A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, October 12, 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 Member

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

Messrs. Wayne, Patterson, Shuford, and Swan, Presidents of the Federal Reserve Banks of Richmond, Atlanta, 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, Garvy, Holland, Koch, Taylor, and Willis, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special 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. Hersey, Adviser, 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

Messrs. Hilkert and Heflin, First Vice Presidents of the Federal Reserve Banks of Philadelphia and Richmond, respectively
Messrs. Eastburn, Mann, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Philadelphia, Cleveland, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Sternlight, Assistant Vice President, Federal Reserve Bank of New York
Mr. Duprey, Economist, Federal Reserve Bank of Minneapolis

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period September 28 through October 6, 1965, and a supplemental report for October 7 through 11, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that the gold stock would remain unchanged again this week for the eleventh week in a row. On the London gold market, the price had been allowed to move up to nearly $35.17 on September 30 in an effort to delay or discourage Chinese buying. Since then the Russians had appeared as heavy sellers and the price had been marked down sharply to $35.10 this morning.

As a result of Russian sales totaling $218 million last week, Mr. Coombs continued, the Gold Pool had been able to liquidate completely its deficit of $170 million and to retain another $47 million in reserve. As the Pool had paid back gold previously drawn from the various countries, the U.S. Stabilization Fund had benefited to the extent of somewhat more than $84 million. Unless the United States received other gold orders in addition to a prospective sale of $35 million to France, it should be able not only to get through October without having to show a reduction in its gold stock, but might end the month with nearly $90 million of gold in the Stabilization Fund.

On the exchange markets, Mr. Coombs said, sterling continued to be the center of attention as it moved up above par for the first time in more than two years. That move through the parity level was deliberately engineered by the Bank of England, one day before the scheduled announcement that the U.K. had run an actual balance of payments surplus during the second quarter of this year. That favorable news had helped to sustain the rate above par since then, although the inflow of dollars to the Bank of England had pretty well dried up during the past five market days. The market appeared to have been awaiting the trade figures for September, which were released this morning. The new figures showed no gain in exports but an appreciable dip in imports, with the result that the trade deficit was reduced by $62 million. Since the operation in support

of sterling was launched on September 10, the Bank of England had taken in a total of about $560 million, and further gains might well be registered this week.

Mr. Mitchell asked whether the British had indicated their intentions with respect to repayment of their drawings on the swap line with the System. Mr. Coombs replied that the British plans in this connection were not yet firm, but he assumed that they would be punctilious about repayments, using a substantial part--perhaps 50 per cent or more--of their reserve gains each month to reduce their debt to the System. There was an important psychological advantage to be gained from showing additions to reserves, of course, and they would be balancing one objective against the other.

In response to a question, Mr. Coombs said that the British had drawn the whole $750 million available under the swap with the System, starting in June and making further drawings in July and August. Their first drawing, of $275 million, already had been renewed and they were likely to renew all or part of the second drawing of $250 million that would mature soon.

Mr. Mitchell then asked whether there was any way of knowing the extent to which the earlier strength in the technical position of sterling had already been dissipated.

Mr. Coombs said he thought that some of the technical strength had been dissipated by the rise in the sterling exchange

rate. He personally would have preferred to see the rate move up somewhat more slowly. On the other hand, the short positions in sterling had been so enormous--perhaps on the order of $2 or $3 billion--that substantial further flows to Britain could be expected if the British did not relax their efforts and if there were no unfavorable developments in the news. With good luck those flows could easily continue through the year end. Sterling would then move into its seasonally strong period, so that the flows might continue into the spring months.

In response to a question by Mr. Hickman, Mr. Coombs said the British had been considering the advantages and disadvantages of allowing the exchange rate to continue to rise. Each rate increase drew in additional funds but if they let rates continue up they would soon run out of space and might suffer some reaction. His own thinking was that for the time being they might hold the rate somewhere between $2.8010 and $2.8040 and not try to ratchet it up further. It was important, he felt, to avoid pushing the rate up to an artificial and unsustainable level.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period September 28 through October 11, 1965, were approved, ratified, and confirmed.

Mr. Coombs then requested Committee approval of renewal for another three months of the $100 million swap arrangement with the Bank of France, which would mature on November 10, 1965.

> Renewal for a further period of three months of the $100 million swap arrangement with Bank of France, as recommended by Mr. Coombs, was approved.

Mr. Coombs then noted that it might be necessary to renew a $40 million equivalent swap drawing on the National Bank of Belgium, maturing November 10, 1965; a $25 million equivalent drawing on the Netherlands Bank, maturing November 12, 1965; and a $7.5 million swap of guilders against marks, with the Bank for International Settlements, maturing November 1, 1965. In each case these would be first renewals.

> Renewal of the two drawings and of the guilder-mark swap, each for a further period of three months, was noted without objection.

Mr. Coombs then remarked that a $250 million drawing by the Bank of England on the System, to which he had referred earlier, would mature on October 29, 1965, for the first time. He hoped the Committee would be prepared to approve its renewal, in whole or in part, if the Bank of England should so request.

> Possible renewal for a further period of three months of part or all of the $250 million drawing by Bank of England under its standby swap arrangement with the System was noted without objection.

Before this meeting there had been distributed to the members of the Committee the regular weekly report of open market operations and money market conditions for the week ended October 6, and a supplemental report summarizing highlights of the entire period from September 28 through October 11, 1965. Copies of the reports have been placed in the files of the Committee.

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

At the time of the Committee's last meeting two weeks ago, the money market was in motion, with short-term interest rates pushing persistently higher despite very sizeable System purchases of Treasury bills. In sympathy with developments in the short end, longer-term interest rates were also tending higher, following a period around mid-September when longer markets had regained some stability after an upward rate movement. In pursuit of the Committee's objective to maintain current money market conditions, the Account Management continued its substantial purchases of Treasury bills for several additional days, more than offsetting the absorption of reserves through market factors and contributing significantly to the stabilizing of short rates that has developed in about the past ten days.

The high point of bill rates came shortly after the Committee's last meeting--around September 29-30--as the market looked forward to the regular auction of three- and six-month bills the following Monday and the auction of $4 billion of tax anticipation bills the day after that. By September 30, rates began edging down--but at first this mainly reflected scarcities in the wake of heavy System buying, while the underlying atmosphere continued rather skittish. Thus, dealers bid quite cautiously in the regular weekly auction on October 4, and were particularly hesitant about taking on the six-month bill which is close in maturity to the March tax bill.

Noticeably greater confidence returned to the market by Tuesday, October 5, and there was fairly

good bidding for the tax bills at lower rates than had been anticipated in the market a few days earlier. With tax and loan deposits expected to be worth perhaps 40-45 basis points for the March bill and some 25 or more basis points for the June issue, banks acquired the bills at average rates of about 3.78 and 3.94 per cent respectively, while trading in the secondary market began in the 4 20 to 4.24 per cent area for each bill. Thus far, secondary distribution of the bills has been proceeding smoothly in the generally more stable market atmosphere of recent days. Dealers' positions in bills, which were sharply depleted in advance of the tax bill auction, rose by about $1.1 billion last Wednesday and Thursday as the dealers willingly absorbed a portion of the tax bills taken by banks in Tuesday's auction. As far as we can tell, banks still hold a large part of their tax bill awards and there may be additional efforts to sell these into the market, particularly as the Treasury calls on its tax and loan deposits. In turn, the dealers' appetite for these and other bills will depend importantly on the course of corporate and other demand for bills in ensuing weeks. While distribution is thus proceeding well up to now, there is still some distance to be traveled.

In yesterday's regular bill auction, the three- and six-month issues were sold at average rates of about 4.01 and 4.18 per cent, respectively, up 3 and 5 basis points from two weeks ago. I should mention with respect to the six-month bill that yesterday's bidding was quite strong, and we learned late yesterday afternoon that the System received only a partial award on its tender to get those bills. For the three-month bill the rate rise from two weeks ago is quite modest considering that we are now dealing with a January bill rather than a late December issue. The upward rate adjustment in the six-month area reflects the increased supply of bills in that maturity area as a result of the tax bill sale. The outstanding three- and six-month bills closed at bids of 3.98 and 4.17 per cent (bid) yesterday, down from highs of 4.05 and 4.21 per cent during the two-week period. The one-year bill, which has become rather scarce in the past two weeks, was bid at 4.15 per cent at the close yesterday, down from a high of 4.24 per cent on September 29, and below the 4.20 per cent level of two weeks ago. In general, then, rates are about back at the levels of two weeks ago, and in a

much steadier market atmosphere. The market remains susceptible, however, to sudden shifts in sentiment, in the event of new economic, financial, or other developments.

Virtually all of the System's operations in the past two weeks involved outright purchases or sales of Treasury bills. While at the time of the last meeting it appeared that some part of the current reserve need could appropriately be met through purchases of coupon issues and short-term repurchase agreements, it developed as the period moved along that the Committee's rate and reserve objectives could be best served by concentrating on outright bill purchases. Toward the end of the interval, unobtrusive outright sales or redemptions of bills were arranged, to absorb currently and prospectively redundant reserves.

In moving readily to supply reserves to the market through substantial Treasury bill purchases, a somewhat more comfortable tone has emerged in the money market. The availability of Federal funds has increased and some sizable trading has taken place at 4 per cent or below, although most trading has continued at 4-1/8 per cent. Estimated net borrowed reserves in the week ending October 6 were down very sharply--to only $40 million--but this would convey an exaggerated impression of easing as an unusually high amount of excess reserves was held at country banks and was inaccessible to the central money market. Borrowing from the Reserve Banks, in fact, was little changed from the preceding week when net borrowed reserves were over $200 million. This week borrowing appears to be running a little lighter.

Longer-term markets tended to move sympathetically with the shorter area during the recent period--first moving lower in price and then recovering to show little net change for the period. Investor activity was light, but with dealers seeking to keep positions fairly close to "even" in a period of uncertainty over the likely course of interest rates there was some tendency for even modest investor interest to produce sizable day-to-day price changes. A case in point is the 4-1/4 per cent Treasury bond of 1992, which closed two weeks ago at 99-2/32 bid, touched a low of 98-22/32 on September 29, and closed yesterday at 99-12/32.

There was little net price change in the corporate and tax-exempt bond markets during the period, but a somewhat more confident atmosphere emerged in these areas, too. The near-term supply of new corporate issues is now rather modest, but some sizable State and local offerings will come in the next few weeks and the extent of commercial bank appetite for additional tax-exempt holdings is something of a question mark.

The next item on the Treasury financing agenda is the refunding of November 15 maturities--of which some $3.3 billion is publicly held. Advisory groups will meet with the Treasury on October 26 and 27, with terms probably to be announced on the latter day. Current market yields pretty much dictate an offering in the shorter-term area. The Treasury may seek at the same time to raise some additional cash--and in any case a cash borrowing would be needed soon after the November 15 payment date for the refunding.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period September 28 through October 11, 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. Noyes made the following statement on economic conditions:

The current performance of the economy continues to be best characterized, it seems to me, by the word "strong"--without much qualification one way or the other. Both an inflationary surge and an adjustment that would stall our forward momentum remain possibilities for the future, but it is very hard to show that either of these unpleasant prospects is imminent.

A survey of recent movements in the broad aggregate measures of output, production, employment, and prices

indicates that the situation leaves little to be desired. In almost every case the figures have moved in accord with the most optimistic expectations. GNP in the third quarter will probably be up at least as much as was generally anticipated--a $10 billion increase to $675 or $676 billion seems as good a guess as any at this point. The global unemployment figure confounded the experts by breaking through the 4.5 per cent level to 4.4 in September, and other labor market data generally confirm this strong showing. Industrial production, in the aggregate, seems to be about on track--with the September figures moderately depressed by the combined effects of the steel settlement and hurricane Betsy. While the calculations have not been completed, it appears likely that the production index will be down about one percentage point. Retail sales were also off a little, due mostly to a decline in seasonally-adjusted auto sales that may well stem from the difficulty of making precise seasonal adjustments during the model change-over period. At the same time, the broad indexes of both wholesale and retail prices have shown little net change.

With all the talk of inflation and of price advances, it is important to remember that average prices of wholesale industrial commodities are only about 1.5 per cent above year-ago levels and non-food commodities at retail are up only .5 per cent. This may be more than any of us would like, but it is an enviable record against our own historical experience or that of other countries.

