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, September 28, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Daane
Mr. Ellis
Mr. Galusha
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Shepardson
Mr. Irons, Alternate for Mr. Bryan

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

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

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Noyes, Economist
Messrs. Baughman, Brill, Holland, Koch, and Willis, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Molony, Assistant to the Board of Governors
Mr. Cardon, Legislative Counsel, Board of Governors
Messrs. Partee and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Associate Advisor, Division of International Finance, Board of Governors
Mr. Axilrod, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Mr. Patterson, First Vice President of the Federal Reserve Bank of Atlanta
Messrs. Link, Eastburn, Mann, Parthemos, Brandt, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of New York, Philadelphia, Cleveland, Richmond, Atlanta, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York
Mr. MacLaury, Manager, Foreign Department, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meetings of the Federal Open Market Committee held on August 31 and September 8, 1965, were approved.

Upon motion duly made and seconded, and by unanimous vote, the action was ratified that had been taken by members of the Federal Open Market Committee on September 14, 1965, authorizing use of the authority for covered purchases of sterling in a manner involving combined System-Treasury participation in the program of assistance to Britain in the amount of $400 million, shared equally by the System and the Treasury, rather than the lesser of this sum or 40 per cent of the total amount of assistance to Britain.

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 August 31 through September 22, 1965, and a supplemental report for September 23 through 27, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury said the gold stock would remain unchanged again this week, and the Stabilization Fund was expected to finish the month with holdings of about $70 million. France would be buying about $50 million in gold on September 30, on the basis of its adjusted reserve gains in August. The effect of that French purchase on U.S. reserves would be offset, however, by a sale of $50 million of gold by the Bank of England. The British sale was arranged toward the end of August to help keep U.S. gold losses at a minimum during a period of more than usual uncertainties.

It looked as though the International Monetary Fund gold mitigation arrangement would be put in operation very shortly, Mr. MacLaury said. As the Committee would recall, that arrangement involved the deposit with the Federal Reserve Bank of New York by the IMF of gold purchased from the U.S. by countries making their gold subscription to the IMF as part of their quota increases. That deposited gold would continue to be shown as part of the total U.S. gold stock, but the amount due to the IMF on demand would be identified in monthly data in much the same manner as was the $800 million sold to the U.S. several years ago under repurchase option by the IMF to obtain investment income.

In the London gold market, Mr. MacLaury continued, the price had remained in a fairly narrow range during September--$35.11-1/2 to $35.15--with Russia continuing on the sidelines. The gold pool, which was able to distribute $74 million to its members early this month on the basis of August's operations, had on balance lost about $30 million so far in September. The cumulative deficit thus had risen again to about $155 million. That decline reflected not only the absence of Russia, but also a smaller volume of gold coming on the market from new production and from South African reserves; and, as had been learned just yesterday, some renewed buying by Communist China through Switzerland, starting last week. The Chinese purchases helped explain why turnover had remained at higher levels than had been expected after quieting down following the Pakistan-India hostilities.

Since the last meeting, Mr. MacLaury went on, the focus of attention in the exchange markets had been, more than ever, on sterling. To date, at least, there was every reason to be encouraged by the market response to the central bank operation that had been put into action on September 10. Since that date, the Bank of England had taken in more than $350 million from the market while the spot rate had been bid up--at first by official intervention, and then by the market itself--some 80 points, from 2.7918 to nearly parity, despite the announcement of mediocre U.K. trade figures for August and the unsettling effects of the Pakistan-India war. In view of the importance of events in the sterling market, the day-to-day (and, during the first day, the hour-to-hour) account of that operation and the market's response had been spelled out in more detail than usual in the written reports submitted to the Committee.

In general outline, Mr. MacLaury said, the sequence was this: On Friday, September 10, following negotiations of which the Committee was aware, the Bank of England announced at 2:00 p.m. London time (9:00 a.m. New York time) that it had entered into new arrangements, in various--unspecified--forms, with all of the banks that had cooperated in support of sterling last November except the Bank of France. The announcement, which the New York Bank read immediately to the exchange trading rooms of banks in the New York market, said that the arrangements would enable appropriate action to be taken in the exchange markets. As soon as all of the banks had been advised, the System Account began to bid the fourteen banks simultaneously for a total of £ 10 million on each round of bids, gradually raising the bid in consultation with the Bank of England as the market backed away, and buying only a small amount. By the close in New York that Friday, the System had bought only $13 million equivalent of sterling while raising the market price some 25 points.

With the European markets already moving toward their pre-weekend close by the time the announcement by the Bank of England was released on Friday, Mr. MacLaury said, it was not to be expected that there would be any sudden move to cover in size that day. The following week, however, there was a surge of buying, mainly from London and the continent, as the markets became persuaded that the cooperating central banks had the means and the determination to make speculation against sterling costly. During the week following the announcement the Bank of England took in $230 million as the rate rose another 40 points without official intervention. The initial rush to cover near-term commitments was quite naturally most evident during the first week following the initiation of the operation. Last week, the week of September 20, the markets were much less hectic, and on a few occasions the rate started to drift off in light trading. However, it took only a small amount of intervention by the Federal Reserve in New York and the Bank of England in London to turn the market around again, and by the end of last week the spot rate was up another 10 points and the Bank of England on balance had taken in almost $50 million. Yesterday that Bank took in $35 million and today another $40 million, raising their total acquisitions since the announcement to about $350 million. That figure did not include some amounts taken in prior to the current operation.

Mr. MacLaury went on to say that the jolt administered to the market by the central bank operation carried over into the forward market as well, although no intervention was undertaken in that area. The discount on three-month sterling, which had been about 2-1/2 per cent at the beginning of September, narrowed to less than 1-3/4 per cent, cutting the theoretical arbitrage advantage in favor of New York considerably, to about 1/4 per cent today. While that strengthening of sterling forwards undoubtedly reflected some covering of open positions, his impression was that the covering done so far had been largely by outright speculators or by those with near-term commitments. The vast bulk of the hedging and commercial covering operations still remained to be reversed, and while there was every reason to believe that if economic conditions in the U.K. continued to improve those positions would be closed out, it was difficult to gauge the timing of the covering. There was no doubt, however, that market sentiment regarding the short-run prospects for sterling had changed completely within just a little over a month. That change, based partly on the technical strength resulting from the oversold position of sterling and partly on the measures dealing with prices and incomes announced by the U.K. government, was beginning to take place even before the central bank operation was put into effect. However, it was the announcement of new central bank arrangements, followed up immediately by forceful concerted action in the market, that provided the catalyst to translate changed sentiment into market response.

For the longer run, Mr. MacLaury remarked, it was clear that many hurdles still remained to be cleared and it was essential, therefore, that the U.K. authorities not let up their efforts to achieve their stated balance of payments objectives. Whatever the developments during succeeding weeks might be, however, the operation, as he had said at the outset, had clearly been very useful and had cost very little. It had not been necessary for the Bank of England to call upon any of the facilities made available by the other participating central banks and the Bank for International Settlements, and the total amount of sterling acquired by the System in the operation to date--and thus subject to the exchange guarantee--had been only a little over $20 million equivalent, as against $350 million taken in by the Bank of England.

As far as other currencies were concerned, Mr. MacLaury said, the turnaround in sterling had had less effect on continental rates against the dollar than might have been expected. In the cases of the French and Belgian francs, there definitely had been some easing against the dollar which could be ascribed to covering into sterling. Although it was difficult to keep track of changes in French reserves, it appeared that they had risen by perhaps $35 million so far this month with almost all of the increase occurring in the first few days of the month prior to the announcement of the sterling arrangements. The flow of dollars into Italy, while continuing to be sizable, had tapered off noticeably, but the change was due less to the recovery of sterling than to the tapering off of seasonal inflows. The Italian authorities were continuing to increase their dollar swaps with the commercial banks, thus reducing published reserve gains. In Germany and the Netherlands, any tendency toward easing had been offset by some tightening in the domestic money markets associated with tax dates. The rise in German reserves during September reflected mainly, if not entirely, the unwinding of previous central bank swaps with the German commercial banks, not new inflows of funds. In general, changes in continental currency rates and, for that matter, in the rate on the Canadian dollar had been limited.

Mr. MacLaury noted that Mr. Sanford had reported at the August 31 meeting that the Bank of England and the Bank of Canada had agreed to use 90-day U.S. Treasury bill rates as the basis for interest rate charges under swap drawings. Since then the Bank of Japan also had agreed to that procedure, thus putting all of the arrangements except that with the National Bank of Belgium on the same footing in that respect.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period August 31 through September 27, 1965, were approved, ratified, and confirmed.

Mr. MacLaury then asked the Committee's approval of renewal for a further period of one year of the $450 million standby swap arrangement with the Bank of Italy, which was due to mature October 20, 1965. He noted that the System's drawings under that arrangement currently amounted to $100 million.

> Renewal for a further period of one year of the $450 million standby swap arrangement with the Bank of Italy, as recommended by Mr. MacLaury, was approved.

Mr. MacLaury then noted that a drawing of $275 million by the Bank of England under its swap arrangement with the System was due to mature September 30 and was likely to be renewed in whole or in part. That would be a first renewal.

> Possible renewal for a further period of three months of part or all of the $275 million drawing by the Bank of England under its standby swap arrangement with the System was noted without objection.

Mr. MacLaury reported that a Federal Reserve drawing of $48 million under the arrangement with the Swiss National Bank, representing the remaining balance of a drawing of $60 million originally made in January 1965, was due to mature October 20, 1965. From the market point of view prospects were not good at the moment for repaying the drawing before maturity, and it appeared that it would have to be renewed for a third time.

Mr. Shepardson observed that a third renewal would put the drawing into the 9-12 month category, bringing it close to the limit of one year the Committee had placed on drawings under the swap lines. He hoped that there were definite plans to repay the drawing within the next three months.

Mr. MacLaury commented that there was no question in his mind but that the drawing would be repaid in the coming period, in accordance with the Committee's guidelines.

Renewal of the $48 million drawing under the standby swap arrangement with the Swiss National Bank for a further period of three months was noted without objection.

Finally, Mr. MacLaury noted that it was expected that the System's swap with the Bank for International Settlements of German marks for Swiss francs in the amount of $40 million equivalent would be rolled over for a second three-month period on October 8, 1965.

Renewal of the German mark-Swiss franc swap with the Bank for International Settlements for a further period of three months was noted without objection.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period August 31 through September 22, 1965, and a supplemental report for September 23 through 27, 1965. Copies of both reports have been placed in the files of the Committee.

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

Viewed from our current vantage point, and without the benefit of perspective that only a longer period of time can provide, the highlight of the period since the last meeting of the Committee has been the performance of short-term rates, particularly bill rates, in just the past few days. For the first three weeks of the period since August 30, Treasury bill rates showed comparatively little change--the three-month rate hovering around 3.88 to 3.90 per cent and the six-month rate slowly inching up from about 4 per cent to 4.04 per cent. One-year bills were bid at rates close to the six-month level.

During the past week, in contrast, the three-month rate has moved to 3.99 per cent and the six-month rate to 4.13 per cent, and the one-year bill (which was bid at 4.03 per cent at the time of the last meeting) closed at 4.20 per cent bid in market trading yesterday after having been auctioned last Friday at no less than 4.24 per cent.

For the most part, the rate rise seems to be traceable to market apprehension about increased supplies of Treasury bills as the Treasury raises new cash in the closing months of the year. The Treasury's announcement last Wednesday of a $4 billion borrowing through the issuance of two tax anticipation bills seemed to surprise the market both by its size and specific content--although certainly the market had expected some cash borrowing at this time. Adding to the unreceptive atmosphere was a rather tight money market in the wake of the September dividend and tax dates, particularly as reflected in higher dealer financing costs. Also in the background, various investor groups that are normally active in the bill market, including corporations and various State and local funds, appear to have had relatively light demands. Indeed, it would appear that many of the same factors which, a few months ago, were tending to produce a relatively low level of bill rates compared with other money market conditions are now being felt in reverse with resultant upward yield adjustments. In yesterday's regular auction for three- and six-month bills the average issuing rates were about 3.98 and 4.13 per cent, with rather cautious bidding for each bill so that some three-month bills were bought as high as 4.02 per cent in rate while the six-month issue tailed out to a rate of 4.15 per cent.

For the recent period as a whole such measures of the general condition of the money market as member bank borrowing, net borrowed reserves, and the Federal funds rate were about unchanged from the level of recent months, but as already indicated there was a tendency toward a tighter atmosphere in the latter part of the period, when required reserves were running strongly above seasonal levels. The weight of heavy credit demands and the redistribution of other financial assets associated with the tax date pressed heavily on the central money market at the time. In part this seemed to result from Treasury fiscal operations, as balances built up to meet quarterly tax payments remained only briefly with money center banks and were soon channeled throughout the country to meet Treasury outpayments. The fact that the tax date coincided with the end of a country bank reserve period, after which there is typically a flow of funds from the money centers to country banks, tended to exaggerate the process.

The combination of these factors produced a substantial demand for reserve balances, from banks both in New York and out of town. Demands for Federal funds expanded; the supply diminished and there was a gradual increase in the willingness of banks to pay the 4-1/4 per cent rate for Federal funds. It was in this atmosphere that the market experienced, last Friday, the first occurrence of a 4-1/4 per cent effective Federal funds rate with slightly more money moving at that rate than at 4-1/8 per cent. Another factor in the banks' willingness to pay up for Federal funds. in a few instances at least, has apparently been the desire to avoid repeated borrowing at the discount window. Major banks have also been more aggressive in their efforts to replace the large volume of certificates of deposit which matured over the dividend and tax dates. In this connection rates of 4-1/2 per cent have been offered by New York City banks for maturities of six months or less. In the last day or two some of these special influences have been reversed--notably, the basic reserve deficiency of the major New York City banks has declined substantially--but some effects of the recent tightness have lingered on.

Through most of September, the market for Treasury notes and bonds tended to fluctuate indecisively after moving lower in price during the previous month. With an assist from System purchases in the early part of September and intermittent buying by Treasury accounts throughout the month, prices steadied in the intermediate area, although longer bonds continued to drift downward--apparently reflecting some continued supplies from investors switching into corporate securities. The corporate market itself tended to develop some greater assurance, as a $100 million Aaa-rated telephone utility offering sold out quickly on September 15, and several other slow-moving corporate bond offerings were distributed in the wake of that sale. Toward the close of the period, however, some of the weakness developing in the short-term area also permeated the markets for longer issues, and some further price declines occurred in the Treasury bond market; corporate issues held fairly steady in price but tended to lose the glow that had begun to develop after the successful sale of Aaa-rated bonds on September 15. In the meantime, the market in tax-exempt bonds, which had come through August comparatively unscathed, adjusted higher in rate during September as sizable price concessions were needed to move recent and current offerings into the portfolios of more reluctant buyers.

For the past four weeks taken together, System operations were pretty much offsetting, as reserve absorption in the first three weeks was nearly counterbalanced in the last week by large-scale provisions to meet current month-end needs. Projections indicate that further reserve provisions will be needed in the next few weeks; it would appear appropriate at some point to meet a part of this need with purchases of coupon issues, as well as with more purchases of bills and acquisitions under short-term repurchase agreements.

