A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, September 13, 1966, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Bopp
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Hickman
Mr. Irons
Mr. Maisel
Mr. Mitchell
Mr. Robertson[1/]
Mr. Shepardson

Messrs. Wayne, Scanlon, and Swan, Alternate Members of the Federal Open Market Committee

Messrs. Ellis, Patterson, and Galusha, Presidents of the Federal Reserve Banks of Boston, Atlanta, and Minneapolis, respectively

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hexter, Assistant General Counsel
Mr. Brill, Economist
Messrs. Eastburn, Garvy, Green, Koch, Mann, Partee, Solomon, Tow, and Young, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Fauver, Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors

1/ Entered the meeting at the point indicated.

Mr. Reynolds, Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Mr. Lewis, First Vice President, Federal Reserve Bank of St. Louis
Messrs. Eisenmenger, Ratchford, Brandt, Baughman, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, St. Louis, and San Francisco, respectively
Mr. MacLaury, Assistant Vice President, Federal Reserve Bank of New York
Mr. Meek, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the action taken by members of the Federal Open Market Committee on September 9, 1966, amending paragraph 2 of the authorization for System foreign currency operations to read as follows, was ratified:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign Bank	Amount of Arrangement (millions of dollars equivalent)	Maximum Period of Arrangement (months)
Austrian National Bank	100	12
National Bank of Belgium	150	12
Bank of Canada	500	12
Bank of England	1,350	12
Bank of France	100	3
German Federal Bank	400	6
Bank of Italy	600	12
Bank of Japan	450	12
Netherlands Bank	150	3
Bank of Sweden	100	12
Swiss National Bank	200	6
Bank for International Settlements (System drawings in Swiss francs)	200	6
Bank for International Settlements (System drawings in authorized European currencies other than Swiss francs)	200	6

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period August 23 through September 7, 1966, and a supplemental report for September 8 through 12, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury said that, on Mr. Coombs' behalf, he would first like to summarize briefly the negotiations that preceded the public announcement today of the $1.7 billion increase in the System's reciprocal credit facilities, from $2.8 billion to $4.5 billion. (A copy of the press announcement, dated September 13, 1966, has been placed in the files of the Committee.) At its last meeting the Committee had authorized Mr. Coombs to negotiate an enlargement of the network subject to the understanding that negotiations were not to proceed until the Board of Governors had received specific notification from the Secretary of the Treasury that the proposed program was fully consistent with United States international financial policy and that the timing was appropriate. While the Treasury had initially expressed sympathy with the Special Manager's proposal simply to negotiate large increases in the swap lines, subsequently the proposal was altered by grafting on additional elements involving direct credits to the U.K. by other central banks. The Special Manager strongly opposed this alteration since he was convinced that it would greatly increase the resistance of the Europeans to the package. Whereas the System's partners in the swap network were prepared to go along with large increases in the reciprocal credit lines with the Federal Reserve, they were exceedingly reluctant to increase their direct aid to the U.K. at this time. Moreover, the need to negotiate an additional $400 million of direct credits involved from the start cutting back the size of the increases that could be negotiated in the System's swap network, thus reducing the potential total from the $5.2 billion originally contemplated. In effect, the United States sacrificed permanent protection for the dollar for the sake of a temporary three-month increase in facilities available directly to the U.K.

As anticipated, Mr. MacLaury continued, the negotiations were difficult in the extreme. Although in the end the package did prove negotiable, the Special Manager believed that the frictions caused by the efforts to raise the $400 million in direct credits to the U.K. cost the U.S. and international financial cooperation more than had been gained by that temporary contribution. One "cost" to the U.S. became apparent immediately. Whereas in the past all increases in the swap lines had been considered by both parties to be more or less permanent additions to the network, on this occasion a number of the continental countries had specified that the increases were to be considered only temporary. That was notably the case with the Netherlands and Belgium, both of which specified that the $50 million increases in their lines were not to be considered automatically renewable in December. In part, that attitude simply reflected the desire of those smaller countries to subject the United States to closer multilateral surveillance in Working Party 3 or the Group of Ten where their voices carried greater weight than in bilateral negotiations. Italy and Germany also indicated that the respective increases in their lines ($150 million each) were to have a term of six months. In contrast with the Netherlands and Belgium, however, Italy and Germany seemed prepared to rely on the less formal multilateral surveillance procedures that now took place at the Basle meetings. At the moment, therefore, Mr. Coombs believed that the increases in the swap lines with the Bank of Italy and the German Federal Bank could be renewed at maturity without undue difficulty. If the Dutch and the Belgians insisted on subjecting the $50 million increases in their lines to formal multilateral surveillance procedures, Mr. Coombs believed the System should simply not ask for their renewal. That issue, of course, did not have to be resolved at the moment.