As I have had occasion to say many times in the last four years, it is hard to find much fault with the performance of the economy--the question is how best to maintain that performance. There was complete unanimity among the distinguished academic consultants who were here last week that this was the question, despite their differences as to the answer.

For this Committee, essentially the same question can be restated in more complex form. If we look behind these broad aggregates which have moved in such a satisfactory way, is there evidence that distortions or imbalances have developed which could be halted or reversed by action on the part of the Federal Reserve to attain money market conditions different from those which have in fact come about and now prevail? Would either firmer or less firm money market conditions enhance the chances of prolonging, and hopefully perpetuating, healthy expansion? And, if so, how much of a change is appropriate?

The case for moving actively to ease some of the pressure that has recently developed in money and capital markets seems to me to be the hardest to support. Granting that we still have some unemployed and underemployed resources, it is doubtful that we could reduce that margin more rapidly than we have been, without serious danger to the price structure and the sustainability of the expansion. Both business and consumer expenditure plans are buoyant. Hence, the case for easing seems to me to rest heavily on the possibility of a fairly imminent unwinding of the inventory positions that have been built up in the last twelve months or so. As you all know, this has worried me for some time and it still worries me, but I can find no convincing evidence that the people who actually hold the inventory share my concern.

Setting aside rates of expansion in financial magnitudes themselves, as coming within the purview of Mr. Brill's subsequent remarks, the case from the nonfinancial side for a tighter policy also seems to me to fall short of persuasiveness. There are unquestionably imbalances in our present expansion, but it is hard to demonstrate that they are more likely to be corrected if credit is less readily available. Bear in mind that I am not speaking here of financial markets themselves, but of the basic relationships between production and consumption of various types of goods and services. An example is the disparity in the expansion of output as between business equipment and consumer goods, which shows up so dramatically on production index charts.

Some tempering of the rate of expansion in business equipment production and some acceleration in production of consumer goods would seem essential to balanced growth in the period ahead. But it is not apparent, at least to me, that tighter credit would contribute to this sort of adjustment. I have also looked hard for some evidence that the pattern of resource utilization is being distorted by inflationary expectations. If this were happening, it would, in my judgment, make the strongest case for a more restrictive policy, but I am unable to find any convincing evidence that it is happening now. In fact, the results of a recent McGraw-Hill survey seem to deny it explicitly.

Thus, I would conclude that recent developments in the nonfinancial sectors do not in themselves provide sufficient grounds for a change in policy, one way or the other.

Mr. Brill made the following statement concerning financial developments:

Over the past month or so market interest rates have bounced around quite a bit, responding in part to seasonal ebbs and flows of funds and in part to rumors, official statements, semi-official interpretations of official statements, and fears of new official actions or statements. In this context, it has become fashionable for some observers to describe the state of financial markets as nervous, and to attribute the generally higher level of interest rates now prevailing to "market expectations." In the limited time available this morning, I would like to present an alternative interpretation. Specifically, I would advance two hypotheses:

(a) That a substantial degree of monetary restraint already exists, and that the higher range within which interest rates are now fluctuating is the result primarily of recent and prospective supply-demand relationships, not only or even mainly dependent on expectational factors;

(b) That even under the present stance of policy with respect to availability of reserves, upward pressure on rates is likely to persist, and probably to intensify.

Turning to the first of these hypotheses, that substantial restraint already exists, let me retrace a bit of financial history. Earlier this year, the level and structure of interest rates was partially shielded from the impact of burgeoning private credit demands by several factors. The increases in time deposit rates following the late 1964 increase in Q ceilings inundated banks with funds in the first two months of the year; even after slipping a bit in the spring, time and savings deposit inflows remained high. Second, banks accommodated their private customers by consistent and large reductions in their holdings of Government securities. Over the first half of the year, banks liquidated almost $4 billion of Government securities--6 per cent of their portfolios of these issues. Third, banks worked down their excess reserves a bit and went into debt to the Fed substantially,

with borrowings rising from $300 million in January to about $500 million by mid-year.

In addition to these maneuvers to find the resources to accommodate customer loan demands, banks were aided by the System's expansion in nonborrowed reserves, which grew over the first half of the year at about the same rate as in 1964. And the Treasury helped moderate rate pressures by reducing the marketable debt substantially; the nonbank public didn't have to absorb many Government securities, on net, over this period.

Even so, private credit demands outpaced supplies of funds, and there was a gradual diffusion of restraint through most financial markets. It showed up in rising rates on Federal funds and CDs at the short end, and in increases in corporate and municipal bond yields at the long end. Increasingly as the year progressed, there were reports of bank rationing of credit and of more restrictive nonprice terms on bank loans.

Over the summer, supply-demand relationships tilted further in the direction of restraint. Private credit demands remained strong, partly because the steel wage negotiation developments encouraged further inventory accumulation and partly because of continued strength in consumer spending and corporate capital investment. Banks had to scramble for funds, and while they were able to garner a larger share of the savings flow--at the expense of other savings institutions--the Fed became a less accommodating source of funds. Nonborrowed reserves actually declined over the summer months. Borrowings didn't rise much, as increasingly banks felt that they had worn out their welcome at the discount window.

To accommodate customers, banks had to continue to liquidate Governments, but now there was less of an offset from Treasury operations. Expanding revenues permitted the Treasury to stay away from the market for new money, but it was not able to retire debt at the pace of the first half year.

In this context, it is no wonder that interest rates reacted strongly when the Treasury returned to the market for its fall seasonal cash needs, with prospects of additional financing requirements occasioned by military developments in the Far East. And it is no wonder that bank lending officers have been reporting to us significant tightening in lending policies.

My second hypothesis is that the financial situation is not likely to ease; if anything, upward rate pressures are likely to intensify under present conditions of reserve availability, even if economic activity continues to expand at only a moderate pace. There is not a simple relationship between GNP and financial flows, particularly in the short run. Changing structure of expenditures and the state of liquidity of spending sectors--as well as shifts in expectations--can create financial pressures that have no immediate counterpart in goods and services markets. So far, business loan demand has been maintained at surprising strength, rising about as rapidly in September as in August, even with industrial production declining as steel inventory liquidation got underway. Plant and equipment expenditures are continuing to rise, while internal generation of funds appears to be leveling off and liquidity is already reduced. All in all, corporate financing demands are likely to continue strong. Consumer credit expansion should also continue if auto sales hold their recent pace. And Federal financing demands over the balance of the year will be substantial, even without unexpected military drains, for the Treasury is now running closer to the wind with its cash balance. A conservative summing of prospective credit needs suggests that actual supply-demand pressures in financial markets are likely to be stronger over the next few months than they were this summer and fall.

What would be the appropriate stance of policy, if the above analysis of present and prospective financial conditions is correct? Mr. Noyes' appraisal of prospects for the real economy--in which I concur--suggests to me that it would be reasonably safe to accommodate at current rates the credit demands likely to accompany this sort of activity outlook. The odds now favor some tranquility in the real sector of the economy. We've gotten through a period of extraordinary demands with nothing worse than a price creep. Short of introduction of a major military spending program, it's hard to see anything on the horizon that would significantly accelerate this price creep. Symptoms of over-ebullience may emerge--the stock market shows signs of becoming one--but, by and large, business and consumer spending plans seem predominantly on the strong but cautious side.

I agree also that there are some important elements of imbalance in the economy, particularly as between capacity and final demands, but I fail to see how a general tool like monetary policy could correct these structural imbalances without slowing an expansion that is not excessive in the aggregate. Over the near term, considering the favorable prospects for further noninflationary expansion, the pressures already extant in financial markets, and the financial pressures looming ahead, it would not seem appropriate to me for the System to intensify financial restraint.

Mr. Ellis asked Mr. Brill whether he thought the current level of the prime rate was affecting the pattern of flows in credit markets.

Mr. Brill replied that it was quite likely that businesses were favoring bank borrowing over capital market financing because of the change in rate relationships. But the volume of capital market financing had increased recently and long-term rates had already risen. If business demands were diverted away from banks they were not likely to be satisfied in the capital market at current rate levels.

Mr. Daane asked whether Mr. Brill thought it would be possible to maintain the current degree of rigidity and artificiality in the interest rate structure in view of the financial pressures now existing and the intensification of those pressures that he (Mr. Brill) foresaw.

Mr. Brill replied that rates undoubtedly would be pushed upward unless the System accommodated the expected credit demands. In a sense, the present rate structure might be considered to have

been artificially produced by the System's policy with respect to the provision of reserves; both total and nonborrowed reserves had declined during the summer months.

Mr. Hayes then asked whether Mr. Brill would agree that the prime rate, which had not changed since 1960, was an example of an artificial interest rate. Mr. Brill commented that banks had been shading interest charges upward even though the prime rate had not changed. The overall average rate on bank loans seemed to have remained generally level because of the increasing use of bank loans by prime customers.

Mr. Hickman noted that the declines in total and nonborrowed reserves in August and September and the recent increases in interest rates had been associated with roughly stable levels of net borrowed reserves and borrowings. He asked whether Mr. Brill thought those trends would continue if net borrowed reserves and borrowings were maintained at about current levels.

Mr. Brill replied that he thought the upward trend in interest rates was likely to continue. The reserve relationships to which Mr. Hickman had referred might be reversed if there was a change in the structure of bank liabilities involving a shift from time to demand deposits, but that seemed unlikely. The burden of his interpretation, however, was that a continuation of present policy with respect to net borrowed reserves probably would result in higher interest rates.

Mr. Maisel then asked what factors underlay the decline in nonborrowed reserves during the summer when marginal reserves had been about unchanged.

Mr. Brill said he did not have any ready explanation for that development, but he thought the recent sharp decline in Government deposits was a factor. Mr. Holmes agreed. He added that the total and nonborrowed reserve figures were seasonally adjusted and he strongly suspected that imperfect allowance for seasonal factors would be part of the explanation.

Mr. Hickman concurred in the view that the change in Government deposits was important. He noted that the Treasury had remained out of the market earlier in the year when, in his judgment, it should have been borrowing, and now was belatedly coming in.

Mr. Brill remarked that there had been some sentiment in favor of Treasury borrowing during the summer but a decision against it had been made because developments in Vietnam had suggested to the market that Federal spending might be rising rapidly. No one then was quite clear as to what was going to happen to military spending, and there was some feeling that a financing operation, particularly at a time when the Treasury's balance was quite large, would mislead the market with respect to the Treasury's expectations on that score.

Mr. Swan suggested that one factor serving to explain the reserve developments Mr. Maisel had mentioned might have been the

large gains in time deposits in July and August, which permitted a given volume of reserves to do more work. Mr. Balderston commented that he thought the time deposit change was an important part of the explanation.

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

> Straws in the wind that can tell us something about month-to-month variations in the balance of payments look on the whole more auspicious today than they did two weeks or six weeks ago. To mention a few: the August export total looks very encouraging; the August (as well as the July) import figure is low enough, even when qualified and corrected, to suggest that the leveling out--or slower rise--which we had expected might occur in U.S. imports in the second half year is going to occur; new Canadian security issues in the United States, though large in September, will be relatively small in the weeks ahead; and, finally, the available weekly data on reserves and liquid liabilities to foreigners suggest a considerably smaller "regular transactions" deficit in September than in August.
>
> It is quite impossible to build up a consistent picture of the whole and the parts of our payments position in any one month from straws in the wind like these. Years of experience with monthly ups and downs leave us no sensible choice but agnosticism about the meaning of monthly figures.
>
> For the third quarter as a whole, the still incomplete data on settlement items suggest a seasonally adjusted deficit of perhaps $300 to $350 million on the "regular transactions" basis. A quarterly deficit of this size would be of the same order of magnitude as the deficit in the first half of 1965--which, blown up to an annual rate, was $1.3 billion.
>
> On the "official settlements" basis, the deficit in the first half was at an annual rate of $0.9 billion. This was less than on the other basis mainly because military export advance receipts are to be counted as reducing the "official settlements" deficit rather than financing it. But in the third quarter, even without assuming any more net advance receipts on military sales, the "official settlements" balance may turn out to have been a surplus--

perhaps of $100 million or more. Here, in the third quarter, the difference between the two bases was due mainly to a very large buildup of foreign commercial banks' balances in the United States (including those of U.S. bank branches). This inflow was associated in part with the more-than-seasonal easing of the Euro-dollar market in August, and it was associated also, no doubt, with the movements out of sterling that were still taking place on a large scale at that time. In September, with recovery in the sterling market and tightening in the Euro-dollar market, there seems to have been a net withdrawal of foreign commercial bank balances from the United States, though perhaps no more than would be seasonally normal in September. In September, therefore, unlike August, the "official settlements" balance may have been once more a deficit, seasonally adjusted; and on the whole that is the likely prospect for the coming months too.

