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 3, 1967, at 9:30 a.m.

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

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

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

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

Mr. Fauver, Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors

Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss McWhirter, Analyst, Office of the Secretary, Board of Governors

Mr. Kimbrel, First Vice President, Federal Reserve Bank of Atlanta
Messrs. Link, Melnicoff, Mann, Taylor, Andersen, Tow, and Green, Vice Presidents of the Federal Reserve Banks of New York, Philadelphia, Cleveland, Atlanta, St. Louis, Kansas City, and Dallas, respectively
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
Mr. Duprey, Economist, Federal Reserve Bank of Minneapolis
Mr. Deming, Manager, Securities Department, Federal Reserve Bank of New York

Mr. Hayes noted that Benjamin U. Ratchford, formerly Vice President and Senior Adviser of the Federal Reserve Bank of Richmond, had retired effective September 30, 1967, that his service as an Associate Economist of the Federal Open Market Committee accordingly terminated as of that date, and that Mr. Wayne had suggested that James Parthemos, Vice President of the Richmond Reserve Bank, be elected Associate Economist in place of Mr. Ratchford.

By unanimous vote, James Parthemos was elected Associate Economist, effective immediately, in place of Benjamin U. Ratchford.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on September 12, 1967, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on September 12, 1967, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period September 12 through 27, 1967, and a supplemental report for September 28 through October 2, 1967. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the Treasury gold stock would remain unchanged again this week, and that the balance of $71 million of gold in the Stabilization Fund might meet needs through the end of the month. During the recent meetings of the World Bank and International Monetary Fund in Rio de Janeiro there was further sharp pressure on the London gold market which reduced the balance in the gold pool to only $5 million by last Friday night. Therefore, another $50 million had been requested and secured in contributions from the pool members. That raised the pool to a new total of $520 million, with $55 million now on hand for further intervention. There was further pressure on the gold market today. In general the situation in the gold market was not benefiting as much from the new international liquidity agreement as had been hoped. That was not surprising since the problem of supply and demand in the

gold market was distinct from those of balance of payments swings and longer run needs for reserves at which the new agreement was directed. He would anticipate that at the November meeting of the Bank for International Settlements there would be strong demands from the European members of the pool for a fundamental discussion of the outlook for the operations of the pool.

On the exchange markets, Mr. Coombs remarked, sterling had remained soggy since the Committee's previous meeting. During September the British had suffered a further sizable reserve loss of $345 million, mainly owing to a continuing drain of short-term funds from London into the Euro-dollar market. The British were still encountering difficulty in rolling over maturing forward contracts because of a small advantage in Euro-dollar rates over short-term rates in London. Today the British would be announcing a reserve loss of only $25 million. That announcement probably would be received with the usual skepticism, but the market was not likely to suspect that the actual loss was as large as it was. As the Committee would recall, he had suggested at the previous meeting that the British perhaps had been relying too heavily on credit assistance from the Federal Reserve, and he had expressed the hope that they would be able to shift some of the burden to other sources. Such a procedure had been worked out; the British had financed the remaining $320 million of their September loss

partly through additional credits of $200 million under the sterling balance credit package after continental central banks had agreed to a considerable liberalization of the terms for drawings under that package. The balance of $120 million had been financed by an overnight credit from the Treasury. The Treasury also renewed on an overnight basis an earlier credit of $125 million extended to the Bank of England at the end of August.

Mr. Coombs added that the total of short-term official credits received by the Bank of England since last May had now reached a very high level indeed. The breakdown as of the end of September was as follows: (1) $250 million under the gold swap with the BIS; (2) $475 million under the sterling balance credit package; (3) $70 million from the Bank of France; (4) $245 million in U.S. Treasury overnight credits; (5) $50 million through Treasury purchases of guaranteed sterling; and (6) $650 million under the Federal Reserve swap line. That added to a total of $1,740 million, which was considerably higher than the peak levels reached in 1964, 1965, or 1966. Curiously enough, the exchange markets had continued to assume that the actual volume of debt outstanding was very much less. That was mainly because the bulk of the pressure had been concentrated on the forward rather than the spot market. Speculative pressure on the spot rate had eased off considerably during the past six weeks or so.

It was unnecessary to point out, Mr. Coombs said, that outstanding short-term debts of over $1.7 billion, in relation to British reserves of $2.7 billion, constituted a highly vulnerable position. In effect, the Bank of England had left only $1 billion of unmortgaged reserves, and it faced further debt maturities before year-end of nearly $500 million owing to the IMF and to the U.S. and Canada under the 1946 loan agreement. There was some possibility that the British might get some additional medium-term credits from the continental countries via the BIS before the end of the year that would help finance their repayments to the IMF.

Mr. Coombs observed that if ever a situation called for firm and decisive action to halt a reserve drain resulting from small interest rate differentials, the present British situation would seem to qualify easily. As the Committee knew, however, action to raise the British Bank rate had been frustrated by domestic political difficulties and it seemed doubtful that there would be any scope for action at least until after the Labor Party Conference that was being held this week. Meanwhile, the Bank of England had been trying to push up the bill rate by driving the discount houses into the Bank, but that had had only a minor effect. In fact, with the jump in the three-month Euro-dollar rate by 1/2 of a percentage point in the past week, the British were now in a worse position than before, with a covered arbitrage conversion

now favoring the Euro-dollar market by nearly 3/4 of a percentage point. Much of the jump in the Euro-dollar rates was attributable to the fact that three-month money now ran over the year-end window-dressing date, and it might be that that seasonal rate adjustment had now run its course.

The critical question, Mr. Coombs said, was whether the Bank of England would be able in the near future to move up its Bank rate sufficiently to check the drain to the Euro-dollar market. He had some hope that such action might be taken within the next two weeks. If so, he thought the Federal Reserve would be well advised to reinforce such a British move by using the authorization to buy guaranteed sterling in the market in an effort to strengthen the spot rate. He thought the Bank of England would be prepared to intervene simultaneously in the forward market to drive down the forward discount. At the same time, it might be suggested to the BIS that they draw heavily on their $300 million swap line with the Federal Reserve to intervene in the Euro-dollar market in an effort to reduce rates there by perhaps 1/8 or 1/4 of a percentage point. Those three operations in combination might succeed not only in stopping the outflow from the United Kingdom, but in inducing some inflow of covered funds, and thus provide a breathing space. There undoubtedly were large short

positions in sterling now, and it was possible that with the right operations and good timing they could be exploited to produce a major turnaround in the position of sterling; but at a minimum the hope would be to stop the drain and enable the British to get through the year end.

All of these actions would be completely frustrated, Mr. Coombs continued, if the New York City banks were to intensify their bidding for Euro-dollars. In fact, the activity of the New York banks in the Euro-dollar market might very well hold the key as to whether sterling would survive through the year end.

With respect to other currencies, Mr. Coombs remarked, at the Rio meetings Governor Carli of the Bank of Italy had suggested to Mr. Hayes and himself that the Federal Reserve make another drawing of $100 million on the swap line to help reduce the seasonal bulge in Italy's dollar reserves. There was some prospect that the Italians might end the year with a modest deficit in their balance of payments for 1967, and that the deficit might be further enlarged in 1968. That would represent an enormous swing from the surplus they recorded in 1965, when the Federal Reserve first undertook forward lire commitments. Bank of Italy officials saw some likelihood that the System might be able to begin reducing its forward lire commitments this winter, perhaps liquidating a sizable amount. In the interim, he hoped there would be no objection by the Committee to rolling over those commitments.

Mr. Coombs concluded by noting that nearly final arrangements had been made for the U.S. Treasury to take over the System's obligations under the swap line with the National Bank of Belgium. The Treasury planned to raise part of the Belgian francs needed for that purpose by issuing a franc-denominated bond, and to obtain the remainder by a drawing on the Fund.

Mr. Hickman recalled that on some earlier occasions the Bank of Italy had put dollar accruals back into the Euro-dollar market. He asked whether Mr. Coombs had discussed the possibility of a similar operation now with Governor Carli.

Mr. Coombs replied that there would be a thorough discussion of the Euro-dollar problem at the next BIS meeting. However, the main issue was dollar accruals by Germany rather than Italy. As the Committee members knew, Germany had run a large surplus over the past year, and roughly $1 billion had been invested in the Euro-dollar market by German banks and other businesses. Those firms were likely to want their money back at year end, but a vacuum would be created in the Euro-dollar market if their funds were suddenly pulled out. In previous years the German Federal Bank had been averse to rechanneling funds back into the Euro-dollar market, but it might be willing to do so now to avoid disruption. In any case, the Italians were not likely to be deeply involved in the matter.

Mr. Brimmer said he had been surprised by Mr. Coombs' observation that the activity of New York banks in the Euro-dollar market might hold the key to whether sterling survived until year end. He asked whether Mr. Coombs had any suggestions as to actions the Federal Reserve might take in that connection to reinforce British efforts to ameliorate the problem. In particular, would he recommend that the Board consider applying reserve requirements to U.S. bank liabilities to their foreign branches?

Mr. Coombs replied that he did not have any specific courses of action to suggest; his object had been simply to bring the problem to the attention of the Committee. He would say, however, that because the problem was essentially of a short-run nature, it probably should not be dealt with by actions of a permanent character, such as an action involving the reserve requirement instrument. Perhaps some form of moral suasion could be used. The matter should be given intensive thought, since the problem could become critical if operations of U.S. banks over the next few months resulted in continued drains of funds from London.

Mr. Hayes remarked that the staff at the Federal Reserve Bank of New York had been giving a good deal of thought to the problem recently and he would expect that along with the Board's staff they would continue to pursue the matter.

Mr. Mitchell observed that U.S. banks might borrow heavily in the Euro-dollar market in coming months if the Regulation Q ceilings limited their ability to obtain funds domestically. That raised the possibility of an increase in the ceiling rates on large-denomination CD's as a means of dealing with the problem.

Mr. Hayes agreed that there was a close relation between U.S. bank activity in the Euro-dollar market and the ceiling on large-denomination CD's. He thought the Committee had to face the fact that if and when the System found it necessary to restrain Euro-dollar borrowings by U.S. banks its action would be regarded as a tightening move. The Euro-dollar market had tended to be regarded as a safety valve of great importance to the large U.S. banks.

Mr. Mitchell said that the only other possibility that occurred to him would be to remove the pressure on U.S. banks by a modification of discount window procedures.

Mr. Hayes remarked that, as Mr. Coombs' had noted, the critical problem lay in the short run. Like Mr. Coombs, he (Mr. Hayes) questioned whether the answer lay in an action of a longer-run nature.

Mr. Wayne observed that the essential problem appeared to be one of inducing a change in the attitudes of U.S. banks toward the Euro-dollar market.

Mr. Ellis referred to Mr. Coombs' comment about the pressure for a fundamental discussion of the gold pool, and asked whether the structure of the pool was being broadly questioned or whether the pressure came mainly from the French.

Mr. Coombs replied that the French had withdrawn from the pool operation some six or seven months ago, and he would assume that they would not participate in discussions of it at open meetings. The risk, as he saw it, was not that other countries would withdraw, but that they would feel they could not afford to show a reduction in their gold reserves as a result of their participation and therefore would buy gold from the United States to replenish their stocks. That process might continue to the point at which the United States was carrying virtually the entire burden of the pool's operations, even though nominally the U.S. share remained 50 per cent. As he had pointed out at several recent meetings, the longer-run trends in the supply-demand situation were not good; over the next two or three years a large drain from monetary gold stocks could be expected. He anticipated serious difficulties as the market became aware of that situation.

Mr. Brimmer asked what position Mr. Coombs thought the United States should take in the expected fundamental re-examination of gold pool operations.

Mr. Coombs replied that there had been pressure for such a discussion for the past year. The United States had suggested that it be postponed until the liquidity exercise had been completed, on the grounds that agreement on monetary reform was likely to have a substantial effect on sentiment in the gold market. The hoped-for effect had not been forthcoming, and unless there was some other valid reason for postponement he assumed that the discussions would take place. The question Mr. Brimmer had posed had been under consideration within the U. S. Government for the past two years, but no conclusions had been reached. Obviously, it was not possible to deny the recent trends in gold demand and supply.

Mr. Brimmer then asked what Mr. Coombs' reaction was to the announcement by the South African Minister of Finance at the Rio meetings that the rate at which his country supplied gold to the London market would decline unless the price of gold was raised.

In reply, Mr. Coombs noted that the Minister had not threatened that South Africa would withhold gold from the market. Rather, he had argued that in the absence of a higher gold price an increasing number of South African mines would be forced to shut down, and that that reduction in supply would advance the date of the crisis.

Mr. Daane agreed with Mr. Coombs that the outcome of the liquidity exercise had had little immediate impact on the situation in the gold market. The market reaction might well be different, however, as the time approached at which new drawing rights would be created to stand side by side with gold and dollars. All one could do was wait to see what the reaction would be then.

Mr. Mitchell referred to Mr. Coombs' suggestion that the drain of short-term funds from London might be stopped by changing interest rate relationships somewhat. Observing that the differential between Euro-dollar rates and U.S. CD rates had been more or less nominal over the past two or three months, he asked whether Mr. Coombs thought the change in rate relations would have to be large enough to destroy the incentive for U.S. banks to borrow in the Euro-dollar market.

Mr. Coombs replied that the relation he had had in mind was that between Euro-dollar rates and U.K. local authority rates, which had been in favor of the former by varying amounts for the past two or three months. As a result people with maturing forward contracts had had no incentive to leave the funds on deposit in London; they could earn a larger return in the Euro-dollar market. The local authority rates would have to be moved up by at least one-half of a percentage point to end the drain.

In reply to a question by Mr. Sherrill regarding the outstanding volume of British forward contracts, Mr. Coombs said that the peak figure reached recently was $3 billion. The present volume was less as a result of the run-offs of maturing contracts during the summer months, but it was still high enough for $200 - $300 million of forwards to mature each month. As he had indicated, the British now had only $1 billion of unmortgaged reserves. How much further they would be prepared to go in mortgaging their reserves was an open question; they would have to plan on having some on hand if a break in the present situation should occur.

Mr. Hayes remarked that the top British financial authorities were fully aware of the problem. The question facing them was the old one of the kind of actions that were feasible from the political standpoint.

By unanimous vote, the System open market transactions in foreign currencies during the period September 12 through October 2, 1967, were approved, ratified, and confirmed.