Next Tuesday the Treasury will auction the aforementioned $4 billion of tax anticipation bills--$3 billion March bills and $1 billion June bills--with payment to be made on October 11. Payment may be made in full by direct crediting of Treasury tax and loan accounts, and it is accordingly to be expected that commercial banks will initially underwrite the entire offering. At the same time, given the limited availability of bank reserves and the prospective demands for credit ahead, it seems likely that banks would want to resell a sizable part of their takings in fairly short order. The substantial volume of bills to be redistributed would certainly suggest that upward pressures on short-term rates may persist during this period. Moreover, in late October the Treasury will be announcing the terms of its November refinancing, which is expected to raise some additional cash in the relatively short-term area. Then, an additional offering of tax bills is expected in late November. Technical factors, then, are apt to be exerting some upward pressure on rates for some time to come.

Mr. Hickman observed that, in view of the recent sharp rise in bill rates, during the next few weeks the Desk might use the repurchase agreement technique less frequently than usually to supply reserves, and rely mainly on market purchases. Mr. Holmes agreed, noting that there certainly was no reason to avoid bill purchases in supplying reserves at present. Repurchase agreements would continue to be useful when it was expected that operations to supply reserves would have to be reversed shortly.

Mr. Mitchell commented that according to Mr. Holmes' description of the events of the past week there had been a change in market conditions, whereas the directive issued at the meeting of August 31 in effect had called for no change. He asked what particular circumstances had led to the Desk's decision not to operate more aggressively in an effort to ease the tighter market conditions.

Mr. Holmes replied that the period in question had been a most difficult one for the Desk, partly because the reserve estimates were much less consistent than usual with the tone of the market. One morning about a week ago, for example, the estimate for net borrowed reserves was at the relatively low level of $68 million. There was an opportunity to sell some bills to foreign accounts, and at the time of the eleven o'clock call he had felt that some additional bills might advantageously be sold in the market. During the day, however, it had been decided not to sell bills in view of the pressures in the market, and that turned out to be the right decision. The reserves were in the banking system, but they seemed to be concentrated mainly at country banks. Net borrowed reserves recently had been running lower, not higher, than earlier, except for the latest week when they were back within the previous range. Required reserves apparently had been rising much more than seasonally, particularly in the last two reserve periods. The combination of the psychology that had been developing in the bill market, the desire of many banks to avoid discounting at the Federal Reserve, and the willingness of many to pay 4-1/4 per cent for Federal funds produced a situation that was extremely difficult to deal with if very low levels of net borrowed reserves were to be avoided.

Mr. Mitchell commented that evidently the Desk was watching the figures on net borrowed reserves closely, and the fact that they were running below the range that Committee members had mentioned at the August 31 meeting was the reason it had not intervened more aggressively.

Mr. Holmes replied that the level of net borrowed reserves was one consideration the Desk had taken into account. The market reaction to the Treasury financing was another; psychological factors such as were involved in that reaction were hard to deal with by the provision of a few more reserves.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period August 31 through September 27, 1965, were approved, ratified, and confirmed.

Chairman Martin called at this point 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. Koch made the following statement on economic conditions:

> At the time of our last meeting the two main uncertainties on the domestic economic scene were the likely future effects of Vietnam on military spending and the prolonged wage bargaining

in the steel industry with its potential disrupting effects on wages, prices, and inventory investment.

It now seems highly likely that some early talk about the size of military expenditures in the near-term future was exaggerated. Last spring, defense spending for the 1966 fiscal year had been projected at about $1-1/2 billion above fiscal 1965. Vietnam may have increased this figure to perhaps $3 to $4 billion. The net expansionary effects of the second stage of income tax reductions, excise tax reductions, and the new social security program will perhaps add up to another $5 to $6 billion. Other forms of Federal spending are also likely to go up a little, but the net effects of all this expansionary Federal activity could be only moderately larger than the normal revenue growth associated with current tax rates and the expected growth in corporate and individual incomes.

As for the likely effects of the ultimate wage settlement in the steel industry, and looking at inventories first, the prospects for further economic growth--both overall and more specifically in the steel-using industries--suggest that steel inventories will be reduced less than had been anticipated earlier. Nevertheless, the net effect of such decumulation could decrease total business inventory growth from the third to the fourth quarter by $2 to $3 billion on an annual rate basis. Inventory accumulation in most lines other than steel, however, will no doubt continue, so that the total inventory change will still be positive.

Time permits only brief mention of the likely future course of other major elements of the GNP, but they are expected either to expand or to show little change. Total consumer spending, which has increased sharply and steadily throughout the current long expansion, will no doubt continue to be strong. The relationship between such spending and personal incomes is relatively stable, and incomes have recently been augmented by a large lump-sum social security benefit payment as well as by an increase in current payments. The spending propensities of the aged are no doubt higher than those of other segments of the population.

Total retail sales in the third quarter are likely to be up 2 per cent from the second. New auto sales, after declining in the spring months, have risen again this summer, perhaps aided by the excise tax cut. High recent sales and the latest surveys of consumer buying intentions suggest a fourth consecutive good auto year.

Turning to business spending, increased outlays for new plant and equipment have been another important factor in the continuing economic expansion. The latest Commerce-SEC survey projects further strength in this area during the remaining months of 1965. Capital appropriations data covering manufacturing firms suggest a continuation of high investment by business well into 1966. Rounding out the picture, State and local government spending will certainly continue its long, strong rise, net exports will at least remain stable and possibly rise further, and residential construction may continue at current levels, somewhat below earlier highs.

Adding all these elements together suggests to me a GNP of perhaps $680 billion or even a little larger in the fourth quarter and about $670 billion or so for the year as a whole, or a year-to-year gain of a little over $40 billion. These figures are at the top-end of the range we had projected earlier in the year, after adjustment for the recent basic revisions in the GNP accounts.

There is still too little evidence available to frame a defensible outlook for next year, but many forecasters are now projecting a dollar rise in GNP of about $40 billion, little changed from that this year, and a rate of increase in constant dollars of about 4 per cent, a little less than this year. All I think one can say with any assurance at this time is that recent developments, including those on the international front, now make it very likely that the current, long-lived expansion will continue well into 1966. In the foreseeable future we still have a good chance of steering the middle course of maintaining our current rate of expansion without veering off into the ditches of either inflation or recession.

The relevance of this discussion about the likely future course of the GNP to monetary policy lies mainly in its probable effects on resource utilization and prices. As for resource utilization, the unemployment rate has now been at 4.5 per cent for 2 months, while the utilization rate of manufacturing capacity was at about 90 per cent through the first half of the year. The utilization rate may have crept up another point in July and August, but it no doubt dropped again in September with an expected decline in the industrial production index of about 1 point resulting mainly from the reduction in steel output.

Of course, this utilization rate is an aggregate measure for total manufacturing; some lines are at practical capacity and others are significantly below it, including now the key steel industry. The important fact for policy, however, is that a projected further leveling off or even decline in industrial production and increase in business plant and equipment spending do not suggest any large further decline in the unemployment rate and probably imply some decrease in the capital utilization rate for manufacturing in the near future.

Recent price developments have indicated no tendency for "overheating." The total wholesale price index has been stable during the past 8 weeks, with industrial prices rising less than earlier and foodstuffs actually declining following earlier marked increases. Wages have continued to rise at the approximately 3 per cent annual rate characteristic of earlier months. Unit labor costs in manufacturing as a whole have probably risen slightly in recent weeks as the pace of output slackened, but this should be temporary.

These recent price developments, plus the fact that the wage settlement in the steel industry was moderate, should keep further price increases selective and small. Of course, business optimism and corporate profits are high, and the stock market is strong. Selective price increases will no doubt continue. Some such price increases will stick but others will not, for competition among domestic producers, as well as foreign importers, continues strong.

Despite the lagged effects of monetary policy, the current domestic economic situation still does not seem to me to call for a further restraining monetary policy move, particularly since more buoyant business expectations, increased actual demands for financing, and the cumulating effects of declining bank and corporate liquidity, as I'm sure Mr. Partee will point out, have led to a significant firming of interest rates and other credit conditions in the last 2 months. This has come about in part accidentally, as a result of a steel strike threat and international tensions. But for whatever reasons, we've been able to make welcome inroads into the sticky unemployment and capital utilization problems. I see no reason to risk curbing such economic progress unless the inflationary thrust becomes more evident or present efforts at improving the balance of payments become less effective.

Mr. Hickman noted that in the statement just made--which he thought was an excellent one--Mr. Koch had expressed the view that net exports would be stable or rising. He (Mr. Hickman) had been under the impression that the trade surplus was expected to decline.

Mr. Koch replied that there already had been some decline in net exports this year and his comment had been based on the assumption that the adjustment had been completed. He added that even a relatively large change in net exports would have little effect on GNP since it was a small item in the total, and Mr. Hickman agreed.

Mr. Partee made the following statement concerning financial developments:

> Financial markets since the last meeting of the Committee have been in transition to a higher yield structure. Mr. Holmes has discussed the succession of market events contributing to this movement. Now I would like to focus on the development in a somewhat broader perspective, since it seems to me that the changes occurring in recent weeks represent a sizable and significant upward movement in interest rates. Since mid-year, 3-month bill yields have risen 20 basis points, 6-month bills 30 basis points, yields on intermediate Governments around 20 basis points, and long-term private and public bonds 10 to 15 basis points. All of these adjustments have taken place during a period when there was no overt change in monetary policy, and when net borrowed reserves--though fluctuating between \$100 million and \$200 million on a weekly basis--have centered fairly closely on \$150 million or a little more.
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> It is evident, therefore, that earlier relationships among financial market variables have been altered by other factors. Principal among these has been the improvement in business expectations, based largely on increased Federal spending, the continuing boom in plant and equipment, and the constructive wage settlement in steel. Improved business expectations have been transmitted to financial markets--most obviously in stocks, where prices have recovered to their spring highs on very heavy trading volume, but also in the credit area, where the implications for financing volume and possibly for interest rates are widely interpreted as bullish by the financial community. The large current

Treasury financing, with the indication that $3 billion more will be coming in November, has tended to reinforce this view, even though the total for the half year apparently will not be much larger than had been expected earlier.

Heavy financing demands during the summer, particularly by businesses, also have contributed to the pressures in financial markets. Public offerings of corporate bonds since the beginning of June have exceeded the year--earlier volume by $1 billion, or 80 per cent; about half of this increase was in bank capital issues, which remained in the investment stream but nevertheless enlarged demands for long-term funds in the corporate market. Bank business loan expansion, at a 17 per cent annual rate in the June-July-August period, was nearly double that of a year ago. Loan demand weakened temporarily after mid-August, but tax date borrowing was very large--one-fifth more than a year ago and nearly twice the average of the three preceding years, at weekly reporting banks.

Inventory accumulation in steel and steel-using products has been a significant factor in loan expansion this year, and a working down of these stocks now will doubtless permit some loan repayment. But the prospects still seem to be for substantially more than seasonal loan expansion this fall. Similarly, looking beyond the immediate calendar, the prospect seems to be for a continued large volume of bond flotations. The extent to which external financing of business will be from banks or in the market depends on a variety of factors, including yield relationships and expectations. Taking into account Treasury needs, however, no significant reduction in aggregate financing demands seems indicated.

Tightening in financial markets also appears attributable in part to the cumulative effects of decreasing liquidity in key sectors of the economy. Corporate holdings of liquid assets have been declining since last fall; the reduction in the second quarter was unusually sharp and it seems unlikely that there was any appreciable rebuilding in holdings during the summer. This has special relevance for banks both in terms of loan demand and in potentials for further expansion in CD sales. Banks have relied heavily on these instruments to finance loan expansion this year, as some corporations apparently shifted liquidity holdings from bills to CDs; a less expansive and more volatile market now could influence both supplies of loanable funds and bank views as to minimum liquidity needs. This, in turn, has implications for bank buying of municipals and mortgages, as well as for the availability of bank credit to businesses and consumers.

Under the circumstances, it is not surprising that we have been hearing increased banker comment lately about efforts to ration credit. And our systematic roundup of such comments, from the September lending practices survey, seems to confirm a marked further shift toward firmer lending policies in the business credit and finance company areas. Similarly, there have been fragmentary indications from other sources of some firming in attitudes regarding mortgage and consumer lending standards.

Thus, it appears that an appreciable firming in financial conditions has been in process, not only in market yields but also in terms of the availability of bank credit. The very large bank credit increase reported for August, it seems to me, should be discounted. The series is volatile and presents serious seasonal adjustment problems; moreover, the member bank credit proxy--essential, total deposits--declined in August and apparently again in September to rates of increase well below the average for this year and last. Similarly, the very large increase for the money supply indicated for September reflected an even sharper decline in Government deposits; partial restoration of unusually low September balances may exert a depressing effect on private money holdings over the next few weeks.

In view of the present ebullience of business and financial sentiment, it may well be appropriate that the combination of strong demand, declining liquidity, and anticipation has been permitted to exert some self-tightening influence on credit markets. Further increases in the structure of rates, however, would bring into question the viability of the discount rate and Regulation Q ceilings. At present market rates, many banks are likely to have trouble competing for CDs under the existing ceilings; further firming in rates would almost certainly bring correspondingly greater pressure to bear on use of the discount window.

For the present, it seems to me that any indication of further moves toward monetary restraint should be avoided. The size and sensitivity of the Treasury cash financing, and the need to avoid additional upsets to the market while new rate relationships are being worked out and tested, would seem to dictate an "even keel" policy stance.

Should the Committee decide that "no change" for this meeting is the appropriate course, there are two further aspects to the problem on which I think the Manager deserves some direction. First is whether primary emphasis should be placed on marginal reserves or on money market rates, since these relationships have changed in recent weeks. Second, in view of the changes that have taken place in both rates and reserves, there is the problem of whether a "no change" policy means maintaining money market conditions as taut as they have been most recently, or as they have been on average since the last meeting of the Committee. Even if "even keel" is taken to mean maintenance of current conditions, the term probably should contemplate permitting some rates that have advanced most sharply to back down a few basis points, while laggard rates are still in process of adjusting upward.

Mr. Reynolds presented the following statement on the balance of payments:

It now appears that the third-quarter payments deficit on "regular transactions" may work out at an annual rate of about $1-1/2 billion, a little above the rate for the first half year. Probably $1-1/2 billion is also still a reasonable guess for the year as a whole, assuming that the United Kingdom will not draw on its credit line with the Export-Import Bank or postpone its year-end debt service payments; but earlier hopes that we might do better than that this year have waned.

Detailed data for July, or July-August, suggest that the trade balance has improved a little compared with the first half, but that net U.S. private capital outflows may have increased more. Earlier reflows of U.S bank credit and of nonbank liquid funds have diminished on a seasonally adjusted basis (the seasonals being large at this time of year), and outflows through new foreign security sales to U.S. residents, for which third-quarter data are fairly complete, increased. Also, net foreign sales of U.S. corporate securities, mainly for British account, totaled $110 million in July alone, three times the average rate of the first half year.