We might sum up the evidence for the third quarter by saying that, apart from a slowing down in the repatriations of liquid funds and bank credit as the voluntary programs got a little older, and apart from side effects of the sterling situation, changes in the U.S. payments position since the spring do not seem to have been particularly significant. The abnormal surplus of the second quarter--and of July and August on the "official settlements" basis--is over, and deficits seem to be still the order of the day.

But I cannot avoid drawing some comfort from the July and August export figures. To me they seem an indication of continuing underlying strength in our export position, simply because I cannot find any special reasons in the demand situations in other countries why our exports should have been turning up this summer. Looking ahead, too, the world demand picture looks at least as strong as it did a few months ago. A decline in British imports may still be in the offing, but at least the first corner has been turned in the return of confidence without a sharp contraction in activity. The rapid rise in German imports will eventually taper off, but there are increases in Japanese and French imports still to come as offsets.

So the next couple of months' U.S. export figures will be something to look for eagerly. We shall also have to watch whether U.S. bank credit outflows will or will not build up more than seasonally in the fourth quarter--as they could without passing the target.

If some further moderate net improvement in the payments position should materialize, what would be its implications for policy? The chief implication, as I see it, would be to restore and strengthen hopes that a lasting adjustment of the payments position may be achievable via a combination of current account improvement as we maintain price stability and moderation of capital outflows as domestic demands rise, without our having to set our feet on the slippery roads of permanent capital controls or of an interest equalization tax broadened beyond its present scope. For Federal Reserve policy specifically, the implication would be to validate and justify the weight that has been given to balance of payments objectives in the long-run strategy of policy. But the short-run tactics of policy, it seems to me, ought to be completely unaffected by moderate changes in the payments position. Whatever monetary policy can do for our external payments equilibrium is something that can best work itself out over an extended period of time, with the help of a domestic economic expansion that is inflationless and recessionless. On this reasoning, short-run decisions to modify monetary policy should continue to be based simply on an appraisal of the domestic situation, without much attention to short-run variations in the payments position.

Today, this conclusion is all the more relevant since the moderate improvement in the payments position of which I have been speaking is still a gleam in the eye, not a live fact.

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

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?

Treasury bill rates have retreated somewhat from the peaks reached at the end of September. Bill rates had adjusted upward in the latter part of that month when the market first reacted to the announcement of a $4 billion Treasury tax bill auction in a period of taut money market

conditions, and against the background of expectations of continuing strong credit demands and rumors of a discount rate increase. The subsequent decline in rates represented a response to a sharp drop in dealer bill positions occasioned by large-scale System and renewed corporate buying and some easing of pressures on central money market banks. The demand for the new tax bills in the secondary market was somewhat better than expected.

Assuming net borrowed reserves in the neighborhood of $100 to $150 million in the coming three weeks, the outstanding 3-month bill, which was at 4 per cent at the market close on Friday, may be expected to be within a 3.95-4.10 per cent range. Any slackening of public demand for bills would likely push rates upward from current levels partly because the System will be a net seller in the next two weeks and partly because dealer positions have been rebuilt, largely through purchases of the new tax bills from banks.

Yields on U.S. Government bonds have moved downward in sympathy with bill rates in recent days, while corporate and municipal yields have tended to stabilize. If short-term rates remain relatively stable and the corporate new issue calendar remains light in October, long-term yields are not likely to adjust upward further in the period immediately ahead. However, in the U.S. Government securities market investor demand still appears light and in the municipal market the calendar seems to be building up again. In general, both bill and bond markets still have an underlying cautious tone and remain susceptible to unfavorable jolts to market psychology.

The upward interest rate movements in recent months have been associated with a reduced rate of bank credit expansion. In September business loans increased at about the same rate as in July and August, but acquisitions of municipal securities were sharply reduced, and security loans were liquidated in substantial volume. Total and nonborrowed reserves, seasonally adjusted, declined slightly, and banks obtained fewer funds through time certificates of deposit in September than in the previous two months.

Rapid growth in bank credit, which resumed in the first week of October, may be stronger over the next few weeks

than in September or August, as banks retain and use for a time the additional U.S. Government deposits associated with the recent tax and loan account financing. Business loan demand may continue to be moderated by further liquidation of the earlier build-up in loans to metals and finance companies, but underlying credit demands are expected to remain strong.

If bank credit does grow more rapidly in October money supply expansion may also continue rapid, although considerably slower than the 12 per cent annual rate of increase in September when there was a much larger than seasonal decline in U.S. Government deposits. For the demand deposit component, a growth rate of 4 to 5 per cent continues to be the most likely expectation. With longer-term bill rates pressing against CD rates, it is likely that time and savings deposit expansion will slow somewhat from the average rate of over 16 per cent of the past 3 months.

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 situation has not changed since our last meeting, and the outlook remains strong far into 1966. Even though the reduction of steel inventories will undoubtedly depress various business indicators for some weeks more, other expansionary forces in the economy are clearly strong enough to more than offset this particular drag on the advance. On the price front, nothing has occurred in the last two weeks to increase our worries that inflationary pressures may be building up. Such pressures as exist continue to be moderate. As we look further ahead, however, growing shortages of skilled labor constitute an important threat to price stability. Although expected additions to plant capacity may more or less keep pace with rising industrial output, the general business climate is certainly more conducive to price increases than to declines; and even the 1.5 per cent rise in industrial wholesale prices in the past year cannot be accepted with complacence.

This concern over prices and costs seems to be particularly warranted by the unsatisfactory state of our balance of payments and the prospect that we may have trouble keeping the U.S. trade surplus up to its present level in view of the likelihood that imports will be strongly stimulated by the domestic business expansion. As I stressed two weeks ago, the basic payments problem is highlighted by our inability to come close to equilibrium in 1965 despite the initial success of the campaign to place artificial barriers in the way of most types of outward capital flows. Doubtless more could be done to damp down direct investment, and this may help in the short run; but the effort to reach ultimate equilibrium without the need of artificial barriers will, in my judgment, call for a strong concerted effort including an appreciable contribution by monetary policy.

Since we met here two weeks ago both President Johnson and Secretary Fowler have gone on record with ringing assurances to the assembled Fund-Bank Governors that the United States will move vigorously to bring its payments into balance. Failure to perform on this promise would place the international standing of the dollar in very serious jeopardy; and the central bank of the country cannot escape an important role in that performance.

In the field of bank credit, as in that of prices and costs, the very latest data do not suggest any recent deterioration in the situation. There may have been some slowdown in September, but short-term swings in these statistics mean very little. To me the important point is that bank credit has advanced over the past six months at about the 8 per cent rate which has been typical of the 1961-64 period and which the Committee has attempted unsuccessfully to slow down on several occasions in the last couple of years. Business loan demand in general has been strong and is expected to remain so throughout the fourth quarter. Banks are responding to liquidity pressures and heavy loan demand by stiffening loan terms and by selective interest rate increases. Several major New York banks feel that market conditions would amply justify an increase in the prime rate, which has not moved since 1960; but in the light of their belief that such an action would meet strong political opposition, they are in effect adopting a method of rationing that discriminates against small borrowers. Open market interest rates of all maturities have moved up considerably in the past month or so.

While exaggerated market expectations may have contributed to the high levels reached about two weeks ago, it seems clear to me that the main cause of the rise has been the strength of business and of current and prospective credit demands. The money market continues to be in a somewhat unsettled state because of uncertainties about interest rate developments, compounded by confusing reports of official pronouncements on this subject.

Looking ahead, I think we have a real basis for concern about potential inflationary pressures, against a background of cumulative large increases in bank credit and a serious international payments problem that leaves us little margin for assuming inflationary risks. For the moment, we are perhaps estopped from any policy change until the market has had a little more time to digest the latest Treasury offering of tax anticipation bills; but this should not take long. In view of recent market developments, little room remains for action through open market operations, and an increase in the discount rate would seem the most appropriate method of signalling a move toward greater firmness in monetary policy and validating the firming that has already occurred in market rates.

The only questions in my mind involve timing and the size of the discount rate increase--and there is some interrelationship between timing and size. As to timing, the Thursday after next (October 21) would seem to offer the last suitable opportunity for quite a while, provided the market does not experience more trouble than is evident to date in distributing the tax anticipation bills. With the November refunding to be announced on October 27, and with the Treasury likely to be raising additional needed cash in late November, it may well be early or mid-December before we shall again be free to move; and even then there may be some natural reluctance to make a policy change so close to the period of year-end pressures.

Another reason for prompt action is to dispel the unfortunate but widespread notion that the System has lost control of monetary policy. Furthermore, interest rates on CDs are perilously close to the ceilings under Regulation Q, so that the System may find itself, on very short notice, in a position where raising of the ceilings is required to prevent a problem of considerable gravity for the banks--especially those outside of the main money centers. Under more normal conditions it might be well to raise the ceilings promptly, regardless of whether a discount rate change is imminent,

if only to dispel the notion that the two actions must always be simultaneous. But in the present state of the money and capital markets, an increase in Regulation Q ceilings without a discount rate move might cause increased uncertainty and nervousness. Finally, prompt discount rate action would avoid possible difficulties in the event that the U.K. authorities should later on be contemplating a rate reduction just when we were considering an increase.

If we do act next week, there is much to be said for making the increase 1/4 per cent. For one thing, the period between the completion of the recent bill financing and the November refunding will be very short indeed, and a rise of 1/2 per cent might require rather sharp market adjustments and could create a very shaky market atmosphere and some sense of having been badly misled by recent official pronouncements. There might also be considerable difficulty in obtaining much public or political support for the larger move, in view of the absence of very recent data pointing to an acceleration of price increases or of credit expansion. A 1/4 per cent increase next week, on the other hand, might be relatively acceptable politically--or so I would hope--and would just about keep pace with recent market rate movements--thus suggesting that money and capital markets might well stabilize, with only modest further upward rate adjustments.

The strongest argument against such a small near-term move is that anything less than 1/2 per cent, which we have thought of in the past as a minimum "normal" increase when we are at the 4 per cent level, might seem very halfhearted in the eyes of foreign holders of dollars who look to U.S. monetary policy to contribute significantly to a bettering of our international position. Indeed, I think a 1/2 per cent increase is fully justified if we look only at international factors. But as I have already indicated, the market situation is not now favorable for so large an increase--and we might well have much better economic justification for a 1/2 per cent rise two months from now than today, in terms of clear-cut domestic statistics on business and credit. Hence, in my judgment, a 1/2 per cent move must probably be delayed till at least early December.

I am not sure which of these courses should be pursued, nor which would be favored by my Bank's directors; and I shall await with interest an expression of views by other members of the Committee.

As for open market operations, I should think we should instruct the Manager to confirm about the degree of firmness that developed in the money market in September, with the understanding that if a discount rate increase is carried out before our next meeting, considerable leeway for the Manager will be desirable.

As far as the directive is concerned I would be willing to accept alternative B, perhaps with the word "confirming" substituted for the word "reinforcing." 1/

Mr. Ellis remarked that while a considerable variety of new monthly data had become available for New England since the meeting of the Committee fourteen days ago, they revealed no material deviation from the pattern reported in recent meetings. Business activity in New England continued to expand in an atmosphere of confidence.

As also reported earlier, Mr. Ellis said, New England banks continued to reflect customers' preference for accommodation at banks rather than in the capital market. In order to provide for their 16 per cent year-to-year growth in total loans in the past year, District weekly reporting member banks had expanded their negotiable certificates of deposit by 40 per cent in a market where rates had pushed close to the Regulation Q ceiling. In that process, loan-deposit ratios had advanced from a year-ago average of 70 per cent for all New England member banks to 75 per cent today, four points above the national average.

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

For Boston banks, Mr. Ellis continued, the average loan-deposit ratio had reached 77 per cent, with individual banks, of course, pushing higher. For the last several months, one of those high-ratio banks had each day been a net buyer of Federal funds at a level averaging 64 per cent of its required reserves. Of course, that "borrowing" by itself consistently exceeded the 100 per cent of capital plus 50 per cent of surplus limitation, entirely aside from the fact that that bank also had unsecured notes outstanding.