Mr. Coombs then referred to the program for shifting the System's swap arrangements to full-year terms maturing around the year end, and noted that the $450 million standby arrangement with the Bank of Italy would mature on October 20, 1967. Although he had not yet discussed the question with the Bank of Italy, he

anticipated that they would prefer to renew the arrangement only until December 29, 1967 now and plan on renewing it then for twelve months, rather than renewing it now until October 1968 and replacing it in December 1967 with a new twelve-month arrangement. He did not think there was any particular disadvantage to the first course, and recommended its approval.

By unanimous vote, renewal until December 29, 1967, of the $450 million standby swap arrangement with Bank of Italy, scheduled to mature on October 20, 1967, was approved, on the understanding that the arrangement would have a twelve-month term after December 29, 1967.

Mr. Coombs then reported that two drawings by the Bank of England on its swap line with the System would mature soon, and he would recommend their renewal if requested by the Bank of England. These were a $150 million drawing maturing October 25, 1967, and a $75 million drawing maturing October 30, 1967. He would also recommend renewal, if necessary, of a number of System drawings. These included three on the National Bank of Belgium--a $5 million drawing maturing October 26, one for $20 million maturing October 27, and one for $13.5 million maturing November 2, 1967. They also included two $10 million drawings on the Netherlands Bank, maturing October 26 and October 31, respectively. All of these would be first renewals.

Renewal of the various drawings as recommended by Mr. Coombs was noted without objection.

Mr. Hayes said he would comment briefly on the recent Bank and Fund meetings in Rio de Janeiro and then ask Mr. Daane to report on developments there in greater detail. Rio provided a beautiful setting, the arrangements made by the Brazilian authorities were admirable, and the meetings themselves were highly interesting. On the less pleasant side, the U.S. balance of payments--while not a major topic on the agenda--nevertheless came in for critical comment in the formal speeches by some of the continental Europeans. Moreover, it was evident from private conversations with bankers from many countries that there was widespread uneasiness about where the U.S. payments balance was headed. That pointed up the fact that the United States was faced with a serious problem, as the Committee members were, of course, aware. With respect to views on the sterling situation, there did not appear to be any fears of an immediate crisis. But here also there tended to be a feeling of uneasiness, and of concern about the future role of sterling in international financial markets.

Mr. Hayes then invited Mr. Daane to comment on the main topic of the Rio meetings--the plan for international monetary reform.

Mr. Daane said he might begin with a comment not directly related to the liquidity exercise. A meeting of the Ministers and Governors of the Group of Ten had been called at the beginning of the week by Mr. Callaghan, in his capacity as Chairman, to discuss the outlook for world trade and interest rates. At that meeting the Ministers of each of the major countries, including the United States, gave brief statements on the economic outlook in their countries. In Mr. Daane's judgment the discussion offered Mr. Callaghan very little hope that interest rates would decline elsewhere and thereby ease Britain's problem. Secretary of the Treasury Fowler had made it clear that enactment of the tax increase would not insure a declining trend in U.S. interest rates. Mr. Callaghan must have come away with the feeling that rates were more likely to rise than to decline as economic activity accelerated in the United States, Germany, and elsewhere; and that impression undoubtedly was confirmed by the Canadian discount rate increase later in the week.

Subsequently, Mr. Daane noted, the Deputies of the Group of Ten held a meeting largely for the purpose of electing a new chairman. Mr. Ossola of Italy was elected. He was the third person to serve in that post, following Dr. Emminger, who received many plaudits at the meeting, and Mr. Roosa. The Deputies were scheduled to meet again for one day in November to clean up some details in the outline plan for monetary reform. However, the

major work in months ahead in connection with implementing the outline plan was likely to be done by the IMF.

Of course, Mr. Daane continued, the main item of business at the Rio meetings was consideration of the plan for special drawing rights in the Fund. When the conclusion--unanimous approval--was reached on Friday, it was somewhat anticlimactic. Here he could take his cue from Secretary Fowler, who said in his closing press conference that "This act is more fundamental and meaningful than all the words that have been and could be uttered."

Specifically, Mr. Daane said, what was approved was a resolution entitled, "Establishment of a Facility Based on Special drawing Rights in the Fund and Modification in the Rules and Practices of the Fund." The resolution requested the Executive Directors to:

1. Proceed with their work relating to both

   (a) the establishment in the Fund of a new facility on the basis of the Outline in order to meet the need, as and when it arises, for a supplement to existing reserve assets, and

   (b) improvements in the present rules and practices of the Fund based on developments in world economic conditions and the experience of the Fund since the adoption of the Articles of Agreement of the Fund; and

2. Submit to the Board of Governors as soon as possible but not later than March 31, 1968

   (a) a report proposing amendments to the Articles of Agreement and the By-Laws for the purpose of establishing a new facility on the basis of the Outline, and

   (b) a report proposing such amendments to the Articles of Agreement and the By-Laws as would be required to give effect to those modifications in the present rules and practices of the Fund that the Executive Directors will recommend.

Mr. Daane thought it might be helpful to give the Committee some of the flavor of the Rio meeting and of the speeches leading up to the final action, which represented the fruition of all the efforts in the liquidity planning area that had been made over the past four years. That might be especially useful since the press, he supposed naturally and understandably, had tended to portray an atmosphere of difference and dissent rather than stressing the fact of complete agreement in moving ahead on implementing the Outline facility and the historic significance of that agreement. In keynoting the meeting in his opening remarks on Monday, Mr. Schweitzer of the Fund referred to the proposed arrangements for international liquidity as in his view constituting "the most significant development in international financial cooperation since Bretton Woods." He noted that the Governors now had before them a specific Outline for a facility to meet the need, as and

when it arose, for a supplement to existing reserve assets, and he went on to say that "The outline reflects the principle that the international community should be able to control reserves instead of reserves controlling the community."

Mr. Daane observed that other points stressed by Mr. Schweitzer were picked up and reiterated by many of the speakers. These were, first, that the new facility was aimed at creating international liquidity in unconditional form. In his words, "The clear desire of members that the new reserve asset should be unconditional and permanent in character is fully met by the Outline." He noted that members could use the special drawing rights whenever they had a balance of payments or reserve need, that they could transfer them to appropriate transferees, and that they were obligated to accept the new reserve assets when presented by other members in accordance with the rules of the Fund. He indicated that the acceptance obligation was an important feature of the reserve character of the new drawing rights.

Secondly, Mr. Daane said, Mr. Schweitzer noted that "The asset will be given certain other characteristics to make it an international asset worthy of standing side by side with gold, reserve currencies, and existing reserve positions in the Fund, such as a guarantee of the maintenance of its gold value and

international remuneration at a moderate rate." Third, and of no less importance, Mr. Schweitzer stressed that the Outline "maintains the principles of universality and of nondiscrimination that are basic in the Fund."

Mr. Daane said that he had taken the time to quote some of Mr. Schweitzer's opening comments because, as he had noted earlier, they were in turn repeated in the speeches by many of the Fund members, all of whom came out one by one in favor of the plan. The major surprise at the meeting was the apparent toughness of the speech given by Mr. Schiller, the German Minister of Economics, on the nature of the new asset and on reform of IMF procedures. Mr. Schiller had been very helpful at the earlier meeting of the Ministers and Governors in London, where it mattered, but he appeared to take a harder stand at Rio. In his (Mr. Daane's) judgment, the press had overstressed that fact; Mr. Schiller had not intended that his remarks at Rio be interpreted as a pullback from the position he had taken in London, and he had said as much in his own press conference.

The press stories, Mr. Daane said, were perhaps more a reflection of Mr. Schiller's speech than that of the French Minister of Finance, Mr. Debre. The latter's remarks were about what had been expected. Not even Mr. Debre insisted on agreement on IMF reform as a condition for completion of the

Fund's work on the Outline. He did call for certain conditions for an activation of the new facilities, which he spelled out in straightforward and hard terms. He said that the mechanism could not come into play until, first, "a worldwide shortage of liquidity has been collectively recognized to exist"; secondly, "there is a more satisfactory operation of the existing adjustment processes"; and third, "the balance of payments deficits affecting the countries whose currencies are designated as 'reserve currency' have disappeared."

Mr. Debre's position was relatively hard on the matter of parallelism between the new drawing rights and modification of the present rules and practices of the Fund, Mr. Daane noted. Debre said that the "agreement regarding the special drawing rights is accompanied by a re-examination of certain provisions of the Bretton Woods Agreement and of practices of the Monetary Fund" and that "the parallel execution of these two reforms" was "one of the conditions of the agreement of the French Government." With regard to parallelism Mr. Schiller noted that the two parts of the resolution constituted "a single entity," and Governor Ansiaux of the Bank of Belgium said that "there is a link between these two proposals" and that "the adoption of one cannot be disassociated from that of the other." But none of the Common

Market representatives, possibly excepting the French, indicated that they would consider agreement on modification of Fund procedures to be a _pre_condition for ratification of the plan for special drawing rights. It remained to be seen what course they would follow when they came to the point of ratification.

Mr. Daane thought that a significant address was made by the Brazilian Minister, Mr. Delfim Netto, who spoke on behalf of all of the Latin American delegations. The Minister stressed certain fundamental principles embodied in the agreement, which he said had been consistently supported by the nations of Latin America and other developing countries. These included the worldwide participation, the absence of discrimination regarding the types and forms of liquidity to be created, the procedures for decision making, and the unconditional nature of the new reserve assets. He went on to say that "There is no question about the appropriateness and timeliness of the task we now undertake."

The next step, Mr. Daane noted, involved casting the language of the agreement into appropriate legal form by March 31, 1968, and he understood that the staff of the Fund had already started that work. The agreement would then be submitted to the parliaments of the members of the Fund, and it would take effect when approved by three-fifths of the member countries having

four-fifths of the weighted votes in the Fund. The first new drawing rights would come into being when a proposal for their creation by the Managing Director of the Fund was approved by countries having 85 per cent of the weighted votes.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period September 12 through 27, 1967, and a supplemental report for September 28 through October 2, 1967. Copies of both reports have been placed in the files of the Committee.

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

> Since the Committee last met, interest rates--both short- and long-term--have generally moved higher on balance, although last week rates on Treasury bills turned rather sharply downward from their interim highs in the face of strong demand for bills from banks over their quarterly statement date and from public funds and the Federal Reserve. Immediate Treasury financing needs and continued concern about the prospects for a tax increase and related spending cuts were the main factors affecting the markets. The general indecisiveness that pervades both the money and capital markets makes future interest rate movements difficult to project. There has been some discounting of an inflationary period ahead, of Treasury financing needs, and of a possible modest shift of monetary policy. But with the budget deficit, the war in Vietnam, and the extent and timing of private credit demands still posing unresolved questions, we should be prepared for sharp and erratic movements in interest rates from day to day and week to week.

System open market operations over the period maintained steady conditions in the money market, at least as measured by the Federal funds rate, dealer loan rates, bank borrowing from the Federal Reserve banks, and average free reserves over the period as a whole. Free reserves have continued to vary widely on a week-to-week basis, depending on country bank desires to build up or reduce excess reserves. One would hope that these fluctuations would lead the market to place less significance on that one measure. Some progress has been made along these lines, but the free reserve figure is still of major importance for many people. The credit proxy for September looks to be in the lower end of the 9 - 12 per cent range of growth (annual rate) projected at the last meeting, and, under the influence of Treasury financing, it is expected to rise at a rate of 10 - 13 per cent in October.

Over the last 10 days we had to supply over $1 billion in reserves to the market, mainly through the outright acquisition of Treasury bills but also through purchases of longer-term Governments and repuchase agreements against bankers' acceptances. Since the Committee last met the Government securities dealers have actively been reducing their portfolios in anticipation of heavy Treasury financing. Holdings of Treasury bills maturing in more than three months have been reduced to unusually low levels--leading to some temporary shortages last week, while holdings of coupon issues of more than one-year maturity were reduced by $265 million to the low level of $50 million. If current projections are borne out we may have about $700 million of reserves to supply over the next week or so. This would most likely involve a moderate amount of outright purchases of Treasury bills and perhaps a few more coupon issues, although availability had been reduced substantially after our purchases last Thursday. Repurchase agreements against Government and agency issues would appear the logical instrument for the bulk of the reserve supply, however, since the reserve picture turns around rather sharply in the statement week ending October 18.

In the market for corporate securities, yields on new issues have edged higher despite a substantially

reduced calendar in September The most recent Aaa issue--the New England Telephone bonds--moved slowly at a 6.06 per cent reoffering yield, the highest on a telephone issue in 45 years, the summer of 1966 not excepted. In the municipal market, where the calendar has remained heavy, the upward yield movement accelerated somewhat, bringing the indices within a few basis points of the 1966 peak.

Treasury bill rates, affected most immediately by prospects of large-scale Treasury financing, were particularly volatile over the past three weeks. The three-month bill rate rose by 1/4 per cent to more than 4.60 per cent after the Treasury announced the sale of $4.5 billion tax bills, scheduled for today, and an addition of $100 million to each regular weekly bill auction commencing October 9. Over the next several days, however, heavy bank demand before the September 29 statement date, our own buying, and the fact that awards of bills in the September 25 auction went mainly to a single dealer, brought the three-month rate temporarily back close to the level prevailing at the time of the last meeting. Yesterday, with bank statement-date buying out of the way and with the new three-month bill maturity area passing from the popular December dates to dates in early January, rates rose again. Average issuing rates in yesterday's auction were set at 4.51 and 5.09 per cent for three- and six-month bills, respectively. In today's auction of April and June tax bills, the market is anticipating issuing rates of somewhere in the 4.95 - 5.20 per cent range, with tax and loan credits estimated to be worth about 20 basis points on the April and 15 basis points on the June bills.

This of course is just the beginning of a crowded fall calendar of Treasury financing operations. The tax bills being sold today will be paid for on October 9. On the day the Committee next meets, the Treasury will be meeting with its ABA and IBA borrowing committees to get their recommendations for the November refunding. As the blue book[1/] points out, there is not much time to work in a change of monetary policy, if the Committee so desires, between these two financing operations.

