to compliment the staff on its presentation today, which he had found very helpful. He thought the projections supplied the kind of framework for policy formulation that he had found distressingly absent at recent meetings. He did not think the staff should be criticized because its earlier projection for GNP in the third quarter had proved to be wide of the mark. In working with projections one always had to accept the risk of a large miss, and in the present case the behavior of consumers had been markedly different from the expectations of almost all observers.

If the staff was to be criticized, Mr. Morris continued, he thought it should be for not having continually updated the longer-run projections that had been presented to the Committee on May 28. It had been clear by mid-August that consumer behavior was not proving consistent with the May 28 model, but the staff had waited until today to present a revised longer-run projection. By the same token, to facilitate policy formulation by the Committee in coming months it would be desirable for the staff to keep today's projections under continual review. Thus, he hoped that at the next meeting the staff would advise the Committee of any significant revisions in the projections that seemed to be indicated by developments in the intervening period.

Mr. Morris went on to say that in light of the many comments he had heard in recent months--both in meetings of the Committee and elsewhere--about excessive growth rates of the monetary variables, he had compared the actual growth rates with the staff projections presented at the meeting of May 28. The results were revealing. They indicated that since the beginning of June growth in both total reserves and the narrowly defined money supply had been about on target. One variable for which growth had been substantially underestimated was commercial bank time and savings deposits. That was partly offset, however, by a large overestimate of the increase in deposits at mutual savings banks and savings and loan associations. Altogether, recent rates of expansion in monetary variables did not appear to him to have been as great as many of the comments he had heard had suggested.

Of course, Mr. Morris continued, the fundamental question remained as to whether the monetary growth rates projected on May 28 were appropriate. It seemed to him the Committee needed to know much more than it did about the kinds of monetary conditions likely to be consistent with its general economic objectives. But the analysis suggested to him that undue emphasis had been placed on the bank credit proxy, in light of the sensitivity of the proxy to large changes in the growth rate of time deposits. In his judgment, rapid increases in time deposits were of questionable significance for policy if they were at the expense of slow growth at nonbank intermediaries.

With respect to the policy decision today, Mr. Morris said, he thought it would be most unfortunate if the Committee were to publish a directive suggesting that it had decided on a change in policy while a Treasury refunding was under way. Since the Committee was scheduled to meet again only 11 days after the payment date for the refunding, he did not believe that a decision today to maintain an even keel would constrain the Committee's actions in any important way. That was particularly so in light of the willingness--which he applauded--the Manager had demonstrated in the recent period to implement the proviso clause. He thought the Manager was to be commended for implementing the proviso at the expense of a relatively large increase in short-term interest rates, since an effort to prevent the advance in rates would have contributed to a larger rise in deposits. The Manager's actions also had helped the Treasury to price the securities offered in the refunding realistically, and as a consequence he did not think there would be serious problems in maintaining an even keel during the refunding.

In conclusion, Mr. Morris observed that he would accept the staff's draft directive with all the changes proposed by Mr. Swan, including that of deleting the word "significantly" from the final phrase of the proviso clause. He thought a one-way proviso, such as was incorporated in the staff's draft, was appropriate at this time.

Mr. Robertson made the following statement:

> With a sizable Treasury refunding operation currently under way, I think our proper course is to follow a policy of even keel between now and the next meeting of the Committee.
>
> I recognize that a number of the latest economic indicators seem to be flashing stronger signals than expected before. I believe it would be unwise, however, for us to respond by any shading toward tightness of the even keel posture. I think we would be better advised to use the time between now and the next meeting to re-examine the accumulating evidence, look for more confirming signs of more vigorous demand pressures, and think through all the consequences of possibly more restrictive action on our part at our late November meeting when we should be free of even keel constraints.
>
> I do not favor as a general rule following a zigzag monetary policy, reversing course with each contrary reading of the statistics. But I do think we have to be prepared to be reasonably flexible in altering policy when an accumulating stream of evidence is going counter to our earlier expectations. I would not even exclude consideration of an increase in reserve requirements, if necessary to curtail undue expansion of bank credit.
>
> Speaking of being flexible, there is another area of Committee concern where I think we should be willing to do a little adapting to events. I refer to the issue of buying and selling Federal agency securities. Even

> though Congress gave us both explicit statutory authority and a good deal of encouragement to deal in such issues over two years ago, we have thus far confined System open market operations in these securities to repurchase agreements only. We had some good reasons for proceeding in this fashion at the outset, and I think there still are good reasons in principle for not becoming heavily involved in agency operations. But I think it would be a mistake to keep the door tightly shut against exploratory purchase transactions in agency issues, especially in view of our policy of operating in Treasury coupon issues from time to time.
>
> Those of us who were involved in fending off a determined Congressional effort to make us buy large amounts of agencies this summer have a lively recollection of how sensitive some Congressmen were to our inaction. I think we would be inviting even more strenuous criticism if, when the legislation comes up for review next year, we still have not lifted a finger to test the response of the agency market to our operations in at least a small way. Here is a clear-cut case in which some tentative and experimental operations on our part might do a good deal to resolve some of the conflicting arguments in principle. This kind of practical, flexible, and experimental approach to a contentious problem has served us well in the past, and I believe it would do so on this occasion as well.

Mr. Robertson added that he would be willing to vote for the directive as drafted by the staff. He thought, however, that the two changes in the first paragraph suggested by Mr. Swan were improvements. He would also be agreeable to Mr. Hayes' suggested substitute for the statement on the money supply, if it was modified to read "The money supply, after growing moderately during the summer, has increased more rapidly in recent weeks." With respect to the second paragraph, he would accept Mr. Swan's suggestion to delete the word "significantly" from the proviso clause. He thought it would be a mistake to adopt the proviso clause Mr. Hayes had proposed for the reasons Mr. Galusha had mentioned. In particular, if the Committee decided to change policy he (Mr. Robertson) thought it should say so in the directive.

Mr. Robertson said that while he agreed with the views Mr. Brimmer had expressed in his speech yesterday, he did not think the subject matter was germane to the Committee's deliberations today. Accordingly, he would not favor making that speech and the comments of Messrs. Daane and Galusha concerning it part of the record of today's meeting.

Mr. Brimmer noted that he had asked that the text of his speech be included in the record only because he assumed that Mr. Daane's remarks would be reported.

Mr. Daane indicated that he did not share Mr. Robertson's view with regard to the record.

Chairman Martin expressed the view that the matter was one which should be decided jointly by Messrs. Daane, Brimmer, and Galusha.

The Chairman then remarked that he favored an even keel policy at present. He thought it would not be desirable, at a time when a Treasury financing was under way, to decide to shade policy toward firmness. The Committee had debated the issue of a policy change at its previous meeting and, with three dissenting votes, had agreed not to make a change; and it would have another opportunity to review the matter at the meeting scheduled for November 26. As the discussion today suggested, the question before the Committee at that time would be whether to make an overt change in policy, and if the members felt strongly that such a change was likely to be desirable immediately after the financing the Committee could plan on advancing its next meeting date, perhaps to November 19. That, in his judgment would be preferable to a decision today to shade policy in the coming period. Personally, however, he thought there would be little advantage to scheduling the next meeting before November 26, since there would be relatively little time between the completion of the Treasury financing and that date.

Mr. Hayes remarked that while the Committee always had to give some consideration to major Treasury financings in formulating its policy, he thought there was some danger that it would accept too rigid a conception of even keel. In the past the Committee had not consistently avoided shadings of policy during Treasury financings. Thus, a check by the New York Bank staff of the directives issued in recent years had revealed five instances in which some change in policy had been made in an interval which included a Treasury financing. Four of those instances involved outright changes, one was in connection with the proviso clause, and all were made to the extent that even keel constraints permitted. On one occasion the Committee had adopted a directive calling for a change in the objective of operations following the conclusion of a Treasury financing--a procedure he now thought was unwise; on other occasions the directive had called for a change subject to Treasury financing considerations.

The course he recommended today, Mr. Hayes said, was not a radical one in any sense. The Committee had to weigh the relative risks of alternative courses, and in his judgment the greater risk lay in not acting while awaiting additional data and another opportunity to review the situation. By permitting bank credit to grow at a rate of up to 12 per cent for another month, the Committee would simply be compounding the problem it now faced. He granted that not much could be accomplished in limiting bank credit expansion in the current period, given the Treasury financing. But in light of the inflationary psychology now prevailing he thought the Committee should do what it could in that direction, and that it should at least indicate in the directive its deep concern about the rate of bank credit growth. He personally was prepared to accept Mr. Coldwell's suggested proviso clause, calling for a modification of operations if bank credit expansion approached the upper end of the projected range. That was not quite as strong a clause as he would like, but he considered it a reasonable compromise.