Since the last meeting, we have learned that in the second quarter there was another very large outflow of direct investment capital. Most analysts had earlier braced themselves for somewhat larger outflows this year than last, despite some attempts at voluntary restraint. But no one, I think, had imagined that such outflows would shoot up to more than $2 billion in a single half year, compared with $2.4 billion for the full year 1964, which was itself a record.

There has been a larger than usual quota of identifiable special elements in this year's outflow. International petroleum companies made large retroactive tax payments, following renegotiation of agreements, and also leased some new concessions. The counterpart of these payments is clearly seen in the statistics of Iran, Iraq, Saudi Arabia, and Libya, whose combined gold and foreign exchange reserves increased by $450 million, or more than 25 per cent, during the first 7 months of this year. When people say that primary producing countries are doing badly this year, they should be careful to exclude the oil countries.

Another special transaction was the conversion of a $100 million U.S. investment in Canada from loans to a direct investment, without net effect on the balance of payments. Finally, there appear to have been some anticipatory transfers of funds early in the year for later use. Altogether, the transactions I have listed may have accounted for $1/2 billion of the direct investment outflow in the first half year. But even without these, the outflow in the first half would have been well above last year's rate.

It seems clear that voluntary restraint has not yet amounted to much in this area, and that direct investment should still be thought of as being on a strongly rising trend, sustained by large U.S. corporate profits, cash flows, and credit availability, and by rapid economic growth abroad.

Direct investment outflows will almost certainly be lower in the second half year than in the first. Indeed, despite the special oil payments, such outflows diminished by nearly $300 million in the second quarter. Even if for the full year they are up by as much as 40 per cent over last year, as Government analysts are now guessing, they would decline by $700 million between the first and second halves. Within total capital flow, this decline could offset--and is perhaps already offsetting--much of the adverse impact of renewed bank lending and of the cessation of reflows of liquid corporate funds.

For the long run, direct investment outflows may not pose very serious problems. They pay out in about 8 years on the average, so that recent large outflows may only briefly interrupt the faster rise of income than of outflow, while later contributing to it. But they raise awkward problems for the middle-range period of these two or three years during which the United States is trying decisively to reestablish payments equilibrium. In particular, it is difficult to keep banks on a tight leash when corporations making direct investments appear to be running free. Therefore, one may now reasonably expect the Commerce Department to try to stiffen its restraint program, difficult though that may be.

I come back, now, to my guess that the overall deficit on "regular transactions" may be $1-1/2 billion for the year. How would such an outcome be interpreted? From one point of view it would be a remarkable achievement--all that had been hoped for as of last February, despite lower exports, higher imports, and larger direct investments than anyone had then envisaged. Also, it should be noted, British Government conversions of roughly $1/2 billion of its nonliquid portfolio into liquid assets during the year will have made our results that much worse than they would otherwise have been, and this might be regarded as a flaw in the bookkeeping, helping to overstate our problem.

On the other hand, the good 1965 result will have been achieved with the aid of some once-for-all transfers, notably the repatriation of $600-$700 million of corporate liquid funds. Also, bank lending to foreigners will have been held well below the level of most recent years, and this would probably have been more difficult, without disrupting other flows, had it not been for last year's extravagant burst of lending.

People seem always to ask of deficit countries the same question that they ask of politicans: "Yes, but what have you done for me lately?" Thus a key question now being asked is whether further improvement in the balance of payments can be foreseen for next year. At the moment, visibility is limited and it is difficult to see where improvement will come from. The current account surplus may well turn up again, but capital outflows also seem likely to increase, unless they are restrained by further changes in relative credit conditions or by intensification of special restraint programs.

Mr. Hickman said he was somewhat puzzled by Mr. Reynolds' conclusion that it was hard to see where future improvement in the balance of payments would come from if one accepted the earlier part of his statement. Mr. Reynolds had suggested that direct investment would decline if the Commerce Department stiffened its restraint program and he had noted that the British conversions into liquid assets this year had had the effect of overstating the size of our portfolio investment.

If the trade balance also was better, as Mr. Koch expected, the balance of payments should improve further--unless, of course, banks stepped up their foreign lending.

Mr. Reynolds replied that he had not meant to imply by his statement regarding the expected reduction in direct investments in the second half of 1965 that such investments would be lower next year than this year. The Commerce Department would be fighting a rising trend and in his view their restraints would have to be made much stronger in order to bring about an absolute reduction from the 1965 level of direct investments.

Mr. Maisel noted that both of the alternative directives suggested by the staff[1/] included the statement that "our international payments have been in deficit since midyear," presumably on the basis of the "regular transactions" figures. He asked whether it was not correct that U.S. payments were in surplus in July and August when the measurement was on an "official settlements" basis.

Mr. Reynolds replied that a surplus probably would be recorded on the official settlements basis for the third quarter, primarily because of large movements out of sterling into dollars in July and August. Although figures for all of September were not yet available, there probably was a deficit in the month associated with the return

1/ The two alternative directives prepared by the staff are appended to these minutes as Attachment A.

flow into sterling. If the improvement in the British situation continued, there was likely to be a deficit on the official settlements basis for the year as a whole.

In response to a question by Mr. Daane, Mr. Reynolds said that the size of the 1965 deficit on that basis corresponding to his estimate of a $1-1/2 billion regular transactions deficit would depend on developments for sterling. It might be on the order of $1 billion, but perhaps would be less than that if sterling did not do well.

Mr. Balderston commented that however the deficit was calculated the crux of the problem seemed to him to lie in the fact that gold outflows were continuing.

Mr. Hayes expressed the view that it was important to keep close watch on the payments figures on both bases of calculation, as well as on changes in the gold stock.

Prior to this meeting the staff had prepared and distributed certain questions suggested for consideration by the Committee, and comments thereon. These materials were as follows:

(1) Prices and costs.--How have near-term prospects for wages, unit labor costs, and prices changed since the steel settlement?

The overall cost of the new labor contract in the steel industry, which runs to August 1, 1968, represents neither a new pattern nor an acceleration in wage increases. Terms of the contract are roughly in line with estimates of the gain in output per manhour in the steel industry--and in the economy generally. Consequently, they imply continued stability in labor cost per unit of steel production and remove one potential basis for a general steel price rise. This new agreement should exert a major influence in holding coming settlements to noninflationary levels. (The next major negotiation, in the electrical machinery industry, does not occur until the middle of next year.)

As contract negotiations are completed in other metal industries where employees are represented by the United Steel Workers, prices may be raised for some products. These developments, however, do not have the potential for a cumulative price and cost rise such as followed the very large increase in steel wages and prices in 1956.

The cost of the new contract is estimated by the Council of Economic Advisers at 3.2 per cent per year. Productivity in the steel industry advanced at an annual rate of 3 per cent over 1957-64, after correction for variations in operating rates. Continued productivity advances at this rate would about offset the scheduled rise in wage rates and fringe benefits. It must be recognized that estimates of both costs and productivity are highly approximate. The actual cost of the new contract will depend importantly on the response of workers to the more liberal retirement privileges; continued gains in productivity will depend importantly on maintenance of a high rate of production. But as best as such factors can be estimated at this time, the settlement seems to promise that steel wage costs will not outpace productivity increases.

The outlook for stability in unit labor costs does not, of course, guarantee stability in prices. Increases in list prices for selected steel products are still widely expected, but there is room for doubt that any considerable number of increases would stick in a period of declining production and inventory liquidation. Even later, market conditions may provide constraints. Competition from imports and from other metals is strong. Capital spending by steel producers has been high, new mills and furnaces will soon begin production at below-average unit costs, and pressure will exist to increase volume by recapturing some of the production lost to imports or competing products. But even if selective price increases are effected, they are not likely to be large enough to raise costs appreciably at later stages of production.

(2) Business conditions.--What are the implications for continued economic expansion of business plans for fixed capital and inventory outlays?

Business plans for increasing fixed capital outlays continue strong and appear sufficient to about offset the probable decline in inventory accumulation. Likely increases in consumption spending and government outlays should bring the rise in total GNP for the third and fourth quarters into the $8 to $10 billion range, about the same as in the second quarter and on average over the past year.

The latest survey of plant and equipment spending reaffirmed business intentions to continue to expand their outlays through the end of the year. Business expenditures for new plant and equipment are now planned to expand by about $3 billion (annual rate) from the second to the fourth quarter of this year. Sharply advanced capital appropriations reported in a survey of large manufacturing companies suggest that the expansion momentum should carry forward well into 1966. On the other hand, business inventory investment has been tending down from the exceptionally high rate reached in the first quarter and, with excessive steel stocks now being liquidated, this slowdown should continue at least through the end of this year. The survey of manufacturers' inventory plans indicates a significant reduction in expected additions to their stocks, from an average of $800 million in the first three quarters of 1965 to $500 million in the fourth quarter.

Additional offsets to the inventory down drag will be provided by rising consumer and government spending. Consumption expenditures this year have been stimulated by rapidly rising incomes. In the third quarter total consumption expenditures apparently increased nearly 2 per cent, about the same as in the second quarter. Further increases in consumption expenditures even at about this rate would constitute a strong expansive influence on the economy; and beginning in September personal income is being given an extra fillip by the increase in social security benefits, including a large retroactive payment, and by the military pay raise.

The Government sector is also providing expansive strength. Federal defense outlays are now increasing by more than $1 billion per quarter (annual rate) and other Federal purchases of goods and services are continuing to rise. In addition, State and local government purchases are also rising by $1 billion plus (annual rate) per quarter.

(3) <u>Balance of payments</u>.--How is recovery in the sterling exchange market affecting international money markets and central bank reserves?

Earlier heavy drains of about $400 million a month on U.K. official reserves and special credits were halted late in August and reversed, at least temporarily, in September. The sterling exchange rate has risen from about $2.79 to nearly $2.80 and the 3-month forward discount on sterling has declined from about 2-1/2 to 1-3/4 per cent per annum. Most of this improvement reflected changes in leads and lags in commercial payments and other speculative movements. Adverse movements of these kinds had probably accounted for more than one-third of the total drain of $3-1/2 billion in the 14 months through August.

Market purchasers of sterling in September must have been reducing, net, their investments or cash assets held outside Britain or held in the form of dollar or other foreign currency claims against banks in London. Withdrawals of funds from the Euro-dollar market by persons moving into sterling may have been among the factors that have brought the downward drift in Euro-dollar rates to an end this month. In turn, the tightening tendency in the Euro-dollar market may help to explain the reduction in U.S. bank branches' balances with head offices up to September 22; in July and August the branches had increased these balances substantially.

Effects of the strengthening of sterling on the reserves of continental European central banks cannot yet be quantified. The softening of the French franc and the Belgian franc in foreign exchange markets is thought to be partly the result of heavier demands for sterling in those countries. Italian reserve gains diminished sharply in September, but seasonal factors could explain much of this. In the Netherlands and Germany, seasonal tightness in the domestic money market in September would normally have tended to increase the demand for local currency and add to official foreign exchange reserves; these tendencies seem to have been partly offset by the strengthening of sterling.

If the recent improvement in sterling should be followed by further reflows on a large scale, continental European reserve gains would certainly be expected to diminish, just as earlier they had been swollen by the flight from sterling. At the same time, there would probably be some worsening of the U.S. balance of payments deficit. Outflows of U.S.-owned funds to London would worsen the deficit on both the official and the regular transactions bases of calculation. There would be an additional deterioration on the official settlements basis to the extent that British reserve gains reflected withdrawal by private foreigners, including U.S. bank branches abroad, of liquid assets from the United States.

Presumably British reserve gains would be used first to repay swap drawings from the United States, and thereafter to repay the IMF, and hence would not be used to buy gold. Meanwhile, smaller reserve gains elsewhere in Europe would tend to reduce demands for gold from that quarter.

(4) Bank credit and money.--How should the strength of fall bank loan demand now be assessed, taking into account recent developments and the influence of likely inventory changes and other factors?

Loan demand at banks this fall is expected to remain strong, although perhaps not as strong as in recent months. Continued rapid expansion in loans to most types of nonfinancial businesses will be offset in part by liquidation of inventory borrowings by metals companies and of the recent bulge in loans to finance companies.

This estimate of continued vigorous loan expansion is based on the premise that GNP will show substantial further gains despite a slowing in business inventory accumulation, as outlined under question 2 above. Under these conditions, business needs for funds are likely to remain large for the financing of rising outlays for plant and equipment and continued large additions to receivables. These requirements for funds are coming at a time when internally generated funds are increasing relatively little and when corporate liquidity is low. External financing demands are consequently expected to be relatively heavy, but how they will be distributed between banks and the capital markets is uncertain.

Bank loans to most groups of nonfinancial businesses are expected to show considerably greater than seasonal strength. The reduction in business loan demand since mid-August seems to have been a temporary lull, particularly in light of the strong tax period borrowing in September. It does seem likely, however, that liquidation of inventory borrowings by metals companies will reduce the growth rate of business loans at banks considerably below the 17 per cent annual rate of the preceding three months.

In contrast to nonfinancial businesses, finance companies may make larger than usual repayments of bank credit over the next two months, working down their bank loans from the high levels attained recently in financing unusually large dealer inventories of autos. Consumer loans at banks are likely to continue expanding in line with the experience so far this year, an annual rate of about $4.5 billion. Growth in real estate loans will depend in part on bank willingness to invest in mortgages, but the continuing nature of most mortgage origination arrangements suggests that there is unlikely to be an abrupt further slackening in the rate of additions to such portfolios.

(5) Securities markets.--How have developments since the last meeting of the Committee affected the near-term outlook for securities markets?

Most long- and short-term interest rates have advanced further since the last Committee meeting, and investors remain highly sensitive to the possibilities of further yield increases. Around mid-September yields on long-term U.S. Government bonds showed signs of stabilizing, and quotations on new and recently offered corporate issues actually turned down several basis points. But pressures on short-term markets around the tax date, and announcement of the Treasury's fall financing plans, have raised short-term rates sharply, and this development--unless reversed--may generate another round of upward pressure on long rates.

With respect to the U.S. Government bond market, its technical position has improved since the end of August. Dealers' holdings of bonds maturing in more than 5 years now have been reduced to less than $150 million. But this has been wholly the result of official purchases; private investors have remained moderate net sellers of Government bonds throughout this period. Thus, while the pressure on the market from professional holdings has been considerably reduced, investors still appear to be backing away from Governments and could be the source of some further upward pressures, especially if corporate securities continue to be relatively attractive.

In the corporate bond market, it appears that investor attitudes about prevailing and expected levels of interest rates are delicately balanced. On the one hand, the unusually high levels reached by yields on new corporate bonds in mid-September attracted investor demand. While this response undoubtedly reflected an awareness that the calendar of new publicly-offered issues scheduled for late September and early October is smaller, it also represented some modification of earlier, more extreme interest rate expectations. Looking somewhat further ahead, however, the continuing need of corporations for external financing is likely to sustain the volume of their borrowings in capital markets at high levels.

Although the visible supply of municipal offerings also shows a moderate decline over the next few weeks, thereafter the volume of offerings will undoubtedly rise again. The likely strength of future bank demand for municipals is questionable, particularly since their ability to raise funds through CD sales may be limited by the level of short-term rates in relation to Regulation Q ceilings.