Turning to monetary policy, Mr. Ellis remarked that the shortened interval since the Committee's previous meeting increased the appropriateness of concentrating attention on the problem of specifying the money market relationships that would be considered to be consistent with a general monetary policy objective of "no change." Two weeks ago the Committee had directed the Account Manager to conduct operations "with a view to maintaining about the current conditions in the money market." Unfortunately, the "current conditions" prevailing at that time included a large element of apprehension and expectation that short-term interest rates, which had already moved up several points in the preceding few days, were destined to move further, perhaps propelled by a discount rate action. The very existence of those expectations and apprehensions blocked a clear appraisal of the underlying relationships. The central question was, and continued to be, essentially that posed by Mr. Brill today; namely, whether the basic strength of the economy, as translated

into increasing credit demands, could be best maintained by accelerated injections of reserves to forestall interest rate increases. Or should the Committee seek to limit reserve creation to the rate so far achieved in 1965--even if market demand so outpaced that rate as to lead to interest rate increases in a market where freely fluctuating rates were expected to play an essential economic role?

In Mr. Ellis' judgment, the Committee failed two weeks ago to give the Manager guidance of the clarity to which he was entitled, and in consequence it had no framework within which it could properly praise or criticize his performance. Nevertheless, on the assumption that the simple arithmetic of the events in the past two weeks did not conceal more than it revealed, he was inclined to approve the Manager's resolution of the issues insofar as he (Mr. Ellis) understood them. The simple arithmetic reported by the Manager revealed that in the last four days of the week in which the Committee last met the Manager bought $741 million of Treasury bills on a cash basis. He thereby converted the average net borrowed reserve figure for the week of October 6 from $260 million projected at the start of the week into an expectation of approximately $65 million that finally resulted in a published net borrowed reserve figure of $40 million. By injecting reserves, the Manager, of course, also supplied reassurance of no change in policy. Apparently many of the funds stayed in New York banks because those banks ended the week without borrowing--for the

first time in 19 weeks--and they sold Federal funds from strong basic positions. In an atmosphere of much banker and official discussion about the prime rate, and on the eve of the auction of $4 billion tax anticipation bills, bill rates steadied and dealers made substantial sales.

Mr. Ellis was prepared to accept such a course of events as having usefully taken some of the excessive speculation out of market discussions and as an antidote to the previous two weeks of aberration on the high side of a net borrowed reserve target of $150 million. At the same time, he urged on the Committee the necessity of clarifying for the Manager its choice between limiting interest rate advances or limiting the rate of reserve creation if credit demands became so intense that such a choice was forced upon the Committee. He referred not to the temporary pressures of market speculation, but to the underlying pressures of credit demands too intense to be satisfied without accelerated creation of reserves.

For his own part, Mr. Ellis said, he accepted the necessity for temporarily abandoning reserve targets from time to time in order to dispel exaggerated--and sometimes poorly informed--market speculation. As a basic objective, however, he urged a "no change" policy expressed in terms of reserve targets. By that he meant a net borrowed reserves target centered at $150 million and borrowings exceeding $500 million, with an expectation that Federal funds would

hold at 4-1/8 per cent, and that short-term bill rates would hold in the 4.00-4.10 per cent range unless market demands built so as to move rates slowly upward. He would not intervene to impede slow upward rate movements reflecting underlying forces.

As for the comments on money market relationships that had been distributed by the staff, Mr. Ellis noted that the question asked for views on mutually consistent money market conditions "assuming a continuation of current monetary policy." The second paragraph of the comments described some possibly consistent conditions if the Committee would accept a slightly lowered and narrowed net borrowed reserve target range of $100-$150 million, compared with recently accepted target ranges centered at $150 million. Successive re-definitions of "no change" of that sort could in fact move the Committee considerably in its policy posture.

Mr. Ellis said he found neither draft directive adequate in meeting even the minimum of directive clarity. Alternative B called for "reinforcing the firmer conditions in the money market that developed in September." That statement failed on two counts First, those firmer conditions were excessive and speculation-based, and should not be reestablished. Second, they had already been corrected and no longer existed to be reinforced.

Alternative A, Mr. Ellis continued, had the fault of assuming that the conditions prevailing since the last meeting could be

meaningfully averaged and that such an average could in fact serve as a "no change" guideline to the Manager. In the Manager's words, the money market had been in motion; since the last meeting sharp reserve injections had reversed the upward trend of market rates, provided the New York banks with net free reserves, held down dealer loan rates, and relieved dealers of high inventories of bills. That could hardly be characterized as "no change" in the sense that it should be continued.

As a minimum amendment, Mr. Ellis said, and to provide a clear and consistent choice between directive alternatives A and B, he would suggest revisions of the concluding words of both second paragraphs. For alternative A he would propose calling for operations ". . . with a view to maintaining a firm tone with stable conditions in the money market." For alternative B he would suggest ". . . with a view to achieving a firmer tone with stable conditions in the money market." His own preference was, of course alternative B. However, he would postpone discount rate action until market rates tightened, if in fact they did.

Mr. Irons remarked that in the Eleventh District during the past two weeks there had been relatively little change in economic conditions, which continued strong. Most of the indicators had shown strength or slight expansion, including construction contract awards, employment, and department store sales. Unemployment had moved down

to about 3.2 per cent, and shortages of some types of labor probably were developing.

In the financial area, Mr. Irons said, bank loans had risen, particularly loans to consumers, and bank holdings of Governments had increased. Time and savings deposits were strong and banks had been active in the Federal funds market, on balance buying a substantial volume of funds. Borrowing from the Reserve Bank had been relatively stable and quite low, but that was because banks were getting the funds they needed from other sources.

With respect to the national situation, Mr. Irons found himself in substantial agreement with the remarks of Mr. Noyes and the other members of the staff. There had been some improvement in money market conditions during the past two weeks, with less nervousness than earlier, and developments had tended to confirm the somewhat higher rate pattern that had emerged. The national economy certainly was strong and on the whole continued to reflect expansionary tendencies. Some of the uncertainties with which the Committee recently had been concerned remained--for example, with respect to inventories and prices--and there undoubtedly were imbalances in the economy. On the whole, however, there was little evidence that such problems posed serious dangers at this time, and some might be absorbed in the workings of the market.

Mr. Irons said that he would prefer to maintain present conditions in the money market at this time. The Committee had been exerting some pressure on the market and had some responsibility for contributing to the recent degree of firmness. He would not like to see a notably firmer posture now, and he would not favor a change in the discount rate at present. His thinking with respect to money market conditions ran in terms of a Federal funds rate around 4-1/8 per cent, the Treasury bill rate moving around 4 per cent, and borrowings around $500 million. He would attach less importance to trying to maintain some fixed figure for net borrowed reserves. He hoped such reserves would fluctuate around $150 million, but if they were influenced by changes in the distribution of reserves or by other special developments, he would not want those developments to prevent attainment of the more basic objectives.

Mr. Irons favored alternative A of the draft directives. Although he had not had much opportunity to consider Mr. Ellis' proposed amendment to that directive, he thought it would be acceptable to him.

A discussion then ensued of the possible implications for open market operations of the directive language Mr. Ellis had proposed, and also of several alternative formulations that were advanced. In the course of this discussion Mr. Holmes responded to a number of questions. He indicated that he thought market

conditions were firm and relatively stable at the moment, with a tendency, if anything, for rates to move somewhat lower, although that tendency might prove temporary. He would interpret Mr. Ellis' proposed language for alternative A (". . . with a view to maintaining a firm tone with stable conditions in the money market") as calling for maintaining market rates at about their present levels, with fluctuations, perhaps, of a few basis point in either direction. His interpretation of the proposed alternative B language (". . . with a view to achieving a firmer tone with stable conditions in the money market") was that it would call for a gradual and orderly movement of interest rates to a higher level. The inclusion or exclusion of the words "a firm tone" in alternative A might affect his interpretation somewhat under certain possible conditions; for example, a Federal funds rate around 4-1/8 per cent would seem to be implied by those words, but such a rate might not prove consistent with stability in other money market conditions.

Mr. Wayne said that he would much prefer the word "orderly" to "stable" in Mr. Ellis' formulation of alternative A, in order to provide the Manager with necessary flexibility; "stable" implied an undesirable degree of rigidity. Mr. Holmes observed that he thought there was a real, if fine, distinction between the two words, agreeing that "orderly" connoted somewhat more movement in the market than "stable."

Chairman Martin commented that he did not favor one suggestion that was advanced--to call for maintaining the "existing" tone in the money market--on the grounds that market conditions sought should not be pin-pointed as those existing at a particular moment in time. In his judgment the most important question arising out of the discussion was that Mr. Wayne had raised--whether "orderly" was preferable to 'stable."

Following this discussion the go-around resumed with remarks by Mr. Swan.

Mr. Swan said that in view of the short interval since the Committee's previous meeting and the fact that the economic situation seemed to be little changed in the Twelfth District, he would not comment on District developments except to note that one major bank had indicated that it expected to add rather substantially to its bill position in the near future.

Mr. Swan agreed with the analyses of the national situation that had been made by Messrs. Noyes and Brill, and with their recommendations for policy. It seemed to him there had been no particular change in the business situation or in financial conditions from those the Committee had expected two weeks ago. In addition, the Treasury financing schedule had to be considered; there still was some distribution of the tax anticipation bills to be accomplished and a refunding operation lay ahead. It seemed to him that the

Manager had performed well in dealing with the situation in the market, achieving some stability and a leveling off of bill rates. For whatever reason, attaining those objectives had required some reduction in net borrowed reserves in the latest statement week.

Mr. Swan hoped that the Committee would decide to make no change in policy today, and that, as discussed at the previous meeting, it would agree to give primary consideration to the bill rate, and to money market rates in general, rather than to a net borrowed reserve target. He would favor a bill rate in the 3.95-4.05 per cent range. It would be fine if that objective could be attained with net borrowed reserves in the $50-$150 million range, but he would not be particularly concerned if a lower level of net borrowed reserves were to result. He was impressed by the point made earlier that seasonally adjusted nonborrowed reserves had declined in August and September, whatever questions might be raised about the seasonal adjustment factors. Larger injections of reserves than in the past two months might be required if, with time deposit rates pressing against their ceilings, time deposits did not expand much. It seemed to him, however, that the provision of more reserves would be quite consistent with current conditions.

Mr. Swan remarked that he was somewhat surprised by the discussion today regarding the wording of the directive. At the previous meeting the Committee had been faced with a real problem of

language, but today the problem did not seem so serious to him. In his judgment, the fluctuations in the money market in the last two weeks were no greater than in many earlier inter-meeting periods when no particular questions had been raised. He favored accepting alternative A of the draft directives as originally submitted. If the Committee did not agree, his second choice would be to retain the language of the September 28 directive, which called for "maintaining about the current conditions in the money market." Although that language involved problems of definition, it seemed better to him than to call for a "firm tone" and "stable conditions"; such terms would add another dimension to the instructions and would undesirably limit the Manager's maneuverability. The staff draft, with its reference to conditions "since the previous meeting," provided a reasonable range in which the Manager could operate and, as he had indicated, was his first choice.

Mr. Swan concluded by observing that he would not favor a change in the discount rate at this time.

Mr. Galusha said there was nothing in recent information about the Ninth District to suggest that the outlook had changed. His guess continued to be that moderate economic expansion would persist through coming months. Moderation of the weather in the western part of the District had improved agricultural prospects markedly. With regard to the credit quality, the last examination summary continued to indicate no significant change in quality.

Mr. Galusha remarked that if his understanding was correct the Committee decided at its last meeting to hold money market interest rates at then prevailing levels, or, in other words, to resist further increases, even if that necessitated reduction in the level of net borrowed reserves. Implicitly, the decision was to focus, for the time being anyway, on money market rates and conditions, and let net borrowed reserves find their own appropriate level. In his opinion the Committee should persist in that approach; the instructions to the Account Manager should again be phrased in terms of interest rates and money market conditions. Mr. Holmes had been able to follow the Committee's instructions last time, and if the Committee gave him the same sort of instructions this time, he should be able to do as well over the coming three weeks as he had in the two just past. In Mr. Galusha's opinion that was very well indeed.