Mr. Daane said he thought the Manager's earlier comments had underscored the difficulty of predicting when even keel considerations would no longer be important in connection with the present financing. In light of that difficulty he saw little point in agreeing to meet next on November 19 rather than on November 26. Moreover, he suspected that the character of the current financing was quite different from those under way on the earlier occasions Mr. Hayes had mentioned when the Committee had given less than usual weight to even keel considerations.

Chairman Martin remarked that while Mr. Hayes had made a valid point, the course the latter had recommended struck him as undesirable on procedural grounds. If the Committee thought an overt change in policy was needed it should act at a meeting when an overt change was feasible--rather than deciding in the course of a Treasury financing to shade policy during or on the heels of the financing. Having made a decision--for better or worse--at its previous meeting, he thought the Committee should now wait until its next meeting, when the financing would be over, to reconsider the matter.

Mr. Maisel observed that he agreed with Mr. Hayes' view that the Committee should feel free to give less than usual attention to even keel considerations when circumstances so dictated.

At present, however, he thought the best course might be to schedule the next meeting for November 19.

Mr. Brimmer said he hoped the Committee would not advance the date of its next meeting to November 19, in view of the fact that he and others would be attending a meeting in Paris on that date.

Chairman Martin remarked that he personally did not advocate holding the next Committee meeting before November 26. He had simply expressed the view that advancing that meeting date would be better than deciding today to change policy in a period in which there was a Treasury financing.

Mr. Hayes asked whether the language Mr. Coldwell had suggested for the proviso clause would represent a change in policy.

Chairman Martin said he thought it could be so construed, and Mr. Robertson added that such a construction would seem to him to be unavoidable.

In response to a request for comment, Mr. Holmes remarked that as he interpreted the language proposed by Mr. Coldwell the proviso clause would be implemented if bank credit growth appeared to be at the midpoint of the range projected, assuming the Treasury financing permitted.

The Committee then turned to a discussion of the several changes that had been suggested in the staff's draft of the first paragraph of the directive. In the course of the discussion it was noted that the phrase "although less than projected" remained accurate, since the amount of slowing in economic expansion reflected by current estimates of GNP for the third quarter once again was less than indicated by the projections prepared for the previous meeting. Also, the staff noted that the statements regarding the money supply shown in the staff's draft and proposed by Mr. Hayes were both accurate, with their differences reflecting the somewhat different time periods employed in making the underlying calculations.

At the conclusion of the discussion the Committee agreed to accept the staff's draft of the first paragraph without change.

Mr. Maisel then asked Mr. Holmes how the Desk's operations would be affected if the word "significantly" was deleted from the proviso clause.

Mr. Holmes said he would assume that by deleting that word the Committee would intend to have the proviso clause implemented if the bank credit proxy appeared to be growing in November at an annual rate of as much as 12 per cent, the upper limit of the projected range--again assuming the Treasury financing permitted--rather than at a somewhat higher rate.

Mr. Mitchell observed that, as he interpreted the discussion today, the majority was not in favor of a modification of the proviso clause more substantial than deletion of the word "significantly."

Mr. Maisel noted that most of the bank credit expansion projected for November reflected an increase in the statement week ending tomorrow. From the beginning to the end of November itself, according to the weekly projections, bank credit would be declining.

Mr. Hayes observed that he found small comfort in the point Mr. Maisel had noted, in light of the cumulative increase in bank credit. As to Mr. Mitchell's observation, what he (Mr. Hayes) was urging was simply that the Committee make clear that it wanted less growth in bank credit than projected and that it was prepared to move in that direction within the narrow range of action that would be feasible in the coming period.

Mr. Kimbrel said he had not modified his view regarding the need for action to counter the inflationary spiral. However, he would not want to disturb the System's relationship with the Treasury in connection with financing operations. Accordingly, he would be prepared for this period to accept the staff's draft directive if the word "significantly" was eliminated from the proviso clause.

Chairman Martin remarked that while he would not favor having the Committee redo all it had done during the past few months, it obviously was perfectly legitimate to argue that the Committee's policy should be more restrictive. Indeed, he might well be taking that position himself at the time of the next meeting if the recent economic trends appeared to be persisting at that time. But he still thought it would be desirable for the Committee to wait until the next meeting to reach a decision on the issue. Today was not an appropriate time for such a decision, considering the System's relations with the Treasury. He agreed that the Committee did not have a perfectly consistent record in maintaining an even keel during Treasury financings, but there were difficult problems for the System in that area that went back to the days of the Treasury-Federal Reserve Accord.

Mr. Hickman commented that he was prepared to vote in favor of maintaining an even keel during the Treasury financing in the interest of System-Treasury relations. However, a change in policy immediately after the financing might be feasible, which suggested the desirability of scheduling the next Committee meeting for November 19.

Mr. Daane remarked that if the Committee met on that date it might well find itself still constrained by even keel considerations.

The Chairman agreed, adding that he would not view a one-week difference in meeting dates to be a matter of great significance.

Mr. Hickman then asked whether the Chairman considered it essential that the Committee's vote today be unanimous.

Chairman Martin replied in the negative. However, he thought it would be unfortunate for the Committee to be deeply divided on an issue that--to his mind at least--was not a fundamental one.

The Chairman then suggested that the Committee vote on a directive consisting of the staff's draft with the word "significantly" deleted from the proviso clause.

Mr. Hickman said that in light of the Chairman's comments he was prepared to vote favorably on such a directive. At the same time, he believed that the Committee would have to face up to the problem of excessive bank credit growth.

Mr. Hayes remarked that he would find it necessary to dissent from the proposed directive.

> With Mr. Hayes 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 somewhat from its very rapid pace earlier in the year, although less than projected, and that upward pressures on prices and costs are persisting. Market interest rates have risen in recent weeks. Bank credit and time and savings deposits have continued to expand rapidly, but savings inflows to thrift institutions have remained moderate. The money supply, after growing little on balance during the summer, has increased in recent weeks. The U.S. 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, while taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury financing, if bank credit expansion appears to be exceeding current projections.

Chairman Martin then observed that a tentative schedule of 1969 Committee meeting dates had been proposed in a memorandum from Mr. Holland dated October 22, 1968.[1/] The Chairman invited Mr. Hayes to open the discussion.

Mr. Hayes noted that the proposed 1969 schedule, like the one for 1968 the Committee had approved last November, called for 14 meetings at three- and four-week intervals. While a number of the meeting dates indicated would occur during Treasury financings, on the whole he thought the staff had done a good job in minimizing conflicts of various kinds.

As the memorandum indicated, Mr. Hayes continued, the staff had been asked to consider the possibility of shifting in 1969 to a schedule calling for twelve meetings, on third Tuesdays of each month; and to facilitate such a Committee schedule it had been proposed that the Federal Advisory Council be asked whether

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1/ A copy of this memorandum has been placed in the files of the Committee.

it would amend the provision of its by-laws calling for meetings with the Board on third Tuesdays of four months of the year. It had been learned, however, there seemed to be no alternative FAC schedule that did not involve conflicts with other commitments for a significant proportion of present Council members.

Accordingly, Mr. Hayes observed, he would favor adoption of the proposed 1969 Committee schedule. However, he continued to believe that a schedule calling for Committee meetings on third Tuesdays of each month had significant advantages, in minimizing conflicts with Treasury financings and BIS meetings, and on grounds of data availability. The only disadvantage he saw to a twelve-meeting schedule was that it would involve some five-week intervals during the course of the year. That might sometimes lead to the need for an interim meeting; but even on a 14-meeting schedule the Committee had found it necessary to hold additional meetings from time to time.

Mr. Hayes said he suspected that many present FAC members had found no feasible alternative to third Tuesdays for their quarterly meetings with the Board simply because they had arranged their other appointments with the present FAC meeting dates in mind. If so, they were not likely to have the same problem of conflicts with respect to 1970 and later years, as long as they knew sufficiently far in advance that some different schedule for

FAC meetings would be introduced in 1970. He suggested, therefore, that the FAC be asked at its next meeting to consider again the possibility of amending its by-laws to change its present meeting dates, but with the change not to be effective until 1970; and that the Committee look forward to shifting to a twelve-meeting schedule in that year.

Mr. Mitchell said he would not favor a schedule involving some five-week intervals and only twelve meetings a year. In his judgment the Committee was now meeting at about the right frequency.

Mr. Brimmer concurred in Mr. Mitchell's comment.

Mr. Daane remarked that he saw real merit in a twelve-meeting schedule. He noted that any tentative schedule the Committee adopted would be subject to modification during the course of the year if developments required a shift in dates or additional meetings.