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

While strong even keel considerations do not necessarily apply to a tax bill financing, the market would be surprised by a visible change in money market conditions a few days after banks had bid for $4-1/2 billion Treasury bills. But, on the other hand, unless there was visible evidence of a change that would enable the market to form some judgment of System intentions, the Treasury would face difficult problems in establishing the terms of the issue or issues to be offered in the refunding. In normal periods the November refunding would be routine, with only $2.6 billion of the $10.1 billion of maturing issues held by the public. Given the Government's substantial cash needs over the remainder of the year, however, it appears highly likely that the Treasury will try to raise additional cash as well as refund the maturing issues. How much extra cash can be raised is by no means certain but it is conceivable that enough could be raised to eliminate one Treasury cash operation later this year. The process of raising additional funds together with the prospect for some debt extension makes the refunding a more important operation than it otherwise might be, and the less uncertainty there is about monetary policy the easier the Treasury's job will be. To me this would mean that if the Committee should decide on a policy change, evidence of the change should be in the market at the earliest possible date. The real problem would be to convince the market that a change in policy has already been carried out, while avoiding an impression that a cumulative tightening process in underway. There are obvious risks involved in such an approach and there can be no guarantee of success.

One final matter. As you know we have on several occasions in the past had a semi-formal program for inviting people from the Reserve Banks and the Board of Governors to participate for about a two-week period with us at the Trading Desk and at the Foreign Trading Desk. Several Reserve Bank Presidents have talked to me about reinstituting such a program and we now plan to get under way around the end of this month. If anyone has candidates to suggest, I would appreciate receiving the names and we will try to work out mutually convenient dates. Clearance for access to FOMC material would be desirable, but we can consider candidates on a more technical and junior basis as well.

Mr. Maisel remarked that in the past ten days there had been one or two occasions when it appeared that the Manager could have shaded the amount of reserves supplied to the market. He asked whether the Manager had not done so because he thought such action would be inconsistent with the Committee's directive or because he was concerned about possible reactions in the market.

Mr. Holmes replied that it had been mainly his interpretation of the directive that had determined his decisions on those occasions. He had been attempting to maintain the previously prevailing conditions with respect to the several money market measures, as described in the last blue book, but that had not proved easy; the Federal funds rate had, if anything, been a trifle higher than the recent range.

Mr. Swan asked for the Manager's opinion as to the earliest possible time that a change in policy could be implemented, if the Committee decided on that course, given the timing of the Treasury's tax bill financing.

Mr. Holmes said it was possible that the Desk could move before the 9th of October if the tax bill auction went well and the market was stable. He thought that even keel considerations would be less significant in connection with the bill financing than in connection with the subsequent refunding. It was

important that the market be able to assess the extent of the policy move by the time the Treasury had to price its refunding issues.

Mr. Ellis noted that at one point the Manager had mentioned that there had already been some discounting by the market of a modest shift in monetary policy, and at another point he had referred to the need, if the Committee decided to change policy, to convince the market as early as possible that the change had been completed. It was not clear to him what types of actions Mr. Holmes thought would be useful in accomplishing the latter.

In the same connection Mr. Brimmer asked whether the Manager was suggesting that any move toward firming should take some form other than open market operations. In particular, did Mr. Holmes have an increase in the discount rate in mind?

Mr. Holmes replied that he had not been thinking of a discount rate change. His point was that during this period there would be, at best, two weeks in which open market operations could be directed toward attaining firmer money market conditions. The market was likely to view such operations as the beginning of a more extended tightening process. It would be difficult in the short time available to make it clear that that was not the case, although public statements of System officials might be helpful in that regard. In sum, there were risks in a firming move and

it would be difficult to carry one out, but it would not be impossible to do so.

Mr. Daane asked whether the Manager thought there was any scope for gradual and moderate probing operations that would not necessarily become apparent to the market immediately.

Mr. Holmes said that he was concerned that such a move might be recognized in the midst of the Treasury financing and for that reason he thought that any firming action should be quickly visible to the market and completed rapidly. The Treasury refunding was likely to meet with a poor reception if the change was still in process after it had been announced or if the market was uncertain about the System's intentions at that time.

Mr. Hickman asked whether the Manager was recommending that the System commit itself not to tighten further after an initial firming action. He would not like to see the Committee frozen into a no-change position.

Mr. Holmes replied that the Committee certainly should not freeze its position for any extended period. He was concerned with the period during which the new securities issued in the refunding were being distributed. The basic problem lay in insuring underwriting support for Treasury financings, particularly in light of the volume of cash the Treasury would be raising in coming months. Accordingly, he thought it would not be desirable

to pull the rug out from under the underwriters while distribution was in process. It was true that any subsequent firming action by the System would involve a risk of loss to those who held the new securities at that time, but the risk would then be shared by a larger group.

In reply to a question by Mr. Mitchell, Mr. Holmes said that it was conceivable that the need for even keel in connection with the refunding would be over by the end of November or even earlier. However, he did not think one could prejudge the matter at this point, because it would depend on what other things were happening.

Mr. Daane remarked that the answer would depend on the kind of reception given to the refunding. An extremely good reception would open the possibility of a relatively early move by the System.

Mr. Hayes commented that developments with respect to fiscal policy also would have a major bearing on the matter.

Mr. Hickman observed that he did not think the Committee could commit itself with respect to policy for the period ahead when it did not have information on such important parameters as the likely nature of Congressional action on taxes.

Mr. Mitchell said that as he understood the Manager, he was implying that the Committee should run the risks involved

in a firming move only if it thought there was great need for such action.

Mr. Holmes commented that he could summarize his position by saying, first, that even keel considerations would be more important at the end of the period before the next meeting than at the beginning; and secondly, that while it would not be impossible to make a move toward firming in the period, there would be certain risks attached to such a move.

In reply to Mr. Hickman's question about the probable feasibility of a change in policy at the Committee's next meeting if no change was made today, Mr. Holmes said that in noting the risks attached to a policy change now he had not meant to imply that there would be a better opportunity for action soon.

Mr. Hayes remarked that it was conceivable that there would be some opportunities to change policy later in the year, particularly if there were favorable developments in the bond market, but one could not be sure at this point.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period September 12 through October 2, 1967, were approved, ratified, and confirmed.

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

Mr. Partee presented the following statement on economic conditions:

Important particulars in the economic situation remain beset with uncertainty. The auto strike is about to enter its fifth week, with no end yet in sight and no firm indication of whether work stoppages may spread from Ford to other manufacturers or of how large the ultimate wage settlement will prove to be. Some aggregate economic measures, such as industrial production and personal income, clearly are being held back by the strike, however, and its effects--though marginal--could spread gradually into many product areas, especially if it is extended or broadened. Because of the strike, as well as differing model introduction dates this year, it is very difficult to judge the reception of 1968 model cars, the list prices of which have been raised by about 4 per cent on average.

Meanwhile, the President's fiscal program is still bogged down in Congress. It appears that sizable further cuts in budget expenditures will be required in order to mobilize sufficient Congressional support for the tax package, but whether and when the President will propose such reductions, as well as their probable size and impact on actual spending levels, is not known, at least to us. Similarly, the amount and timing of the tax increase remains in doubt, though the odds increasingly favor a delay in effective date until the first of the year. Assuming no tax increase before January 1, Board staff estimates are for a Federal deficit, on a national income accounts basis, averaging $13.5 billion in the third and fourth quarters, which would be only modestly below the peak rate of deficit reached in the spring.

Reflecting continuation of this large Federal fiscal stimulus and the increasing strength of demand in some key private sectors, the underlying position of the economy seems to me to be one of great buoyancy. I am particularly impressed by the recent surge in retail sales, which are reported to have jumped 4 per cent in the three months from May to August. The rise has been especially marked in the non-durable lines and, judging from the weekly sample, it appears to have continued in September. Part of the increase represents a catching-up in sales following the flatness in trend last fall and winter, and part reflects an accelerated rate of increase in income flows.

With both employment and wages rising at a fast pace, and with the sales/income relationship still on the low side, it seems apparent that the outlook for the consumer goods industries generally is bright indeed.

Also impressive to me are the indications of strengthening in the investment sector. Housing starts rose to new highs for the year in July and August, despite rising mortgage interest rates, and one major finding of our recent mortgage survey is that lenders generally anticipate some further strengthening in the demand for mortgage funds. In the business investment area, new orders for machinery and equipment have recovered sharply in recent months, and the first private surveys of spending plans for 1968 point to some increase over the flat 1967 average, which could imply a sizable rise over the course of the year. The latest inventory figures, which show a substantial increase in manufacturers' holdings in July and August--largely in autos and aircraft--probably should be discounted. There were special seasonal adjustment problems due to the early model changeover, and the rise at manufacturers may have been largely offset by declines at the distributor level. But the next major change in business inventory policies seems certain to be towards desired accumulation.

A new economic projection, through mid-1968, will be presented to the Committee at its October 24 meeting, and I would not want to prejudge its findings, to which I have not yet been exposed. For the next several months, however, I am confident that the economy will continue to show large gains. Acceleration rather than deceleration seems to me most likely, following agreement on a new labor contract in the automobile and related industries. Indeed, the question in my mind is whether fiscal action, once taken, is likely to be sufficient to slow the growth in aggregate demand to a tolerable pace. We can probably accept a fast rate of expansion for a time, given the shortfall earlier this year. The utilization rate in manufacturing averages only 84 per cent, and our potential labor force can be employed more intensively, through longer hours and increased participation. Indeed, preliminary indications are that the labor force grew especially sharply in September, with the result that the unemployment rate rose in the month.

But the amount of headroom available for rapid growth is much less than at the beginning of previous cyclical recoveries. And the economy clearly faces some difficult inflationary problems already. A pattern of wage settlements around the 6 per cent level seems to be in the making, well in excess of what is likely to be absorbed through productivity gains, even in a period of rising industrial output. Unit labor costs in manufacturing have already increased 5 per cent over the past year, and business pressures to raise prices in order to compensate for that cost increase are intense.

Fluctuations in the price indexes over recent months reflect a good deal more than the vagaries of farm and food supply developments. Average prices of both non-food commodities and services in the CPI have risen steadily and at 3-1/2 per cent annual rates since last March. And the industrial commodities component of the wholesale price index rose one-half of a point in August and September, or at an annual rate of 3 per cent. Moreover, numerous price increases had not become effective, or were not announced, until after the mid-September pricing date.

The very real danger now, it seems to me, is that an inflationary psychology may spread throughout the economy. There is already evidence of this in the financial community, and if firm expectations of sizable and unstoppable inflation should take hold also in the nonfinancial sectors, the result could be a general acceleration in spending plans--for inventory, business equipment, construction, and even consumer durables. If so, the resulting economic momentum might become very hard to control and the makings of a second round of inflation could be upon us.

A substantial and convincing program of fiscal restraint, if enacted, would probably do much to check the spiraling of speculative sentiment, as would any move toward peace negotiations and de-escalation of the war in Vietnam. But, in the interim, what should be the posture of monetary policy? It is easy to conclude that a prompt and decisive move toward restraint is needed, but I am not so certain that the benefits at this point are worth the possible costs. Increased monetary restraint would have only a negligible effect on the current round of price and wage increases, and it could entail some risk for the economy and for our financial structure. The recovery in housing, the planning and development of private and public investment programs, the competitive position of the financial intermediaries, the orderly financing of the Federal deficit--all would be jeopardized.

If inflationary ebullience does spread from the financial community to business and consumers, and if there is to be little or no real help from the fiscal area, increased monetary restraint certainly will become necessary. In particular, it will be essential to resist the burgeoning of private credit demands that would accompany any significant speedup in investment and stockpiling for speculative reasons. But this does not seem to be happening now. Therefore, I believe the best course for monetary policy at present remains one of nervous and watchful waiting, hoping for favorable--or at least adequate--resolutions of the many problems that we face.

Mr. Axilrod made the following statement regarding financial developments:

As Mr. Partee has pointed out, the economy shows the prospect of growing ebullience, with inflationary overtones. The question naturally arises as to whether conditions in financial sectors are such as to encourage the inflationary overtones that appear to be accompanying this growth, or whether financial conditions as they have developed thus far may tend to exert some braking action against too rapid growth. To approach answering such a question requires a brief review of recent changes of lending conditions and lender and investor attitudes in key financial sectors and markets, against the background of the current stance of monetary policy.

After easing early in the year, monetary policy has been essentially unchanged since spring when measured in terms of money market conditions narrowly defined, including the Federal funds rate, dealer loan rates, and free reserves and member bank borrowings. When policy is gauged in terms of financial flows such as increases in the money supply and in bank credit, the magnitude of these increases at times over the spring and summer has raised the question of whether policy has not in fact eased further--or at least become easier than intended. The reasons for the rapid increases shown by money supply and bank credit in recent months have been pointed out many times before, but I might briefly mention them--the culmination in April, June, and July of the accelerated

program to accelerate corporate tax payments; Treasury cash and debt management policies which led to a declining and relatively quite low level of U.S. Government deposits in spring and early summer; large net cash borrowing by the Treasury in early summer and after; and, finally, but far from least, the demands of private financial and nonfinancial sectors of the economy to restore liquidity that had been seriously depleted during the 1966 period of monetary restraint and investment boom. Some of these reasons, such as tax accelerations and restoration of liquidity, reflect non-recurring forces, and it might therefore be concluded--hesitantly--that money supply and bank credit expansion is likely to be somewhat less rapid over the months ahead than in early summer, although because of the Treasury financing both are likely to pick up from their September pace over the next few weeks, as the blue book suggests.

But however one views past behavior of bank credit and money and judges prospects for the future, financial markets, and monetary policy, remain considerably more complex than is revealed in bank deposit behavior. Considering financial markets as a whole, it is probably accurate to note that there has been a firming of credit conditions. This firming has been partly the result of Governmental fiscal policy and partly the result of corporate demands on long-term markets to restructure their balance sheet positions.

Since early July, and including the tax bill auction today, the Federal Government has issued about $10 billion of new Treasury bills for cash. The Government has also raised almost $3 billion through coupon issues. It would appear that another $5 billion or so of cash remains to be raised this year, including more than $1 billion of additions to weekly bill auctions already announced, and more cash will have to be raised early next year. Under these conditions--with the Treasury's cash needs well in excess of other similar periods since World War II--short- and intermediate-term market rates have adjusted rather sharply upwards, despite sizable money supply and bank credit expansion and despite large purchases of U.S. Government securities by banks. Of course, these rate increases do mainly represent a response to credit demands--demands by the Government to finance expanded spending--but the point is that the rate increases have also affected market instruments that are important in relation to private

spending. For instance, while Treasury bill and intermediate-term coupon rates have thus far risen 100 to 135 basis points from their spring lows, there have also been rises of 50 to 100 basis points in finance company paper, bankers' acceptances, and certificates of deposit. Thus, the accommodation of Governmental demands has resulted in what might be termed countervailing interest rate increases facing private sectors of the economy.