Apropos of the discussion on the directive today, Mr. Galusha said he happened to have at hand an article by a colleague from which he would like to quote the following:

> In the field of Federal Reserve policy it is possible, of course, to give very precise directives to the Manager of the open market account. It must be recognized that such directives would have to be couched in terms that the Manager can in fact execute. They would have to be written in terms of the amount and issues of Government securities to be bought or sold, regardless of what happens to yields, or in terms of yields, without regard to what happens to the portfolio. They cannot be written precisely in terms

of both--at the present state of our knowledge. It is an elementary error to suppose that they can be written precisely in terms of the supply of money, however defined, or in terms of some reserve total, be it total reserves, excess reserves, free reserves, borrowed reserves, or whatever, or in terms of the liquidity of the economy--whatever that may mean. The reason is that each of these magnitudes is influenced by factors over which the Manager has no immediate or direct control, and the present state of our knowledge is insufficient to predict the behavior of these other factors with sufficient accuracy to make appropriate allowances for changes in them.

I confess that I have on occasion couched a directive--or voted for a directive couched--in inappropriate terms. But this always has been with the knowledge that the Manager was present to hear all the discussion that led to the formulation of the directive.1/

Mr. Galusha went on to say that the question at issue was whether the Committee should continue resisting further increases in rates and further tightening of money markets. He believed it should. He favored no change in policy at this time. A sharp increase in interest rates had already been experienced and there was nothing in the present economic outlook to suggest that further increases would be appropriate.

Nor, more particularly, did Mr. Galusha believe the discount rate should be increased now. Perhaps what some who advocated discount rate action had in mind was making an increase in the prime rate possible--or necessary. There was no denying that the prime rate was out of line, and if that rate had been increased earlier the Committee

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1/ The quotation is from a lecture by Mr. Bopp, entitled "Confessions of a Central Banker," published in the volume, Essays in Monetary Policy in Honor of Elmer Wood (University of Missouri Press, 1965).

would be more aware than it was of how much monetary restraint it had already effected. If it could be guaranteed that an increase in discount rates would produce only an increase in the prime rate there would be less reason to oppose such action. But that would be unlikely. All of the available evidence suggested that when discount rates were increased, money markets tightened and money market rates rose. It was no good trying to hide behind the phrase "technical adjustment." For one thing, money market rates were not anything like substantially above present discount rates. And that being so, increases in discount rates could not constitute other than further monetary restraint.

In conclusion, Mr. Galusha said, he would like to say a few words about "natural forces," which were mentioned at the previous meeting of the Committee. There could be no doubt that such forces affected interest rates, but that did not absolve the Committee of responsibility. The Committee's task was to determine whether it should resist or reinforce whatever natural forces were operating, as, most emphatically, it could.

Mr. Galusha added that he favored alternative A of the directive in its original form. However, he would not object to Mr. Ellis' suggested revision. The Manager was cognizant of the whole context of today's discussion and could be expected to operate in terms of the Committee's consensus whatever specific language might be included in the directive.

Mr. Scanlon commented that the past two weeks had produced further evidence of the vigorous tempo of Seventh District activity. The machinery and equipment industry continued to report strengthening demand for their products. Chicago steel producers reported that new orders had begun a surprising increase in the past 10 days. Local analysts had raised their estimates of output for the fourth quarter and now expected that output in the quarter might drop only 15 per cent below the third quarter. Little decline in steel employment in the District was contemplated in the near future, partly because of the need to make up deferred repairs and maintenance on hard-pressed equipment. Since August virtually all announcements of price change had been increases, with very few decreases reported.

In agriculture, Mr. Scanlon said, there had been some damage to corn and soybean crops by heavy rains and cold weather, but no overall assessment of the importance of that damage was possible at this time. It was apparent, however, that there would be a sizable amount of soft corn and corn left in the field by harvesting machines and that that would cause farmers to increase purchases of feeder cattle. Such purchases, of course, would increase demand for feeder loans and would tend to depress cattle prices later on.

The increase in business loans of major Seventh District banks in September was double that of a year ago and bankers expected continued strong loan demand, Mr. Scanlon observed. There was some

evidence that demand currently was less broadly based than was the case earlier in the year. A large share of the September increase was accounted for by the metals and utilities groups and might have been chiefly to cover temporary needs of large firms with low cash positions over the corporate tax date. Failure of the quarterly interest rate survey to reflect the higher rates that banks indicated they had been charging might be attributable to the unusually heavy volume of that type of borrowing in the survey period. The proportion of loans at the prime rate was slightly lower than in June.

Whether temporary or not, Mr. Scanlon remarked, loan expansion, coupled with the runoff of CDs and outflow of demand deposits as tax checks cleared, had been reflected in a substantial increase in both Federal funds purchases and borrowings of major banks in both Chicago and Detroit over the past three weeks. Nevertheless, those banks did not reduce holdings of Government and municipal securities and their mortgage portfolios continued to expand. At current levels of borrowings they appeared to have very little room to maneuver should loan demand increase further, and unless they were able to increase their deposits some liquidation of longer-term assets would appear likely.

As to policy, Mr. Scanlon said, he would favor maintaining on average the existing firmness in the money market, recognizing that the objectives which the Committee cited in the form of bill

rates, reserve targets, and Federal funds rates might not be mutually compatible. He gathered that the Manager currently regarded the bill rate as his prime objective, and he (Mr. Scanlon) agreed with Mr. Irons' comments on that score. He continued to feel that any significant additional move toward restraint would necessitate a discount rate change and reconsideration of the maximum interest rates permissible under Regulation Q. He would avoid such a move today and, therefore, he favored alternative A of the draft directives. He would not quarrel over the suggested words in the second paragraph, and he also could accept the paragraph in the directive adopted at the previous meeting with no change.

Mr. Clay remarked that such additional information as had become available concerning the national economy since the previous meeting of the Committee did not lead to any change in his interpretation of the economic situation and prospects. The situation remained one of moderating influence from the inventory side following the steel strike settlement, of continuing expansion in aggregate final demand, and of orderly present and prospective economic developments in terms of resource utilization and prices.

The money and capital markets had given some evidence of relaxation from the tightness of two weeks ago, Mr. Clay noted. Nevertheless, there was evidence of rather delicate markets, sensitive to any stimulus toward further credit tightening. Under those

circumstances, any overt move toward tightening monetary policy probably would have a pronounced effect upon the money and capital markets.

In the period ahead, Mr. Clay said, it should be the Committee's objective to continue essentially the current monetary policy. That included as intermediate goals moderate rates of growth in the reserve base, bank credit, and the money supply. It included as the immediate goal the maintenance of about the current conditions in the money market. In view of the sensitivity of the money and capital markets, the conditions of the money market should be the Manager's primary guide, with reserve availability adjusted accordingly, rather than looking toward any particular net borrowed reserve goal as the primary target.

Alternative A of the draft directive was satisfactory to Mr. Clay. He felt that no change should be made in the discount rate.

Mr. Wayne reported that Fifth District business continued upward and appeared to be gaining strength from several sources. Because of its heavy concentration of military and civil service personnel, the District would receive a somewhat stronger stimulus than other areas from the recent rise in the military pay scale and the anticipated increase in civilian salaries. The textile industry, operating at practical capacity under heavy backlogs and spending

record amounts for expansion and modernization, would receive an additional boost from the new farm bill when the domestic price of cotton dropped another three cents next summer. Contract award values rose sharply in late summer, bringing significant new strength to the construction outlook. The furniture and lumber industries had recently displayed renewed vigor and anticipated an unusually busy fall season. Cigarette consumption was running nearly 5 per cent ahead of last year's pace, but this year's prospects for flue-cured tobacco growers had softened somewhat. Receipts to date continued substantially above year-ago levels, but on the basis of estimates for the rest of the season a 5 per cent drop in total dollar sales now seemed probable.

Mr. Wayne favored no change in monetary policy at this time. He noted that attention in recent weeks had focused on the run-up in yields on most types of debt instruments. In view of market sensitivity to rumors and unexpected developments, there had been some concern that the markets might become disorderly, requiring substantial intervention by the System. Evidence of a jittery condition was the sharp run-up in bill rates in response to the Treasury's decision in the recent auction of tax bills to raise more new money than was generally expected and to rumors about the possibility of increases in the discount rate, the prime rate, and margin requirements. While the markets seemed to have quieted down

somewhat, it was difficult to be sure because of the unsettling news of the President's operation.

There were reasons, however, for believing that rapid price erosion might now be over, Mr. Wayne continued. First, the strong performance of sterling in the exchange market and the published gains in British reserves had at least temporarily removed one depressing factor. Second, the Administration had indicated its opposition to across-the-board increases in interest rates and had suggested that fundamental factors did not justify the advances which had occurred. While he did not believe that "open mouth" policy could determine the level of interest rates, he had observed that on several occasions in the last few years such statements by high Administration officials had had a stabilizing effect on the market. Thus, it did not appear likely that the Federal Reserve would have to intervene with a massive rescue operation.

On the other hand, Mr. Wayne did not believe that the markets were in any position to withstand further tightening at this time. While dealer inventories of Governments had been reduced dramatically in the past two months, they were still large enough to precipitate disorderly conditions if there should be an overt shift to tighter policy.

In calling for no policy change, Mr. Wayne recognized that the economy was presently strong, that prices might continue to creep

up, and that the outlook for the next several months was for continued expansion in economic activity. New evidence of that was found in the latest survey of purchasing agents which indicated that new orders and production were up sharply in September, that prices continued to rise, and that a decline in the rate of inventory accumulation was confined largely to steel stocks. The agents also noted a higher rate of capital investment. Keeping in mind the possibility of overheating, the Committee should also remember the significant amount of tightening which had occurred in recent weeks in the form of higher interest rates. Since rates might edge up further, even under present policy, he thought it was wise for the present to pause to assess the effects of recent developments before prescribing stronger medicine.

That conclusion was reinforced by still another consideration, Mr. Wayne said. While the view was rapidly spreading that sterling was over the hump, he thought the situation was still too delicate to risk additional monetary restraint at this time. If an overt move did become necessary, hopefully the Committee would be able to wait until the British had had more time to consolidate and capitalize on their recent gains.

Concerning the directive, Mr. Wayne preferred alternative A, and he could accept the amendment suggested by Mr. Ellis; but as he had indicated earlier he would greatly prefer the term "orderly" to

"stable" to give the Manager necessary flexibility. He noted that in the proposed amendment "maintaining" preceded "firm" and did not connote a change in the Committee's policy posture. The Committee had recognized in earlier discussions that market forces were moving in the direction of slightly firmer rates, and a policy of "no change" would permit those pressures to work out through the market unless disorderly conditions appeared. In his opinion that should continue to be the Committee's posture. A change in the discount rate did not appear appropriate to him at this time.

Mr. Robertson then made the following statement:

> I do not agree with those who feel that the odds are clearly in favor of a breakout of inflationary conditions this fall. We certainly have not had any spreading of price increases since the change in business tempo introduced by the steel wage settlement the first of September. In the absence of such evidence, we need to be very careful not to base our decisions on judgments that inflationary conditions are bound to develop, just because they have in past expansions. This has been a very different kind of expansion, with both productivity advances and profit levels maintained in a way that has effectively held off the build-up of the kind of cost-push pressures so damaging in some earlier cycles. I think in these circumstances we would be well advised to wait for facts to call for action rather than acting upon our own guesses as to what the future might hold.
>
> There is also another reason why I believe a policy of "watchful waiting" is the best counsel right now. A significant tightening of general credit conditions has unfolded over the past two months, extending into every major credit market according to all the indicators of credit terms and conditions that we have in hand. This tightening has not yet had time, however, to exercise its full influence on the real economy. In the absence of more overt inflation signs than I see today, I believe

> we should wait to judge the dampening influence of this market tightening before considering the launching of a second round of restrictive actions.
>
> With this policy in mind, I think we should make it crystal clear to the Manager that we do not want to see another flurry of market tightening such as occurred in the first days following the last meeting of this Committee. If anything, I would want him to resolve his doubts on the side of easing bank positions slightly, in the interests of precluding another sinking spell in the long-term markets fed by assumptions that the System is about to take another overt tightening step.
>
> To convey this policy to the Manager, I would be satisfied with the alternative A directive distributed by the staff, assuming that the language means what it says and does not constitute a license to permit still further tightening.