Mr. Sherrill observed that he would also favor a twelve-meeting schedule.

After further discussion, it was agreed that the question of a possible change in Federal Advisory Council meeting dates, beginning in 1970, should be raised with the Council at its next meeting with the Board.

Mr. Kimbrel noted that the proposed schedule called for a meeting on September 30, 1969. He recommended changing that date to October 7, to avoid a conflict with the annual convention of the American Bankers Association.

Chairman Martin then suggested that the Committee tentatively agree on the schedule for its 1969 meetings proposed in Mr. Holland's memorandum of October 22, 1968, with the change Mr. Kimbrel had recommended.

There was general agreement with the Chairman's suggestion.

It was agreed that the next meeting of the Committee would be held on November 26, 1968, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

October 28, 1968

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 29, 1968

The information reviewed at this meeting suggests that over-all economic expansion has moderated somewhat from its very rapid pace earlier in the year, although less than projected, and that upward pressures on prices and costs are persisting. Market interest rates have risen in recent weeks. Bank credit and time and savings deposits have continued to expand rapidly, but savings inflows to thrift institutions have remained moderate. The money supply, after growing little on balance during the summer, has increased in recent weeks. The U.S. 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, while taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury financing, if bank credit expansion appears to be significantly exceeding current projections.

ATTACHMENT B

FEDERAL RESERVE DISCOUNT POLICY IN PERSPECTIVE

A Paper Presented

By

Andrew F. Brimmer
Member
Board of Governors of the
Federal Reserve System

Before the

54th Annual Fall Conference
of the
Robert Morris Associates

Sheraton Hotel
Philadelphia, Pennsylvania

October 28, 1968

FEDERAL RESERVE DISCOUNT POLICY IN PERSPECTIVE

By
Andrew F. Brimmer*

Changes in the discount rate and policies governing discounting together constitute the oldest instrument of monetary management. Yet, discount policy remains today one of the most useful tools available to the central bank. At the same time, the discount mechanism provides for the individual bank an opportunity to meet temporary reserve needs which are inherently difficult to anticipate. Moreover, because of the contact through the discount window, the Federal Reserve and member banks have a direct avenue of communication; thus, the System has a ready means of keeping abreast of trends and developments in the banking system and in the money market. Member banks in turn can keep in touch with System thinking with respect to monetary policy.

Compared with other principal instruments of monetary policy, the discount mechanism has several advantages (although these are clearly not so great as to justify abandoning the other tools). In the first place, the discount arrangement allows the central bank to serve as a lender of last resort through the monetization of a wider range of debt than would be the case if reliance were solely on open market operations.

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*Member, Board of Governors of the Federal Reserve System. I am indebted to several members of the Board's staff for assistance in the preparation of this paper. Miss Elizabeth L. Carmichael supervised the search of the records to establish the order of Reserve Banks' requests for approval of discount rate changes. Miss Priscilla Ormsby helped with the summary of recommendations and issues raised by the proposal to revamp the discount mechanism, and Miss Mary Ann Graves calculated the lags in discount rate changes at Reserve Banks.

Secondly, it enables the central bank to make reserves available directly and immediately to individual banks most in need of assistance. This could not be accomplished via open market operations. Finally, the existence of the discount mechanism permits open market operations or changes in reserve requirements to be undertaken much more vigorously, since the impact on individual banks can be cushioned through borrowing from the central bank.

This historic role of the discount function is widely appreciated. However, much of the current interest in this instrument stems from the role it may play in the future. As is generally known, the Federal Reserve has underway a basic re-examination of the discount mechanism. This re-appraisal centers on a set of recommendations advanced by a special System Committee which spent about three years on a comprehensive inquiry into the performance of the discount instrument. Although the Committee's proposals have been available for public comment since mid-summer, it may be well to summarize them here. Furthermore, it may be particularly helpful to sketch the kind of schedule the Federal Reserve Board may follow, if it decides to revamp the discount function along the lines suggested by the System Committee.

In the meantime, however, a number of questions can be raised about the current functioning of the discount mechanism which are of major significance for the execution of monetary policy under present circumstances. For example:

- When the Federal Reserve Board approves a change in the discount rate at one or more Reserve Banks, do other Banks adjust their discount rates in a manner sufficiently timely to insure that a consistent monetary policy will be followed throughout the

System? The evidence accumulated since the mid-1950's leaves some doubt in my own mind.

- Is the present statutory authority of the Federal Reserve Board to review and determine the discount rates established by Reserve Banks really meaningful? Interpreted literally, I personally think it is not. Yet, in the context of the actual experience in the System over the years, I am convinced that the ultimate responsibility of the Federal Reserve Board for the discount rate has enhanced the efficiency of the discount mechanism.

- Nevertheless, several steps could be taken (aside from the basic revamping now under consideration) to strengthen the contribution of discount policy to monetary management. For instance, the existing machinery for System-wide consideration of discount policy should be further developed, and a much clearer policy should be evolved with respect to discount rate adjustments once the Federal Reserve Board has approved a rate change for one or more banks. A fuller explanation of rate changes by the Board would enhance the public's understanding of the aims of monetary policy.

Finally, it may be helpful to examine the pattern of member bank borrowing from Federal Reserve Banks during the current period of monetary restraint, compared with the experience in 1966.

Re-examination of the Discount Mechanism

As I mentioned above, the Board has recently published for comment the report of a System Committee recommending changes in the Federal Reserve discount mechanism. In addition to reflecting almost three years of intense study throughout the System, the report was strengthened by contributions from a number of outside sources. While the Board at this stage has not made any binding decisions on the recommendations, the report obviously represents one of the most important documents of recent years in the field of banking and monetary policy, and the proposals it contains will be weighed seriously.

Very briefly, the proposed revamping of the discount arrangement would establish four categories of credit extension to member banks. Perhaps the most innovative of these would be the "basic borrowing privilege;" this would enable each soundly operated member bank to borrow a limited amount of funds from its Reserve Bank on request in as many as half its weekly reserve periods. The second category would be the "seasonal borrowing privilege;" under this plan a member bank foreseeing seasonal needs for credit exceeding some specified minimum could arrange for loans from its Reserve Bank to meet that excess. These arrangements would be more explicit and more liberal than currently provided and, it is hoped, would be of significant help to banks with wide seasonal swings in fund availability.

Thirdly, it is fully expected that member bank needs for discount credit would arise, perhaps frequently for some banks, which because of their size or nature could not be accommodated under either of these borrowing privileges. In such cases, short-term adjustment credit would continue to be available under essentially the same kinds of administrative procedures as currently apply. The fourth category of credit to member banks might be termed emergency credit. Such credit would be available, as at present, to member banks caught in special regional or local adversities for as long as reasonably needed for the banks to work out of their circumstances. In addition, the report reaffirms the role of the Federal Reserve as "lender of last resort" to the entire financial system in the event of serious and widespread emergency.

A final major new idea proposed by the report is to make the discount rate -- the interest rate charged by Federal Reserve Banks on their loans to member banks -- more flexible than heretofore and thereby to make it a more significant influence on the volume of borrowing.

As I mentioned, the Board has not yet taken any action on these proposals. We are currently receiving and analyzing comments on them from member bankers and from a variety of other interested groups. On the whole, the comments we have received so far have been quite sympathetic to the over-all proposal. Of course, there have been questions raised and changes suggested with regard to some of the specific features of the recommendations. Views expressed within the System have been similar. There is general sympathy with the proposal as a whole, but we are also continuing to consider and study some of the details.

Our current timetable calls for formal Board action to publish in the Federal Register by mid-winter a proposed revision of our Regulation A covering borrowing by member banks. This publication would then be followed by another period for public comment on the revised proposal; it would also represent a concrete action on which a Congressional review of the matter could be based, if that is desired. Thereafter, we would hope that a final agreed-upon version of the new Regulation A would go into force. While I cannot be definitive about the schedule, it is expected that the process will be completed before the end of next spring.

Looking at the proposal against the background of monetary policy in general, I can see two major issues which deserve special attention in any review. The first of these is the relationship of the redesigned discount mechanism with Federal Reserve open market operations. The latter tool is presently the preponderant means of System reserve provision and the leading edge of monetary policy implementation. This dominant role would not be changed under the proposal. However, the suggested redesign would be expected to increase somewhat the volume of reserves injected through the discount window, chiefly as this tool assumes an increased part of the burdens of intra-monthly and seasonal reserve adjustment.