There have been similar developments in long-term sectors of the market, but not primarily because of Governmental credit demands (although such demands might become a factor when the Treasury uses its new authority to issue debt with maturity up to 7 years irrespective of the interest rate ceiling or when necessary legislative authority is obtained for participation certificates in the current fiscal year). The very large volume of corporate security flotations has been the dominant factor in long-term market behavior, although recently there have also been glimmerings of inflationary psychology beginning to influence investor attitudes in bond and stock markets. Since spring, long-term market rates generally have risen more than 50 basis points, and in the case of corporate and Federal Government bonds are above their 1966 peaks. These rate increases have in turn led to rate increases in the mortgage market, in which yields have risen about 30 basis points since spring. Thus, the mortgage market has felt the impact of credit demands from other sectors, which have been related not only to spending needs but also and importantly to a desire to restructure financial positions.

There is also some possibility that the mortgage market may be beginning to feel the competitive effect of the recent rise in short- and intermediate-term interest rates on market instruments. Inflows of savings shares and deposits to savings institutions remained large recently, but seem to have shaded off a little from the strong pace of earlier months. And any further substantial rise in short- and intermediate-term rates or moderation in the rate of personal saving could begin to cut into such inflows significantly and thereby exert a strong drag on the flow of future mortgage loan commitments.

I do not mean to have implied in this review that interest rate relationships, including the relation of market rates to official ceiling rates on deposits, and current lending conditions in financial markets represent any assurance that economic expansion will not get out of hand. But they do mean that an expansionary fiscal policy and corporate liquidity demands have generated some offsetting forces in credit markets. This may provide a little comfort for monetary policy standing pat in terms of money market conditions at the present time--a policy which seems best on balance in view of the fiscal restraint still under consideration. Moreover, with the distance already travelled by short- and intermediate-term interest rates also suggesting that we are moving within striking distance of triggering a noticeable reduction in net inflows of savings to financial institutions, it may also be necessary to guard against further marked increases in short- and intermediate-term rates--say, increases of 50 basis points or so--in keeping policy unchanged.

As a final point, it is worth noting that the leverage of a change in money market conditions on financial variables more directly affecting private spending--such as mortgage and consumer credit conditions and business financing terms and costs--is probably greater than usual at the present time, in view of the highly sensitized and cautionary attitudes of financial institutions and business corporations. This suggests two conclusions about policy: first, that there may be more limited scope than usual for probing actions on the part of monetary policy in the sense that the probabilities of market overreactions are relatively high; and, second, that the costs of delaying policy actions may not be undue because the financial system will react faster to tugs on the rein.

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

It now appears that the payments deficit on the published liquidity basis, seasonally adjusted, was somewhat larger in the third quarter than in the second. However, if the balance is struck before deducting acquisitions of long-term U.S. time deposits by foreign official and international institutions--as seems analytically more useful--then the deficit did diminish in the third quarter.

On this modified basis, the liquidity deficit was at about a $2-1/2 billion annual rate in the third quarter--down from the $4 billion rate of the first half year, and a bit below the $3 billion figure for the year from mid-1966 to mid-1967.

On the official reserve transactions basis, there was a large surplus in the third quarter, after seasonal adjustment, as U.S. banks drew liquid funds from abroad in heavy volume through their foreign branches. But this state of affairs is clearly temporary, as was the similar situation a year ago. While the precise behavior of U.S. banks is difficult to predict--and I agree with Mr. Coombs that we must watch it very closely in coming weeks--the banks are surely not going to continue to want, or be able, to attract foreign liquid funds at a $4 billion annual rate over any extended period. Indeed, they obtained less from their branches in September than in either July or August. For the four quarters through September, there was an official settlements deficit of roughly $2 billion, and an increase in U.S. bank liabilities to foreign branches of roughly $1/2 billion. These figures probably give a more representative picture of the underlying situation than do those for any single recent quarter.

Since the last meeting of this Committee, new monthly or quarterly data have shed a good deal of additional light on recent trends in the U.S. balance of payments, and also on the developing business cycle situation in Europe. In both fields, the new information is mildly encouraging.

Merchandise imports dropped in August, after being disappointingly high in June and July. Unfortunately, the drop from the second quarter level to that of July-August seems to be wholly explained by a reduction in petroleum imports as a result of the Middle East crisis. Apart from that, we are still not getting the sort of decline in imports relative to GNP that we hoped would result from diminishing domestic pressures on capacity. Indeed, a number of categories of imports have been rising recently, including iron and steel, textile materials, building materials, and machinery.

Meanwhile, however, merchandise exports--after correcting for an undercount in the published August figure--have shown some renewed advance, despite slack demand in Europe and despite continued weakness in agricultural exports. For the year to date, merchandise exports are up 7 per cent from a year earlier, and nonagricultural exports are up 11 per cent. Shipments to Japan have shown the largest

percentage gain--nearly 20 per cent. But even exports to Europe are up a bit from last year, thanks largely to rising deliveries of commercial aircraft. We seem to be heading for an improvement in the trade balance of nearly $1 billion this year as compared with the year 1966, despite some disappointments along the way.

Some other payments items, however, have fared much less well than we had hoped. The second quarter figures, released last week and summarized in the green book,[1/] indicate the dimensions of these shortfalls.

The centennial exposition in Montreal has hit our international travel account much harder than had been generally foreseen. In the second quarter alone, the travel account with Canada seems to have been about $150 million more adverse than one would have expected on the basis of previous trends. For the year as a whole, the net adverse impact of EXPO 67 may be as much as $300 million.

A second item has been a large bulge in private remittances to Israel and in purchases by U.S. residents of Israeli Government bonds, in connection with the Middle East crisis. The bulge in these outflows seems also to have amounted to about $150 million in the second quarter, and may also total as much as $300 million for the year.

Here, then, we have two temporary factors that are worsening the balance of payments by a total of about $1/2 billion this year. In addition, both the trade account and the investment income account have been adversely affected by the economic slowdown in Europe to an extent that must be substantial and could easily amount to $1 billion, although these shortfalls are very difficult to measure until long afterwards.

Given all these temporary adverse influences, it is not surprising that the liquidity deficit is running larger this year than last despite somewhat larger official window-dressing. It may be that the whole increase should be viewed as temporary, so that in some adjusted sense we really have been holding our own.

Holding our own, of course, is not good enough. We still need a decisive balance of payments improvement. I think the latest evidence on the business situation in

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

Europe--particularly the sharp upturn in German industrial production in July, and subsequent reports of increasingly optimistic business sentiment in Germany--indicates that there will be an opportunity for some improvement during 1968. Next year may even be a year of rapid advance in European demand, somewhat like 1960 and 1963, although it is still too early to be sure.

But whether we are able to take advantage of any such upturn, and translate it into a solid current account improvement, will depend very much on developments in the United States. It will be extremely important to limit our domestic price advances to whatever extent we can, and to avoid the intensification of pressures on capacity. Fortunately, the prospects seem to be that the capacity utilization rate in manufacturing will not rise very much during the coming year, even with buoyant demands. But on the price front, developments and prospects are much less encouraging. It ought to worry us a good deal--at least as much for balance of payments reasons as for domestic reasons--that the GNP deflator is rising at a rate of nearly 3 per cent a year, and that prices of machinery--our main export--have risen 3 per cent over the past year and are still rising at about that rate, whereas such prices have actually been falling not only in Germany but also in Italy.

Mr. Hayes then began the go-around of comments and views on economic conditions and monetary policy with the following statement:

The view that the economy is beginning to move ahead strongly is supported by virtually all of the information that has become available since our last meeting. The auto strike is bound to have a temporarily depressing effect on the economy, which will probably be exaggerated out of all proportion by commentators on the economic scene. Indeed, insofar as the strike results in a surge of demand and output later on, it is likely to add to, rather than subtract from potential overexuberance toward the end of this year and into 1968. On a broader view, our staff's projections are closely in line with the green book figures suggesting a $15 billion rise in GNP in the third quarter and a $20 billion rise in the fourth quarter. As for the first half of 1968, our projections suggest a continuation of

unsustainable advances in the absence of effective fiscal action. Even with fiscal restraint of the magnitude now under consideration, it is not clear that the growth of aggregate demand will be cut back to a sustainable pace.

Already, of course, we are beginning to see what happens to prices when stronger demands develop in an environment of pre-existing cost pressures. Over the past five months the consumer price index has risen at a 4 per cent annual rate. More recently, we have also seen an end to the stability in industrial wholesale prices--which for two months have risen at a pace that is disturbingly in line with that experienced in late 1965 and early 1966. Moreover, further price increases, not yet reflected in the over-all indexes, have already taken place. Inflationary expectations are growing, and the present prospects for an even stronger advance in business activity over the rest of this year and into 1968 suggest that price pressures are likely to increase still further.

These trends have unpleasant implications for our balance of payments. The published liquidity figure for the third quarter is likely to show little net change from the first half of the year, and thus will doubtless continue to show a sizable deterioration as compared to 1966. The underlying liquidity deficit for the third quarter may be at an annual rate of about $3 billion, a considerable improvement from the $4-1/2 billion annual rate of deficit in the first half of 1967, but obviously much too large. The apparent third-quarter surplus on the official reserve transactions basis cannot be considered encouraging; it can be fully accounted for by the fact that U.S. banks drew funds from their overseas branches at a pace that is obviously not sustainable without causing real problems for sterling which might require some remedial action on our part. Indeed, the balance of payments, however measured, is most unsatisfactory thus far in 1967; each of the three common measures shows a worsened situation as compared with 1966. The outlook is even more discouraging. An overexuberant advance in domestic activity in this country, even if paralleled by a revival in Europe, is likely to bring about a deterioration in our trade surplus. As a longer run matter, recent and prospective price advances in the industrial sector are likely to be a more permanent added handicap to any effort to correct our payments imbalance.

In this setting, I think it has become very clear that the rate of growth of bank credit has been, and is, excessive. First, so far this year the proxy shows a 13 per cent annual growth rate. Indeed, at almost every meeting this year the cumulative growth rate from the end of 1966 has shown up at around 12 - 13 per cent--clear testimony to the persistence of our easy posture. Second, the October projection of about 10 - 13 per cent is only slightly less strong. Third, earlier it could be argued that generous provision of credit was needed to make up for the declines of last fall. It is now difficult to maintain this position since we have reached the point where the growth rate since mid-1966 is fully 8 per cent. Fourth, even a growth rate of 8 per cent seems high in the light of longer-term historical experience. Thus, during the upswing from early 1961 through mid-1965 the growth rate was only slightly higher at about 8-1/2 per cent--and this included, of course, the period when prices were relatively steady and when a stimulus from credit policy was needed in order to absorb into productive activity unused resources. Fifth, as full capacity was reached, many of us were disturbed by the accelerated 10 per cent increase that characterized 1965. Even the growth rate for the first eight months of 1966 of 8 per cent--which is what we were looking at a little over a year ago--was considered serious enough to lead to the September 1 letter.

An excessive growth of bank credit in the context of a stronger economy, increasing prospects for overexuberance, mounting inflationary pressures, and a continued and increasingly unsatisfactory international position, provides a prima facie case for a reduced degree of monetary ease.

As I see it, however, the problem is not so much whether or not the System should move towards less restraint, but rather to find a suitable time for the move. At the last meeting of the Committee I was prepared to do some cautious probing towards less ease. I would not be inhibited today from recommending such a move by the auto strike, or by the risk of some moderate upward adjustment of interest rates, a risk that we will face no matter when a decision to move to less restraint is made. However, the highly critical position of sterling and its vulnerability to any increase in Euro-dollar takings by U.S. banks, the current uncertain status of Congressional

action on taxes and expenditures, and the very short time period for carrying out any policy change allowed by the Treasury financing schedule, in combination lead me, with reluctance, to the conclusion that we should not attempt a change in policy today. I recognize that there may not be a better opportunity for a move before the year end, particularly in the light of the likely Treasury financing schedule. But I would hope that an opportunity may present itself within this period, and we should be alert to take advantage of any favorable situation that would permit a move towards less restraint that is badly needed on basic economic grounds. I continue to be concerned that by postponing action now we may face later on an even more unpleasant choice between putting on the brakes too rapidly and doing nothing to contain inflationary pressures. For the moment I feel that we should take that risk. I therefore favor alternative A of the draft directives,[1] although I would suggest a minor modification in the first paragraph to restore the last directive's language with respect to bank credit expansion. The statement in the staff's draft reads "Bank credit expansion had moderated somewhat from the rapid rates of recent months." It is true that the rate of expansion in September was well below that of July and August. It was still high, however, and from the somewhat longer perspective of the period since, say, April, it is hard to make a case that growth has moderated. Moreover, some acceleration is implied by the projection for October. Accordingly, I would prefer to retain the earlier statement that "Bank credit expansion has continued large."

Mr. Ellis said that firm evidence of business strength in New England was supplied by statistics covering production and employment. The August index of manufacturing output expanded 2.8 points after seasonal adjustment. The greatest strength was shown in durable goods production, with much of that reflecting resumption of activity following strikes. Producers of electrical

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

machinery and instruments were still pushing to fill defense orders and the entire durable goods sector might be said to reflect that kind of pressure. Nondurable goods production in August rose 1 per cent after seasonal adjustment, almost solely on the strength of substantial gains in rubber and plastics production. Textile and apparel production remained unchanged from July to August. In the construction field, preliminary reports suggested that residential and nonresidential construction alternated in taking the lead in expansion and contraction from month to month. Even though total awards for the year ran behind year-ago levels, the industry found difficulty in locating manpower to complete the projects it accepted, and residential contractors emphasized the difficulty of securing buyers at the higher prices they must charge as costs rose. Those trends showed up in the employment statistics as a general improvement for the month of August. Both manufacturing and nonmanufacturing employment registered further gains. The unemployment rate peaked in June and had fallen in the subsequent two months, to a level of 3.9 per cent in August.