(6) Money market relationships.--Assuming a continuation of current monetary policy, what range of money market conditions, interest rates, reserve availability, and reserve utilization by the banking system might prove mutually consistent in coming weeks?

Since late August, relationships have changed markedly among the major elements customarily encompassed in "money market conditions." Over the first three weeks ending in September net borrowed reserves declined to about $100 million, while member bank borrowings were about unchanged, and Treasury bill rates moved up. In the last full statement week, net borrowed reserves returned to the August level of about $170 million, borrowings increased, and bill rates rose further.

Pressures developed around and after mid-September as tax and dividend payments were reflected in large CD run-offs and expanded loan demand. Increased reserve availability was less effective than usual in moderating money market pressures, apparently because of the redistribution of reserves away from city banks as Government balances were transferred to private holders. Another influence at work may have been the adjustments of banks with extended borrowing records at the discount window.

Announcements last week of the Treasury's tax bill financing and of its financing needs over the balance of the year resulted in an abrupt further upward adjustment in rates. Most of the rate adjustment was in longer bills, where the additional cash financings are to be concentrated, but yields on both shorter bills and coupon issues also have risen in reaction to this development. The current level of 3.98 per cent on the 3-month Treasury bill is the highest since late February, despite its attractive December maturity date. Federal funds have continued to trade mainly at 4-1/8 per cent, but with more frequent reports of trading at 4-1/4 per cent.

The upward pressures on short-term rates that have developed recently do not seem likely to be reversed significantly in the weeks immediately ahead. Net borrowed reserves of around $150 million should be associated with 3-month Treasury bill yields in the 3.95 to 4.10 per cent range. Movement toward the upper end of that range may develop as the 3-month bill maturity shifts beyond December--the January 6 bill closed Friday at a yield of 4.06 per cent--even though further increases may be moderated by substantial System purchases of bills to meet reserve needs. Long-term rates, which began rising before pressures developed in short-term markets, may now be subject to further yield adjustments, as discussed above under question 5.

With 6-month and 1-year bills currently yielding about 4.30 and 4.40 per cent on an investment yield basis, further upward adjustments in longer-term bill yields may make it increasingly difficult for many banks to attract time deposits within present Regulation Q ceilings. This would tend to curb bank credit expansion, and/or to intensify bank efforts to raise funds through very short-term CDs, Federal funds, and promissory notes, or at the discount window. Bank takings of the March and June tax bills can be expected to lead to a bulge in bank credit in the early part of October, but this expansion will moderate as banks sell off the tax bills and U.S. Government deposits are drawn down. Growth in money supply, which was large in September as Government deposits were reduced more than seasonally, is likely to be slower in early October, but may pick up again in later weeks. For the demand deposit component, an average growth rate in the 4 to 5 per cent range seems the most likely expectation.

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

The business outlook has strengthened appreciably since our last meeting. For one thing, the labor settlement in the steel industry has removed one of the major uncertainties that were troubling the Committee a month ago. Despite the reduction in the strike-hedge inventories of steel that is now under way, and that will undoubtedly continue at a moderate pace through the turn of the year, this adverse influence is likely to be submerged by continuing aggregate gains in spending by business (on plant and equipment, and on inventories other than steel) as well as by consumers and Government. In fact we have now seen a major turnaround in business sentiment--triggered in the first instance by the implications of the build-up of the Vietnam war, and subsequently abetted by growing expectation of well sustained demand in key sectors of the economy. There is now little talk of a pronounced slowdown in the closing months of the year, and forecasters are busy comparing estimates of another solid advance in calendar 1966. Fears of a fiscal drag early next year have largely evaporated, mainly because of the prospect of much higher defense spending, together with higher Government civilian salaries.

On the cost-price front, the steel settlement came out reassuringly close to the guidelines; but this has removed only the danger of an over-generous pace-setting settlement. We still face the pressures on prices and labor costs normally arising in an economy operating close to capacity. The labor market appears to have tightened significantly, with growing shortages of trained and skilled workers. As for industrial wholesale prices, it looks as if the uptrend which started in mid-1964 is continuing. Announcements of individual price increases seem to be becoming more frequent. All in all, the threat of inflationary tendencies remains quite serious. The exuberant stock market of recent weeks is doubtless one more manifestation of incipient inflationary psychology.

Despite the outstanding success of the voluntary credit restraint program with respect to foreign lending by banks, I find it hard to feel much encouragement with respect to our balance of payments. Sizable deficits have predominated in recent weeks--and even after seasonal adjustment the regular deficit for the third quarter may be close to a $2 billion annual rate. Increases in direct investment and foreign security issues have played a part. The outlook for the trade surplus is not encouraging. While the prospect for exports is not unfavorable, imports are almost sure to rise further as economic activity in the U.S. moves ahead. The basic payments problem lies in our inability to date to come close to equilibrium without the strong support of artificial barriers to outward capital flows. While foreign confidence in the dollar is generally stronger than it was some months ago, this is based in large part on the belief that our payments disequilibrium has at last been cut to a low level.

With the recent pronounced improvement in the market for sterling, another major uncertainty at the time of last month's meeting has at least receded into the background.

As for bank credit, the recent figures, while inconclusive, suggest the possibility of a continued excessive pace of expansion, and further strength in the demand for funds seems likely this fall. To many of us the 8 per cent rate of increase that characterized bank credit over the last couple of years seemed rather excessive, and the Committee has taken several deliberate steps to check it. Yet the gain in recent months has been around 9 per cent, whether based on the last-Wednesday-of-the-month data or on the "proxy" series for bank credit. Business loans have been rising at about 20 per cent per annum; and money supply plus time deposits at 8.6 per cent, with time deposits accounting for most of the gain. It is of interest to note that the banks have been actively adjusting the liability side of the balance sheets in response to the pressures exerted by rising credit demands.

Returning to this country after a fairly extended absence abroad, I have been struck by the increases that have occurred in market rates of interest, for almost all maturities and for most types of market instruments. Of course, temporary factors have played a part in these tendencies. But, more basically, the pressure of rising demands for credit and growing business optimism have acted to tighten the market despite our efforts to maintain stable market conditions and despite the maintenance of a more or less constant or even a somewhat reduced level of net borrowed reserves. To my mind we should recognize and reinforce this tightening tendency in the light of all the factors I have touched on, both international and domestic. I believe we should try more decisively than we have done in recent months to check the excessive rate of credit growth; and for this purpose an overt move seems to be required, combining a discount rate increase with some further increase in net borrowed reserves to the $200 to $250 million level. An increase in the prime rate would almost certainly follow immediately; but this does not seem to me a valid obstacle to our own action, especially since the prime rate is now clearly out of line both with the underlying availability of bank funds and with the rates prevailing in the bond market. The ceilings under Regulation Q would certainly have to be adjusted upward in the event of the policy move contemplated; and in order to avoid the appearance of pin-pointing a new rate level for time deposits sought by the System, I would think a flat ceiling of 5 per cent for all maturities would be useful. It seems to me that there is little justification for differentiating between shorter and longer maturities, especially in view of the flatness of the present market yield curve. Obviously, the directive would have to be modified also.

There is an important question of timing, whatever action we may take. On October 5, the Treasury will be conducting an auction of $4 billion of Treasury Tax Anticipation Bills for payment on October 11, the day before the next scheduled meeting of the Committee. In the last week of October, the Treasury will be setting the terms for refunding the Treasury notes maturing November 15, of which a bit over $3 billion are held by the public. These prospects consel, I believe, prompt action which will afford an opportunity for the market to adjust before the October 5 bill auction. If action is not taken promptly, it would probably be necessary to defer action three weeks or perhaps a month and a half or more. Therefore, it seems to me, it would be appropriate to act today to change the directive to call for greater restraint and to act this week to increase the discount rate.

Whether the discount rate should be raised 1/4 per cent or 1/2 per cent can be readily debated. In recent years we have thought of a change of 1/2 per cent as a normal change when the rate has been somewhere around the present level. It certainly does not seem excessive, and the adoption of a 1/2 per cent increase would lessen the possible need for any further increase in the near future. Moreover, a 1/2 per cent rise would be much more likely to convince foreign authorities that we are determined to maintain the dollar's strength abroad. On the other hand, an increase of 1/4 per cent would probably suffice to signal that the Federal Reserve is concerned but not alarmed by current developments. The important point is to signal the need for further restraint; the amount of the rate increase is less important. On domestic grounds alone I would be inclined to prefer an increase of 1/4 per cent, whereas on international grounds the larger change would be distinctly better. I would like to defer judgment on the amount until there has been a full discussion of the subject today.

Mr. Shuford observed that although some recent statistics had indicated a pause in the economic upswing total demand seemed to be strong and rising. Since April personal income had been expanding at an annual rate of 6 per cent, and retail sales had risen even faster. The automobile industry was talking in terms of a 9 million unit year. Industrial production had been increasing at about an 8 per cent rate since April, and employment had been rising rapidly. In the Eighth District manufacturing output had been rising since early this year at about the same rate as in the rest of the nation.

A major question, Mr. Shuford said, seemed to be whether further expansion in demand would be matched by expanding output or whether it would result in higher prices. Current price developments were difficult to interpret. Overall indexes had changed little since June, but that might reflect a temporary offsetting of general upward pressures on prices by the cuts in excise taxes and the special situation with respect to agricultural prices. He was not of the view that inflationary pressures had subsided. It was his impression that there recently had been an increase in announcements of "selective" price markups. While the price situation in the automobile industry was not clear, it appeared that at least one company had announced a price increase, and in St. Louis two large firms in the shoe industry had raised prices. He noted that a Boston shoe company also had raised prices.

From June to early September, Mr. Shuford continued, financial and monetary developments turned less stimulative. Yields on most marketable securities moved up. Bank credit expansion moderated somewhat from its extremely rapid earlier pace, and the rate of increase in money slowed. In the same June to early September period the fiscal situation turned more expansive with the excise tax cuts and expanded social security benefits. In view of the strong economic situation, the mix of public policy--with fiscal actions easier and monetary actions less expansionary--seemed appropriate; it appeared likely to foster a sustainable domestic growth and to place moderate upward pressures on interest rates beneficial in reducing net outflows of funds from the country.

Most recently, however, the money supply had risen markedly, Mr. Shuford observed. While figures for a few weeks should not be overemphasized, and while, as Mr. Partee had mentioned, recent changes in Government deposits had influenced the money supply, he felt the Committee should take care that money growth not continue to be out of line with what was called for by the current economic situation. Although money market conditions might have firmed in the past month, apparently the demands for funds under those conditions were strong enough to provide an acceleration of monetary expansion. He was hopeful that this most recent increase in money would be reversed, and that the more moderate rate of expansion that had been developing earlier would prevail. The demand for bank credit had been strong, he noted, and all indications--both formal reports and discussions with bankers--were that it would continue strong for the remainder of the year.

Under those conditions Mr. Shuford felt that the Committee should move to a slightly firmer policy. That would call for consideration with respect to the discount rate, but at the moment he was inclined to feel that a discount rate change could be postponed a bit. He would reserve final judgment on that question, however, and also on the amount of the change, if one was to be made, until after discussion around the table today. He did feel, however, that it was time to move in the direction of a somewhat firmer policy.

Mr. Patterson reported the single most important recent development in the Sixth District was clearly Hurrican Betsy, which had hit two widely separated areas in the District--the southern tip of Florida and southeast Louisiana. While both the old New Orleans Branch building and the new building escaped with only minor window damage, many of the Branch's employees were not as fortunate. Loss of property for many was large; in three instances it was virtually 100 per cent. Even at this point, some of the employees had not fully determined what their total losses would eventually be. Thus, it might not be known for months whether the $1 billion loss figure for the whole State of Louisiana set by the Governor was correct.

In Florida, however, it appeared that Hurricane Betsy caused less damage than had Hurricane Hilda last year, Mr. Patterson said. Apart from the relatively unimportant lime and avocado crops, damage to Florida's farm economy was relatively small. In Louisiana, power disruption posed a serious problem to the chemical industry. Oil operations in the face of the storm were cut, and there was some damage to New Orleans shipping.

A telephone survey made of farm creditors revealed that Louisiana's sugar cane crop would be largely salvageable, cotton output would be substantially reduced, and rice production cut slightly, Mr. Patterson reported. Farm creditors said they would be able to meet the credit needs without difficulty. One unfortunate aspect was that some farmers, especially cane growers, had now experienced two hurricanes in successive years, so that they would need to go even more heavily into debt. But all in all, the District's agricultural economy had withstood the shock of Betsy quite well.

Still another telephone survey of feed, farm machinery, and fertilizer suppliers revealed that agricultural credit conditions in the Sixth District generally remained good, Mr. Patterson continued. Delinquency rates were near or below those of last year. The employment picture was good. Employment gains in July set some sort of record for the month, and the August figures pointed to a further appreciable increase. Incomes were advancing close to the vigorous pace of early summer.

The steady expansion also carried into banking, Mr. Patterson remarked. Whereas in past years loans slowed down during the summer, this year's interruption was short-lived and loans increased considerably in August and in early September. Loan demand from business borrowers was particularly strong. The intensity of those loan demands had forced most of the just-surveyed Atlanta and New Orleans banks to become increasingly selective in their lending, to firm up on rates, and to demand higher compensating balances from their business borrowers. Now that those banks faced peak seasonal demands, they might find it necessary to raise their lending rates further, irrespective of Federal Reserve policy.

Mr. Patterson concluded with the observation that it would seem difficult to change policy at this meeting with the Treasury cash financing under way.

Mr. Bopp said he would address his comments this morning primarily to the staff questions on capital spending and bank credit. Opinions about the outlook for capital spending had become increasingly optimistic in the past few weeks, he noted. Evidence from a number of sources--the upward revision of spending plans for the latter part of this year, analysis of capital appropriations, new orders for equipment, and corporate cash flow--all seemed to be pointing toward an increase in expenditures next year at something like the same rate as in this year.

Another approach to the overlook for capital spending, and one which suggested to Mr. Bopp a more moderate view, was to calculate the likely rate of capacity utilization next year. It seemed to him that current capital spending and that slated for the near future would bring roughly a 5-1/2 to 6 per cent increase in capacity on stream during 1966. Given that increase in capacity, a rise in industrial production of approximately 8 per cent would be necessary to bring the operating rate as much as 1 per cent above the preferred rate. If, as he felt was more likely, industrial production in 1966 increased by only 4 to 5 per cent, then the operating rate either would hover around the present figure of approximately 90 per cent or would decline slightly to a figure of 89 per cent or so.

But if the majority of recent forecasts turned out to be correct, Mr. Bopp said, another very strong year in capital expenditures might present a dilemma for Federal Reserve policy. In recent months there had been increasing evidence of imbalance in an economy so long characterized by balance. As had been pointed out at earlier meetings, that was seen in the components of industrial production. Growth in production so far this year had been concentrated in materials and equipment; output of final products for consumers had leveled off. That kind of gap could not be sustained indefinitely and, in the past, had been typical of later stages of expansions. The current decline in steel inventories should help bring the materials component back into closer relationship with production of consumer goods, but the prospect seemed to be for a continuing gap between consumer goods and producers' equipment.