We believe that this partial realignment of the two tools will result in their operating in a more complementary fashion than they do now. As the discount window provides for an increasing part of necessary day-to-day reserve adjustment, for which the initiative would then rest largely with the individual member banks, System open market operations could be undertaken with greater attention to longer-run concerns. The generally higher level of borrowings which this would entail is not conceived to mean a corresponding increase in total reserves or a loss of control in this area. The Federal Reserve would retain the ability to bring about and maintain the desired level of over-all credit availability (taking into account the relatively small increase expected in credit outstanding at the window) through purchases and sales of securities in the open market. Thus, it is expected that the proposed changes in the discount mechanism would not cause any special problems for open market operations. In fact, the changes would increase the long-run effectiveness of such operations.

The second major issue which I would cite is that of discount rate policy. The level and the role of this rate are important for a variety of reasons, not the least of which is insuring that discounting and open market operations, in fact, complement one another as I have just outlined. The proposal for redesign of the discount mechanism contemplates, as I mentioned, that the discount rate will play an increased role as an influence on the volume of member bank borrowing. This would come about as a result of a rate kept reasonably closely in line with the movements in other money market rates. Such a policy would require more frequent changes in the discount rate than have typically been made in the past. In a period of changing financial conditions and rapidly moving market rates, changes might be necessary as often as every several weeks.

This increase in the frequency of discount rate changes will present challenges to both the Federal Reserve and the financial community -- the former with regard to actually accomplishing the changes and the latter with regard to learning to interpret what the changes mean under the new rules. As far as our own role in this area is concerned, the proposal recommends that the current mechanics of setting discount rates be retained. Thus, the rates in the various Districts would continue to be set by the Reserve Bank Boards of Directors, subject to review and determination by the Board of Governors. The more frequent use of this mechanism would call for more active communication within the System than currently obtains in setting rates. But, as I mentioned at the outset, it would be beneficial to develop such communication independently of the outcome of the proposals to reshape the discount mechanism.

The proposed arrangement has no special provisions to insure uniformity of discount rates from District-to-District. While the proposal assumes a single System-wide discount rate under most circumstances, the Committee did not feel it was necessary to include any special arrangements for achieving this result. Thus, under the proposal, there would be a possibility of short-run inter-District differences. However, the Committee thought that the use of the requirement for periodic Board of Governors approval of each discount rate could be relied upon, if it were ever to be needed to resolve non-uniformities among Districts. In any case, the Committee felt it is somewhat unrealistic to contemplate the maintenance of wide inter-District discount rate differentials for a long time in today's highly interdependent economy. I personally share this view, and I think a policy should be evolved to cope with this possibility -- short of relying solely on the Federal Reserve Board to review and determine the rate

The proposed movement to a more flexible discount rate would undoubtedly impose some burden of readjustment on participants in the financial community. Actually, once the new procedures are established and recognized, the typical discount rate movements, generally following market rate movements, should become regarded as normal and self-explanatory. However, I recognize that in the past a change in the discount rate has been a comparatively infrequent and meaningful event -- even if that meaning was sometimes cloudy and debated -- and I assume that for a time there would be attempts to read equal significance into the smaller and more frequent changes. One of the goals of these more frequent changes would be a dampening of these often troublesome announcement effects, and the adoption of this recommendation might be helpful in this regard. On the other hand, as I stressed above, a better job of explanation by the Board of discount rate changes needs to be done in any case.

Lags in Reserve Bank Discount Rate Changes

Once the Federal Reserve Board has approved a change in the discount rate for one or more Reserve Banks, the remaining Banks normally follow suit rather quickly. Consequently, a situation is ordinarily avoided in which different discount rates would prevail at various Federal Reserve Banks. However, the period over which adjustments in discount rates have occurred has not been uniformly short. From time-to-time, one or more Reserve Banks have lagged considerably behind others in establishing the new rate. The most recent example was provided by the reduction in the discount rate from 5-1/2 per cent to 5-1/4 per cent in mid-August of this year. Initially, the lower rate was established only by the Federal Reserve Bank of Minneapolis, and three days later the Richmond Bank also fixed the lower rate. However, a week passed before another four Banks made the adjustment, and still another week lapsed before the last four Banks took the same step. Although this situation did not produce any concern about artificial segmentation of the money market or about the possible disturbance of the flow of funds, it did help to create doubts and uncertainty. A similar situation arose on a few other occasions in the past.

In order to put these events into better perspective, an examination was undertaken of the pattern of adjustment to discount rate changes among Federal Reserve Banks during the years 1955-1968.[1] The general pattern is displayed in Table 1.

During the nearly 14 years covered, the discount rate level changed 26 times. Eight of these changes were decreases and 18 were increases. About two-thirds of the adjustments (17) involved changes of 1/2 per cent, and the remainder (9) were for 1/4 per cent. However, in the last decade (since August, 1958), all discount rate adjustments -- except the most recent one in August of this year -- involved changes of 1/2 per cent.

It will also be noted that there has been considerable variation in the amount of time the Reserve Banks have taken to bring their discount rates into line once a change has been approved by the Federal Reserve Board. In the typical case, about five Banks posted rate changes effective on the initial day, and others followed fairly promptly. However, in five cases, only one Bank made the change initially. On eight occasions, one or more Banks allowed 14 days to elapse before making the adjustment. In three instances, the time span was 21 days, and in one case four Banks did not make the change for 28 days. On that same occasion, two Banks took even longer -- one waiting 35 days and the other 39 days.

In an attempt to summarize this experience, weighted averages of the time lag (measured in days) involved in these adjustments were calculated, using as weights the number of Reserve Banks posting the change on a given day. The calculations were performed for all 12 Reserve Banks taken

1/ The analysis began with 1955 because that was the year of the last major revision in the Federal Reserve Board's Regulation A governing discounting by member banks.

TABLE 1

Pattern of Adjustment to Discount Rate Changes, Among Federal Reserve Banks, 1955-1968 (Number of Banks)

Dates of Initial Rate Change:	4-14 '55	8-4 '55	8-26 '55[a]	11-18 '55	4-13 '56	8-24 '56[b]	8-9 '57	11-15 '57	1-22 '58[c]	3-7 '58	4-18 '58	8-15 '58	10-24 '58	3-6 '59	5-29 '59	9-11 '59	6-3 '60	8-12 '60	7-17 '63	11-24 '64	12-6 '65	4-7 '67	11-20 '67	3-15 '68	4-19 '68	8-16 '68
Time Lag (days) 0	1	4	1	6	11	4	4	4	1	3	5	1	5	4	5	8	2	4	7	5	2	10	10	10	4	1
1	7	5	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	1	.	.	1	.	.	.
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4	.	1	1	3	.	4	3	1	.	1	2	.	1	1	2	.	.	1	.	.	7	.	.	.	2	.
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7	.	.	1	.	1	1	.	3	.	5	3	1	1	4	2	1	8	3	1	.	1	1	1	1	5	4
8	3	1	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
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39	.	.	.	.	.	.	.	.	.	.	.	1	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Weighted Average: (Days)	4.1	1.6	11.8	1.9	0.6	2.6	5.7	7.0	5.7	5.2	5.3	21.7	5.5	4.8	5.3	1.3	6.4	7.3	1.8	2.1	3.3	0.8	0.7	0.8	3.8	9.2

[a]The Cleveland Bank did not raise its rate. In the previous period, they raised it a full 1/2 point.

[b]The Minneapolis and San Francisco Banks did not raise their rates. In the previous period, they raised them a full 1/2 point.

[c]The San Francisco Bank did not lower its rate. In the subsequent period, they lowered it a full 1/2 point.

NOTE: Circled figures indicate in what group the New York Bank can be found.

together, and separate calculations were done for the Federal Reserve Banks of New York, Chicago and San Francisco, the three largest banks in the System. In addition, the time lag was estimated separately for instances of discount rate increases and instances of rate reductions. The results are shown in Table 2.

Several conclusions stand out in these results. On the whole, Reserve Banks do adjust their discount rates rather quickly after the initial announcement by the Federal Reserve Board has signaled a change in the direction or intensification of monetary policy. During the last 13-1/2 years, the average time lag before all Banks adopted the new rate was just under 5 days. For the Federal Reserve Bank of New York and Chicago, the average time lag was somewhat shorter -- being about 4 days; at the San Francisco Bank it was slightly over 5 days, or somewhat longer than the average for the System as a whole.

As a group, the Federal Reserve Banks seem to bring their discount rates into line somewhat more rapidly when rates are increased than when reductions are effected. For all Banks combined, the average time lag for rate increases was 4.4 days, compared with an average of 5.9 days for occasions when discount rates were reduced. The pattern for the Chicago and San Francisco Banks was roughly the same as that for the System as a whole. The New York Bank generally changed its discount rate more quickly in cases of rate reductions than in those instances when rates were raised.