Mr. Ellis reported that the Boston Reserve Bank's mid-September survey of mortgage market conditions reinforced the statistical indication that liquidity positions at all types of institutions were currently regarded as reasonable or very good. The flow of funds into District insurance companies, mutual

savings banks, and commercial banks continued to be quite satisfactory. Nevertheless, the volume of present mortgage commitments was running somewhat low. Perhaps one of the most interesting findings was that both commercial and mutual savings banks commented upon a lack of demand from "quality or acceptable" sources. That in turn was attributed to interest rate levels and to a widespread impression among consumers that money was tight and now was not the time to borrow.

As the Committee formulated monetary policy today, Mr. Ellis said, it was likely to consider policy in two separate frameworks--one having to do with economic impact and the other having to do with the strategy of policy changes. There had been two meaningful developments since the Committee's last meeting that reflected importantly on both of those frameworks. In the economic framework, it had become increasingly clear that the economy was thrusting upward at an accelerating rate. The evident pressures of existing and prospective demand in major sectors of the economy were now being reflected in a general trend toward larger wage increases and in price advances spreading through basic materials into finished goods. Conventional wisdom suggested that the economy should be restrained and that monetary policy should not maintain its posture of aggressive ease assumed a year ago. In that respect he agreed with Mr. Hayes' analysis of the need for a change in policy.

The second major development in the past three weeks, Mr. Ellis continued, had been Congressional debate about the Administration's tax program to a point that made it abundantly clear that a tax increase would not begin to restrain consumer spending effective October 1, as requested by the Administration. Perhaps the best that could be hoped for was a pared-down version of the Administration's program, effective January 1st. In a strategy framework, therefore, the Committee must in good conscience ask if it could delay a shift in monetary policy for the indefinite weeks and months that might elapse before some increases in taxation began to register their impact.

Mr. Ellis went on to say that strategy reasons, initially expressed as a desire to have the Administration strongly advocate a tax increase, and now as a desire to have Congress adopt one, had been given increasing weight in Committee policy deliberations for the past several months. Unhappily, the longer the Committee accepted strategy reasons as overriding the logic of economic needs, the more difficult it became for the Committee to extricate itself. He suggested that what had been true in the past was likely to remain true in the next several months. To whatever degree the Committee was successful in influencing Congress to adopt a tax program in lieu of monetary restraint, to that same degree it would be accused of breach of faith if it moved

immediately after a tax vote to execute those restraint measures which now appeared so needed. It was likely that in the months to come the Committee would have to bear the onus for having delayed too long in shifting from its policy of ease. If that were true, the Committee should not compound that exposure by still further postponement.

In the interval between the October 9 payment date for the present Treasury refinancing and the mid-November need for another Treasury financing, Mr. Ellis remarked, it would seem quite feasible to make the modest shift in policy that was now regarded as almost inevitable by the market. By making a modest shift, as outlined on pages 5 and 6 of the blue book,[1/] the

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1/ The blue book passage referred to read as follows: "If the Committee should favor a move toward somewhat firmer money market conditions, it might contemplate operations leading to an increase in member bank borrowings from current levels to a $100 - $150 million range and a rise in the Federal funds rate to trading more frequently at 4-1/8 per cent. The psychological and other effects of such a policy shift are difficult to specify in the present environment, dominated as it is by a number of fiscal uncertainties. The 3-month bill rate would be more certain to move towards the upper end of the previously specified range and would likely break through to around 4-3/4 per cent. The equilibrium bill rate would depend in large measure, however, on how strong an effort banks would make to secure CD's by raising their offering rates while it was still feasible to do so. With such an effort, a temporary quickening of bank credit growth could develop, with a further impetus if banks also become more aggressive in the Euro-dollar market. Intermediate- and long-term market yields would also tend to rise further, with the extent of increase depending in part on how apprehensive market participants become about the future mix of fiscal and monetary policies, including discount rate action, and about prospects for disintermediation."

Committee would at least clear the air of some of the uncertainty that traced to the possibility that it might be forced to make a much more dramatic and unsettling change at a later date.

Concerning the first paragraph of the directive, Mr. Ellis said, since bank credit growth was projected to accelerate in October he agreed with Mr. Hayes that it would be desirable to retain the previous statement to the effect that "Bank credit expansion has continued large" rather than to refer to the fact that it had moderated somewhat. Concerning the second paragraph alternatives, there was perhaps an inadvertent use of the proviso clause to ensure that the projected 10 - 13 per cent annual rate of bank credit growth actually materialized as a goal of policy. Thus, the proviso in alternative A told the Manager to moderate any tendency for the rate of bank credit growth to exceed the projected rate. The alternative B proviso said, in effect, not to execute any firming action if the growth rate tended to fall below 10 - 13 per cent. He would suggest that the second of those provisos was self-defeating, since one objective of the firming action called for in alternative B would be to slow the rate of bank credit expansion. He urged adoption of alternative B without the proviso clause.

Mr. Irons reported that conditions in the Eleventh District showed continued strength in various segments of

economic activity. Employment was unchanged at the high level that had been prevailing for some time and unemployment was low. The industrial production index rose about a point and a half last month to a level 11 per cent above a year earlier. Construction activity was improving--for the year to date it was running 13 per cent over last year--and the situation in construction probably would continue favorable. Department store trade increased in the past month and was up 8 per cent from a year ago. A large part of the State had been affected by the floods following the recent hurricane, but the consequences for agriculture in the District were as yet unknown.

In banking, Mr. Irons continued, the ready availability of reserves had been reflected in increases in loans in the past few weeks, and loan volume had been strengthened further by increased tax borrowing. District banks were increasing their investments, particularly in the area of Treasury bills; holdings of Treasury notes and bonds were down. Demand deposits were up substantially in the recent period. There had been virtually no borrowing from the Reserve Bank recently by either reserve city or country banks.

Attitudes in the District were similar to those that had been expressed in the discussion so far today, Mr. Irons said.

There was a feeling that inflationary pressures were building up and would continue to mount, and there were doubts as to the outcome with respect to the tax bill. At the national level, developments with respect to bank credit and related measures certainly seemed to be reflecting strong inflationary tendencies. Inflationary pressures could be found in most of the areas where one would tend to look for them. He saw the same elements of strength in the economy as Mr. Hayes had noted, and would add only that the projected rates of economic growth had been rising as time passed. There had been improvement in liquidity positions of banks and corporations, but corporations were continuing to seek funds actively, possibly in anticipation of monetary restraint. Action on the tax bill had been delayed and January 1 now appeared to be the earliest possible effective date. One could only wait to see whether the Administration's proposal would be watered down.

On the basis of the economic and financial situation it seemed to Mr. Irons that the appropriate prescription for monetary policy was some moderation in the degree of ease the Committee had been maintaining for some time. The Committee might have delayed too long in changing policy, and he did not believe that there was much to be gained by further delay. He was not thinking in terms of a strong, overt action, but rather

of a moderate move along the lines suggested in the blue book. He would favor probing measures, with the Desk moving forward and back as market conditions required. Obviously the Desk would have to be given very considerable leeway in carrying out such a policy. He realized that there were risks in a policy change but there also were risks in giving primary emphasis to even keel considerations and ignoring the economic and financial conditions that made a change appropriate. The ground that would be lost under the latter course would be very difficult to recapture.

In sum, Mr. Irons said, he would urge cautious probing in moving away from the prevailing state of aggressive ease. He agreed that the Treasury financing activity would have to be taken into account and that there were other limiting factors that the Desk would have to consider. But he saw no short- or long-run advantage in deciding again not to change policy in the hope that a better opportunity for a change might present itself later. Such hopes had not proved justified in recent months. He would favor alternative B for the directive.

Mr. Swan reported that nonagricultural payroll employment in the Twelfth District had remained steady in August as declines in manufacturing and mining were offset by gains in other industries. However, the over-all unemployment rate in the District

edged up 0.1 to 5.1 per cent. As indicated in the green book, housing starts increased more from July to August in the West than in any other area. The same statement held for the three months from June through August relative to the first five months of the year. That appeared to be related both to the continued high level of activity in the Pacific Northwest--particularly the Seattle area--and to the recovery in Southern California from the exceptionally depressed levels of last year.

In the first three weeks of September, Mr. Swan continued, total loans and investments at District weekly reporting banks increased substantially, in contrast to a decrease in the same period a year earlier. Also, during this three-week period, District banks showed a greater gain this year than last in commercial and industrial loans. Real estate loans continued to increase and loans to securities dealers remained at high levels. The major banks in the District continued to be net purchasers of Federal funds from other banks, but extensions of credit to securities dealers exceeded interbank purchases of funds. In the last two weeks of September borrowings from the Reserve Bank were somewhat higher than they had been since early August, although they certainly were not high in any absolute sense. Preliminary figures for August indicated that the gains in both savings accounts and loans at California savings and loan associations were well above those of July.

Turning to the question of policy, Mr. Swan said that many of the implications of relevant circumstances today seemed to be much the same as they had been at the time of the previous meeting of the Committee, except that three weeks had passed without progress on the proposed tax legislation and the Treasury's auction of $4-1/2 billion of tax anticipation bills now was at hand rather than in the future. Like those who had already commented he thought the logic of the economic situation, taken alone, called for some slowing of the rates of expansion of reserves, bank credit, and the money supply. It was for that reason that the instruction in alternative B of the second paragraph of the directive to move "toward somewhat firmer conditions in the money market" appeared to follow the statements concerning economic and financial conditions in the first paragraph more logically than the no-change instruction of alternative A. In his opinion, however, the thrust of alternative B as a whole was brought very close to that of A by the inclusion of the qualification "to the extent permitted by Treasury financing."

But there also was the overriding matter of the tax bill, Mr. Swan continued, and the question of whether firming action by the Committee might adversely affect its chances for passage. At its previous meeting the Committee had concluded that the effect of such an action was likely to be adverse, and he knew of nothing

that had happened since then that would suggest a different conclusion. Accordingly, like Mr. Hayes, despite the logic of the economic situation he would favor alternative A at this point.

With respect to the first paragraph of the directive, Mr. Swan said that he also would favor retaining the previous statement that "Bank credit expansion has continued large." However, to reflect the facts of the situation more fully, that statement might be followed by a phrase reading "even though the September rate of expansion was somewhat below that of previous months." Also, he thought the qualification reading "apart from the effects of the strike in the automobile industry," to the statement about economic conditions and prospects in the first sentence of the draft was ambiguous, since it did not make clear whether the effects of the strike were major or minor. He would prefer using some more specific language, such as "apart from the effects of the strike in the automobile industry on industrial production."

Mr. Galusha reported that farm income in the Ninth District was headed lower during at least the remainder of 1967. The crop harvest, although not yet complete, should prove to be as large as projected three months ago, but crop prices were down substantially from a year ago and were expected to remain at reduced levels over

the immediate near term. Livestock prices, which had proved particularly difficult to predict this past year, were now expected to move somewhat higher this fall; but the rise that was anticipated should provide no more than a modest offset to the impact of reduced crop prices on cash farm income.

District industrial production held steady in August, Mr. Galusha said, and it appeared to have changed little in September. The failure of production to advance during those two months was in large part the result of widespread work stoppages. Currently, about 12,000 workers at Ford, Minnesota Mining and Manufacturing, and Anaconda Copper were on strike and at least at the latter two companies prospects for quick settlement seemed small. Such labor management disputes, he was afraid, were likely to continue and perhaps become more frequent during the coming year. Officials of local unions recently indicated in the Reserve Bank's bimonthly meetings with them that the next twelve months would be the worst in many years.

Turning to policy, Mr. Galusha said that the logic of the economic situation was certainly in favor of restraint, as had been stated at the preceding meeting of the Committee. But it seemed to him there were two major considerations to be weighed, neither of which was directly related to the condition of the economy. First, unless the move was so modest as to be imperceptible, the money

market could easily view a step toward restraint as the beginning of a major sequence and overreact. Such a sequence would be impossible to complete within the next several months because of the Treasury financing problems later this fall--not to mention, of course, the problems that a significant shift in short-term rates in the United States would cause for the British. However, a flurry from a modest change now might be less than that which would flow from the major changes that might be required by a too long deferred tax increase.

The second consideration was a political one, Mr. Galusha observed. While he still believed a tax increase would come eventually, it was quite doubtful that it would be very timely because the issues being debated were, in the main, irrelevant to the immediate economic necessity for the increase. For what it might be worth, he would sketch his assessment of those issues. The President had stated that the primary reason for his request was to support Vietnam, which was hardly a popular war. The issue of military policy and national interest in Vietnam was the first of those irrelevancies. If the United States was in a major war, there was little evidence of the national sacrifice that had always accompanied such wars. There was no rationing and no wage and price controls to remind people daily that "there is a war on." So the second irrelevancy was the political dilemma of those men

in Congress who were deeply concerned about urban problems, economic development, and other pressing domestic issues. They were simply not of a mind to vote a tax increase to support Vietnam, nor were their constituents of a mind to support them if they did so--or so they feared. Finally, there were those who insisted on tax reform and economies in the Government as a price tag for the Administration's proposals. He had not mentioned that small but determined band of lemmings who maintained that all was right with the world and no tax increase was warranted at all.

Given that political climate, Mr. Galusha continued, how would a tightening of money markets be viewed? His guess now, which was different from the opinion he expressed at the last meeting, was that it might be welcomed by the first three groups at least as a decisive step in a political climate characterized by indecision and a sense of desperate frustration. How did he come out then? Very reluctantly, he favored a modest step toward restraint. He believed, however, that the Committee should immediately concern itself with the alternatives available to it when disintermediation reappeared, as it well might. Quite apart from the domestic dislocations banks would suffer was the pressure on the Euro-dollar market and on the beleaguered British if the competitive position of U.S. banks for U.S. funds was restricted.

Mr. Galusha concluded by noting that he could see little difference in policy courses indicated by the two alternatives for the second paragraph of the directive unless the proviso clause was deleted from alternative B. He would be interested in hearing how the staff, including the Manager, would interpret the two alternatives.

Mr. Scanlon remarked that a review of economic developments in the Seventh District since the last meeting of the Committee provided little basis for modifying the assessment he had presented at that time. Steel output had declined sharply in the Detroit area as a result of the Ford strike and of the possibility that the strike might hit other auto producers. Automotive components makers had been forced to curtail output as a result of the strike. Layoffs of those firms probably accounted for a significant portion of the recent increase in unemployment insurance claims in industrial centers.