Mr. Shepardson said that both the staff reports and the information generally available appeared to indicate continuing strong economic activity and an outlook for continued strength in the economy. His main concern was with the rate of bank credit expansion, which he thought was higher than could be expected to be maintained. If the Committee formulated its policy in terms of the level of interest rates it would feed in automatically whatever volume of reserves was needed to hold rates at the target level. He hoped the Committee would not accede to all demands for credit for the purpose of holding down interest rates. It would be preferable, in his opinion, to attempt to gauge the appropriate rate of bank credit expansion and, if demands for credit were greater than that, to let the demands be reflected in some increase in rates. He was not sure how the Committee could best quantify the appropriate growth rate for

bank credit. On the whole, however, while he thought it might not be appropriate to retard the present rate of growth, he would prefer to see no rise. If the demand for credit strengthened he would expect to see some increase in interest rates. He thought that alternative A of the draft directives, with Mr. Ellis' suggested change, was consistent with such a conclusion.

Mr. Mitchell remarked that the basic uncertainties in the outlook that the Committee had faced for the past several months still remained--namely, the amount of economic stimulus that would be provided by the war in Vietnam and the magnitude of the inventory adjustment and its secondary and tertiary effects. Until those basic uncertainties were resolved the Committee would not know how much encouragement it should give to the upward thrust of the economy. For that reason he agreed with Mr. Noyes that there was no reason to change policy at present.

Many people outside the Committee had seemed to be trying to make monetary policy recently, Mr. Mitchell said, by resolutions, statements, and market participation, and he did not like to think that the Committee would yield to those forces against its better judgment.

His own view was that the System should not be maneuvered into a change in the discount rate but that such action should be reserved for a real crisis or clearer evidence that the announcement

effects of a discount rate change were needed. In his judgment that was not the case now.

Mr. Mitchell agreed with the view that the question today was whether to pursue a rate or reserve objective. His preference was for the former; he would attempt to maintain market rates in the range of 3.90 to 4.05 per cent unless that would require very low levels of net borrowed reserves--say, below $50 million. For the directive he would favor alternative A, as originally written. He continued to believe that M_2 (currency and total deposits), a "proxy" variable for total bank credit, was a more useful guide and reference variable than the official bank credit series. The rate of increase in both, however, reflected the growing competitiveness of banks among depository institutions and market instruments. For that reason he thought it would be undesirable to attempt to formulate policy in terms of restraining total bank credit growth.

Mr. Daane said that the decision facing the Committee today seemed to him to be a particularly difficult one--more difficult, perhaps, than it appeared to some other who had spoken. He was impressed with Mr. Noyes' presentation--the last he would be giving, in view of his plans to leave the System--and felt that it demonstrated clearly how much the Committee would miss his balanced judgment and appraisals. He agreed with Mr. Noyes today that on the economic side there was no conclusive evidence for a need to change policy. Thus,

on that score, the case for any move depended more on an intuitive judgment that pressures were building up--if they had not already built up--that would be detrimental to the sustainability of the present expansion. His own intuition told him that that was the case, and for support he would point only to the ebullience of expectations evident most clearly in the stock market, to what seemed to him to be an investment boom in process, and to the disquieting price changes of the past year. Those price movements, he thought, represented a significant change from the price situation of the three preceding years.

In the bank credit and financial markets area the case for a policy change seemed to Mr. Daane to be much stronger. The rapid growth in total bank credit--tempered, and perhaps disguised, only by declines in dealer loans and in holdings of Government and other securities--still seemed to him to point toward the need for some further moderate restraining action.

Finally, Mr. Daane said, despite Mr. Hersey's reassuring remarks today, he was still concerned about the balance of payments situation. He frankly was worried by the fact that the United States was now in the negotiation stage on new monetary arrangements at a time when its balance of payments position was not as strong as some of the System's European colleagues believed. As evidence became public of the lack of appreciable further improvement and perhaps of

some weakening, the System's posture would become even more important. Thus, while he saw nothing really new in the area of the balance of payments to justify a policy change, such a move would be helpful in the total picture.

Having said all of that, Mr. Daane continued, he would add that he came out about where he had at the last meeting--with the conclusion that the question of timing was all important. Obviously, any action on the Committee's part that would call for a change in the discount rate should be taken only after the Treasury financing was completed. If the discount rate was to be changed he would prefer an increase at that juncture of 1/2 per cent coupled with greater reserve availability, similar to last November's operation. He would anticipate that such an action, as was also true last November, would not offer any deterrent to healthy expansion of the economy; he believed it would be helpful to financial markets and to the appropriate flows of funds, and also to the country's international posture. But perhaps it would be wiser to wait until sometime nearer the end of the year when the signs and portents he sensed at present might either have become clearer or, hopefully, have disappeared.

Mr. Daane said he might add one or two comments on the discussion thus far. He did not understand how Mr. Ellis could advocate a firmer policy and yet not favor discount rate action.

He thought Mr. Brill had made it clear that, given the anticipated market rate pressures, a firming of policy would make the present discount rate untenable.

Secondly, Mr. Daane felt quite strongly that the Committee could not so readily resist basic market forces as Mr. Galusha evidently believed. In his judgment an effort to do so would be at a real cost to the System in terms of its later ability to arrest possible inflationary developments. The Account Management should not at all costs resist upward rate pressures if they developed. For the directive, he could accept alternative A with Mr. Ellis' amendment and the further modification proposed by Mr. Wayne.

Mr. Maisel remarked that it seemed to him the Committee's appropriate policy course was clear today--the economy was on a satisfactory growth path and should be helped to stay on it. He favored no change in policy; anything else, in his view, would repeat past errors of reacting too fast to fears that later proved unfounded. He would define "no change" primarily in terms of bill rates, with the objective of a bill rate somewhere between 3.90 and 4.00 per cent. Maintaining the bill rate in that range might require supplying owned reserves at the rate of last year and the first half of this year; the decline in owned reserves that had occurred in the third quarter had been undesirable, he thought. Maintaining the bill rate might also require a decrease in borrowed and net borrowed

reserves. The Manager should feel free to let net borrowed reserves decline below the $100-$150 million range, if necessary. With that interpretation in mind, he favored alternative A as drafted by the staff.

Mr. Hickman said that there was little to add to the discussion of recent business trends that had not already been covered this morning. In general, the liquidation of steel inventories was going forward at about the rate expected, consumer and business takings continued upward as anticipated, and the amount of Federal defense spending because of Vietnam was still unknown. Moreover, the recent behavior of prices--in terms of both the popular broad indexes and various diffusion indexes--suggested continued stability, with no evidence of a breakout either on the up side or down side.

It seemed to Mr. Hickman that additional spending for defense would increase only moderately from now to the year end, barring unforeseen reversals in Vietnam. The first solid evidence of Federal outlays for 1966 would not be known until the budget took shape in December. When known expansionary factors in the Federal budget--due to increased social security payments, tax cuts, and higher military pay--were balanced against already legislated higher social security taxes, it would appear that an increase of $4 to $6 billion in additional Federal spending could be absorbed by the higher tax

revenues expected to be generated by an expanding economy in calendar 1966. If defense spending should go much beyond that, the situation would call for a reduction in other types of Federal spending, higher taxes, more restrictive monetary policy, or some combination of the three.

Mr. Hickman still thought the Committee should be careful about jumping to conclusions concerning the prospective course of the economy. Much of the recent instability in money and capital markets had been based on expectations of economic and financial developments that had not yet been confirmed by facts. Whether those expectations would prove to be correct or not, only time would tell.

Mr. Hickman believed that in an atmosphere of speculative change, based on uncertainty, the System should act as a stabilizing force. Accordingly, in the absence of definite evidence of overheating in the economy at this time, he recommended no change in policy. As he had frequently done in the past, he would recommend a more restrictive policy--or even an easier one--if he thought it would promote stable growth.

The average of net borrowed reserves of about $135 million over the past two weeks was about what he had recommended at the last meeting, Mr. Hickman said. He was not pleased by the jump in net borrowed reserves to above $200 million in the last week of September, when interest rates were rising sharply, but he assumed it reflected

the shortage of reserves in central money market centers. In any event, in his opinion the market at that time was too firm.

A substantial amount of tax anticipation bills would have to be digested in the next few weeks, Mr. Hickman continued, and that would be facilitated by stable, or perhaps slightly lower, intermediate and short rates. Specifically, he would like to see the 91-day bill rate between 3.90 and 4.00 per cent; net borrowed reserves below $150 million; and bank borrowings close to $500 million. Alternative A of the draft directives as originally written was acceptable to him, provided that it was not interpreted to mean a gradual creep towards a more restrictive policy. He did not favor an increase in the discount rate at this time.

Mr. Hilkert remarked that it was becoming more and more difficult to find pessimistic things to say about the Third District's economy. At the same time, it was increasingly easy to find evidence of pressures on District banks. Recently, output in manufacturing in the District compared favorably with national indicators, although steel production there had dropped faster than in the nation. Construction contract awards, both residential and nonresidential, had shown more strength in the District than nationally.

Despite the generally favorable environment, Mr. Hilkert said, the District's performance had not been without some shortcomings. The District had arrived at the current position by a somewhat different

route than had the nation. In the country as a whole, unemployment had declined because employment had increased faster than the labor force. About half the metropolitan portion of the District had followed that national pattern of expansion in 1965. The rest--not only the perpetual pockets of unemployment but also Philadelphia--had expanded less, and in a different way. Unemployment had declined, but the labor force had not grown. In other words, although unemployment had dropped sharply, in about half of the District people had not been drawn into the labor force. Moreover, in those same areas, increases in employment had been primarily in manufacturing. Growth of the economy had not been strong enough to spill over into secondary or supportive types of activity. All that would seem to imply that slack remained in some areas--notably in Philadelphia.

On the financial front, Mr. Hilkert continued, all six Philadelphia reserve city banks had hiked rates on savings and time deposits and had introduced new, high-yielding savings bonds. In a period of one month they had picked up $33 million. The high yield and attractive redemption feature seemed to be producing the results the city banks were looking for. Contrary to some public statements, the banks had not been motivated by an inability to compete against other savings institutions in the area or against banks in other money centers. On the contrary, even before the recent rate hike the banks

had been able to increase their share of total savings in Philadelphia and had been holding their own in comparison with reserve city banks throughout the nation.

Rather, Mr. Hilkert remarked, the increase in rates was related more to cumulative reserve pressures and rising strength of loan demand. The Philadelphia Reserve Bank's latest survey of bank lending practices highlighted the tightening that was going on in the District, especially in business loans. All banks reported that loan demand was stronger now than three months ago. And, for the first time, there was evidence that the banks were shifting toward price as a rationing device. Five out of six banks were taking a firmer attitude on interest rates on commercial and industrial loans. Two-thirds of the banks were seeking new business loans less aggressively. They reported further tightening in their policies concerning nonlocal customers, the applicant's value as a source of business, and compensating balances.

Other evidence of the tightening showed up in the basic reserve deficit, Mr. Hilkert said. The longer run drift clearly had been toward greater restraint--from a daily average deficit in January of $12 million to an average of $184 million during September. Borrowing over that period had increased greatly, especially in the Federal funds market. During January, Federal funds borrowing averaged $23 million daily; in September, $154 million. The loan-deposit ratio continued upward: from 71 per cent in January to 78 per cent by the

end of September at reserve city banks. Business loans had increased 15 per cent since the beginning of the year. During September, they rose 3.2 per cent, and bankers reported that the demand would stay strong for the rest of the year. In recent weeks reserve positions had eased somewhat, but financial markets in the District, as in the nation, were still unsettled and sensitive to shifts in market psychology.

Mr. Patterson reported two contrasting developments in the Sixth District. Measures of economic activity continued to show increases and, in some sectors, acceleration. Steel production in September topped the August output, and heightened activity characterized many industrial sectors, judging from the gains in nonfarm employment. Tightness in the labor market in August brought a jump in the average hours worked per week, with the gains heaviest in Florida and Tennessee. In banking, on the other hand, there might have been a slowing down of loan expansion. Business loan growth at the weekly reporting member banks in leading cities slowed in September and time deposits increased less than in previous months.

Mr. Patterson said that he would abbreviate the remarks he had prepared on national economic conditions because most of his points had already been made. He noted that the discussion at this meeting and the preceding one seemed to be centered on how the System should react to the upward pressures on interest rates. Before reaching

a decision on that point, he would like to have better explanations than seemed to be available at present of the forces behind the recent firming of rates, and of what could be expected if action of a major sort should be taken to further tighten credit. If the higher rates resulted from technical factors, temporary changes in expectations, and the like, that was one thing; if they were the result of stepped-up demands for credit, it was another. He did not think there were firm enough answers for a verdict that would do justice to the problem. At this point, the evidence did not seem conclusive enough to him to justify the kind of major change in policy that would be involved in raising the discount rate. Until the evidence was clearer, therefore, he would favor following the policy set forth in alternative A of the draft directive, amended to include, ". . . with a view to maintaining a firm tone in the money market."