Turning to recent developments in gold and the exchange markets, Mr. MacLaury reported that the Treasury gold stock would remain unchanged this week. As things stood now, the Stabilization Fund did not have enough gold on hand to meet anticipated sales during the remainder of September if France converted its August dollar gains--which amounted to $45 million prior to their $49 million gold subscription payment to the International Monetary Fund--into gold. There was a chance that the U.K. might sell the U.S. additional gold, so it was uncertain at the moment whether there would be a drop in the stock this month. With respect to the London gold market, conditions had not improved noticeably since the last meeting. Demand remained steady with the price not far below $35.20, and Communist China had reappeared as a buyer, although in very small amounts thus far. One helpful development had been the tapering off during the past month or so of South African reserve gains, with the result that a larger proportion of new production had been available to the market. Nevertheless, the gold pool had continued to lose small amounts fairly steadily. As arrangements stood prior to the recent negotiations, there would have been less than $60 million still available to the pool from the participating central banks. At the meeting in Basle two weeks ago, however, it was agreed to increase the total amount of the commitments by $50 million to $320 million, with a possible further $50 million increase available if needed, after further consultation. In general, it was fairly clear that high interest rates had been an important factor in keeping private demand for gold lower this year than last. Any falling off of interest rates, therefore, could be expected to lead to an increase in demand for gold.

Mr. MacLaury commented that tight credit conditions and high interest rates, particularly in the Euro-dollar market, had also had a significant impact on the exchange markets. The dollar had shown surprising strength against most major currencies despite the continuing U.S. payments deficit, precisely because private foreigners had had a substantial interest incentive to hold on, for the time being at least, to the dollars they earned. That strength was reflected not only in exchange rates but in foreign central bank intervention. For example, for the first time in a number of years the Bank of France had actually sold dollars to support the franc in Paris during the past few weeks. Similar support operations by the Belgian National Bank caused it to buy $20 million from the Federal Reserve against francs, thus enabling the System to repay that amount of the $30 million drawings previously outstanding under the Belgian arrangement. On the other hand, Italian reserve gains this summer, while smaller than anticipated, had nevertheless been substantial; and on September 2 the System again drew $100 million under the arrangement with the Bank of Italy to absorb part of their recent accruals.

Although the attractiveness of foreign interest rates had also been a factor in sterling's continued weakness, Mr. MacLaury observed, the causes in that case, of course, went much deeper. Despite the drastic measures announced by Prime Minister Wilson in late July, there had been no return of confidence, and the Bank of England had to provide further support during August. The actual drain on British reserves in August amounted to about $300 million. The announced reserve decline was $53 million, with foreign credits making up the difference, plus the refinancing of earlier month-end credits. The U.S. Treasury provided $400 million of the refinancing on the basis of an overnight credit at the end of August, and the Federal Reserve made available $100 million--$50 million under the swap arrangement, bringing the U.K. total drawings to $300 million, and $50 million on an overnight basis. It was hoped that today's announcement showing that the U.K. still had available more than

$1 billion under its expanded facility with the System, plus additional credits from other central banks, would help turn market sentiment and stem the continuing erosion of recent weeks. In any case, the announcement of the very large general increase in Federal Reserve reciprocal credit lines should do much to insure market confidence in the ability of monetary authorities in general and the U.S. in particular to deal with speculative threats to their currencies.

In concluding, Mr. MacLaury said that he would like to call one other matter to the Committee's attention--a $75 million drawing on August 30 by the Bank for International Settlements on its facility with the System providing for swaps against European currencies other than Swiss francs. As the Committee was aware, for some years the System had had a $25 million gold loan facility with the BIS to permit financing of short-term dollar drains. From its inception the System's swap line with the BIS was less clearly a two-way street than its other swap lines and, for that reason, he thought it was useful to have the BIS employ the facility.