Changes in credit demands at banks in recent weeks appeared to be seasonal, Mr. Scanlon continued. The business loan increase in mid-September appeared somewhat stronger in the District than nationwide. Consumer borrowing remained low. The major Chicago banks were in a position to accommodate sizable loan demands. In recent weeks they had made substantial net sales of Federal funds and increased their dealer loans quite

sharply, but they had not made net acquisitions of either Treasury or municipal securities. Those active in the Euro-dollar market had maintained sizable borrowings from that source. They had not been aggressive in seeking CD money, although there had been some firming of rates offered on longer maturities. Their performance appeared consistent with their reported expectation of a moderate rise in demand for commercial and industrial loans in the fourth quarter.

As the Committee knew, Mr. Scanlon said, he had favored a less easy monetary policy. The discussion the Committee had had at the previous meeting had caused him to go back to review the various arguments that had been presented to support positions of "no change" in recent months, and he would like to talk about those.

There appeared to have been at least three major reasons for the Committee's recent posture, Mr. Scanlon remarked. First, it had had the usual problem of deciding when forecasts of economic activity were sufficiently persuasive to be accepted as a basis for a change of policy. That the Committee must always act on the basis of forecasts or expectations was, of course, obvious, since "today's" policy had its effect on the future, not the past. The evidence in support of the staff's forecasts had become increasingly persuasive, and it probably was as persuasive

now as such evidence could ever be. There seemed no reasonable basis, in his view, for deferring a policy change any longer simply in order to have better economic intelligence. It must be for another reason.

Second, Mr. Scanlon continued, the Committee had been, and still was, concerned with the differential impacts of monetary restraint on the different sectors--in particular, the possibly disproportionate impacts on residential construction and depositary-type financial institutions. Given that reduced credit availability and rising interest rates might bear disproportionately on those sectors, the Committee was still confronted with the basic necessity of achieving an approximate balance, over all, between flows of funds and flows of goods and services in order to retain some semblance of price stability. While the Committee might wish that it did not face that problem, or that fiscal policy would cause it to go away, it was on the Committee's door-step, at least for the present. How much price inflation should be accepted in order to avoid substantial monetary policy impacts on a few sectors? He thought efforts to restrain over-all demand and the development of an unsustainable pattern of expectations should be given priority over the concern with the differential impact on various sectors. There were several reasons for that view: He believed that increases in the general level of prices

were not reversible in modern industrial economies, and even if they were, that substantial fluctuations would be objectionable; he believed that price increases tended to be self-perpetuating in that they set the stage for successive rounds of wage and price increases; and he believed that the impact of monetary and credit restraint on financial intermediaries and mortgage markets probably would not be as great as it was in 1966, given the recent experience and its sobering effects on borrowers, lenders, and investors.

Third, Mr. Scanlon said, in order to provide every opportunity for corrective fiscal action to make its needed contribution to economic stabilization, the Committee had desired that monetary policy not play any part in obscuring the case for Congressional action. In his view, suggestions that any moves on monetary policy, however slight, would delay or thwart the needed moves in the fiscal policy area were not valid; certainly, he would hope they did not have solid foundation. For if monetary policy was to play its role effectively, it had to be executed with promptness and flexibility so as to cushion and smooth the often abrupt and sometimes unpredictable changes in the fiscal sector. He was concerned that the Committee discharge fully its responsibility in that respect. That responsibility, as he saw it, called for monetary restraint now while fiscal measures were being shaped.

Mr. Scanlon then offered a further word on financial intermediaries. As he had indicated, he considered the special problems of the financial intermediaries to be distinctly secondary to the general problem of economic stabilization--the Committee's concern should be directed primarily to developments in prices and unemployment. The problems of the financial intermediaries largely reflected weaknesses in management policies and outmoded institutional arrangements. Those should be rectified so as to enable such institutions, insofar as they served real economic needs, to adjust to the vicissitudes of the financial markets in a full employment economy which was subjected to the rigors of "fine-tuning" in the public policy area. Now, it might be possible that a goal of higher unemployment would soon be embraced as an objective of public policy, although he doubted it. So he concluded that the basic features of the current "stabilization" problem were likely to recur periodically--although hopefully in reduced dimensions--and that the Committee might as well recognize the need to adapt the financial institutions and institutional arrangements to such an environment.

Mr. Scanlon feared that any further delays on the monetary or fiscal fronts now, in moving to stem inflationary forces, could only give impetus to further experimentation with direct controls--which he regarded as a generally unsatisfactory alternative.

As to the Treasury's needs, Mr. Scanlon said, the Committee could not permit a Treasury financing to fail in the sense that there were too few offers to take an issue. It was necessary, of course, that the Treasury offer yields consistent with market rates. Furthermore, in the current economic setting it would seem that the Treasury should undertake to tap nonbank sources to the extent that could be done within present rate and maturity restrictions. That suggested that issues not be tailored so as to have special appeal for the banks. He questioned the necessity or desirability of providing reserves to accommodate bank purchases of an additional large volume of Treasury securities.

As for current policy, Mr. Scanlon continued, the outlook for further substantial strengthening of demand and concern that strong expectations of further price inflation were developing led him to continue to urge greater restraint in the provision of reserves. He would recommend that total reserves be expanded at about a 3 per cent annual rate and he would expect that, over time, to be associated with a rate of expansion in the money supply, exclusive of Treasury balance effects, of about 4 per cent and in bank credit of about 10 per cent, along with somewhat higher interest rates across the board. With borrowings of member banks at the discount window at a very low level, the

discount rate was not under pressure from that source. However, it seemed inappropriate to undertake to maintain the rate below relevant market rates. The yield on 3-month bills was now somewhat above the discount rate and any significant slowing in the provision of reserves probably would be followed by a rise in rates for Federal funds. It might be appropriate soon to demonstrate the System's intention to maintain a posture of rate flexibility by making a small change in the discount rate. While he did not consider it urgent to make such a move immediately, he did consider it of utmost importance that the Committee avoid becoming committed to the maintenance of specific rate ceilings or floors, one consequence of which could be to force it to undertake to establish specific priorities for various users and uses of credit whether or not it considered such action desirable on its own merits.

Like Mr. Hayes, Mr. Scanlon said, his real concern was one of timing. He recognized the shortness of the current gap in the Treasury calendar but he did not see a better time for a policy change down the road. As a result he favored alternative B for the directive, with the first paragraph amended as suggested by Messrs. Hayes and Swan. He saw no problem in retaining the proviso clause in alternative B because he interpreted the word "significantly" to mean that bank credit would have to rise at

a rate significantly--perhaps 2 or 3 percentage points--less than 10 per cent before the Manager would implement the proviso.

Mr. Hayes then said that in view of the comments in the discussion thus far it would be desirable for the Secretary to explain the intended differences in the alternative directives submitted by the staff.

Mr. Holland remarked that like Mr. Scanlon the staff had thought that the word "significantly" in the proviso clauses was important in distinguishing between implications of the two alternatives. Alternative A called for no change in money market conditions unless bank credit growth was significantly above the projected rate of 10 to 13 per cent, whereas alternative B called for no change only if bank credit growth was significantly below that rate. Furthermore, as the blue book indicated, the staff thought that the dynamics of the immediate response to a firming of money market conditions were likely to be such as not to result in a decline in bank credit growth in the very short run. Thus, if market conditions were tightened, a significant shortfall in bank credit growth from the projected rate presumably would mean that the dimensions of credit demands were considerably less than had been anticipated. The proviso clause of alternative B was intended to guard against that contingency, just as the corresponding clause in alternative A was intended to guard against the contingency of greater than expected credit demands.

Mr. Ellis asked whether Mr. Holland's interpretations of the two alternatives would have been different if the projected rate of bank credit growth had been, say, twice the actual projection of a 10 to 13 per cent rate.

Mr. Holland replied that the staff presumably would have proceeded on the assumption that any Committee member who would favor no change in money market conditions in the face of so high a projected rate of bank credit expansion was prepared to accept that growth rate--unless his own expectations were different from those of the staff--but would favor a proviso clause to guard against still higher rates. In drafting the firming alternative, however, the staff probably would have omitted the proviso clause--particularly if both private and public demands were reflected in the high projected rate of bank credit growth and if the discussion at preceding meetings of the Committee had suggested that the members probably would favor an unqualified instruction to firm.

Mr. Galusha then asked whether the Manager would also comment on the differences he saw between the two alternatives and on the conditions under which he thought the respective proviso clauses would come into play.

Mr. Holmes replied that the difference between the alternatives could be formulated in terms of the circumstances

under which they would lead to firming. Firming would be called for under alternative A only if bank credit was rising significantly more than expected, whereas under B it would be called for unless bank credit was rising significantly less than expected. However, the word "significantly" was subject to various interpretations and today, as at other times, he would hope that in their comments the members would give him some guidance by indicating what departures from the projections they would consider significant for purposes of the proviso clause.

Mr. Hayes remarked that the Manager clearly needed guidance on the matter from the Committee.

The go-around then resumed with remarks by Mr. Clay, who observed that some encouragement could be derived from the lower rate of bank credit growth for September. In terms of what the economic situation appeared to call for, he thought a similar or rather a somewhat smaller rate of credit growth would be appropriate in the weeks ahead.

However, Mr. Clay noted, once again the Committee was faced with Treasury financing, including the current tax anticipation bills and the expected announcement in late October of the terms for the Treasury's mid-November refunding. Moreover, there might be little if any respite from Treasury financing

over the balance of the year. Considering the strongly stimulative nature of both fiscal and monetary policy and the prospective state of economic developments, the Treasury financing requirements created a very difficult situation for monetary policy formulation. Admittedly, that situation was further complicated by the risk of financial disintermediation and by the desire to avoid any disturbance to the Administration's fiscal program now before the Congress.

Mr. Clay said that the Committee could not be unmindful of Treasury financing operations, and accordingly it usually followed an "even keel" policy during the periods involved in such undertakings of substantial proportions. It would seem, however, that the System should seek to avoid a situation whereby the maintenance of prevailing money market conditions would prevent action to restrain bank credit expansion unless it appeared to be going significantly beyond the 13 per cent upper limit of the expected range. Moreover, as the System would face that type of problem in successive periods, it had to be on guard lest it find itself not simply involved in even keel operations during Treasury financings but actually financing the Treasury through the banking system.

If the Committee wished to avoid overt action to reduce the degree of ease, Mr. Clay asked, was there nothing that could

be done short of this? That might not be the case. The Committee could still shade policy on the side of being sure that it avoided any further easing. The argument might be advanced that the potential gain for monetary policy objectives would be so slight that it was not worth the risks in other ways. But that was not necessarily so. Under circumstances such as the Committee faced over the balance of the year with repeated Treasury financings and little if any departure from even keel considerations, that kind of emphasis might make a substantial difference in the degree of credit expansion over those months.

For the period ahead, Mr. Clay said, Treasury financing considerations played a dominant role in policy formulation. Under the circumstances, it was doubtful whether an overt change in policy would be appropriate. That presumably called for alternative A of the draft directives.

Mr. Wayne reported that business activity in the Fifth District appeared to be improving, although recent gains remained moderate. The Reserve Bank's latest information indicated some tapering off in the recent flurry of buying in the textile industry but definite improvement in most other manufacturing lines. The District's chemical industry appeared to be recovering from its first-half slump, and furniture manufacturers reported further improvement in orders and shipments. Construction activity had

picked up somewhat, with most recent gains in residential building although the District continued to lag behind the nation in that area. Although automobile sales had slowed in recent weeks, due perhaps to inventory shortages at dealers, retail sales of non-durables had been strong. Business loan demand in the District had shown much the same lack of vigor noted for the rest of the country. The Bank's latest grass roots survey, however, showed a significant improvement in optimism among both businessmen and bankers, and in a spot survey made by the Richmond Bank last week large District bankers indicated that they expected some improvement in loan demand over the remainder of the year.

At the national level, the current advance appeared to Mr. Wayne to be following closely the lines projected earlier by the Board staff and he found it difficult to quarrel with the staff's rather bullish fourth-quarter projections. In the light of current and prospective performances of prices and of the general business indicators, continued growth of money and credit at the recent rapid rates appeared clearly inappropriate. Yet it seemed to him that the budgetary problem and the Administration's fiscal program continued to impose serious constraints on the Committee's policy action today. Despite the slow progress of the surcharge proposal in Congress, he remained reluctant to take any action that might prejudice the Committee's chances of meeting the

prospective business upsurge with a more desirable policy mix than it could contrive on its own. To a lesser extent, the heavy pall of uncertainty which the Administration's budgetary problem continued to cast over financial markets gave him pause. All sectors of the market seemed to remain unsettled and might well be seriously disturbed by any overt move in the direction of restraint. He was impressed, for example, by the failure of the long end of the market to show any significant recent improvement even in the face of a notable slowdown in the rate of business borrowing and of sizable System purchases of coupon issues.

The blue book suggested that the market was sufficiently firm to tolerate a slightly more restrictive policy posture, Mr. Wayne said. For his part, he saw little to be gained from any limited move in the direction of restraint. On the other hand, in the face of the heavy Treasury borrowing now in prospect, any restraining action would seem to involve a risk of an unacceptable escalation in market rates with undesirable effects on the flow of funds through credit markets. So far as he could see, an orderly resolution of the budgetary problem, which incidentally would not disappear with passage of the surcharge, would require even keel, or something very much like it, over much of the remainder of the year.

Mr. Wayne commented that Mr. Scanlon's provocative summary was almost persuasive but not timely. In his (Mr. Wayne's) view the appropriate point for the adoption of such a program had passed several months ago. He thus arrived at the conclusion that while slower rates of credit and money expansion might be desirable from one standpoint, an overt move to bring about such a slowdown might involve unacceptable risks in the current circumstances. He would hope that demand conditions in credit markets over the next few weeks were such that even with the present reserve availability, the rate of expansion of private credit would be moderate. In any event, he favored maintaining the present posture for the next three weeks at least. "Nervous and watchful waiting"--to adopt Mr. Partee's apt phrase--seemed appropriate to Mr. Wayne. Alternative A of the draft directives was acceptable. In his judgment both the changes the staff proposed in the language of the previous directive and the notes explaining those changes were well done and appropriate.