Mr. Shuford commented that like Mr. Patterson he would not dwell on economic and financial conditions because they had been adequately covered this morning. As far as the Eighth District was concerned it continued to follow the national pattern of economic strength.

As to policy, Mr. Shuford said, he seldom attempted to look very far into the future and he hesitated to do so now, but his guess for the longer run was that it might be necessary for the Committee to move toward some further restraint. He also was inclined to think

that the next move probably should involve a change in the discount rate, but he was not prepared to say that such action should be taken now. He was pleased that there had been some firming in the market over the last few weeks. He thought, however, that the Committee needed more time to assess the strength of the demand for funds at current rate levels before it decided to tighten further.

For the moment, then, Mr. Shuford favored maintaining the somewhat firmer money market conditions of recent weeks. He certainly would not favor any easing. Both monetary and fiscal policy had been stimulative recently and the economy was operating close to capacity. Accordingly, he was inclined to believe that any relaxation of money market pressures would run the risk of promoting inflationary pressures.

Mr. Shuford remarked that he also hesitated to try to quantify policy targets; as had been observed, the Manager had heard the discussion at the meeting today and knew what the Committee's objectives were. Nevertheless, he would note that his thinking ran in terms of a three-month bill rate between 3.95-4.10 per cent, and a Federal funds rate around 4-1/8 per cent and probably fluctuating above that level. Under those conditions he would expect borrowings to continue in excess of $500 million. He would not suggest a target for net borrowed reserves; he agreed with those who had suggested that such reserves should be allowed to find their own level. He would hope that under the conditions described growth in the money supply would slow from

its recent rate. As for the directive, Mr. Shuford found alternative A as originally drafted more to his liking than the other suggested wordings because he thought it allowed more flexibility to the Manager. If language along the lines of Mr. Ellis' suggestion was to be adopted, however, he agreed with Mr. Wayne that the word "orderly" should be substituted for "stable."

Mr. Balderston said he would attempt to state the case for reexamining present policy. He thought his position at the moment would be found to be close to that of Mr. Daane.

Mr. Balderston then made the following statement:

Satisfactory as the System's monetary policy between the years 1961 and 1964 may appear in retrospect, it is appropriate to ask if the System should not now take steps to prevent steady business expansion from being undermined by interest rate distortions and by inflationary pressures. At stake is the continuance of the healthy expansion and the steady but tedious improvement of our competitive position abroad.

A number of highly publicized wage advances, including those in the automobile, aluminum, steel, construction, and maritime industries, have added enough to labor costs to encourage larger and more widespread "selective" price advances. Wage pressures combined with Government spending for war and welfare activities both suggest to businessmen that things will cost more later on than now. In the face of favorable business forecasts it is inevitable that many should increase both inventories and plant investment.

What are the symptoms of instability that can already be seen?

(1) For some months production in excess of end use has caused inventories to grow.

(2) Both actual plant investment and investment plans continue strong. Rising expectations are encouraging further marked increases in plant and equipment outlays, and they are already at a high level--up 28 per cent in the two years from the third quarter of 1963 to the third quarter of this

year, and up 12 per cent from the third quarter of last year. Consumer outlays for goods, meanwhile, have risen only about half as much--14 per cent and 6 per cent. Production of business equipment by August was nearly 60 per cent above the 1957-59 average, while output of consumer goods was up about 40 per cent. Further widening of this difference would be likely to lead eventually to over-capacity and consequent sharp curtailment of equipment outlays, even though many outlays are for modernizing rather than expanding plant.

(3) Business loan activity is exceptionally heavy. The annual rate of increase exceeds 20 per cent. Rising expectations encourage borrowers to borrow and lenders to lend--at rising interest rates. Bank credit expansion for some time has been exceeding the rise in dollar GNP and threatening our noninflationary economic growth. Security-market yields higher than rates charged to bank customers divert long-term credit demand from the open market to the banks. This structural disequilibrium in interest rates tends to undermine our financial stability by further encouraging the expansion in bank credit and money.

(4) Stock market trading volume has mounted sharply and prices have climbed this week to historic highs. In September the average of 6.7 million shares was about 50 per cent above that of August and 40 per cent higher than that for 1965 through August. Furthermore, recent trading has featured some highly volatile stocks, thus giving evidence of speculative participation in the market.

(5) Last, but not least, the war in Vietnam has now expanded to the point where it has erased any lingering bearish uncertainties, and manufacturers currently expect it to increase Federal spending considerably at the same time that it impinges upon the supply of useful labor.

What are the implications of these symptoms of developing instability? They have contributed to, and been reinforced by, the wave of heady business optimism. Such optimism almost always overreaches itself, and gives rise to overextended investment efforts and price mark-ups that are greater than can be sustained by the level of final demand. Two incentives in particular have been pushing up investment outlays; the desire to keep labor costs from rising, on the one hand, and the yearning for new markets, on the other. For many businessmen, an obvious way to serve both of these objectives has been to build new plants close

to foreign markets, and the result has been a major drain in the direct investment account in our balance of payments.

Business outlays both at home and abroad have now grown to the point where they are exceeding the internal generation of funds, and businesses are turning increasingly to banks and to the capital markets for financial assistance. So, with less reason, are many State and local governments whose spending proclivities have been outrunning their ability and willingness to tax. Abetted by the abundant availability of credit from banks eager to buy their securities, these governments have been engaged in deficit financing that since 1963 has exceeded the Federal Government's total debt increase.

In this kind of financial environment, I submit that an important degree of monetary restraint is called for, both for domestic and balance of payments reasons. To be sure, we have had an appreciable degree of firming in most credit markets since the end of July. But ironically, that firming has had the least effect upon the availability of prime-rate bank credit. Yet this is the cheapest and the most open-ended source of external funds available to the large firms who are chiefly responsible for the great bulge in both domestic and overseas investment by American businesses.

This development, I would point out, is in contrast to the more normal cyclical experience, in which the prime rate increases more than other bank lending rates. This process provides about the only effective resistance banks can mount against the loan demands of their most powerful corporate customers. In the current expansion, however, not only has there not been any such positive rate deterrent to prime-customer borrowing at banks, but the artificial stability of the prime rate in the face of rising corporate bond yields has provided a powerful extra incentive for big firms to borrow from banks, both short-term and long-term.

We have to recognize that the consequence is to force banks to impose just that much more restriction on the availability of their credit to other and smaller borrowers. Moreover, while this discriminatory influence has been at work on the loan side of bank balance sheets, smaller banks have also been the first to find their ability to solicit time deposits inhibited by Regulation Q ceilings. Since smaller

banks generally lend to smaller borrowers, the Q ceilings also have worked to favor most those bank customers who least need assistance, and to hurt most those who are most in need. However well-intentioned public policy has been, it has served to increase the discriminatory impact of the degree of credit restraint presently prevailing. Given the stimulation of more prime-customer borrowing created by business ebullience, such discrimination is likely to increase unless remedial action is taken.

In these circumstances, it seems to me it is incumbent on the System to act if the problem of timing can be solved. I think our most therapeutic action would be two-fold: an increase in the discount rate, accompanied by a similar increase in Regulation Q ceilings. These steps should be beneficial in several ways. The psychological impact of our higher discount rate, and attendant higher money-market rates, should help to calm business exuberance at home, and hopefully lead to reconsideration of some planning now in progress for still further capital investment, inventory additions, and price increases. Internationally, we should win a new measure of confidence in the dollar, and perhaps create interest rate incentives to investment in the U.S. Assuredly, most banks would follow with increases in the lending rates charged their best business customers, thereby redressing both the present rate distortions vis-a-vis smaller borrowers and the cost of funds in the capital markets. Finally, the higher Q ceilings should restore a range of flexibility for bank time-deposit rates, and the probable higher cost of time money might induce a review by banks of the liberality of their current lending policies.

Fitting such actions into the skein of other official actions for Fall would require adroit timing and execution. With one Treasury financing just completed, another due to be announced about October 27 for payment in mid-November, and a third tentatively listed for late November, about the only times at which the System could take action would be either in the week of October 18 or conceivably just after the November refunding (November 15) and before the third financing around the end of November. A policy action about October 18, however, would appear to interfere less with market distribution of Treasury financings.

If changes in discount rates and Q ceilings were made, they would undoubtedly generate some immediate market reaction. The Account Manager would need to moderate any extreme reactions without preventing orderly adjustments. It might even prove necessary for him to produce somewhat

smaller net borrowed reserves for a few weeks in order to moderate bank and credit market adjustments to the higher rate charged for borrowed reserves.

Chairman Martin commented that he believed in the deliberative processes of the System and had never tried to use his position as Chairman to exert one-man leadership on matters of policy. His position ordinarily was not crystallized until he had heard the discussion around the table, and as the Committee knew it was his practice to speak last. At this juncture he was concerned about creeping inflation. While the evidence was not clear, he thought there were many signs of inflation and of inflationary psychology in the economy. His judgment of the Committee's record differed from that of Mr. Maisel; in his opinion policy changes had tended to be too late rather than too early. One virtue of monetary policy was that it could be flexible, changing quickly to meet changing circumstances. But the Committee had a tendency to feel that it was best to "wait until all the evidence was in" before making a policy change. The difficulty was that when all the evidence was in it was likely to be too late. While he could not be certain of his judgment he thought that might be the situation the Committee faced now.

Nevertheless, the Chairman thought the Committee should not make a policy change today. As Chairman, he had the responsibility

for maintaining System relations within the Government--for getting the thinking of the President and members of the Administration, and for apprising them of the thinking within the Committee--and he had made that one of his principal concerns during the fourteen years he had held his present office. Last week he had given the President a paper expressing his personal views, which he proposed to read to the Committee shortly. Also, since the last meeting he had talked with the Chairman of the Council of Economic Advisers, with Treasury officials, and with the President. They all had expressed the view that it would be unwise to change monetary policy now. The President had not taken a rigid position on the matter--he had not suggested that the Committee should abdicate its responsibility for formulating monetary policy--and the Council and Treasury officials were continuing to consider their position actively. At the moment, however, the Administration was strongly opposed to a change in policy. From the discussion today it was evident that the Committee itself was divided in its views. With a divided Committee and in face of strong Administration opposition he did not believe it would be appropriate for him to lend his support to those who favored a change in policy now. At the same time, it should be borne in mind that the role of the System was involved: certainly he did not believe the Committee should become subservient to the Council of Economic Advisers or to the Treasury, nor that it should follow an unchanged policy at all times.

The Chairman went on to say that there were two facets of the present situation that had to be considered--the economic and the financial. Perhaps, as Mr. Noyes had concluded, a clear case could not be made for a policy change on economic grounds. But he thought there was a clear case on financial grounds. A policy move would help overcome the distortions that followed from the interference in the market process last year, when some banks that had announced prime rate increases rescinded them after the President had expressed his disapproval of the increases. He thought the President's action had been a mistake--as he had told him on several occasions--because it put the matter of interest rate determination into a political framework.

In the Chairman's judgment the role of interest rates was being exaggerated out of all reasonable proportions. The country's foreign friends, while not attempting to influence decisions here, seemed to have been united in that opinion at the recent Bank-Fund meetings. The head of a large domestic corporation recently had expressed to him the view that a 1/2 per cent increase in interest rates might have some slight effect on housing and utilities but otherwise would have little impact on the economy and would have no implications at all for his company's operations.

As was clear from the discussion at the last meeting, the Chairman said, the Committee was attempting to resist a trend resulting from market forces. He was confident that the Manager had been doing

everything possible to carry out the Committee's instructions, short of destroying those forces. Perhaps the Committee should dampen some of the market forces, but he did not think it should operate in terms of the level of interest rates alone. To continue the attempt to keep interest rates from rising would be to approach the pegging operation conducted until 1951 and to restrict the flows of funds. He held no particular brief for bankers--for one thing, he thought many had exercised poor judgment in their competition for time deposits--but the distortions were real and one unfortunate consequence of them was that small borrowers were being discriminated against.