In Table 3, the time lags in rate adjustments for these three Banks and for all Reserve Banks combined are shown more fully. Again the

Table 2. Time Lags in the Adjustment of Federal Reserve Bank Discount Rates, 1955-1968 (Number of Days)

Type of Change	All Federal Reserve Banks	Selected Banks		
		New York	Chicago	San Francisco
All Changes	4.8	3.9	4.0	5.2
Rate Increases	4.4	4.4	3.7	4.1
Rate Decreases	5.9	2.9	4.6	9.7

NOTE: Time lags are weighted averages of days involved in the adjustment to discount rate changes, using as weights the number of Federal Reserve Banks posting the change on a given day.

Table 3. Distribution of Discount Rate Adjustments,
Ranked by Size of Time Lags (in days)
1955 - 1958

Period (Effective date of initial rate change)	Rate Change	New Rate	Rate Adjustment Time Lag (in days): All Reserve Banks*	New York	Chicago	San Francisco
8-15-58	+1/4 %	2 %	21.7	28	21	0
8-26-55	+1/4	2-1/4	11.8	14	14	14
8-16-68	-1/4	5-1/4	9.2	14	7	14
8-12-60	-1/2	3	7.3	0	7	21
11-15-57	-1/2	3	7.0	0	14	14
6- 3-60	-1/2	3-1/2	6.4	7	7	0
8- 9-57	+1/2	3-1/2	5.7	14	0	6
1-22-58	-1/4	2-3/4	5.7	2	2	**
10-24-58	+1/2	2-1/2	5.5	14	7	13
4-18-58	-1/2	1-3/4	5.3	0	0	13
5-29-59	+1/2	3-1/2	5.3	0	0	13
3- 7-58	-1/2	2-1/4	5.2	0	0	6
3- 6-59	+1/2	3	4.8	0	0	6
4-14-55	+1/4	1-3/4	4.1	1	8	8
4-19-68	+1/2	5-1/2	3.8	0	7	0
12- 6-65	+1/2	4-1/2	3.3	0	0	4
8-24-56	+1/4	3	2.6	0	0	**
11-24-64	+1/2	4	2.1	0	0	3
11-18-55	+1/4	2-1/2	1.9	0	0	0
7-17-63	+1/2	3-1/2	1.8	0	2	2
8- 4-55	+1/4	2	1.6	1	0	1
9-11-59	+1/2	4	1.3	0	0	0
4- 7-67	-1/2	4	0.8	0	0	0
3-15-68	+1/2	5	0.8	7	0	0
11-20-67	+1/2	4-1/2	0.7	0	0	0
4-13-56	+1/4	2-3/4	0.6	0	7	0
Average Time Lag			4.9	3.9	4.0	5.2

* weighted average
** periods of split rates where San Francisco did not change its rate.

greater tendency for the Banks to respond more rapidly when rates are advanced is clearly demonstrated. The explanation for this behavior pattern is not readily evident. However, from an operating viewpoint a Reserve Bank might be reluctant to maintain its existing rate once one or more other Banks have posted higher discount rates. Behind this reluctance may be the apprehension of exposing itself to excessive borrowing by member banks -- perhaps to satisfy an enlarged demand for funds by customers in Districts where interest rates may have advanced in response to higher discount rates. The Reserve Bank would not necessarily face the same situation when discount rates are reduced in one or more other Districts.

On the other hand, from the viewpoint of monetary management, the asymetrical response of Federal Reserve Banks to changes in the discount rate is not a matter of indifference. Given the breadth and resiliency of our national money market, once it has been decided that a change in the discount rate is appropriate, it is obviously desirable that the impact of the new rate be transmitted as expeditiously as possible to all sectors of the economy. The maintenance of split discount rates for any length of time -- especially when the large Reserve Banks are among those whose rates remain unchanged -- would clearly make it more difficult to achieve the objective sought.

Still another conclusion can be drawn from the above data, especially from Table 1. It appears that the New York Bank is typically among the first to adjust its discount rate when a change has been decided upon. Yet, it is also clear that, if the New York Bank is reluctant to make the change, it is likely to delay for two weeks or more -- and a few other Banks may well follow suit. Thus, the New York Bank was included in the lead group during 16 of the 26 discount rate changes over the period. There were four occasions during which 4 or more Banks delayed adoption of the new rate for 14 days or more, and the New York Bank was among the last on three of these instances.

Potentially Adverse Effects of Split Discount Rates

As I observed above, under most circumstances, the existence of different discount rates at Federal Reserve Banks for a short while is of no consequence from the point of view of monetary management. So, while the pattern of rate adjustments sketched above may be interesting, it is generally not a cause for deep concern. However, on a few occasions in the past this has not been the case. Once in 1955 and again in 1958, a substantial number of Reserve Banks -- for a fairly long time -- resisted an increase in the discount rate. On both occasions, the Federal Reserve Board felt the change was needed and demonstrated its conviction by approving the establishment of the higher rate by at least one Reserve Bank. In both of these earlier periods, participants in the financial markets became aware of the differences within the System over the appropriateness of the particular action. As a result, confusion and uncertainty over the probable course of monetary policy prevailed for some time. The third situation arose this year and centered on the discount rate changes effective in mid-March and in mid-August, especially on the latter. Putting aside the change in March of this year, the other three occasions represented the longest delays among the 26 discount rate adjustments made during the last 13-1/2 years. The first experience, in August and September, 1955, involved a weighted average time lag of 11.8 days; the second period, in August and September, 1958, involved a weighted average time lag of 21.7 days, and the most recent episode involved a weighted average time lag of 9.2 days. Each of these experiences is reviewed briefly. The following comments on the two earlier are based primarily on the published record of the Federal Open Market Committee. For the most recent case, they reflect my own personal experience and observations.

In the summer of 1955, the Federal Reserve concluded that the recession of 1953-54 was over, and a period of sustained expansion lay ahead. However, there was a difference of opinion within the System about the vigor of the recovery and about the timing of actions and the steps needed to restrain the growth of bank credit. The situation was further complicated by the Treasury's need to finance a sizable amount of maturing debt. Against this background the Board of Directors of the Federal Reserve

Bank of Cleveland concluded in late July, 1955, that economic conditions in their District necessitated an increase in the discount rate by 1/2 per cent to 2-1/4 per cent. However, before they established this rate, the President of the Cleveland Bank inquired informally as to the views of the Federal Reserve Board. The Board was inclined to support such a step but it thought it best that the Treasury's reaction be ascertained in view of the fact that a major Government financing effort had just been concluded. Although Treasury was sensitive to the impact of such a move on the Government securities market, and thought a change of 1/4 per cent would be preferable, it accepted the proposed change of 1/2 per cent as necessary to combat inflation. Satisfied that Treasury could go along with the change, the Board informally indicated to the Cleveland Bank that an increase of 1/2 per cent was acceptable. With this assurance, the Cleveland Bank on July 27 established a new discount rate of 2-1/4 per cent and formerly requested the Board's approval. However, the Board felt that the matter might better be postponed until it could be discussed from a System viewpoint, which could be done at the August 2 meeting of the Federal Open Market Committee (FOMC).

At this meeting, it developed that all except one of the Reserve Bank Presidents strongly opposed a 1/2 per cent increase in the discount rate. On the other hand, all of the other 11 Presidents, except one, supported an immediate increase of 1/4 per cent (and the one exception would have accepted it reluctantly), putting the rate at 2 per cent. They thought this step should be re-inforced by a more restrictive open market policy, and another rate increase of 1/4 per cent might be made later in the fall if economic conditions continued to strengthen. The opposition to the one-step increase, led by the President of the Federal Reserve Bank of New York, rested partly on concern over its impact on the Government's securities market and partly on doubts about the pace and sustainability of recovery. Among Federal Reserve Board members, however, there was a conviction that inflation was the real issue to be confronted, and they were willing to risk some weakness in the securities market -- if that were the cost of combating inflation. The Board was strongly supported by its staff -- which, in fact, advocated the 1/2 per cent increase as a move to transform the discount rate into a penalty rate. At the conclusion of the August 2 FOMC meeting, the System remained deeply split.

While this internal debate was in progress, knowledge of it seeped into the public domain, and the effects were considerably adverse. This was especially true in the Government securities market which was still trying to digest the recent Treasury debt offering. The deterioration in the market situation persuaded the Treasury to reverse its early indication that an increase of 1/2 per cent would be acceptable. This shift in the Treasury's position apparently strengthened the reservation expressed by those opposed to the move.