Mr. Mitchell said it seemed to him that the time for firming somewhat had passed. The Committee had decided not to take such action at its preceding meeting and he did not see how it could do so at this time, given the constraint imposed by Treasury financing. He suspected that that constraint would be with the Committee for a while in the future.

Mr. Axilrod's comments today struck him as highly appropriate, Mr. Mitchell continued. If one considered certain measures, such as recent growth rates in the monetary aggregates, there did seem to be a case for tightening; but the case was somewhat less evident when one noted that some other measures indicated that there was a good deal of restraint now. If the System wanted to firm further it could get a considerable amount of restraint by reducing the ceiling rate on large-denomination CD's by as little as one-eighth of a percentage point. It was the anticipation of lenders that they might not be able to get funds in the future that was holding down the operations of financial intermediaries in general.

While he would like to see a little more firmness, Mr. Mitchell concluded, he was content to make no change now--partly because there already was quite a bit of restraint but mainly because he did not think the Committee had any alternative. The main consideration at the moment was to get the Treasury financing done.

Mr. Daane said that, to borrow an old Richmond expression, the Committee found itself today "between the rock and the hard place." The rock consisted of the clear signs of developing inflationary pressures and the fact that the Committee was contributing to incipient, if not actual, inflation by overstaying

its policy of ease. The hard place consisted of the costs of firming Mr. Partee had enumerated, including the risks of jeopardizing both Treasury financing operations and the competitive position of financial intermediaries. On the latter point, he did not think the kind of structural changes Mr. Scanlon had suggested could be effected overnight. Even more important were the considerations Mr. Hayes had mentioned concerning the highly vulnerable position of sterling and the uncertain status of Congressional action on taxes.

While he felt much sympathy for Mr. Scanlon's position, Mr. Daane said, he reluctantly concluded that the Committee had to wait a while longer before changing policy, despite the risks in doing so. He was hopeful that it would prove possible to act earlier rather than later. For the moment, however, he would retain the present posture of policy and would accept alternative A for the directive, with Mr. Hayes' suggested amendment to the first paragraph.

In a concluding comment Mr. Daane noted that there had been some discussion today of the alternatives of an overt move and a delicate probing operation. While probing operations had proved feasible at times in the past, he was not convinced that such an operation was feasible at this juncture. An action intended as a minor step would be quickly perceived by the market

and the financial press, and was likely to provoke a market reaction that would carry far beyond the intention. He was extremely skeptical about the suggestion that the System could make a move, however subtle, without creating the impression that it foreshadowed further steps of that sort in the near future.

Mr. Maisel commented that both those who believed the rate of credit expansion would decrease because expectations would moderate if the System maintained its nerve and did not change policy and those concerned primarily with the money supply could be pleased with the results of the past two periods. Since August 16 the money supply had contracted not expanded. While that was a relatively short period, he noted that projections for the next seven weeks also showed very little change in the money supply. The moderation of growth in money and a slighter one in the bank credit proxy were an indication that the Committee's policy was correct.

The Committee members must all be concerned with the rate of credit expansion, Mr. Maisel said. However, that concern should not lead the Committee to alter policy unless it had a very specific result it hoped to achieve as a result of such a change. It could choose between two alternative courses if it felt that the rate of expansion in income might be too high next

year. The first clearly would be applicable if the Committee believed prospects were for a proper rather than too rapid expansion.

The first course, Mr. Maisel continued, would be to maintain current policy, recognizing that banks and firms were rebuilding liquidity, that interest rates were near record highs, and that the additional bank credit was going into corporate hoards and was purchasing goods for Vietnam. With present interest rates, particularly if fiscal policy tightened, the demand and amount of credit furnished the private market with a no-change policy would continue to fall.

The second course, Mr. Maisel said, would be to tighten, even if gradually or by probing, and make the heroic assumption that the move would go unnoticed and uncommented on; that it would not cause a sharp increase in the demand for credit and thus a greater expansion at higher interest rates; and that it would not help defeat the tax bill. He had some sympathy with Mr. Galusha's views on the last point, but felt they were somewhat premature.

Mr. Maisel went on to ask what the Committee would hope to achieve by shifting policy, over and above the satisfied feeling that it had done something supposedly to fight inflation. The aim of policy would clearly be to raise interest rates above

their record-breaking levels. The high level would be expected to curtail some demand per se. More importantly, however, it would lead to disintermediation so that more of the public debt would be held outside the banking system. Credit for additional purchases would be curtailed. Hopefully the curtailment would occur in those parts of the economy where the Committee believed existing demand to be a problem rather than in those parts which still seemed to have more than adequate capacity. He thought such a program should not be adopted without specific decisions as to when the Committee believed demand would be excessive; how much too great it would be; and how and where the excess would be removed through the higher interest rates and disintermediation.

The Committee's policy decision for such a change should, if it was logical, move to a total reserve objective, Mr. Maisel felt. The Committee should determine the rate at which it was willing to have the bank credit proxy expand. It should hold total reserves to such a rate of expansion even if it meant a very sharp rise in interest rates. Without maintaining a total reserve target the Committee could end up with the worst of two worlds--rapidly rising interest rates and reserves and a more rapid credit expansion because of expectational shifts.

Current demands for a change seemed to Mr. Maisel to be based partially on a general uneasiness and partially on what he believed to be an incorrect picture of how the lags in monetary policy worked. While the economy would be expanding rapidly next quarter, the current projections indicated the expansion would not during that period fully take up existing slack. It was really next year that most were concerned with. There was an assumption that the Committee had to start now to curtail credit expansion if it was to decrease demand next year. That was what he sometimes called the "sausage machine" view of monetary policy. Basing policy on that view was one possible technique but not a necessary one. In the current situation using the sausage machine technique would, he believed, have a negative expected value. It would risk more losses than it could hope to gain.

In a sausage machine, Mr. Maisel said, the meat went in at one end, the crank was turned a given number of times, and the sausages dropped out. The number of sausages produced was directly related to the amount of meat put in, and they appeared at a fixed time interval after the start. The economy did not work that way. Demand in any period was not the result of monetary policy at one fixed point in the past. Instead it depended upon a weighted average of monetary policies over many past periods.

Demand next March would depend partly on today's action, just as it would be influenced by the amount of credit destroyed a year ago. In addition, however, it would also depend on action taken next January and February. How much it was influenced by policy in each of these periods would depend upon the extent of policy changes as well as their timing.

Thus, Mr. Maisel continued, the demand in any quarter was not dominated by actions taken six months previously. It could be determined as much or more by the strength of action during the quarter under consideration. That was particularly true since, as the staff had pointed out, monetary policy now had greatly increased leverage for institutional reasons.

Mr. Maisel observed that the Committee had a choice between taking action now, risking a rise in expectations and a looser fiscal policy; or delaying action, recognizing that that might require more vigorous changes to obtain the equivalent fall in demand which a currently successful policy could also obtain. While such a delay obviously had dangers, it seemed to him that it was the safer, less risky path.

Mr. Maisel believed that because the credit proxy was expected to move up far more than the money supply, under the Committee's no-change strategy the Manager should set his weekly targets closer to the lower quartile than to the median of the

range of market measurements experienced under the current directive, recognizing there would still be considerable variance. That would mean, in effect, that Federal funds would average between 4 and 4.05 per cent; that member bank borrowings could fall closer to $125 million; that free reserves for two-week periods would fall between $200 and $250 million; and that dealer borrowing costs would run between 4.3 and 4.4 per cent.

Mr. Brimmer said he would like to go directly to the question Mr. Coombs had raised concerning the role of foreign branches of U.S. banks in the Euro-dollar market. While inflows through foreign branches helped the U.S. payments balance in the short run, he was highly disturbed by the fact that such help might be purchased at the cost of serious damage to sterling. In his judgment the problem was sufficiently serious to call for some cautionary action on the part of the Federal Reserve, and he was impressed by the suggestion that the System might use some moral suasion in the period immediately ahead. Perhaps members of the Board and the Presidents of the Reserve Banks of New York, Chicago, and San Francisco--the Districts in which most of the banks with foreign branches were located--could attempt to work out some specific approach to the problem of moderating the inflows in question.

Since the Committee had discussed this matter today, Mr. Brimmer continued, he thought it should take specific note of it in the first paragraph of the draft directive. The sentence on the balance of payments in the draft directive read, "While there recently have been large inflows of liquid funds from abroad, the balance of payments continues to reflect a substantial underlying deficit." He would suggest inserting the clause "particularly through foreign branches of U.S. banks" following the comma in the draft sentence. Mr. Hayes' suggested amendment to the first paragraph also appeared to be desirable.

As to the second paragraph of the directive, Mr. Brimmer said, after talking with members of the staff before today's meeting he had concluded that there was a meaningful distinction between the two alternatives. To put it most simply, the primary instruction of alternative B was to move toward somewhat firmer money market conditions, whereas that of alternative A was to maintain prevailing conditions. He favored alternative A on the understanding that "prevailing conditions" would be defined as specified in the blue book, and that the Manager would attempt to avoid the kinds of conditions described in the blue book as associated with a firming policy. Since the Committee last met the tax bill had gotten further bogged down in Congress, and it was becoming increasingly clear that a tax increase would

not become effective before 1968. Despite the arguments Mr. Scanlon had presented, he thought the risks were too great to warrant firming action now.

Mr. Hickman asked whether his understanding was correct that Mr. Brimmer thought firming action at this time would have an adverse effect on the tax bill.

Mr. Brimmer replied that was correct. He had been trying to follow the progress of the bill closely, and had become convinced that more and more members of Congress were receptive to arguments for not favoring a tax increase. In his judgment a move toward a firmer policy by the System would be taken as providing an additional argument of that type.

Mr. Sherrill commented that he had become increasingly impressed with the accuracy of the staff's GNP projections, and he was now convinced that there would be a surge in economic activity in the early part of 1968. Perhaps surprisingly, that led him to believe that the Committee definitely should adopt alternative A for the directive at this time.

By way of explanation Mr. Sherrill observed that, assuming his expectations for economic activity were correct, there were two main alternatives for stabilization policy. One would involve an effective fiscal program, including both spending cuts and a tax increase, coupled with a moderate degree of monetary restraint.

The other would involve very heavy monetary restraint. He did not think the Committee should now attempt to move to a position intermediate to those alternatives because such an action would invite frustration of the fiscal program. Financial markets had been watching for a shift in monetary policy for some time, and there was every possibility that such a shift, even if intended to be as moderate as possible, would produce serious reactions in the markets and would lead to a significant increase in the level of interest rates. That, in turn, would set off a chain of undesirable events. A new element would be introduced into the debate on the tax bill which might be the final straw resulting in its defeat. Even a slight increase in the level of interest rates was likely to result in disintermediation and consequent pressure on the System to raise Regulation Q ceilings. If the System refused to do so, the large banks would turn increasingly to the Euro-dollar market with resulting damage to the position of sterling. If the System raised the Regulation Q ceilings, that would put pressure on savings and loan associations and the housing industry.

Accordingly, Mr. Sherrill thought that the Committee should hold to its position at this time while waiting for clearer indications of what action Congress might take on taxes. He favored alternative A for the directive, and would like to

see the word "significantly" in the proviso clause given a very narrow interpretation so that the Committee would be holding as closely as possible to its present policy. To do so, he thought, would prove helpful for the future.

Mr. Hickman remarked that the economy was clearly in a rising phase, although the automobile strike made it difficult to know exactly where it was and how it was going. After the strike was settled, the replenishment of dealers' stocks and hedge-buying of steel in anticipation of labor negotiations in that industry would provide further stimulus to production and inventory building.

In that environment, Mr. Hickman found the August rise in the wholesale industrial price index plus the further rise reported for September to be highly disconcerting. After half a year of stability, industrial wholesale prices rose 0.5 per cent from July to September, and additional price increases were being reported almost daily. The Cleveland Reserve Bank's September survey of leading manufacturers in the Fourth District--numbering about 100--revealed that about 70 per cent of the respondents expected further price increases, the largest proportion in the three-year history of the survey. Moreover, recent sharp gains in consumer prices were also disconcerting, since wage demands normally intensified as consumer purchasing

power eroded. With unemployment below 4 per cent, it was difficult to foresee anything but further inflationary pressures in the period ahead.

In a similar vein, Mr. Hickman continued, there was widespread concern at the meeting of Fourth District business economists held at the Cleveland Reserve Bank on September 22 about the likelihood of wage and salary costs outpacing productivity gains this year and next--with more concern, he thought, about next year. The group was, however, more optimistic and more confident about the general business outlook than in June, since inventory adjustments would no longer exert a drag on output. Despite uncertainties associated with the length of the auto strike and the politics of fiscal policy, the group's GNP forecast was revised upward for the second half of 1967. The median forecast for GNP, in current dollars, showed an increase of $12 billion in the third quarter, and increases of $15 billion in the fourth quarter and in each of the first two quarters of 1968. Although that forecast was less ebullient than those of the Board's staff and the Cleveland Bank, the group nevertheless expressed grave concern about price inflation. Because of the automobile strike, the group's median forecast for industrial production in the third and fourth quarters of 1967 was revised slightly downward from the June forecast.

So far as monetary policy was concerned, Mr. Hickman remarked, he would first like to express approval of the more moderate rates of growth in the major monetary and reserve measures that apparently occurred in September. He was disturbed, however, about the high early projections for reserves and bank credit in October, which, if realized, would represent a return to aggressive ease. As he had stated before, he would prefer lower rates of growth, in the range of 6 to 8 per cent. In view of the inflationary pressures now dominant in the economy, he believed the Committee should continue to move gradually towards further moderation in money and credit expansion.

Mr. Hickman said that he realized, of course, that the Treasury was in the midst of a financing and that it would return to the market in November. He also realized that the Committee was confronted with major problems of political strategy and tactics. For those reasons, he would rely heavily on the opinions of the Washington members of the Committee, who were close to the local scene. Political factors and Treasury financing aside, the economics of the current situation clearly called for less ease, as expressed in alternative B of the staff's draft directives. He would, however, express a preference for alternative A on grounds of short-run expediency, on the understanding that doubts would be resolved on the side of less ease.

Whatever the Committee decided, Mr. Hickman observed, it should begin to think about the ultimate costs of continued monetary ease. Continuation of ease--for whatever reasons--would almost inevitably lead to a credit crunch later on. The question was whether the Committee would have many defenders then, if it failed to move towards moderately less ease when that was clearly called for on economic grounds.