Although monetary policy could make the financing of some planned capital projects more difficult and expensive, Mr. Bopp continued, the potential dilemma in pursuing that route was presented by the likelihood that the imbalance would occur in an environment lacking overall inflationary pressures. The prospect that the operating rate in manufacturing would level out or even decline slightly suggested that overall pressure on prices from the capacity side was not ahead. Many things could happen to change that outlook, and perhaps he was raising possibilities which would not develop. But the current very optimistic predictions for capital spending did raise questions that deserved some thought.

A more immediate consideration was the demand for loans, Mr. Bopp remarked. The principal Philadelphia banks had just completed their loan forecasts for the fourth quarter. Two of the banks had not thus far experienced the net loan liquidation which usually occurred for several weeks following the September 15 tax date. Moreover, business loan demand was exceeding their forecasts and was expected to continue at a high level. Another bank expected loan demand to be generally steady, although not in excess of expectations at this time of year. Only one bank expected business loans to fall below the usual seasonal increase, and even that bank expected no overall decline in total loans in the fourth quarter. That kind of picture added up to a continuing strong loan demand.

As the green book[1/] pointed out, Mr. Bopp said, some of the uncertainties which obscured the outlook in recent months had now been resolved. A steel strike had been avoided, a non-inflationary wage settlement had been signed, and sterling had gained a stronger footing. Meanwhile, industrial commodity prices were generally stable; the upward pressure of rising nonferrous metal and food prices had largely subsided.

Although escalation of the conflict in Vietnam could change the situation, Mr. Bopp thought the prospects were for a continued absence of overall inflationary pressure. Therefore, he would maintain the current posture of monetary policy. By this he meant about the current level of reserve availability and interest rates. If more aggressive purchases of Government securities, possibly long-terms, were necessary to reassure the market that further increases in rates were not likely in the near future, he would favor such action.

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

The new, larger, estimate of the deficit in the balance of payments for July-August was discouraging, Mr. Bopp said. But at present he would be inclined simply to be on the alert for further deterioration. He favored alternative A of the draft directives.

Mr. Hickman said that the recent strength and momentum of the economy provided a strong foundation for the tests of coming months. The combination of a downdrag from steel and some setbacks from Hurricane Betsy would likely result in no gain, or possibly a slight dip, in the index of industrial production for September. For the remainder of the year, the key question was whether the adverse effects of the steel inventory liquidation would be offset by advances in other sectors. On balance, his guess was that the production index would probably average about the same in the fourth quarter as in the third. The downdrag from steel apparently would be slightly less than anticipated earlier--about 1-1/2 points in the production index on average in the fourth quarter. Auto production was expected to have no significant effect on the production index, either way, during the fourth quarter; but other components--reflecting strength in capital spending and in consumer goods other than autos--should add about as much as would be lost from steel.

Such a view was consistent with the consensus of 24 Fourth District business economists who had met recently at the Reserve Bank, Mr. Hickman observed. The group's median forecast for the fourth quarter was for no change in the production index--which, incidentally, was a substantial upward revision from the last, pre-Vietnam, forecast of the same group. In addition, those economists anticipated successive modest gains in industrial production of about 1 index point for each quarter of 1966.

It was becoming increasingly clear, Mr. Hickman said, that Federal fiscal policy would be expansionary in 1966, particularly in the second half. While the amount of the increase in defense spending was indefinite, the second stage of the excise tax cut, further reductions in corporate income taxes, and medicare benefits would all be stimulating. The increase in social security taxes at the beginning of 1966 would act as a considerable offset to those expansionary factors.

Mr. Hickman thought there still was no evidence of a general uptrend in prices, despite the steel wage increase and the escalation of defense spending. Nevertheless, there was some indication that upward pressures on industrial prices might emerge from the cost side, a view expressed frequently by the business economists attending the Reserve Bank's recent meeting. Among potential future pressures were the expected extensions of the steel settlement into various metal-fabricating industries, the costs of wage settlements yet to be negotiated this year in aircraft and ordnance, the airlines, and other industries, and the 2-1/2 per cent "productivity" increase in wage rates that became effective this month under last year's auto contract. In general, with unemployment among adult workers at 3.7 per cent--which was about as low as at any time during the past ten years--the shortage of experienced workers might easily worsen. In past business expansions, increased use of inexperienced and less-qualified workers had adversely affected productivity and cost-price relationships, thus working toward bringing the business expansion to an end.

On the financial front, there appeared to Mr. Hickman to be less nervousness than at the time of the Committee's August 31 meeting, largely because of the improved status of the pound. Yields on long-term Treasury bonds and on corporate issues apparently had stabilized around the highest levels in five years. Somewhat belatedly, municipal yields had increased recently, due possibly to large dealer inventories and to bank selling.

Bank selling of municipals was a reflection of strong demands for bank credit and the apparent "bite" of System policy, Mr. Hickman observed. While borrowing to finance steel inventories would decline, he expected that to be more than offset by increased demands to finance retail inventories and consumer durables purchases. In addition, a reduction in corporate liquidity had caused business firms to turn increasingly to external financing for working capital and plant and equipment spending.

Mr. Hickman was pleased to see that net borrowed reserves averaged about $100 million in the three weeks following the August 31 meeting. In the latest week, however, the first published figures showed a substantial deepening of net borrowed reserves and a sharp increase in bank borrowings to the highest level in nearly three years. The stringency thus introduced into the money market--along with seasonal factors, a distribution of reserves in favor of country banks, and the Treasury decision to finance in the short-term market--contributed to an increase in the bill rate, which, if continued, would probably trigger an increase in the discount rate. That might be necessary later on, if price increases began to accelerate, but it hardly seemed justified now on the basis of information currently available.

In view of domestic and international uncertainties, as well as the forthcoming Treasury financing, Mr. Hickman supported alternative A, which called for no change in policy, of the staff's draft directives. More specifically, he would like to see net borrowed reserves below $150 million most of the time, and borrowings below $500 million. Moderately easy reserve availability until the delivery date of the new tax-anticipation bills would facilitate redistribution by the banks and prevent a sharp rise in bill rates.

Mr. Maisel said he would note first that he thought it important that the draft directives be changed to show that the Committee recognized and, he would hope, followed the "official settlements" basis for the balance of payments. Since that balance was running at a surplus, he would suggest that the last clause in the opening sentence of both draft directives be revised to read, "our official international payments have remained in surplus while our gold losses remain moderate."

The Committee's more important task, however, was to agree on the meaning of the language of its previous directives, Mr. Maisel continued. In particular, what was "moderate growth," and what were "the same conditions in the money market?" He assumed that "moderate growth" of the reserve base, bank credit, and the money supply meant that they would expand at a rate at least equal to the growth potential of the economy so that if there was merely normal growth there would be no tightening of interest rates.

Unfortunately, Mr. Maisel remarked, that did not seem to have been the case. The Committee had not been accommodating the normal growth of the economy. While GNP this year was growing at a 6 per cent annual rate, somewhat below the hoped-for level and that necessary to employ the full labor force, the Committee had increased nonborrowed reserves at a rate of only 2.4 per cent. The money supply had grown at a rate of only 3.7 per cent.

The money and credit to finance the economy's moderate growth rate had been supplied by the banks' curtailing their liquidity, Mr. Maisel commented. Recently the banks appeared to have come close to the end of their ability to make up for the Committee's lack of accommodation. That would account for the rapid increases in money rates.

It seemed clear to Mr. Maisel that the Committee could not at this time responsibly put such monetary pressure on the economy as to cause a cutback in capital investment and a halt to the expansion of jobs at the same rate as the labor force. He thought the Committee had to keep its eye on the basic problem of lack of utilization of resources and not feel it necessary to ratify by further action its own failure to allow the economy the credit it needed. He felt the argument that because credit was tight, the Committee should make it tighter was basically circular.

Mr. Maisel said he had thought he understood that the sense of the Committee's directives was to accommodate the normal growth rate of the economy. Recent market actions made it clear that the Committee had not furnished sufficient reserves for that purpose. The liquidity of the banking system had been lived off long enough. It was necessary that the Committee now look ahead and determine that its policy of the past six months of no change required making more reserves available. The level of borrowed reserves should be decreased sufficiently to enable banks to meet normal demand. That would mean a more rapid increase in owned reserves. Such a growth would solve the problem of current market rates. They would decline back at least to the summer's rates. Action showing that the Committee was not desirous of curtailing production would return the markets to the more comfortable position they were in before they became so acutely aware of their lack of liquidity.

On the assumption that he had correctly stated what was meant by "moderate growth" and by the "same conditions in the money market," Mr. Maisel said he would support alternative A with the necessary correction on the balance of payments. In doing so, however, he believed it should be made clear that the behavior of the markets in the past month had not been consistent with the basic desire of the Committee to furnish sufficient money to the economy to meet the needs of normal growth.

Mr. Daane said that he would note at the outset that he dissented vigorously from Mr. Maisel's proposal that the balance of payments reference in the directive be formulated solely in terms of the figures on the "official settlements" basis. Such figures did not represent the only "official" concept of the Administration, nor should they be the only ones considered by the Committee. But even if the "official settlements" basis were to be used, it still would be true that a deficit was in prospect for the rest of the year and for the year as a whole.

Mr. Daane remarked that he shared the feeling of Mr. Hayes and others that the U.S. balance of payments problem continued to be worrisome, and on that ground alone he felt the Committee should not take any easing action today. Also, he was not persuaded by the staff view that the recent firming of market conditions meant that it would be inappropriate for the Committee to act in the direction of further firming. In light of the strength of loan demand and the growth rate of the money supply, and of the fact that the very solid expansion underway certainly had not been inhibited by the firming of market conditions, he did not think it was circular to argue that the Committee should reinforce the market firmness with some further moderate restraint. He was sympathetic with Mr. Hayes' position in that respect.

However, Mr. Daane observed, he did have some real question as to the timing. He noted that both draft directives gave the impression that the uncertainties in foreign exchange markets had been largely resolved. He did not agree; the fact that the British effort to restore the position of sterling was continuing had to be taken into consideration in the Committee's deliberations. Accordingly, while he had considerable sympathy with alternative B of the staff's drafts, he was not certain that this was the best time to adopt such a directive. He leaned toward some version of a "no change" directive at this juncture, with the expectation that the Committee would maintain close surveillance over developments in the weeks immediately ahead.

Mr. Daane then noted that there had been meetings over the past few days of the Deputies, as well as of the Ministers and Governors, of the Group of Ten. This morning the latter had issued a communique concerning, among other things, two matters on which he had reported to the Committee on previous occasions. The communique indicated that the Group of Ten had agreed that the General Arrangements to Borrow should be renewed for a second term of four years, with a review to be undertaken in two years of any possible need for adaptation in the Arrangements. Thus, by October 1968 the Group would be in a position to make any adaptation considered desirable.

A second point covered by the Communique, Mr. Daane continued, related to the question of "where do we go from here" with respect to international liquidity arrangements. The agreement announced this morning involved a first phase consisting of intensified efforts on the part of the Deputies to determine what basis of agreement could be reached on ways to strengthen the international monetary system, including arrangements for future creation of reserve assets as and when needed, looking toward a preliminary report in the spring of 1966. The first phase would not necessarily terminate then, but it presumably would culminate at some point in a measure of agreement on essential points.

It was contemplated, Mr. Daane said, that once such a basis for agreement had been reached the matter would pass from consideration by the Ten to consideration in a somewhat broader forum. Since the problems concerned the world economy as a whole, the Ministers and Governors had agreed that it would be useful for the Deputies to seek ways by which efforts of the Executive Board of the IMF and those of the Deputies could be directed toward consensus as to desirable lines of action. The Ministers and Governors instructed the Deputies to work out procedures to achieve this aim, in close consultation with the Managing Director of the Fund, with a view to preparing for final enactment of any new arrangements at an appropriate forum for international discussions.

Chairman Martin commented that he thought that the developments Mr. Daane had reported represented progress on the part of the Group of Ten.

Mr. Mitchell said he thought he fell within the group that was somewhat skeptical about the prevailing optimism on the business outlook. It seemed to him that the optimism was based primarily on a somewhat exaggerated notion of the economic stimulus that would be provided by the Vietnam hostilities. He was more concerned about the secondary and tertiary effects of the inventory adjustment in steel and steel products; time was needed to learn how much of an adjustment would have to be absorbed. Mr. Koch had confined his analysis largely to projections of components of GNP, but it also was necessary to consider the future course of industrial production. Personally, he expected little change in the production index in the next four months, and perhaps some decline. In general, he thought there was greater uncertainty about business prospects than one might gather from many of the statements currently being made.

With respect to prices, Mr. Mitchell thought the steel settlement overshadowed all other developments of the past few months and he felt reference to it should be made in the Committee's directive. The settlement was a noninflationary one; while it did not mean there would be no selective increases in steel prices, the settlement itself and the precedent it established were both on the side of price stability.

The problems in the international area appeared no nearer a solution than they had two or three years ago, Mr. Mitchell said, except that the Group of Ten Deputies were going to study the liquidity question more intensively and broadly, and hopefully they would move forward. But he saw no great need on balance of payments grounds for altering monetary policy any more than the Committee already had unconsciously altered it.

On the financial side, Mr. Mitchell found himself in complete agreement with Mr. Partee's remarks. He (Mr. Mitchell) wanted to avoid the very thing Mr. Hayes favored--namely, a change in the discount rate--because he thought that might well result in a grinding interruption to the economy's upward progress. For the same reason he was disturbed by the recent trends of interest rates in capital and money markets. He would favor an effort to tranquilize those markets rather than, as some had suggested, moving toward further firming in an already firm situation. For whatever reason, banks were reluctant to borrow from the Federal Reserve, and were not getting the reserves they needed. Under those circumstances he thought that the System should be supplying reserves somewhat more freely than it had in recent weeks.

Mr. Mitchell said he was unhappy about the staff's draft directives. He would suggest the following wording:

> The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further in a climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit since midyear. Some of the uncertainties previously affecting the domestic outlook for price stability and foreign exchange markets have diminished, but the impact on the business outlook of contracting steel and steel and allied product inventories cannot yet be gauged with

significant accuracy to say that it will be offset by expansive factors. In this situation, it is the Federal Open Market Committee's current policy to conduct its operations so as to promote stability in money and capital and foreign exchange markets, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, and taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to easing somewhat the pressures in the money market that have developed recently; this would involve net borrowed reserves averaging about $50-$100 million, borrowing of under $500 million, and Federal funds trading most often at the discount rate.

In Mr. Mitchell's judgment the Manager had not had sufficiently specific instructions to cope with the problems he had faced in the market recently. The purpose of the proposed second paragraph was to provide some criteria to which the Manager could refer if he continued to encounter a difficult situation. While he had specified certain numerical targets in that paragraph he would defer to Mr. Holmes' judgment if the latter thought the targets mentioned were likely to prove inconsistent.