Nevertheless, on August 3, 1955, one day following the FOMC meeting in which the depth of the System policy split was revealed, the Federal Reserve Board approved a 1/2 per cent increase in the discount rate at the

Federal Reserve Bank of Cleveland, raising it to 2-1/4 per cent, effective August 4. However, no other Reserve Bank established the same rate. Instead, eight Banks (including New York) raised the rate by 1/4 per cent to 2 per cent, and the Board approved all of these -- five effective August 5 and the other three effective between that date and August 12. Two Reserve Banks made no change at all in their discount rate at this time.

Then, following another meeting of the FOMC on August 23 during which the split rate situation was discussed further, the second 1/4 per cent change in the discount rate was made. Effective August 26, the Federal Reserve Bank of Atlanta (which had not raised its rate to 2 per cent) posted a rate of 2-1/4 per cent. Other Banks began to move into line gradually. However, six Banks (including New York) waited two weeks, and one Bank waited 18 days. So, it required almost two months to resolve the issue of what discount rate should be set for the System.

In retrospect, it is clear that the Federal Reserve Board's assessment of the economic situation was correct, although it is hard to express a judgment about the weight which should have been assigned to the problem of Treasury financing. But, in the context of this experience, the differing appreciation of economic developments on the part of the Federal Reserve Board and the Boards of Directors of the Reserve Banks -- to a considerable extent reflecting difference in the amount and quality of information available to each -- was clearly an obstacle to the determination of monetary policy. While a greater awareness of current developments would not necessarily result in the same judgments on monetary actions, it would enable such different judgments to be introduced into the policy process without being hampered by questions of uneven information.

To some extent, the second split discount rate espisode of August and September, 1958, closely paralleled the 1955 experience. This time, the economy was recovering from the 1957-58 recession, and a policy of monetary ease had been in effect since late in 1957. However, the pace of recovery was quite uneven among Federal Reserve Districts. Moreover, in the nation at large, considerable excess capacity still existed, and the unemployment rate in August, 1958, was over 7 per cent. Yet, the economy was advancing on a broad front, with gains in industrial production and construction being particularly sharp. Since mid-June wholesale prices had been rising and by August exceeded the peak reached in March, 1958. Partly reflecting these improved economic conditions -- but also the prospect of a large Federal deficit for that fiscal year -- the Federal Reserve Board concluded that there had been a sharpening of expectations with regard to a renewal of inflationary pressures. During mid-July, monetary policy was diverted temporarily to the correction of a disorderly condition in the Government securities market, and, effective August 5, margin requirements had been raised to 70 per cent to dampen the sharp expansion of stock market credit. Although open market policy had been modified at the end of July and in early August, 1958, to recapture and avoid redundant reserves, there was no general expectation within the Federal Reserve System that a policy of monetary restraint was called for in the near future.

Thus, the surprise was considerable when the Federal Reserve Bank of San Francisco on August 13, 1958, raised its discount rate by 1/4 per cent to 2 per cent and requested approval from the Federal Reserve Board. The reaction at the Board was not unfavorable, but there was also a feeling that it would be preferable to postpone the decision until the matter could be discussed at the next FOMC meeting set for August 19. However, within a day following the action by the San Francisco Directors, rumors asserting that they had acted were circulating widely. Under the circumstances, the Board approved the new rate effective August 15.

At the FOMC meeting of August 19, all Board members present supported their prior approval of the rate increase at the San Francisco Bank. However, only two Reserve Bank Presidents (other than the San Francisco representative) endorsed the move; one President gave reluctant support, and one made no comment on the rate change. On the other hand, six Reserve Bank Presidents and the First Vice President of the Federal Reserve Bank of New York expressed strong opposition to raising their own discount rates at that time. While several of them thought a rate advance might be appropriate later in the year, they generally held that the recovery from the previous recession had not gone far enough to justify such a move during the summer.

Following the Board's approval of the rate change at the San Francisco Bank, a week passed before another Bank made the move. Two weeks after the initial change, only three additional Banks had posted the higher discount rate, while eight still maintained their previous rate. In the meantime, the split rate situation again led to market uncertainty and confusion.

It was against this background that the next meeting of the FOMC was held on September 9, 1958. By this time, two more Reserve Banks had adopted the higher rate, but six still had not done so. At this meeting, the difference in view between the Board members and some of the Presidents was -- if anything -- even sharper. Three Presidents still felt that an increase in the discount rate was not called for in their Districts, and two Presidents stated they would -- reluctantly -- recommend the change to their Directors in the near future. This time, however, unlike the situation in 1955, virtually all of the Board members took the view that the persistence of split discount rates could not be defended and strongly urged the remaining Banks to bring their rates into line at the earliest opportunity. The need tc do this, some Board members suggested, was supported not only by continued strengthening of economic activity and the growing threat of inflation but also by the prospect of another Treasury financing operation in the early fall.

Under these circumstances, three of the remaining Banks (including New York) raised their discount rate within a few days following the FOMC meeting of August 9. However, by this time, four weeks had passed since the rate was changed initially by the San Francisco Bank. Nevertheless, one Reserve Bank (Philadelphia) delayed the step for a total of 35 days, and the last Bank to move (Boston) delayed for a total of 39 days.

The third episode to be discussed occurred this year. As mentioned above, this experience is still unfolding, and one can say much less about it than was true of the events in the 1950's. It will be recalled that, effective last August 16, the Federal Reserve Board approved a reduction in the discount rate by 1/4 per cent -- from 5-1/2 per cent to 5-1/4 per cent -- at the Federal Reserve Bank of Minneapolis. In approving the change, the Board stressed that it was primarily technical and was undertaken to bring the discount rate into alignment with money market conditions -- which had strengthened somewhat in response to the adoption of the various fiscal restraint measures last June. However, there was some feeling in the financial community (some of which was shared within the Federal Reserve System) that no reduction in the discount rate was necessitated at the time. Reflecting this sentiment, only one other Bank changed its discount rate within a few days. About a week after the initial change, four additional Banks adopted the slightly lower rate. The last four Banks (New York, Atlanta, St. Louis and San Francisco) waited two weeks to establish the new discount rate.

Again, because this experience is still so close to us, I think it is best to refrain from saying much more about it. However, it will be recalled that the delayed response of some of the Reserve Banks was a matter of considerable comment. Although other factors were involved, this delay also contributed to some uncertainty and confusion in the financial community. In my personal opinion, the latest situation was heightened to some extent by the experience last winter when the discount rate was raised by 1/2 per cent to 5 per cent at ten Reserve Banks, effective March 15. A few days later, another Bank adopted the same rate. This left only one Bank (New York) at the old rate of 4-1/2 per cent which had been set following the devaluation of Sterling last November. The mid-March increase of 1/2 per cent in the discount rate, it will be recalled, was one of several moves designed to cope with the extremely difficult situation then prevailing in the gold and foreign exchange markets. These moves included closing out the London Gold Pool and the establishment of the two-tier market for gold. There has been considerable comment on the fact that the New York Bank was not included when virtually all the other Reserve Banks made the move on the initial effective date of the change. Some of this public comment has suggested that the Directors of the New York Bank felt that an increase in the discount rate larger than 1/2 per cent was required in light of the serious international situation. Without focusing on whether these comments are well-grounded or not, I would like to stress that the information available to the Federal Reserve Board about the other elements in the package of measures designed to deal with the gold and foreign exchange problem at the time could not be shared fully with the Directors of the Federal Reserve Banks. By their very nature, these measures involved Government-to-Government proposals which had to be closely held -- even among Government officials. While I obviously cannot know how different Reserve Bank Directors actually viewed that experience last March -- nor how they would have reacted with respect to the discount rate if they had known more about the other proposals under consideration -- I did want to call attention to the fact that sometimes changes in the rate are necessary for reasons (especially those associated with international developments) that only become completely apparent later. It should be noted that the discount rate was raised in the latter part of April to 5-1/2 per cent but because of circumstances which had developed subsequent to the March action.

But let me emphasize again that I believe such occasions are likely to be rare. Under most circumstances, I would anticipate that proposals to change Reserve Banks' discount rates would be established by their Directors and submitted to the Board for approval in the usual way. Again, in most situations, the amount of time the Banks take in responding to discount rate changes need not be a matter of concern to the Federal Reserve Board.

A Unique Case of Discount Rate Determination

Having reviewed the above instances of delays in some Reserve Banks' adjustment to discount rate changes, one might naturally ask why the Federal Reserve Board did not exercise its statutory authority to review and determine the rate. This is especially true with respect to the situation that developed in the summer of 1958 when the Board was virtually unanimous in its conviction that all Reserve Banks should bring their discount rates into line more promptly. Actually, it appears that the question of using such authority was never considered by the Board.