Mr. Daane said he would like to pay special tribute to the Special Manager for the way in which he had conducted the recent negotiations; Mr. MacLaury's account did not give the full flavor of the difficulties Mr. Coombs had faced nor of the skill he had exercised in negotiating the package. In spite of his (Mr. Coombs') reservations as to the appropriateness of some elements of the package, he had carried out his instructions to the letter.

Mr. Daane observed that to some extent he shared Mr. Coombs' feeling that a Pyrrhic victory might have been won in persuading the Europeans to extend $400 million additional direct credits to the U.K. One cost was that the enlargement of the System's own network was smaller than it might otherwise have been; and a second, longer-run, cost was that the System had been brought one step closer to more formal multilateral surveillance for the entire swap network. At the same time, Mr. MacLaury's report might not have done full justice to the rationale of seeking the direct credits to the U.K. It was not simply a matter of getting $400 million more assistance to the British; the main objective was to make the new assistance package multilateral, rather than have the U.S. take a unilateral action.

Mr. Brimmer agreed with Mr. Daane that the System probably was moving in the direction of greater multilateral surveillance, although he hoped that could be avoided. In any case, he wondered whether WP-3 was the best group for that purpose. WP-3 was originally established as a purely technical forum. If basic questions of international policy were to be discussed the Committee might want to give some thought to the appropriate forum.

Mr. Daane commented that the August, 1964 report of the Governors and Ministers of the Group of Ten, in the preparation of which the U.S. had participated, quite clearly assigned a multilateral surveillance role to WP-3, although it did so in the expectation that the surveillance would be more informal than that which now appeared to be developing. Thus, in a sense that bridge had been crossed some time ago, although not necessarily correctly. At the same time, that report also assigned a surveillance role to the Basle group, as was noted in the Ministers' and Governors' more recent report, of June 1966.

Mr. Hayes noted that there had, in fact, been a substantial amount of multilateral surveillance at Basle. Moreover, it was the distinct wish of a majority of Governors attending the Basle meetings to confine surveillance to their group.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period August 23 through September 12, 1966, were approved, ratified, and confirmed.

Mr. MacLaury then noted that a $50 million drawing by the Bank of England on its swap line with the System would mature on September 30, 1966. He recommended its renewal for a further period of three months if the Bank of England so requested. That would be a first renewal.

Renewal of the Bank of England's drawing was noted without objection.

Mr. MacLaury reported that two $50 million System drawings of Swiss francs, on the Swiss National Bank and the Bank for

International Settlements, respectively, would mature on October 13, 1966. He recommended their renewal for a further period of three months if no opportunity arose for their repayment in the interim. Both would be first renewals.

Renewal of the two Swiss franc drawings was noted without objection.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period August 23 through September 7, 1966, and a supplemental report for September 8 through 12, 1966. Copies of both reports have been placed in the files of the Committee.

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

> Since the Committee last met the capital markets have passed through a state of near disorganization with prices of Government, corporate, and municipal bonds declining precipitously until August 30. On that day, following a statement by a Treasury official that was generally interpreted as foreshadowing a change of Administration thinking on fiscal policy, a sharp and sustained rally took place that brought yields on intermediate- and long-term bonds back below where they had been three weeks ago. The hectic daily swings in prices and yields have been spelled out in some detail in the regular written reports to the Committee and I will not dwell on them here.
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> The President's announcement of a new anti-inflationary program, involving both fiscal and debt management policy, at the close of business last Thursday, came at a time when the market rally was running out of steam. In general,

after some initial skepticism, there was a favorable psychological reaction in long-term markets. This reaction was based mainly on relief that the Government had recognized the seriousness of inflationary pressures and the pressures of agency financing on financial markets. While the President's program was generally considered a step in the right direction, there were many questions in the market as to its adequacy and its eventual impact on spending decisions, both Governmental and private. Most market participants felt that the program was not forceful enough to warrant any early change in Federal Reserve policy, although many also felt that the System had again been put squarely on the political hot seat. The Board's statement of September 7 was generally interpreted as a reaffirmation of the System's policy of restraint, although there are a number of observers who will be watching closely for any evidence of easing in System policy.