Chairman Martin commented that he would interpret Mr. Mitchell's proposed directive as calling for a change in policy in the direction of ease. There was no reason, of course, why such a course should not be proposed. He thought it should be clear, however, that while Mr. Hayes advocated a firmer policy, Mr. Mitchell favored an easier one.

Mr. Mitchell remarked that he would place a different interpretation on his proposal. In his opinion policy already had firmed; what he advocated was a restoration of the market conditions the Committee presumably had intended to maintain under its August 31 directive. The present situation would not have arisen, he thought, if the Committee had been more specific about its intentions in the August 31 directive. The problem of formulating instructions to the Manager was, of course, an old one, but it had plagued the Committee particularly seriously in the recent period.

Mr. Maisel noted that the Committee's previous directive had called for maintaining about the same conditions in the money market. Nevertheless, as both Mr. Hayes and Mr. Holmes had noted, and as was clear from all indications, market conditions were now tighter than they had been a few weeks ago. For purposes of clarification he would ask whether the change in market conditions should be viewed as a change in policy; or, to put the question differently, whether a restoration of the conditions of, say, three weeks earlier should be viewed as maintaining the prior policy or changing to an easier one.

Chairman Martin commented that the Committee could maintain market rates at any given levels if it were willing to supply whatever amount of reserves were necessary for that purpose. In his judgment, however, that was not the Committee's objective under "no change" directives.

Mr. Daane observed that the present situation, in which previous relations among money market variables no longer were consistent, provided an excellent illustration of why the Committee should not attempt to introduce quantified targets into its directive.

Mr. Swan remarked that he differed with that view; in his opinion the current situation offered an excellent example of the need for numerical instructions.

Mr. Hayes said he concurred in Mr. Daane's view that it was not feasible to quantify instructions to the Manager. At any time various cross-currents were at work in the market, and the Committee faced a new set of circumstances each time it met. He submitted that at the time of the August 31 meeting no one could have foreseen accurately the manner in which developments subsequently unfolded. It also was necessary to recognize that the market could tighten by itself without any effort on the Committee's part to create firmer conditions, and that was what in fact had happened recently.

Mr. Mitchell observed that the Manager nevertheless had not acted to counter the firmer conditions that had developed in the market. He added that he did not mean to imply any criticism of the Manager; in his opinion the fault lay with the Committee.

Chairman Martin remarked that it would be possible for the Committee to ignore market forces, in effect making the market itself and driving all others out. Perhaps it had approached that position at times; but in recent years it had attempted to give some play to market forces, in the process obtaining indications of the nature of the pressures existing.

After some further discussion the go-around resumed with remarks by Mr. Shepardson.

Mr. Shepardson said that he concurred in Mr. Hayes' analysis of the present situation. It seemed to him that expansionary forces definitely were at work. He was not ready to accept the statement that the steel settlement was a noninflationary one. It was not as inflationary as some had feared it might be, but he still thought that upward pressures on prices would be manifest. He had difficulty in interpreting the price indexes against the background of the many announcements of price increases being made. Nevertheless, however one measured prices there had been a continuing upward crawl, although there had not been rampant inflation. Given the state of business optimism, there seemed to him to be a definite possibility of an outbreak of price increases.

In that connection, Mr. Shepardson continued, the situation would not be so difficult if there were prospects of a correction when prices got out of hand. What concerned him was that, as far as he had been able to observe in the last ten years or so, such corrections had not occurred. There were so many built-in rigidities that the best one could hope for was a leveling off after a burst of increases, with subsequent increases starting from the higher plateau. Accordingly, it was important in his opinion to try to forestall any outbreak.

For some time, Mr. Shepardson said, he had felt that the Committee should move to a firmer position soon. As he had noted at previous meetings, he thought the Committee had about reached the point where its next move should be a significant one, probably involving a change in the discount rate. But he questioned whether this was the time for such a change; unlike Mr. Hayes, he thought a better opportunity would arise after the current Treasury financing was completed. On that basis Mr. Shepardson favored continuance of the present policy, and alternative A for the directive, on the understanding that the money market conditions to be maintained were those existing at the present time.

Mr. Hayes said he might clarify his reasoning with respect to the question of timing. His thought was that if the Committee made a change in policy now the market would have all of the circumstances in view at the time of the Treasury financing. If, on the other hand, a policy change was made after delivery of the new securities had been effected, there was the possibility that the action would be construed as "pulling the rug out" from under the market.

Mr. Robertson made the following statement:

I do not think it can be emphasized too often that we meet today in an atmosphere of significantly tighter credit conditions than prevailed one or two months ago.

We know that several factors have contributed to that run-up in yields--among them increases in demands for funds from both government and private borrowers and major shifts in market expectations. Some people would go on to argue that the Federal Reserve has had virtually nothing to do with that tightening, and presumably therefore bears no responsibility with respect to it. I have absolutely no sympathy for that position. We may not have triggered the tightening by an overt act, but we acquiesced in its taking place. We could have moderated or resisted the rise in interest rates by a more aggressive supplying of reserves, and we chose not to do so.

Now, with tighter conditions prevailing in every major credit market, we again face a policy choice. I think we must be very careful not to fool ourselves with semantics in the process. I would argue that, broadly speaking, we have three alternatives today. First, we could choose to foster general credit conditions not much changed from around the end of July, or, if you prefer, around the end of August--in which case we would need to tell the Manager to act forcefully to ease bank reserve positions and relax current money market pressures. A second possible choice would be to maintain money market conditions and reserve availability about as is--with such relaxation of reserve pressure (by the Desk) as would be necessary to avoid any further tightening regardless of the cause. Finally, there is a third policy choice--an unappealing one in my view--of compounding the recent tightening of credit conditions by instigating (or, if you wish, permitting) still further tightening.

Which course we choose, of course ought to depend upon our appraisal of the underlying business situation. As I review the evidence before us, I am impressed with the generally vigorous pace of economic and credit expansion, particularly in the investment area, but I note that it has not yet had to bear the full weight of the inventory adjustment that will follow the steel settlement. Business sentiment seems optimistic, but it has not yet bubbled over into widespread advances in prices. Our balance of payments picture is still not as good as one might wish. But in those payments accounts alleged to be sensitive to interest rates and credit conditions, we seem to be doing very well. Probably this is due more to our voluntary restraint program and the Interest Equalization Tax than to changes in the general credit climate in this country, but it provides no argument for still further credit tightening now.

All things considered, given the strength of credit demands that have evolved recently and the probable need for some kind of "even keel" in connection with the Treasury financing, I am disposed to go along very cautiously with maintaining for the next three weeks about the degree of firmer general credit availability that has developed. To resist further tightening, however, I think the Manager may need to operate in a manner designed to achieve a lower volume of net borrowed reserves and a less tight money market than developed last week. I want to emphasize that, in my view, such a posture should only be regarded as appropriate so long as credit demands continue in their present strength. Any tendency for market pressures to relax, reflecting some underlying moderation in the forces of credit demands, should not be resisted by the Manager; rather, he should be directed to permit and even reinforce it somewhat by a corresponding easing in bank reserve positions. I regard this as a delicate period, with a potentially important influence on the life expectancy of the current business expansion, and I think we have to be wary of allowing the current climate of firmer credit conditions to overstay its usefulness.

With these thoughts in mind, I deplore the vagueness of the second paragraph of both alternative directives distributed by the staff. I would favor a first paragraph as suggested for alternative A, followed by a second paragraph that tells the Manager to maintain about the same money market conditions as prevailed on average during September, taking into account the current Treasury financing and also the rate of expansion in reserve utilization by the banking system. (The September averages I refer to are: 3-month bill rate--3.90 per cent; 6-month bill rate--4.05 per cent; Federal funds rate--4.10 per cent; and net borrowed reserves--$118 million.)

Mr. Wayne reported that general economic advance continued in the Fifth District, with strength evident in all major industries. The Richmond Bank's latest business survey reflected increased optimism and suggested that the pace of activity might be quickening. The employment situation had continued to improve throughout the District. In West Virginia, for example, the rate of insured unemployment was recently at the lowest point since November 1956. Reports of labor shortages, especially in the skilled categories, appeared to be coming in more frequently.

In the national economy, Mr. Wayne continued, liquidation of steel stockpiles had already begun and would probably proceed for several months. In view of the continuing high rate of steel consumption and of the prospect of some upward price adjustments, however, the rate of liquidation might prove to be less than past experience might suggest. On balance, with final demand in all sectors of the economy continuing to rise and with a further increase in business outlays for plant and equipment now a virtual certainty, he would expect the dampening effect of the inventory development to be more than offset. The inventory turnaround in metals might be expected to take some of the edge off business loan demand. Inventories would likely increase in other lines, however, and further increases in business capital outlays would appear to insure that business loan demand would remain strong for the rest of the year.

Despite the recent stability in the price indexes, Mr. Wayne was not convinced that the present situation was without an inflationary potential. Prospects in all sectors suggested expanding final demand in the months ahead and, on the supply side, it seemed to him that conditions might favor cost-push pressures. The Committee had been interpreting the high rate of business capital outlays as a sign of expanding capacity that would dampen upward price pressures. He wondered if the Committee had given sufficient attention to recent developments in the labor market. The effective rate of capacity expansion was limited by the scarcest factor and it might be that significant labor bottlenecks were approaching. He wondered if the U.S. actually had 4-1/2 per cent of "employables" unemployed. He was impressed with the increasing evidence of labor shortages and with the growing number of announced price increases.

On the international scene, Mr. Wayne said, the recent improvement in sterling was encouraging and it appeared that recent changes in the distribution of international reserves had worked in favor of the United States. But the problem in that area, at least for the near-term future, remained essentially unchanged.

Mr. Wayne went on to say that the market for Government securities had been adequately discussed and analyzed, so he would like to take a brief look at the market for municipals, which had some interesting aspects. Commercial banks had been the mainstay of that market for the past four years, and had acquired over 70 per cent of the net addition to State and local debt during that period. They now held some $36 billion of tax exempts, or roughly 35 per cent of the total and those made up 10 per cent of total bank assets. At weekly reporting banks, holdings of municipals were now approaching holdings of Governments.

Mr. Wayne was somewhat concerned about the reversibility of that heavy bank movement into municipals. The secondary market in that area was thinner and much less well developed than was the case with Governments, and if banks should attempt to meet growing loan demand through liquidating tax exempts, a particularly severe strain might develop. The strain might, indeed, be severe enough if banks simply slowed down their rate of new acquisitions. In any event, the fact that weekly reporting banks had added little to their "other" securities in the past three weeks and reports that some banks were considering selling some of their holdings could be a prelude to a significant problem in the municipals market. What impressed him here was that that market might well have become the bellwether of money and credit restraint.

In the area of policy, Mr. Wayne continued, recent weeks had seen a more distinct and more general firming of conditions in both money and capital markets than there had been thus far in the long period of expansion. When the Committee moved toward less ease late last year and early this year, most short-term rates rose but there was no appreciable change in long rates. Probably more important, the expansion of bank credit and the money supply actually accelerated somewhat. To him it would seem quite hazardous to back away from the firm conditions that had developed. The substantial additions to personal income this month and next, the high level of business optimism, the large capital outlays by business, the rising level of defense expenditures, and developing labor shortages, especially in the more skilled categories, all would add upward pressures on prices not likely to be offset by declining activity in the steel sector. Even with its present posture, the Committee might well see a continuation of the slow upcreep in prices, and any easing would be quite likely to speed it up.

If approximately the present level of reserve availability was maintained, Mr. Wayne said, the firming of financial markets would probably continue--a movement he would favor so long as it was moderate and orderly. On the other hand, he believed that any tightening move at this time might well produce acute stringency in the capital market, especially in the municipal sector, and might also prejudice the recent improvement in sterling. Further, the large sale of tax-anticipation bills just ahead would probably cause a significant increase in bank credit, at least temporarily, and any reduction of reserve availability might jeopardize the success of the offering. For those reasons he favored continuing the present policy.

Mr. Wayne added that he had no desire to reopen the discussion of the subject of quantification. In his opinion, however, all the Committee would have achieved if it had included quantified instructions in its August 31 directive would have been to insure the need for meeting several times in the interim. For that and other reasons he was not in favor of quantification. For today's directive he would favor alternative A of the staff's drafts. He had no objections to attempts to improve the wording but since he was not optimistic about the possibility of reaching agreement on new language he would recommend acceptance of the draft as submitted.

Mr. Clay remarked that the most important issue before the Committee today was the tightening of the money and capital markets and the upward pressure on interest rates. Substantial movement already had taken place, and the markets appeared to be quite sensitive to further advances in yields.

Economic prospects appeared to be quite favorable, Mr. Clay said, although readjustments in some areas growing out of the settlement of the steel strike were likely to weaken the industrial production index. Expansion was likely in final demand for goods and services in all major sectors of the economy--consumer, business and government. Moreover, it appeared probable that the economic advance could continue to take place in an orderly fashion in terms of resource utilization and price developments. The principal question in that connection arose out of the unknown proportions of the military programs and expenditures.

In evaluating the economic prospects, however, account had to be taken of the reduced liquidity position of business as compared with earlier in the economic upswing, Mr. Clay commented. Accordingly, business now required more outside financing than earlier for any particular degree of economic growth. In addition, the commercial banking system's liquidity also had been reduced substantially. Under those circumstances, it was essential that monetary policy prevent credit restraint from becoming a disruptive force in the economic advance.

In approaching the period ahead, Mr. Clay said, the Manager should not pay much attention to the net borrowed or free reserves guide, in view of the circumstances prevailing. The guide should be the condition of the money and capital markets. While it was particularly important to forestall further upward movement in open market interest rates, some turnaround in yields would be desirable. The impact of open market operations to alter the recent course of interest rates should have a powerful effect upon market attitudes and expectations, facilitating the desired change in the money and capital markets. Moreover, open market operations supplying seasonal reserve needs in the weeks ahead should be of assistance in implementing such a policy. In that connection, it was important to prevent Treasury bill yield developments that would force an increase in the Federal Reserve discount rate.

Neither of the draft directive alternatives appeared to Mr. Clay to be satisfactory. Alternative B called for further firming of credit conditions, and that would not be appropriate for reasons he had already indicated. Alternative A simply accepted what already had happened with respect to credit tightening and, judging by developments since the August 31 meeting, would be compatible with further tightening in the period ahead. He suggested that in the second paragraph of alternative A the language following the phrase "with a view to" be replaced by "attaining somewhat easier conditions in the money market." With the Treasury financing a week away and of the auction type, it should be possible to pursue such a policy in the interim.

Mr. Scanlon reported that developments of the past month appeared to have increased confidence of Seventh District businessmen that economic expansion would continue through 1965 and, probably, well into 1966. Steel producers had been surprised at the limited extent of order cancellations and postponements following the labor settlement early in September. There had been no period thus far when cancellation of orders exceeded new bookings, as had occurred in the spring of 1962. Demand for steel plates, structurals, and galvanized sheets remained strong. Heavy inventories and large imports suggested that any attempt of steel producers to make general price increases in the near future probably would not be successful.

Demand for workers continued strong in nearly all Seventh District areas, Mr. Scanlon said. Many firms continued to report great difficulty in hiring sufficient numbers of workers--both skilled workers and unskilled adult males.