At some point, the Chairman continued, it would be desirable to clear up that situation. He hoped that action by the Committee would not be delayed to the point that inflationary pressures became so dominant that monetary policy could do little to counter them. He also hoped that the debate about the role of monetary policy in dealing with the balance of payments problem could be shifted away from the question of whether the deficit could be entirely overcome by interest rate action alone. Like almost everyone else, he did not believe that was possible.

Chairman Martin then read the following paper which he had presented to the President on October 6, 1965:

Memorandum for The President.

Too much emphasis is being put on interest rates.

The real problem is to keep funds flowing freely and effectively to sustain healthy progress in the economy.

Whether interest rates move a bit higher--or a bit lower--is not of cardinal importance to the economy.

What is important is whether rates are allowed to respond to market forces so that an effective flow of funds is assured.

The trouble confronting us is that rate ceilings--governed by policy determinations--are proving obstacles to the flow of funds in accordance with natural forces.

And the most immediate obstacle is the ceiling not on the rate that banks may charge borrowers but on the rate they may pay depositors to attract funds that the banks need in order to expand their loans.

Specifically, this is the way matters stand:

> In vigorous competition to attract funds to meet increasing loan demands, banks have been offering higher and higher rates for certificates of deposit.
>
> But under ceilings imposed by the Federal Reserve's Regulation Q, going back to November in 1964, banks are forbidden to pay more than 4-1/2 per cent to obtain deposit funds.
>
> Some of the leading financial-center banks are paying the top rate already, and cannot now go any higher to attract further funds.
>
> Banks with lesser standing, especially those outside the chief financial centers, are being hard-pressed even to hold present deposits, much less to gain added deposits, since the ceiling puts them at a competitive disadvantage with financial-center banks of higher credit standing.
>
> These impediments are being reflected in the credit distribution process in a way that is distinctly adverse to smaller borrowers.

This obstacle to the attraction of funds for lending could be overcome by lifting the 4-1/2 per cent maximum rate that banks presently may pay for deposits.

But two other things would logically be required:

1. A simultaneous increase in the 4 per cent discount rate that member banks presently must pay on their borrowings from the Federal Reserve, lest the widened disparity impel these banks to converge on the Federal Reserve as the cheapest possible source of funds.

2. A greater willingness to recognize that, if banks find it more costly to obtain the funds needed to expand their loan volume, they will either (a) charge more for new loans, to recoup their higher costs, or (b) show less interest in meeting new loan demand, since that would entail increased risk for a smaller net return.

The disadvantage of the course outlined would, quite obviously, be higher interest rates. But there would be these outweighing advantages:

> Far from restricting the flow of funds to meet mounting loan demands, the higher rate structure would open up a freer, more effective flow of funds in response to the most economically justified borrowing demands. The position of smaller borrowers would clearly be improved.
>
> With this freer, more effective flow of funds that are already available in the economy, economic growth would be made less dependent on a burgeoning stream of newly created money and--in consequence--made less vulnerable to dangers of inflationary developments that would end growth, and bring recession.
>
> While these dangers can be debated--one is always confronted by the statistics that are not there--rising expectations, evidenced in financial markets and real investment, and price warnings suggest slightly higher interest rates would prove beneficial to sustaining and stretching out the expansion. And our present balance of payments picture suggests the further advantage of needed reinforcement of the voluntary program in the manner outlined.

The Chairman then said that he hoped the Committee members would continue to concentrate on the problem and on the many imponderables in the economic situation. Perhaps the chief question

concerned the size of the Federal budget, which would remain uncertain until more was known about the probable impact of the hostilities in Vietnam. How much stimulus Vietnam would give the economy was still conjectural, but he was inclined to think it was likely to be larger, rather than smaller, than the current guesses. In any case, the possibility of a "fiscal drag" in 1966 under discussion a short time ago seemed to have been completely eliminated. As had been noted, if the Committee made no policy change now the question probably would have to be carried over until late in the year.

Turning to the question of the directive, the Chairman commented that Mr. Ellis' observations on the matter of clarity were well taken. The passage Mr. Galusha had quoted also was much to the point; at times the Committee had to choose between interest rate and reserve targets and could not have it both ways. He continued to feel that "money market conditions" could not be defined in specific terms. For today's directive, he could accept alternative A as suggested by the staff or with the amendments proposed by Mr Ellis and Mr. Wayne. Subjective interpretations of words were involved, but to him the implications of the amended language were no different from those of the original draft.

Mr. Hayes said that he had some question about using the term "orderly conditions" in the directive because of the Committee's standing policy to prevent disorderly conditions. Moreover, he was particularly dubious about the desirability of introducing

the term today, after the threat of disorderly conditions had faded. Several members concurred in Mr. Hayes' statement.

Mr. Young commented that similar points could be made with respect to the term "stable conditions." He proposed that the directive simply call for "maintaining a firm tone in the money market."

Mr. Mitchell asked whether Mr Holmes would interpret the language Mr. Young suggested as calling for no change in policy. Mr. Holmes replied that he would, on the understanding that there might still be considerable variation among the various elements making up the complex of money market conditions.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity has expanded further in a continuing climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit on the "regular transactions" basis since midyear. 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 Treasury financing schedule, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining a firm tone in the money market.

In voting favorably, Mr. Ellis said he would like to quote a few lines from the same authority as Mr. Galusha had:

> ... I admit that interpretation would be easier and more useful if every directive were straightforward and precise. I agree that maximum effort should be devoted to achieving this result.

Chairman Martin then said that he thought it would be desirable to move forward with the study of the dealer market in Government securities that the Committee had discussed in August of this year. If there were no objections he would appoint five persons from the System to the Steering Committee for the study. He would expect them to be joined by officials of the Treasury, including Secretary Fowler (ex officio) and Under Secretary Deming to serve actively.

No objections being heard, Chairman Martin named Messrs. Daane, Ellis, Hayes, and Mitchell to the Steering Committee, and himself as Chairman.

Chairman Martin then noted that members of the staff had been discussing possible means for improving some of the reports prepared at the Board for the Committee's use. He invited Mr. Brill to comment.

Mr. Brill said that the staff had received informal comments

from some Committee members about deficiencies in certain documents prepared by the staff prior to each meeting, including the green book[1] and the questions and comments. With respect to the latter, for example, it had been said that the questions had fallen into a rut, with little change from meeting to meeting in the issues raised; and that the comments were received too late to be of much use to the members in preparing for the meetings. Among the criticisms of the green book were that it often involved "number reading" rather than analysis, and that it had inadequate scope and perspective, focusing on details rather than on the overall picture. Also, both documents were said to be insufficiently forward-looking.

He might say, Mr. Brill continued, that the staff welcomed such criticism; it liked to know whether or not it was being as helpful as possible to the Committee. Also, the staff not only was inclined to agree to some extent with those criticisms but could add a few of its own. In defense, however, he would note that it was extremely difficult to be profound, detailed, global, and penetrating every three weeks, given the rates at which the economic situation changed and at which new data became available. Nor did the staff feel that it was able to provide a full interpretation of all the links in the economic process. A System-wide investigation of those links was now underway, and he thought the System was about

1/ The report, "Current Economic and Financial Conditions."

as far along in such research as was the economics profession generally. Academic economists who had participated in some of the staff work agreed that the System's research into linkages was moving along at a good pace. However, the research was far from complete.

As to the criticism that the questions had fallen into a rut, it seemed to Mr. Brill that as long as the Committee's policy discussions focussed on the same issues--such as prices, inventories, interest rates, and so on--it was appropriate for the staff to continue to pose questions in those areas. The question-comment procedure had been introduced at the suggestion of Mr. Robertson and of some staff members, and for a time it seemed to have been employed to some extent as a framework for the Committee's deliberations. That had been less true recently, although some Committee members evidently believed the procedure still was useful.

After considering alternative means for adapting procedures to meet such criticisms, Mr. Brill said, the staff would like to suggest a change in procedure for the Committee's consideration. The proposal was to combine the green book and the questions, using the latter as the framework for much of the analysis presented in the green book. The green book would not be limited to comments on the questions; other background information not directly pertinent to the policy issues posed would still be included. Also, comments on the usual final question, relating to the interrelationships among

money market variables, would continue to be distributed at the latest possible moment because of the volatility of the elements involved. He was not sure the procedure would work, but perhaps it was worth exploration. He would like to know whether the Committee thought such a procedure would be more helpful to it than the present one.

Mr. Wayne said that, as one who had made some criticisms, he would favor experimentation with the suggested new procedure. His criticism had been directed to the fact that the questions had tended to become routine and in the main were no longer discussed by the Committee. Thus, there was a loss of connection between the staff comments and the Committee's deliberations, and the practice of including the questions and comments in the minutes lent more weight to the staff's responses in the historical record than he thought was desirable. He was not critical of the green book, which he considered useful.

Mr. Scanlon concurred in Mr. Wayne's remarks. Since the questions and comments were being used less by the Committee they had become a needless burden on the staff. He also would applaud the green book, and he favored the proposed experiment.

Mr. Hayes remarked that he felt much as Messrs. Wayne and Scanlon did. He would stress from his viewpoint the green book was more useful than the questions and comments, and while he saw no

objection to the experiment he would hope that it would not involve much curtailment of the present scope of the green book.

Mr. Mitchell said he thought the reason the questions had become sterile was that they often were not closely related to the issues that in fact most concerned the Committee in its discussion at the meeting. He was not sure whether the staff could predict accurately the issues the Committee would focus on, but if it was possible to do so and to work analyses of those issues into the green book he would favor such a course. In his opinion the green book had an excessive amount of verbalization of figures that could be obtained from tables. But he thought it had established itself as an extremely useful document and he would not want to lose any of its valuable content. Also, he would favor an effort to make it available earlier than at present.

Mr. Hickman said he thought the green book had been substantially improved over its earlier form, but there was room for further improvement. It was somewhat uneven; some parts contained helpful analysis, but some were less useful. He was a little concerned about the proposal to incorporate the questions and comments into it; that might result in the omission of materials on important subjects that should be before the Committee every time, such as developments in GNP and prices, and international conditions. Since he was not sure that the proposed experiment would work out well,

he would favor an effort to bring the weaker parts of the green book up to the level of the most useful parts.

Mr. Maisel said he thought the green book should be organized around a series of standard questions, standard tables, brief commentaries, and analytical appendixes. Much of the material now presented in full paragraphs could be compressed to advantage into single sentences. He would hope that the analytical appendixes covering nonrecurrent subjects would continue.

Mr. Galusha said he found the green book tremendously useful and hoped that it would not be curtailed materially. To the extent that the questions were related to the subjects that the Committee actually discussed they also had been highly useful to him and to his staff in preparing for the meetings. Their main value was in pinpointing emerging issues.

Chairman Martin commented that he thought this discussion would be of some help to the staff in working out new procedures.

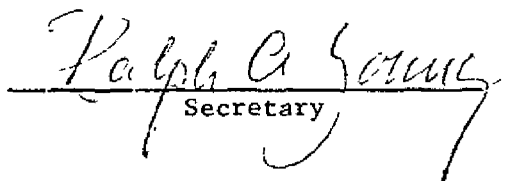
Mr. Brill noted that the staff might find it desirable to spend some time in experimenting with possible formats.

It was agreed that the next meeting of the Committee would be held on Tuesday, November 2, 1965, at 9:30 a.m.

Mr. Hayes noted that both this meeting of the Committee and the next meeting were scheduled for days that were holidays in some

of the Reserve Districts. He said that he hoped in working out next year's schedule, the Secretariat would keep in mind the holidays that were observed in the various Reserve Districts.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

CONFIDENTIAL (FR) October 11, 1965

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 12, 1965

Alternative A (no change)

The economic and financial developments reviewed at this meeting indicate that overall domestic economic activity has expanded further in a continuing climate of optimistic business sentiment and firmer financial conditions, and that our international payments have been in deficit on the "regular transactions" basis since midyear. 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 Treasury financing schedule, 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 since the preceding meeting.

Alternative B (firming)

The economic and financial developments reviewed at this meeting indicate that overall domestic economic activity has expanded further in a continuing climate of optimistic business sentiment, and that our international payments have been in deficit on the "regular transactions" basis since midyear. In domestic credit markets demands have been strong and interest rates have been under some upward pressure. 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 Treasury financing schedule, System open market operations until the next meeting of the Committee shall be conducted with a view to reinforcing the firmer conditions in the money market that developed in September.