At the moment, the long-term markets are in better shape than they were three weeks ago. The risks of panic have greatly diminished, although major uncertainties remain and the market will continue to respond to developments in Vietnam and elsewhere in the international sphere. The municipal market benefited also from the Board statement on discount window administration, which was generally interpreted as tending to discourage bank sales of municipals. The corporate market may again come under pressure later, particularly if bank credit to business borrowers is significantly curtailed, but a better atmosphere prevails for the time being.

In contrast to the situation in long-term markets, short-term rates remain under pressure. Banks and corporations both have liquidity problems which are likely to be keenly felt over the tax and dividend dates. Banks have a particular problem with the heavy volume of CD maturities and we are getting close to another interest payment period at savings institutions at a time when market rates are higher than at the end of June. There has been little evidence yet of any large scale recourse to the discount window on the part of the money center banks which have moved into deep basic deficit--a deficit caused in part by heavy Treasury calls on tax and loan balances. On the other hand, the Federal funds rate moved to an effective rate of 6 per cent last Wednesday with a heavy volume of trading at 6-1/8 per cent and, on Friday, to an effective rate of 6-1/8 per cent with a fair volume at 6-1/4 as well. As a result of pressure on the banks, dealer loan rates have moved into the 6-3/8 - 6-5/8 per cent range with loans simply not available at some banks.

In the Treasury bill market a heavy atmosphere prevails and rates have penetrated into new high ground. Dealer bill inventories are higher than they have been in some time as the result of bank selling, particularly of the new tax bills sold by the Treasury in late August. Bidding in yesterday's auction was very skittish and the average issuing rates set on the new three- and six-month bills were about 5.45 and 5.93 per cent, respectively, up 43 and 52 basis points from the rates set three weeks ago.

The Treasury's press conference on Saturday on the probable course of agency financing over the rest of the calendar year implies, of course, a much higher level of direct Treasury borrowing than had been expected earlier this year, and this has been a major longer-run factor contributing to yesterday's higher Treasury bill rates. It is, of course, impossible to pinpoint at this moment what will be added to the Treasury's borrowing needs. Regular Treasury spending has been running on the high side of late, and a quantitative estimate of the new spending restraint, and particularly the timing of it, is hard to come by. The suspension of FNMA and Export-Import Bank sales of participation certificates may add as much as $2 billion to direct Treasury borrowing and the limitation on net market borrowing by all Government agencies to the replacement of maturing issues will add another substantial amount.

The new financing approach should provide, overall, a more orderly marketing of debt, but it will still require great ingenuity on the debt management side. At this juncture, we can only hope that agency financing programs can be pared back, but plans to assist the mortgage market and the reduced cash flows of savings and loans institutions may make this hard to accomplish. For the System, the new financing approach will probably involve more important even keel considerations over the rest of the year, although not much can be said about this until a financing schedule can be worked out.

At the moment, of course, the Treasury is running with a very low cash balance. Deposits at the Federal Reserve Banks are estimated at only about $200 million tomorrow and uncalled balances at commercial banks are at a minimum. Our best estimates are that the Treasury can just barely avoid borrowing directly from the System through an adroit juggling of its commercial bank deposits, but even a normal miss in the day-to-day estimates could lead to an overdraft in the next few days. Given the increase in Treasury cash needs it is likely that the Treasury will be running with lower than usual cash balances over the remainder of the year and this could lead to recurring problems in this area.

As far as open market operations are concerned, the System has provided reserves over the past three weeks to offset the reduction in float brought about by the settlement of the airlines strike and the pre-Labor Day drain of reserves. The state of near disorganization of the Government securities market also required attention and a large volume of Treasury bill purchases was necessary early in the day on Monday, August 29, in view of the nervous conditions then prevailing in the market. With the improvement in atmosphere on the afternoon of August 30, an effort was made to recapture redundant reserves through the execution of matched sale-purchase transactions which again proved to be a very useful tool. As a result, the net borrowed reserve figure published for the week ending August 31, $422 million, was well within the recent range, although it was subsequently revised substantially lower. Since then money market conditions have continued to be tight with Federal funds, dealer loan rates, and Treasury bill rates moving higher, as indicated earlier.