Wholesale prices probably were rising on balance, Mr. Scanlon remarked. A recent internal survey of prices paid for identical items by one large retailer showed a very small increase over last year. No special adjustment was made in this comparison for the cut in excise taxes. Also, higher priced items were added continously to the lines handled.

Mr. Scanlon expected some moderation in the trend toward tighter labor markets in the District in the months ahead. There had been three prime movers in that area--steel, autos, and machinery. Steel firms were now reducing labor requirements and needs of auto producers probably were at a peak. Of the three, only machinery and equipment producers were still attempting to increase employment and their order backlogs continued to rise. Machine toll builders reported a high level of interest at their convention now in progress in Chicago.

Reports from District banks indicated that loan demand continued to be strong, Mr. Scanlon observed, although in recent weeks loan increases at those banks were slightly less rapid than for the United States as a whole. Business borrowing had been only moderately larger than a year ago but loans to finance companies were up sharply and real estate loans had risen further. In the first half of September borrowings by producers of machinery and other metals products rose more than last year.

A large share of the rise in business loans in the first half of September, Mr. Scanlon said, was attributable to public utilities, which often borrowed to pay taxes. The rate of growth in business loans, although rapid by past standards, had slowed in comparison with the first half of the year after allowance for seasonal factors. Nevertheless, with growing business expenditures in relation to cash flows, further vigorous demand for bank credit could be expected, especially if rates on capital issues continued to rise relative to rates on bank loans.

Mr. Scanlon went on to say that five of the District's eight reporters in the lending practice survey of September 15 stated that loan demand was stronger and interest rates on commercial and industrial loans firmer than three months ago. Seven banks indicated firmer policies with respect to at least some of the lending terms covered. Officials of some savings and loan associations reported that they had observed improvement in quality of loan applications and attributed that to tightening up by banks.

Reserve pressures on major banks in Chicago and Detroit over the tax date were relatively mild but might increase as deposits declined following the tax payments, Mr. Scanlon said. The volume of borrowing from the Chicago Reserve Bank by both city and country banks had been averaging somewhat higher in recent weeks despite the relatively small national totals of net borrowed reserves. However, the number of borrowers had not increased.

Mr. Scanlon shared the view of those who felt that any change in policy should be one of firming. He certainly would not back away from the present position and if he were convinced market forces were bringing enough upward pressure on rates to call for a discount rate change he could accept the change. However, like Mr. Shepardson, he did not feel that today was the time to make a firming move. Accordingly, he favored alternative A of the draft directives.

Mr. Galusha commented that, appealing to the well-known maxim "good news is no news," he would say little this morning about Ninth District developments. The simple fact was that the District continued to enjoy heartening advances, particularly in employment. In August wage and salary employment was up 2.3 per cent from a year ago. And the August unemployment rate for the District was estimated to have been 3.7 per cent. Average hours worked and average weekly compensation had continued to increase more rapidly than in the nation as a whole, and similarly for retail sales. Ninth District cash farm income was up from a year ago, if on a cumulative basis slightly less than in the nation. Snow, heavy rains, and early frosts had dimmed the brilliant prospects of a month ago. Still, the expectation was that 1965 would turn out to have been a relatively good year for agriculture.

Banks in the Ninth District continued relatively tight, Mr. Galusha noted. Both weekly and nonweekly reporting banks had record high average loan-deposit ratios in July. Those ratios declined slightly in August, but preliminary evidence indicated that they would be up rather substantially in September. Over the first part of September weekly reporting banks broke their seasonal pattern and sold large quantities of Treasury and other securities, presumably to accommodate a larger-than-seasonal business loan demand.

Finally, Mr. Galusha said, it appeared from the Reserve Bank's most recent business survey that the outlook continued bullish. To a greater extent than a year ago, District firms were reporting large increases in new orders and order backlogs. Also, more firms were reporting slight increases in prices received. On the other side, more were reporting large increases in finished inventories.

Turning to the national scene, Mr. Galusha found encouragement in the steel settlement, if the Council of Economic Advisers and Mr. Wernick of the Board's staff were correct in their appraisals of the increase in hourly compensation. Those appraisals suggested that if steel price increases occurred in coming months they would be selective and quite modest. He also found encouragement in the continuing virtual stability of wholesale prices generally; and in recently expressed opinions about the intermediate-term outlook, the most optimistic included, which indicated that demand inflation was not likely to become a reality over the coming six to nine months. He agreed, of course, that Government spending, particularly for defense, had to be watched carefully. But it would seem that the Committee could do no more than be guided by the best current guesses about what level Government spending would reach in fiscal 1966. And official guesses--which contrasted oddly with some hard-to-credit Congressional guesses he had heard--were such as to suggest that at the moment there was no cause for alarm.

Mr. Galusha thought it was possible that if the Committee continued to hold average net borrowed reserves in the range of past weeks the market's expectations would be confounded and rates, having been pushed up by a change in guesses about monetary policy, would retreat to levels of a while ago. But that seemed unlikely. He personally believed that any attempt to "confirm" the present rate structure in a market as volatile as that currently existing would be quickly translated into further increases. That prospect had to be viewed against a background of rather considerable increases in rates generally; the increases recorded in the period since early 1965 were not insignificant. Against that background, moreover, the risk of a slight decline in rates appeared less than compelling.

Mr. Galusha was inclined, however, to regard "no change in policy at this time" as a conservative statement. But it should be clear, he said, that in urging no change in policy he was urging that deliberate tightening be avoided and further increases in rates on Treasury securities be resisted.

Mr. Galusha added that there seemed to be a general discomfort induced by the continuation of the high level of economic activity, as if that fact in itself was cause for concern. There did not appear to him to be any obvious aberration across the broad spectrum of business nor in the numbers being generated to justify the degree of concern. The market place had moved to curb credit creation with significant increases in rates. Why not see what developed at those rate levels before making an overt act which could have an unwanted geometric effect?

Mr. Galusha concluded by remarking that he suspected he would vote for alternative A of the directive unless it lost its present flavor through revisions agreed upon by a majority.

Mr. Swan reported that on the Pacific Coast employment had increased somewhat in August, as it had in the country as a whole, but the rate of unemployment remained unchanged. Employment in the aerospace industry rose for the fifth consecutive month but the major factor seemed to be a rise in production of commercial aircraft rather than an increase in military output. Retail sales, although well above a year ago, were still lagging behind those for the nation. The expansion in credit at District weekly reporting member banks from mid-August to mid-September again was less than a year ago and also less than in the rest of the country. However, the increase in the business loan category was larger than a year ago.

Mr. Swan noted that the Twelfth District was one of the areas in which there had been far less borrowing from the Reserve Bank during the past several weeks. At the same time, District banks had been actively seeking funds in the Federal funds market. As elsewhere, the survey of bank lending practices, according to the figures received thus far by the Reserve Bank, indicated some further firming of rates and some tightening of other terms.

With respect to the national situation and policy, it seemed to Mr. Swan that some of the earlier uncertainties had diminished, if they had not been resolved. On the other hand, some of the uncertainties seemed to have been transferred to the securities market. Since the August 31 meeting of the Committee there had been a steel settlement which certainly was less inflationary than it might have been. Some slowdown in overall inventory growth presumably was underway, although its magnitude would depend to a considerable extent on developments in steel inventories. Also, the pound was in a somewhat better position. This country's own international position was not good, but as far as he could see most of the causes were not new; the Committee had been discussing them for some time. A substantial Treasury financing lay just ahead. Money and credit markets were somewhat tighter, even though that resulted from developments in the markets themselves rather than from any positive action on the Committee's part.

Considering all of those factors, Mr. Swan said, it seemed to him the Committee should not tighten further at this point. He thought it quite likely that either a positive step toward firming by the Committee or any further tightening by the market itself would produce a reaction that would result in considerably more than "slightly" firmer conditions. In such a situation, System was likely to be confronted with a need to take the steps Mr. Hayes had recommended but which he (Mr. Swan) did not favor at this time--namely, to raise the discount rate and the Regulation Q ceilings.

On the other hand, Mr. Swan continued, given the basic strength in the present economic situation he would not necessarily try to back away from the conditions existing at the moment. He would accept a policy of "no change" but he agreed that that term needed further definition. The tightening that had occurred did not appear to him to have been inconsistent with the sense of the Committee's decisions for "no change" at the late-August meeting or other recent ones; the Committee, he thought, had focused primarily on the level of net borrowed reserves in discussing immediate policy objectives, and the rate structure had firmed without any appreciable change in the net borrowed reserve level. But the Committee had the responsibility for deciding whether or not to act to offset market forces, as Mr. Robertson had noted, and at this time he would define "no change" to call for attempting to offset any tendencies in the market toward further tightness. In other words, emphasis should be placed on market rates, with the object of keeping the bill rate around present levels. If a lower level of net borrowed reserves was required to keep the bill rate from rising further, as might well be the case, that would be acceptable to him.

Mr. Swan said he would not suggest any changes in the second paragraph of the directive, even though he would prefer a quite different formulation. He agreed with Mr. Mitchell that it would be desirable to include a reference to the results of the steel settlement in the first paragraph.

Mr. Irons reported that economic activity in the Eleventh District, as reflected in data for production, construction, employment, and retail trade, was at a very high level and was continuing to expand. The District was particularly fortunate in that it probably would have a highly favorable agricultural situation this year. Most major crops were showing production increases over a year ago.

There continued to be tightness in banking, Mr. Irons said, and bank liquidity was at relatively low levels. Loans continued to rise, there had been some further reductions in Governments, and deposit increases continued. District banks were very active purchasers of Federal funds, with net purchases running at about $250 million. City banks in particular were actively seeking funds to meet loan demands, which were strong and were expected to continue strong over the rest of the year.

At the national level, Mr. Irons continued, some of the earlier uncertainties had been removed. A steel inventory adjustment was occurring, but he doubted that its consequences would be drastic; it would have some effect on industrial production, but probably not a highly significant or long-continuing one. As to the major categories of demand, business outlays on new plant and equipment promised to be very large, consumer expectations were strong, and government expenditures at both the Federal and State and local levels were expected to increase. Personal incomes were rising and the attitudes of consumers seemed to fortify their willingness to spend. The labor market, particularly that for skilled workers, continued to reflect some degree of firmness, despite the persisting 4-1/2 per cent unemployment rate.

Mr. Irons thought there might be some lessening of upward price movements as a result of the steel settlement, but in his opinion the tendency on balance would be for prices to continue to move up. The possibilities of absorbing increased costs were reduced as the economy moved closer to optimum rates of resource utilization.

In light of domestic conditions as well as international developments with respect to sterling and the U.S. balance of payments, Mr. Irons preferred to continue present policy at this time. It seemed to him that the Committee had three alternatives: it could adopt a policy of somewhat greater ease, move overtly and strongly in the direction of greater firmness, or attempt to maintain the availability and cost of reserves about as they had been during the past month. He favored the last of these alternatives, having in mind the general patterns prevailing over the period rather than those existing at any particular time, such as the last two or three days or some day two weeks ago. The market appeared to be transmitting signals of changed conditions, and the basic significance and importance of those signals should become clearer if an effort were made to maintain conditions as nearly as possible as they were. In his opinion the Manager should not be bound by any statistical guide with respect to, say, the level of net borrowed reserves or the interest rate on some particular market instrument; he should have the authority to exercise judgment and to operate in terms of the feel of the market.

Mr. Irons concluded with the observation that he would accept alternative A for the directive as submitted, and would not attempt to make any changes in wording.

Mr. Ellis remarked that with the national economy operating at a high level and manufacturing output advancing on a broad front, New England's factory-oriented economy was receiving substantial stimulus. Manufacturing output in August was averaging more than 8 per cent year-to-year gains, with the important electrical machinery industry posting a 14 per cent gain. Nonfarm employment had risen to new peaks and unemployment had fallen to lows not experienced since 1956. With high employment and rising wages, aggregate personal income in the region continued a steady growth that bolstered high levels of consumer spending. Auto registrations for the first seven months cumulated to a 7 per cent gain from last year. Department store sales in the four weeks ending September 18 had averaged a 12 per cent year-to-year gain.

Mr. Ellis noted that preliminary tabulations of the Reserve Bank's fall capital expenditure survey for New England suggested that outlays this year would outstrip spring expectations by 3 per cent, yielding a 22 per cent year-to-year gain.

Substantial carry-over of plant building expected for the year helped to boost recorded present plans for 1966 outlays to a 9 per cent gain, with many firms yet to be heard from.

In that ebullient atmosphere, Mr. Ellis said, District bankers both recorded and reported strong loan demands. Their records revealed year-to-year growth of 16 per cent in total loans, with the 21 per cent growth in real estate loans leading the parade. Their reports indicated their customers would be expecting full accommodation this fall, especially in view of the fact that bank loans at the prime rate of 4-1/2 per cent were "bargains" in today's market, where the average yield on new Aaa corporate bond issues had risen to 4 70 per cent. At 4-1/2 per cent, the prime rate was an artificial rate.

Turning to monetary policy, Mr. Ellis commented that compared with last spring there was substantially less diversity in opinions about the business outlook. Most analysts now would agree with the green book's summary statement that "...for all major categories of final demand--business, consumers, and government--the prospect is for further expansion." Given the existing high level of business activity, with factory operations other than steel at 90 per cent or more of capacity and with shortages of skilled workers, the central issue revolved around meeting the expected demand increases without substantial price inflation.

In his judgment, Mr. Ellis said, upward pressures on prices were likely to continue, with the indexes showing steady upward movement. Since the steel settlement, price increases had been announced for products in a number of categories which he would not take the time to list. He would note, however, that freight handling charges at Atlantic and Gulf ports were scheduled to rise from 5 to 12 per cent on October 1 to cover higher dock labor costs. There were important areas in which strikes existed or threatened: Boeing Aircraft, the oil industry--which was facing a 5 per cent wage demand--and the United Aerospace Workers. In that atmosphere the extent to which demand pressures were stimulated by rapid--he almost said unsustainable--bank credit expansion could play a vital role in determining whether price pressures were contained or escaped to feed inflationary expectations.

Agenda question 6, Mr. Ellis noted, requested views on what range of monetary developments might prove to be consistent within an assumed policy objective of "no change" in coming weeks. The question seemed to imply that a "no change" choice continued to be available to and definable by the Committee. But he was pleased to see that both the staff comment and Mr. Partee in his remarks today emphasized the changed relationships among elements in "money market conditions."

There were at least three developments suggesting that the Committee might have to make a choice between internally inconsistent intermediate goals, Mr. Ellis observed. One development might be loosely labeled "changes in rate relationships." He had in mind the facts that certificate of deposit rates were more generally touching their 4-1/2 per cent ceiling while the prime rate remained pegged at the same ceiling by other forces; that large corporations might now borrow at the bank prime rate of 4-1/2 per cent less expensively than in the bond market; and that a divergence existed between the discount rate and a Federal funds rate that was consistently at 4-1/8 per cent and edging toward 4-1/4 per cent.