Mr. Bopp commented that the stream of information was confirming earlier forecasts of a pickup in the national economy and announcements of wage and price increases were becoming more frequent. The signs of spreading strength were less clear in the Third District, perhaps because the available data were not as recent. Thus, although unemployment rates were down somewhat and construction contracts had increased modestly, most economic indicators for the District continued the pattern of oscillation that had prevailed so far this year.

Mr. Bopp observed that concern about the inflationary prospects for the economy and their implications for credit and interest rates could be read into the results of a survey of corporate treasurers which the Philadelphia Reserve Bank had conducted in late August and early September. The questionnaire was sent to treasurers of the largest 500 manufacturing and 150 nonmanufacturing corporations, and about 60 per cent responded.

Among other things, the treasurers indicated that they expected interest rates to stay high through 1968. That seemed to reflect a reaction to circumstances of the past two years, and it confirmed the view that many now believed rates were at a "permanently" higher level. At the same time, the treasurers indicated a continuing concern about the state of their liquidity positions and planned further moves to improve it.

The survey indicated that the treasurers expected the supply of internal funds to pick up sharply in 1968, Mr. Bopp said. As a result, they would rely less on external financing. This year those corporations would have raised 37 per cent of their funds externally. In 1968 they expected to raise only 27 per cent. In addition to that favorable expectation, the treasurers almost uniformly looked for a tax increase of 8 to 10 per cent, to become effective at the first of the year. Nevertheless, the prevailing psychology apparently was one of some anxiety about the outlook for credit markets.

In the Philadelphia Reserve Bank's recent survey of the mortgage market also, Mr. Bopp continued, it found some continuing edginess about capital market developments as well as about possible disintermediation. Lenders believed that the demand for mortgages would continue fairly easy for the balance of the year. And because of the continuing attractiveness of corporate

bonds, they were not anxious to seek new commitments actively. Mutual savings banks were a bit concerned about their October rollover of CD's and potential outflows. Disintermediation had not yet occurred but the overhanging threat was always there.

As far as policy was concerned, Mr. Bopp thought that the need for less ease had become even greater now that the signs of economic strength had become clearer. Although the risks of substantial impacts on interest rates were also quite apparent, economic considerations on balance led him to recommend a move toward less ease. He favored alternative B without the proviso. However, if the Chairman of the Committee believed action should be further postponed for strategic reasons, he would agree to a continuation of existing policy for the next three weeks.

Mr. Kimbrel remarked that in his part of the country at this time of the year people liked to take stock of how well the farmers had been doing. Even though there had been a great deal of industrialization in the Sixth District, agriculture still made a substantial contribution to income. And, of course, many were still farmers at heart. What was found was a mixed picture. Except in the case of cotton, the 1967 production of crops probably would exceed last year's. Prices for several crops, however, had not been as high, so cash receipts probably would

be down a little. Current conditions in the broiler and egg industries continued discouraging. Although Government payments might offset some of the decline in cash receipts, rising costs meant that farmers would probably end the year with less net income than in 1966.

Mr. Kimbrel observed that the Sixth District agricultural conditions were, of course, not related directly to monetary policy. Nevertheless, the form of that mixed picture bore some semblance to the mixed picture in other sectors where developments were more closely related. Total manufacturing employment, for example, was slowly expanding along with a lengthening of the work week, but the expansion was concentrated in certain types of industries. Construction employment increased in August for the first time in several months, and a preliminary tabulation of announced plans for new and expanded manufacturing plants suggested further stimulus for nonresidential construction. The dollar volume of plans announced in the third quarter was up sharply from that of the second quarter. The greatest volume was accounted for by the petroleum, petrochemical, and chemical plants, with some planned expansion in fabricated metals, rubber, and paper. However, there might be some future slackening in the recovery of home building, according to information gathered in the recent survey of mortgage financing. There apparently had been some deterioration in the over-all mortgage situation.

When one turned to Sixth District banking, Mr. Kimbrel continued, he found a mixed picture there also. Time deposit growth was slowing. Demand deposits were near year-ago levels, although in recent weeks they had risen substantially more than seasonally at the banks outside the large cities. Passbook-type savings, nevertheless, were continuing to increase. In August and September total loans were down after seasonal adjustment at the District's large banks. At other than large banks, the previously strong rate of loan expansion had slackened. Despite those contrasts, the evidence seemed unmistakable that the renewed vigorous demand for loans bankers had been expecting had not materialized. Sixth District banks remained in an easy reserve position with borrowings averaging around $3 million in September.

Somewhat the same situation seemed typical of other parts of the country, Mr. Kimbrel noted. Thus, it was hard to conclude that a slightly less liberal policy in supplying reserves to the banking system would have serious repercussions. The Committee might be precluded from a gradual tightening by current Treasury financing activity, but he would hope that some such move might be taken as soon as the opportunity arose.

Taking everything into consideration, Mr. Kimbrel concluded, if he had to choose he would choose alternative B of the draft directive.

Mr. Francis observed that evidence of excessive demand for goods and services continued to mount. Not only was present total demand pulling up prices and reinforcing cost-push forces, but with output rising at a much faster rate than capacity there was likely to be a rapid worsening of the price situation during the next six months. The present and prospective conditions might have been moderated by some fiscal and monetary restraint over the past several months, but the Committee had to accept the lagged effects of past actions and strive to improve the future. So long as commercial bank credit and the money stock increased at the unprecedented rates that had prevailed this year, and the Federal Government continued to spend far in excess of its income, further acceleration of total demand and of upward pressure on prices might be expected.

Mr. Francis believed the basic upward movement of interest rates had been and could be only temporarily slowed and postponed, not reversed, by a rapid creation of bank credit and money. Such monetary expansion produced greater total demand for goods and services, enlarged demands for credit, and expectations of inflation with consequent upward pressures on interest rates. Reasonable restraint of growth in the monetary variables might be accompanied initially by greater interest rate increases than otherwise, but that would basically be the result of an excess of existing and prospective demands for funds over the supply.

But any temporary interest rate increases resulting from restraint of monetary expansion would not be without benefit, Mr. Francis continued. Total demand would be dampened and inflationary pressures reduced. Furthermore, higher interest rates would be a basic aid to the U.S. balance of payments. Rates in this country were lower than those in most other countries. Containing inflationary pressures would also benefit the U.S. balance of trade.

In Mr. Francis' view there was no question but that fiscal restraint was required at the present time. But even if the proposed tax increase was enacted, the budget would still be highly stimulative by historical standards. With a $10 billion tax increase, the budget might still be expected to be in deficit by about $6 billion on a high-employment basis in the first half of 1968, compared with an average surplus of $8 billion from 1963 to 1965.

In order to lay a basis for reasonable price and interest rate restraint, Mr. Francis said, there was a need not only for fiscal restraint, but also for moderation of the growth of money and credit. The urgency of the need for such moderation had been underscored by the failure of Congress to enact a tax increase by July 1 and by October 1, as successively proposed by the Administration.

As he examined the data for the past few months, Mr. Francis remarked, he noted that bank credit had increased at a 13 per cent annual rate and the money stock at a 7 per cent rate. In the face of highly expansive fiscal policy, he thought it would be prudent to cut those rates of growth, perhaps by half. Such rates could, of course, be adjusted later in light of the evolving fiscal and economic situation. With those objectives in mind, he suggested permitting necessary increases in short term interest rates and firming of other money market conditions. He recognized the risks of firming action that had been mentioned, but he believed that a failure by the Committee to act during this brief period when there was an opportunity for action would involve even greater risks. He favored alternative B without the proviso clause for the second paragraph of the directive, and he liked the modification in the draft of the first paragraph that Mr. Hayes had proposed.

Mr. Robertson made the following statement:

An important part of the preparation for this meeting--at least for me--was to go back and read with special care the record of discussion at our previous meeting. I did so because I believe the discussion last time set forth clearly and candidly some very obvious constraints on our choices as to which monetary policy we should be following. I think we ought to ask ourselves first, what, if anything, has changed since that meeting, and second, whether any such changes are important enough to warrant our coming to a different policy conclusion.

On the first question, two developments immediately come to mind. One is the continuing auto strike, which has now dragged on more than a month with no quick end in sight. The other is the prospect for some move toward more fiscal restraint, featuring expenditure cuts as well as a tax increase; the odds on action on this front seem to seesaw from day to day, but I, myself, read them as somewhat higher today than they were at the time of our last meeting. Both of these shifts are in a direction that would argue more strongly for a "no change" directive today than they did three weeks ago.

Recent economic and financial indicators, apart from strike effects, seem to me to be about a standoff, describing an expansion about as vigorous as we had expected, and not much more or less. On the financial side, developments actually are a little less exuberant, with money and bank credit growth becoming slower for a time and interest rates edging up to somewhat more restrictive levels. On the other hand, action on the price front is every bit as disturbing as we had feared, with sizable increases being reported over a wide range of goods and services at both wholesale and retail levels. Finally, we do have a Treasury financing on our hands that we cannot simply ignore in setting policy.

On balance, I come out at the same place I did last time: feeling that the economic situation alone calls for the introduction of a greater measure of restraint but that the best way to get it is to keep monetary policy essentially unchanged while hopefully waiting for more pressure to be applied on the fiscal brakes. This is not the happiest of postures, and we may not be able to continue on this course a great deal longer; but I think our responsibilities as public officials leave us with no other choice at this juncture.

Accordingly, I am prepared to vote for alternative A of draft directives put forward by the staff, with its cautiously worded proviso clause to guard against any breakout of private credit demands.

Mr. Robertson added that he agreed with Mr. Sherrill that the interpretation of the word "significantly" in the proviso clause should be very narrow. He also favored the changes in the draft of the first paragraph that had been suggested by Messrs. Hayes, Swan, and Brimmer.

Mr. Hayes remarked that most members of the Committee seemed to believe that there were strong economic grounds for taking some firming action today. It was clear, however, that after carefully weighing various other considerations the majority thought it would not be desirable to change policy at this time, although some members were of a different view. He noted that the Secretary had been attempting to work out revised language for certain sentences in the first paragraph of the draft directive to take account of the several suggestions for change made during the go-around, and he invited Mr. Holland to comment.

Mr. Holland then read revised versions of the opening sentence of the first paragraph and of the sentences concerning bank credit growth and the balance of payments. A discussion ensued, in the course of which the Committee agreed upon certain further modifications in the language Mr. Holland had proposed.

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

> The economic and financial developments reviewed at this meeting indicate that, apart from the effects of the strike in the automobile industry, underlying economic conditions have strengthened and prospects favor more rapid growth later in the year. Upward pressures on costs persist, average prices of industrial commodities have risen further, and the rate of increase in consumer prices remains high. While there recently have been large inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large, although there was some moderation in September from the rapid July-August rate. The volume of corporate bond flotations has slackened, but Federal and State and local Government financing demands remain large and most interest rates have on balance moved up somewhat further. The President's new fiscal program is still pending before Congress. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified, to the extent permitted by Treasury financing, to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 24, 1967, at 9:30 a.m.

Mr. Hayes then noted that the staff had distributed a tentative schedule of proposed Committee meeting dates in 1968. It appeared to him that the staff had done a commendable job in resolving the various types of problems that arose in developing

such a schedule. He asked whether any members had reservations regarding the tentative schedule.

Mr. Swan said that while he had no specific objections to the tentative schedule he would hope that at some point the Committee would again consider a suggestion that had been made in the past for holding at least the majority of its meetings shortly after the middle of each month. The bulk of the economic and financial data for the preceding month would be available then, and the Committee would have a similar body of data before it at each meeting. He realized that the desirability of holding the Committee's organization meeting early in March would create some problems in working out such a schedule.

Mr. Hayes said he thought there was merit in that suggestion and he assumed that the Board staff would agree. An additional advantage in holding meetings after the middle of the month was that the probability would be reduced of having the meeting date fall between the subscription and payment dates of a major Treasury financing.

A discussion ensued of the reasons underlying the Committee's practice of holding its organization meeting on the first Tuesday in March. During that discussion it was suggested that consideration might be given to alternative arrangements for handling routine organizational matters that would allow greater freedom in scheduling the Committee's meetings.

Mr. Hickman then suggested that the staff be asked to re-examine the question of the 1968 meeting schedule in light of the discussion today.

Mr. Brimmer recalled that when the Board had discussed the matter on a preliminary basis there had been a suggestion that the Committee schedule its meetings at four-week intervals. If there was sentiment in the Committee for such a schedule it might be given further consideration.

Mr. Hayes noted that some Committee members had felt for some time that the best arrangement would be to hold twelve meetings a year, perhaps around the middle of each month. Such an arrangement would involve four-week, and occasionally five-week, intervals between meetings.

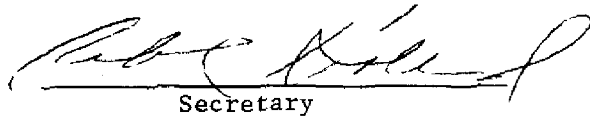
Mr. Daane indicated that he would find such an arrangement desirable. He noted, however, that there had been considerable sentiment in the preliminary Board discussion to which Mr. Brimmer had referred in favor of maintaining the present arrangement in which Committee meetings were held at three- and four-week intervals.

Mr. Hayes then said that there appeared to be no need to reach a final conclusion today regarding the tentative 1968 meeting schedule. He suggested that the staff be asked to

review the matter further and that the Committee plan on pursuing the discussion at its next meeting.

There was general agreement with Mr. Hayes' suggestion.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

CONFIDENTIAL (FR) October 2, 1967

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 3, 1967

FIRST PARAGRAPH

The economic and financial developments reviewed at this meeting indicate that, apart from the effects of the strike in the automobile industry, economic activity has strengthened and prospects favor more rapid growth later in the year. Upward pressures on costs persist, average prices of industrial commodities have risen further, and the rate of increase in consumer prices remains high. While there recently have been large inflows of liquid funds from abroad, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has moderated somewhat from the rapid rates of recent months. The volume of corporate bond flotations has slackened, but Federal and State and local government financing demands remain large and most interest rates have on balance moved up somewhat further. The President's new fiscal program is still pending before Congress. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

SECOND PARAGRAPH

Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified, to the extent permitted by Treasury financing, to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Alternative B

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to moving toward somewhat firmer conditions in the money market to the extent permitted by Treasury financing, unless bank credit appears to be expanding significantly less than currently expected.