In fact, there has been only one occasion in the entire history of the System when the Federal Reserve Board determined the discount rate over the opposition of the Board of Directors of a Reserve Bank. That was during the late summer of 1927, or 41 years ago, and it involved the Federal Reserve Bank of Chicago. Well before then, however, the right of the Board to take such an action had been questioned by the Federal Reserve Bank of New York, but an opinion of the U.S. Attorney General in 1919 had definitely established the Board's legal authority in the matter. Yet, until 1927, the Board had not actually found it necessary to use it.

The experience concluding in the determination of the Chicago rate on September 6, 1927, began at the end of the preceding July, when a decision was made to bring about a national policy of lower interest rates through a

System-wide reduction in Federal Reserve Bank discount rates (then called re-discount rates) from 4 per cent to 3-1/2 per cent. At a joint meeting of the Federal Reserve Board and the Open Market Investment Committee (OMIC) on July 27, it was concluded that lower interest rates in the United States were appropriate in light of both national and international developments. To insure that a 3-1/2 per cent rate would be effective, it was suggested that it might be desirable to make further purchases of a substantial amount of securities.

At that time, the OMIC was composed of five Governors of the Federal Reserve Banks (now called Presidents), including the Governor of the New York Reserve Bank. In addition to the Committee members, the Governors of the St. Louis and Minneapolis Banks also attended.

While there was some slackening in U. S. business and commodity prices were continuing to decline, the immediate objective was to widen the spread between interest rates in New York and London. It was felt that, because of the drain of gold from a number of European central banks, rates in Europe might rise significantly during the coming months. The German and Austrian central banks had already raised their lending rates, and there was the possibility of a 1 per cent advance in the Bank of England's rate. If European rates were to rise further, the effects on U.S. exports would be adverse. To help forestall this development, a policy of seeking lower interest rates in the U.S. was adopted. Although it was recognized that conditions in some interior Districts (judged by the small volume of rediscounting) might not appear to indicate a demand for a rate reduction -- and some bankers opposed such a move -- all participants in the joint meeting agreed that national objectives called for the move. At the conclusion of the meeting, the Board took the unusual step of directing that the minutes of the meeting and the report of the Chairman of the OMIC be sent on a confidential basis to each Federal Reserve Bank for presentation to its Board of Directors.

In preparation for the moves to implement the decision to strive for a System-wide interest rate policy, the Federal Reserve Board on July 28 voted to delegate to a member or members of the Board present authority to approve any recommendations received from Reserve Banks to reduce the discount rate from 4 per cent to 3-1/2 per cent. The expected response came quickly from some Banks. The Federal Reserve Bank of Kansas City led the move with a rate reduction effective August 2. By mid-August, all the Reserve Banks -- except four -- had adopted the lower rate. The four maintaining the 4 per cent rate were Philadelphia, Chicago, Minneapolis, and San Francisco. (It will be recalled that the Governor of the Minneapolis Bank had participated in the joint Board-OMIC meeting and had not voiced objections to the policy decision).

In the case of each of these four Banks, their Boards of Directors or Executive Committees met during the month of August to consider the proposed rate reduction and explicitly voted not to adopt it. In each instance, it was argued that conditions in their respective Districts did not call for a lower rate. In light of the action by the other three Banks (none of which changed its rate until after the Chicago rate was determined) it may not be readily apparent why the Board felt so strongly about the situation at the Federal Reserve Bank of Chicago.

On closer examination, however, the Board's concern is quite understandable. Then, as now, Chicago was the principal financial center in the country behind New York. It was widely felt that if a national trend toward lower interest rates were to be achieved, the Chicago Reserve Bank had to assist in bringing it about. Beyond that fact, however, the Directors of the Chicago Reserve Bank reacted early, frequently -- and negatively -- to the proposition. On July 29, two days after the basic policy change was adopted by the Federal Reserve Board and the OMIC, the Chicago Board voted not to reduce its rate from 4 per cent to 3-1/2 per cent. On August 5, the Executive Committee of the Chicago Board also voted to maintain the 4 per cent rate. Chicago's full Board met on August 26 and again voted against a reduction, and this was followed on August 30 by another vote of the Executive Committee to retain the 4 per cent rate.

By this point, the Federal Reserve Board, acting through its Executive Committee, decided that enough time had been allowed the Chicago Reserve Bank to bring its rate into line. So on August 30, the Board's Executive Committee voted formally not to approve re-establishment of the 4 per cent rate which the Chicago Directors had voted on August 26. On August 31, the Chairman of the Chicago Bank was informed by telephone of the Board's action. The Chairman reported that he was reasonably confident that a favorable vote to reduce the rate would be forthcoming at the regular meeting of his Bank's Executive Committee set for September 9, until which time he was hopeful that the 4 per cent rate would be allowed to stand. He was told that any change would have to be made by September 2.

A special meeting of the Chicago Bank's Executive Committee was held on September 2, but only three of the six members attended. The Chairman of the Chicago Bank's Board of Directors moved that the rate be reduced to 3-1/2 per cent, and it did not carry. The other two members indicated that, while they were personally disposed to respond favorably to the Federal Reserve Board's request, there was not a majority of the Committee present. Since they already knew that the remaining three members of the Executive Committee opposed the rate reduction, they thought it best to hold the matter over until the Committee's regularly scheduled meeting on September 9.

News of this action was not received warmly at the Federal Reserve Board. Although the Chairman of the Chicago Bank thought a favorable vote by his Executive Committee might still be possible on September 9 -- if the status quo were maintained until then -- the Federal Reserve Board found the situation unacceptable. A special meeting of the Board was held on September 6 to consider the rediscount rates at the Federal Reserve Banks of Chicago and San Francisco. After considerable discussion, a motion was made and passed (although not unanimously) to fix a rediscount rate for the Federal Reserve Bank of Chicago of 3-1/2 per cent effective at the close of business on the same day. No decision was made to fix the rate for the San Francisco Bank; instead it was decided to advise the Chairman of the San Francisco Bank that the Federal Reserve Board felt its rate should be reduced and requested that its Board of Directors or Executive Committee consider the matter promptly. Following the Board's determination of the rate at Chicago, the other three Reserve Banks reduced their rates to 3-1/2 per cent. Board approval was given on September 7 to the Philadelphia Bank's action, and the Minneapolis and San Francisco Banks established the lower rate effective September 14, 1927.

I have reviewed at some length this single case of discount rate determination by the Federal Reserve Board because I find it most instructive.

Undoubtedly, the entire System was so chastened by the experience that it has never been repeated. From the vantage point of 40-odd years, it is clear that much more was involved in the controversy than whether the discount rate should be reduced by 1/2 per cent at a particular Reserve Bank. The fundamental issue was whether the System should try to pursue a common monetary policy in the national interest -- or whether mainly regional considerations should be given the most weight. But there were also questions about the availability of information and the relevance of international factors in the determination of monetary policy. Moreover, as is usually the case, there were strong personalities involved -- both at the Federal Reserve Board and in the various Reserve Banks. Thus, this episode, as a first class drama should, helps us to understand how vital -- but also how fragile -- is our basic discount mechanism. Its significance should not be missed because of a lack of historical perspective.

Strengthening the Contribution of Discount Policy to Monetary Management

Returning to the current scene, I am personally convinced that a number of steps can be taken to enhance the role of discount rate changes as instruments of monetary policy. I think a special opportunity exists for expanding the contributions which the Reserve Banks' Boards of Directors can make.

In the first place, we need a more efficient mechanism for keeping the entire System abreast of the way in which different parts of the System are reading those economic and financial developments which influence judgments about possible changes in discount rates. Of course, I fully realize that each Reserve Bank provides for its Board of Directors ample information and analysis not only of developments in its own District but in the national economy as well. Moreover, the regular meetings of the FOMC enable each Reserve Bank President to participate with his colleagues in a full discussion of the economic and financial outlook and weigh the key factors bearing on monetary policy. Members of the Federal Reserve Board and its Senior Staff also share fully in this exchange. While the FOMC does not have any responsibility to review or fix discount rates, it does serve as a forum for the consideration of monetary policy generally -- including possible changes in discount rates. Thus, under current arrangements, it is difficult to anticipate that a discount rate adjustment would come as a surprise.

Nevertheless, there is still room for further improvement in our communications system. As is generally known, the FOMC meetings are conducted on a confidential basis. While Reserve Bank Presidents undoubtedly share with their Boards of Directors their own appraisal of economic and financial trends, this almost certainly does not extend to the results of the deliberations of the FOMC. While there is more or less frequently communication between a few Directors and one or more members of the Federal Reserve Board, this network is not very extensive. Finally, while once each year Reserve Bank Chairmen and new Directors meet separately as a group with the Federal Reserve Board, these are not occasions best suited to the discussion of discount rate changes or other aspects of current monetary policy.