A second development, Mr. Ellis said, might be labeled "changing market expectations." As he read the signs, the rate increases he had noted as well as the gradual upsurge of long-term bond rates suggested that both lenders and investors were coming to believe that higher interest rates were forthcoming. That had to be evaluated as an evolution of the market itself, because monetary policy certainly had been accommodating during the past several months. If anything, the slight dip in average net borrowed reserves of the past six weeks suggested that the Committee had been eager to avoid the rate developments that had come anyway.

A third development might be labeled "changed rate-reserve relationships," Mr. Ellis continued. Since establishment of the discount rate at 4 per cent last fall it had proved possible to hold the short-term bill rate below 4 per cent while holding borrowings at a $460 million average and net borrowed reserves between $150-$200 million. During the past month, with net borrowed reserves averaging only $127 million, borrowings averaged $550 million and short-term bill rates had climbed to 3.96 per cent. It seemed apparent that market pressures seeking to swell the rate of bank credit expansion--which, incidentally, had totaled 10.6 per cent in 12 months--would force a choice between acceptance of higher rates on the one hand, or faster credit expansion facilitated by lowered net borrowed reserve targets and member bank borrowings on the other.

Four weeks ago, Mr. Ellis observed, his own choice between those alternatives was conditioned by the uncertainties attending the steel negotiations and the sterling crisis. Both of those problems, while not finally settled, had been substantially alleviated. Meanwhile, the evidence of the need to choose between conflicting intermediate monetary goals had strengthened. His own judgment was that the Committee should not seek to maintain a ceiling on upward interest rate movements, either of bill rates or the prime rate. Once such a peg was accepted as a definite goal, he saw no ready way to abandon it without even more serious consequences than the Committee now faced. To attempt to forestall rate advances would entail an overt action to ease policy by setting lower targets of net borrowed reserves. He submitted that such action would create more apprehension than it would inspire confidence in existing rate levels.

Mr. Ellis' choice of policy, therefore, was for a target for net borrowed reserves centered at $150 million, with an expectation that borrowings might average about $500 million if credit demands followed strong seasonal patterns and reserves continued to expand as they had recently. He would agree with the staff's expectation that short-term bill rates might rise to 4.10 per cent, especially as the maturity date on the three-month bill moved into January. Under his approach, as distinct from that of Mr. Hayes, a decision on discount rate action would be withheld until late October, after the Treasury financing.

In Mr. Ellis' judgment the second paragraph of alternative A of the draft directives did not provide sufficiently clear instructions to the Manager. The Committee owed the Manager a statement of its choice between higher rates with existing reserve targets or more rapid credit expansion with lower net borrowed reserves and existing rates. And the Committee owed itself a renewed effort to improve the content of the directive, with specification of choices between targets if not quantification of targets. Mr. Robertson had described three alternatives facing the Committee, and had selected the second alternative of seeking average September conditions. Some such type of policy prescription should be provided the Manager--whether it was the second alternative, as Mr. Robertson preferred, the third alternative, which he (Mr. Ellis) favored, or Mr. Hayes' more aggressive fourth alternative. In contrast with the view expressed by Mr. Galusha, he expected to vote against alternative A for the directive unless it was amended to provide more adequate specification.

Mr. Balderston said that although he had great sympathy for Mr. Hayes' approach, it was his feeling that today was not the time to move to a firmer policy. His position was generally similar to those of Mr. Wayne and Mr. Ellis. He thought Mr. Robertson had clarified the nature of the Committee's problem by differentiating the several alternatives for policy.

He would like to stress two things, Mr. Balderston remarked. The first was a point that Mr. Wayne already had brought to the Committee's attention--the fact that starting in 1962 banks had been acquiring the bulk of the net additions to outstanding State and municipal debt. In that year they had bought $4.4 billion out of $5.5 billion net additions, or 80 per cent, and they had been buying such issues at a high rate ever since. Some of those issues no doubt were marketable, but some, he thought, had to be called unmarketable; it was hard to imagine where purchasers other than banks might be found for the bonds of, for example, many small and little-known townships. Having acquired those bonds, the banks probably would be holding them indefinitely.

Secondly, Mr. Balderston continued, the Committee should note that the Treasury had announced a financing of considerable size, involving $4 billion in bills with 100 per cent tax and loan account credit. The proceeds of the financing probably would be expended by the Treasury fairly rapidly over the next few weeks. During the period when the proceeds were in tax and loan accounts, required reserves would be increased accordingly. If the Committee adhered to a policy of keeping money market conditions unchanged during the coming weeks the System, at its own initiative, would supply the reserves to take care of those added requirements. Meanwhile, the Treasury would be drawing on those bank deposits to take care of its fall expenses, and the funds thus expended would find their way into private demand deposit accounts. He recognized that the bulge in bank credit associated with tax and loan financing might prove temporary; it certainly would be temporary in a period of slack credit demand. But that was not the case at present, and if fall loan demand remained high the Committee might find some of the reserves it had provided in October haunting it in November.

The issue today, Mr. Balderston remarked, centered on the meaning of "status quo" at a time when a sizable Treasury financing had been superimposed upon unusually strong credit demand. Should the System accommodate both? If it did, it would be acquiescing in the ballooning of bank credit beyond the constructive needs of the economy. If the System supplied sufficent reserves to roll rates back to the levels of a month ago, it would be acting to depress a rate level that had resulted from the forces of the market--more specifically, from the impact of expectations of enlarged demands.

It seemed to Mr. Balderston that a more sensible and prudent interpretation of a "status quo" policy for the next two weeks would involve providing just enough reserves to accommodate the normal seasonal increase in demand plus those that were directly related to the temporary bulge in tax and loan accounts. In his view, such a policy would not interfere with an orderly distribution of the Treasury's current issue. He thought the Committee should anticipate that the somewhat higher rates attending the money market conditions of recent days might continue, and that rates might even rise further.

As he had indicated, Mr. Balderston said, he favored a status quo policy, as suggested by alternative A of the draft directives. However, he was somewhat unhappy about the wording of the draft. In his opinion the description of economic and financial developments contained in the first two sentences tended to lay the basis for a shift of policy toward firmness. However, the next sentence began with the words, "In this situation," and went on to indicate, in effect, that the Committee's policy had remained unchanged. He thought it would help somewhat if the words "In this situation" were deleted. Also, he would strike the opening words of the second paragraph, "To implement this policy and taking into account," and have the paragraph begin, "In view of the current Treasury financing, System open market operations shall be conducted with a view . . . ." That change seemed desirable because in his judgment the financing was the primary reason for maintaining the status quo at this time.

Chairman Martin remarked that he agreed with Mr. Galusha that there was no reason to fear prosperity, even though many people seemed to feel that the current expansion could not last simply because activity was at so high a level. He could not believe, however, that all periods of prosperity floated on constantly rising levels of credit, or that one could ignore such matters as loan-deposit ratios of banks or credit quality and assume that it was possible to propel prosperity forward without any adjustments occurring in markets. Everyone wanted to see the prosperous conditions the country was experiencing continue, and he personally had no fear of higher interest rates in that connection.

As to policy, the Chairman said, he thought that this was the wrong time to make a change. The Treasury already had announced its October financing and, while one might argue on technical grounds that if a change were going to be made it should be done in advance of the actual financing, the Committee had not yet decided that a change was in order. The consensus appeared to be against a policy change today and some members were of the view that the Committee should ease conditions somewhat. In his judgment it would be desirable to keep to the status quo, with the Desk maintaining market conditions on as even a keel as possible at this juncture. If that suggested that the Committee should write some more specific target levels into the directive, he did not know how that could be done effectively. He assumed that the Manager had been trying to carry out the Committee's previous directive; when forces built up in the market the Manager could not be expected to adjust market conditions day by day. He agreed with Mr. Wayne that any attempt to specify quantitative instructions in the directive would force the Committee to meet more frequently. The Committee had wrestled with the problem of the directive for years and he personally did not believe that it was feasible to write it in quantitative terms.

The Chairman then noted that it was obvious from the discussion that the Committee had a difficult drafting problem today, and he invited suggestions.

Mr. Robertson said he thought that a change of a few words at the end of the second paragraph of alternative A would give the Manager a much clearer idea of what the Committee wanted. The change involved replacing "as have prevailed in recent weeks," as the description of the money market conditions to be maintained, with "as have prevailed on average in September." In response to a suggestion that there might be some advantage to using the phrase "since the last meeting" in place of "in September," Mr. Robertson said he thought either phrase would serve the purpose.

Chairman Martin suggested that there might be some problems of definition with respect to the word "average," and he then turned to Mr. Holmes for comment.

Mr. Holmes said that he thought the most difficult problem such a directive would pose for the Desk was in connection with the three-month bill rate, which this morning was at 4.02 per cent. He would interpret the language Mr. Robertson proposed to call for rolling the bill rate back to about 3.90 per cent, which might be hard to do in the current atmosphere.

Mr. Robertson commented that he had not intended the proposed instruction to apply to the rate on any particular instrument; what he had in mind was the overall span of money market conditions.

Mr. Hayes remarked that the wording suggested by Mr. Robertson carried more of a flavor of easing market conditions from their present state than he thought was reflected in the consensus around the table. It was true that some members were strongly in favor of the course indicated by the suggested wording. More, however, had spoken in favor of maintaining the recently firmer conditions, and several had indicated a preference for overt action toward further firming, although not immediately. He would suggest retaining the original language of alternative A.

Mr. Swan commented that he could see little difference between "in recent weeks" as in alternative A, and "since the last meeting," as Mr. Robertson proposed. The real issue, he thought, was whether an attempt should be made to roll back conditions to those prevailing four weeks ago or to maintain those prevailing at present. Mr. Daane agreed, and added that it was his impression that a majority of the Committee had indicated a preference for the latter course.

Mr. Wayne suggested that the matter might be settled simply by calling for "maintaining conditions in the money market within the ranges which have prevailed since the last meeting."

Mr. Ellis said he would not favor avoiding a decision on what he thought was the real question facing the Committee--whether or not to roll back bill rates. As the staff had pointed out, previous relations among elements of money market conditions were no longer consistent, and it was necessary to decide what the Manager was to be asked to do. Once that decision was made the Committee could turn to the question of language for the directive.

Mr. Mitchell commented that he had not detected such exclusive emphasis on bill rates. The discussion, in his opinion, had been more in terms of the whole structure of market rates.

Mr. Ellis replied that he understood the language Mr. Robertson proposed to imply a rollback of bill rates from their present level of 4.02 per cent. That, he thought, was the question with which the Committee was faced.

Chairman Martin said he would reiterate a point he had made earlier; namely, that the course that Mr. Mitchell and some others favored seemed to him to involve a definite change in policy in the direction of ease.

Mr. Mitchell replied that he did not believe he was recommending a change in the Committee's policy posture. It seemed to him that the Committee had found itself in a situation in which money market conditions were much firmer than it had intended them to be. If he favored a "change" in policy it was only in the limited sense of advocating the earlier conditions rather than those of the most recent week.

Mr. Hayes said he thought it was important to distinguish between the temporary factors that had led to the developments of the latest week and the underlying situation of strong credit demands that was producing tighter conditions in the market. To his mind, the alternatives were clear: the Committee could recognize the basic strength of the forces in the market and let current rate levels continue to prevail, or it could try to restore the earlier rate levels.

Chairman Martin agreed that the choice was between maintaining the status quo with respect to interest rates or rolling them back.

Mr. Robertson said that he did not advocate a drastic rollback of rates; as he had indicated, he favored maintaining the average conditions prevailing during September.

Mr. Mitchell said he thought there were some unwarranted implications in the way the term "rollback" was being used in the discussion today. The average of net borrowed reserves in September was $118 million, as compared with $167 million for the most recent week. Net borrowed reserves were one of the factors governing the Manager's actions, but Mr. Robertson's prescription, which he favored, also provided for an average bill rate of 3.90 per cent and an average Federal funds rate of 4.10 per cent, as other elements in the general pattern of conditions to be maintained.

Mr. Ellis commented that he thought market conditions had gone beyond the point where that pattern could prevail; the

September averages now were inconsistent with one another. As he understood the staff and the Manager, net borrowed reserves would have to be below $118 million if the bill rate was to be maintained at less than 4 per cent.

Mr. Holmes agreed that money market relations had changed. He noted that in its comment on question 6 the Board's staff had estimated that net borrowed reserves of $150 million were likely to be associated with a bill rate near the upper end of the 3.95-4.10 range.

Mr. Hickman asked what level of bill rates was likely to be consistent with net borrowed reserves of about $118 million. Mr. Holmes replied that he found it hard to answer that question with any precision. Some market forces would be tending to push bill rates higher and some to move them lower, and he did not think one could be specific about the outcome.

Chairman Martin then proposed that a vote be taken, essentially on the question whether to maintain the status quo as presently constituted with respect to market rates or to roll rates back to lower levels. That, he thought, was what the issue amounted to.

Mr. Shepardson suggested that the vote be taken on a directive with the last phrase of the second paragraph of alternative A modified to read, "with a view to maintaining about the current conditions in the money market."

Thereupon, upon motion duly made and seconded, and with Messrs. Maisel, Mitchell, and Robertson 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 the domestic economy has expanded further in a climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit since midyear. Some of the uncertainties previously affecting foreign exchange markets have diminished. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, and taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current conditions in the money market.

Chairman Martin then noted that there had been distributed copies of a letter dated September 21, 1965, from Congressman Wright Patman, Chairman of the House Committee on Banking and Currency, requesting that certain recent records of the Open Market Committee be made available in his office at an agreed time, with necessary personnel from the Committee present, so that he might review and examine the records. These included records relating to the dollar value of the portfolio, trading in the Account, income of the Account, the procedural way in which it was obtained, the procedural way in which it was transferred, and the way in which the Federal Reserve Board and the Reserve Banks received their operating income.

After discussion, the staff of the Committee was authorized to assemble appropriate records bearing on the questions raised, with the understanding that arrangements would thereafter be made for their transmittal.

> Secretary's note: The following letter was sent to Congressman Patman, over the signature of Chairman Martin, on October 1, 1965:

> This is in reply to your letter dated September 21, in which you request information relating to the securities in the System Open Market Account and the income derived from these securities. The staff of the Federal Open Market Committee is getting together the records bearing on the questions raised in your letter.
>
> I have asked Mr. Cardon to get in touch with Mr. Nelson when this material is ready, so that arrangements may be made for the review and examinations referred to in your letter.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 12, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.

Ralph A. Young

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

September 27, 1965

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 28, 1965

Alternative A (no change)

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further in a climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit since midyear. Some of the uncertainties previously affecting foreign exchange markets have diminished. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, and taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market as have prevailed in recent weeks.

Alternative B (firming)

The economic and financial developments reviewed at this meeting indicate that the domestic economy has expanded further in a climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit since midyear. Some of the uncertainties previously affecting foreign exchange markets have diminished. In this situation, it is the Federal Open Market Committee's current policy to move further to strengthen the international position of the dollar, and to counter the emergence of inflationary pressures, by moderating somewhat the pace of growth in the reserve base, bank credit, and the money supply.

To implement this policy, while taking into account the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining slightly firmer conditions in the money market.