Thus, I am in favor of further strengthening our network of communication. As noted in the recently published report on the discount mechanism, several procedures now exist for the formal exchange of information and experiences among the discount departments of the 12 Reserve Banks and the Board staff. For a number of years now, a two-day conference of discount officials has been held early each Fall. This provides an opportunity for intensive discussion of the broad issues currently facing the discount officers or expected to arise in the near future and has proved to be a most useful forum for this purpose.

In addition, a series of telephone conference calls was instituted approximately two years ago for interim exchanges of ideas and experiences. These calls were begun with the issuance of the System's September 1, 1966, letter regarding discounting and restraint of business lending, with the original intent of coordinating the program established by that letter. They were held first on a weekly basis and then biweekly for the duration of that program. When the letter was rescinded in December, 1966, it was decided that the calls had proven of such value for the exchange of more general information than originally contemplated that they should be continued. Since that time they have been held approximately once a month, with the exact scheduling depending on current conditions.

It will be noted, however, that so far the discount conference, for the most part, has involved technical personnel, and the focus has been primarily on the functioning of the discount window within the framework of a given discount policy. I would like to see the participation in this conference broadened considerably. In my opinion, it would be helpful to include more policy-oriented staff in the Reserve Banks and at the Board. From time-to-time, Reserve Bank Presidents and Board Members might also join. Such a concentrated focus on the performance of the discount function should certainly improve the chances for the emergence of a commonly understood discount policy throughout the System. It would enable the officers of each Reserve Bank to keep its Directors more current with respect to the trend of thinking in relation to the possible need for a change in the rate.

Being better informed about national and international as well as regional developments, the Directors would also be in a better position to decide more quickly whenever a rate adjustment seems called for. Having said this, I certainly am not suggesting that all Directors will agree more readily to support a particular rate action. Quite the contrary, each Director would obviously retain his right to vote for or against any proposed change. What it does mean is that he would be in a much better position to express his judgments about policy less hampered by questions concerning the adequacy of information. By the same token, the Federal Reserve Board would be in a better position to perform its own responsibilities to review and determine the rate established by a Reserve Bank. In making its own decision, the Board would have greater assurance that the Bank Directors, in fact, had acted against the background of a full awareness of the requirements of the nation's monetary policy.

In the meantime, the administration of the discount function would also be improved if the arrangements under which the Directors of the Reserve Banks transact their business were refashioned to permit a more rapid consideration of discount rate issues. A review of the current by-laws of the Reserve Banks covering the frequency of meetings of their Boards of Directors and of their Executive Committees shows a variety of practices. For example, the by-laws of only three Banks provide explicitly for a meeting of their full Boards approximately every 14 days. Eight of the Banks provide for a full Board meeting roughly every 30 days. The remaining Bank simply states that the Board of Directors should fix the date; currently the schedule calls for a meeting about every 30 days. The by-laws of all Reserve Banks authorize the calling of special meetings of the Boards of Directors. All of the Banks seem to provide for a schedule of meetings of their Executive Committees which insures that either the Committee or the full Board meets at least once approximately every two weeks. However, while all of the Reserve Bank Executive Committees have authority to act on discount rates, their authority to change rates varies somewhat. Thus, the by-laws of six Banks specifically authorize Executive Committees to act on discount rates in the same manner open to the full Boards. But the Committee in one Bank may not make a change in rates unless it communicates with all of the Directors and obtains the consent of the majority. Although none of the Reserve Banks' by-laws contain express authority for telephone meetings of the Boards of Directors, three of them do specifically authorize telephone meetings of their Executive Committees. Yet, in one case no change can be made in the discount rate.

From the examination of the arrangements at Reserve Banks, I conclude that they might well be reviewed with an eye on their flexibility with respect to discount rate changes. Certainly, if the proposal to make smaller and more frequent changes in discounts is adopted, the Reserve Banks would have to adapt their own procedures.

As I also mentioned above, I think a fuller explanation of rate changes provided by the Federal Reserve Board would enhance the public's understanding of the aims of monetary policy. While the situation has improved greatly in recent years, there is still leeway for doing better. Until the announcement of the discount rate change effective in July, 1963, the Board had issued a statement indicating that it had approved action by the Directors of a particular Reserve Bank establishing a new specified discount rate, effective on a given date; the previous rate was also indicated. Apparently this type of non-explanatory statement was used from the beginning of the System (perhaps on the ground that a central bank's actions spoke for themselves. By 1960, however, the situation had clearly become unsatisfactory. Between August 11 and September 8 of that year, the Board issued a series of announcements, following past practices, contained no written explanation. A Board spokesman did provide some oral background, as had been done for a number of years, but the burden of dealing with the press had now become heavy, and the difficulty of explaining fully what the Board was really trying to achieve was considerable. To correct the situation, the Board adopted a new policy calling for an explanation of the reasons underlying its approval of a rate change. However, since the next discount rate adjustment did not occur until the summer of 1963, the policy was not put into practice for almost three years.

Since then, the amount of explanation provided has been somewhat uneven. For example, in the first application of the policy in connection with the rate changes in July, 1963, the press release was particularly ample in explanations. Again, when the rate was raised in December, 1965, the factors influencing the action were reviewed at some length. On other occasions, the extent of the explanatory material provided has varied greatly. The statement explaining the most recent rate reduction last August was one of the more limited variety. The Board did stress "that the change was primarily technical to align the discount rate with the change in money market conditions which had occurred chiefly as a result of the increased fiscal restraint and a lower Treasury demand for financing resulting from the enactment of the tax increase and its related expenditure cuts."

However, in view of the variety of comments (and some criticism) which have been focused on the action, I am personally convinced that it would have been better if the Board had spelled out more fully the extent to which it considered the rate adjustment in relation to its own assessment of prospective economic conditions. Hopefully, this can be done in the future.

Recent Trends in Discounting

Let me conclude this review of Federal Reserve discount policy with a brief look at the pattern of discount window use in the 1968 period of monetary restraint, as compared to that in 1966. In general, the patterns in these two periods have been somewhat similar. In fact, during the first half of 1968, movements in the level of borrowing at the discount window were virtually a repetition of those in the comparable period of 1966. However, as shown in Table 4, the peak of discount window use this year came in the late Spring, while the upward trend continued until the Fall of 1966. The result is that, while this year's borrowing exceeded that for the like week in 1966), the peak this year was earlier and lower than the earlier-period peak. Moreover, the aggregate level of activity for the calendar year 1968

Table 4. Member Bank Borrowing
From the Federal Reserve
Quarterly, 1966-1968
(Amounts in Millions of Dollars)

All Member Banks

Year	1st qtr	2nd qtr	3rd qtr	4th qtr
1966	481	675	753	633
1967	316	119	89	166
1968	422	704	531p	

Reserve City Banks

	1st qtr	2nd qtr	3rd qtr	4th qtr
1966	333	389	460	443
1967	247	84	39	101
1968	283	405	319p	

Country Banks

	1st qtr	2nd qtr	3rd qtr	4th qtr
1966	148	286	293	190
1967	69	35	50	65
1968	139	299	212p	

p -- preliminary figure

will apparently be significantly lower than in 1966.

The number of banks borrowing at the discount window in any given week likewise moved upward in the first half of 1968, as it had in 1966. However, in this case the absolute level remained consistently below 1966 figures. The number borrowing also reached a peak in the second quarter and has fallen further below 1966 levels since then. Final data on the number of banks using the discount window at some time during the year will not be available until after year end, but preliminary indications are that this figure will also be significantly below the 1966 level. This suggests that, contrary to some expectations, the use of the window has not become more widespread among member banks. Offsetting this suggestion, however, is a qualitative feeling on the part of some within the System (thus far unsupported by hard data) that, while the number of banks which have turned to the window may not be unusually high, this group includes some banks which have not in the recent past been regular borrowers at the window.

The absolute level of borrowing referred to above is perhaps more meaningful if it is related to some measure of bank reserves. When taken as a percentage of total bank reserves, the 1968 figures are consistently below those of 1966. This is to be expected, since borrowing levels in the current year were somewhat lower and total reserves had of course increased in the two-year period. More interesting, however, has been the contribution of discount credit to the growth in total reserves during the two periods of restraint. Using quarterly averages for the fourth quarters of 1965 and 1967 and the third quarters of 1966 and 1968, the amount of growth accounted for by an increase in borrowing levels is about the same in the 1968 period as in 1966 -- 31 per cent and 30 per cent, respectively. However, the difference becomes striking if one shifts back one quarter in the current period (third quarter, 1967 to second quarter 1968), a change justified by the earlier peak of 1968 borrowing levels. On this basis, approximately 37 per cent of the 1968 increase in total reserves was attributable to the higher discount window use.