The current statement week, ending tomorrow, has been plagued with a highly skewed intra-weekly pattern--with very high net borrowed reserve figures prevailing before the weekend, turning into substantial free reserve figures thereafter. Much of the post-weekend ease was expected to develop from the sharp decline in Treasury balances at the Reserve Banks, and the market, of course, had no way of knowing that this would occur. As a result we went over the weekend anticipating a relatively low average net borrowed reserve figure after doing a token amount of RP's on Friday in light of the pressures on the money market, but with the expectation that we could mop up any redundant reserves today and tomorrow through matched sale-purchase agreements. The high level of borrowings at the Reserve Banks over the weekend ($1-1/4 billion) should help lead to easier money market conditions that would facilitate these operations if they prove to be necessary. I should add that Friday's RP's were made at the discount rate. We thought it prudent not to undertake any innovation that could lend itself to misinterpretation at the present time.

Throughout the period since the Committee last met, required reserves have been falling short of estimates, and estimates of growth of the credit proxy have been marked lower. As the blue book[1/] sets forth, August saw a decline of about 2-1/2 per cent in the credit proxy and the Board staff September estimates now indicate little or no growth, compared with a 6 per cent estimate at the time of the last meeting. Current estimates at the New York Bank are now in the 2-4 per cent range after making allowance for growth in foreign branch balances.

I should note that some unusual problems had to be faced in yesterday's hectic Treasury bill auction. Normally our problem is to compete with other bidders to make sure the System can roll over its maturing holdings. Yesterday, in contrast, the problem was to redeem at least part of the $359 million Treasury bills maturing September 15 without leaving the auction uncovered at anything like a half-way reasonable rate. As my supplementary report indicates, bids were submitted for both the 3- and 6-month bills at a wide scale of prices. The report notes that on the basis of preliminary indications the System had apparently redeemed $100 million. Final results indicated that the redemption amounted to $119.6 million, which will be of at least some help in absorbing reserves in the statement week ending September 21.

Looking ahead for the next few weeks, estimates indicate that we will have a substantial reserve absorption job to

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

do in the week ending September 21 at a time of peak tax date pressures and with the Treasury's cash position in a precarious state. Following that week, until the Committee next meets, we will be supplying heavy seasonal reserve needs. Some of the potential problems of the period ahead are spelled out in the blue book. I do not believe it possible to spell out in advance how things will turn out, but open market operations may very well have to be conducted with as much flexibility as the Committee's over-all policy position can allow.

Mr. Scanlon asked whether the Manager planned to continue making repurchase agreements at the discount rate.

Mr. Holmes replied he would prefer not to, since the discount rate was so far below market rates; it would be better to make any RP's at about the three-month bill rate. If Friday had been anything like a normal day he would have made RP's at 5-1/8 per cent, which was about the average rate in the preceding weekly auction. However, in view of the circumstances prevailing then, he had considered it better not to take an action that might be misinterpreted.

In response to Mr. Mitchell's question concerning the outlook for bill rates, Mr. Holmes said that much would depend on the nature of Treasury financing activity. The market saw little demand for bills at present. On the other hand, rates had now reached a level at which some bills could be carried profitably, and that fact might lend a little more stability to the market. He thought the odds were that the bill rates would be stable or would move lower, but in view of the many imponderables that could not be expected with assurance.

Mr. Daane asked what consequences Mr. Holmes thought would follow if member bank borrowings rose to a much higher level.

Mr. Holmes said that it was hard to visualize a large increase in borrowing that did not lead to an immediate easing throughout the whole banking system. Such a development would create problems for open market operations. The situation might tend to be self-correcting, with banks repaying their borrowings as money market conditions eased, but it was not clear that that would be the case. In any event, he did not think there would be a large increase in borrowings unless banks changed their attitudes toward the discount window. Such a change was possible, but it had not yet occurred.

Mr. Hickman asked if the Desk had talked with the large New York banks about their ability to roll over maturing CD's into October.

Mr. Holmes replied that the question had been discussed quite recently with the seven largest New York City banks. All of them expected a run-off of CD's over this month, but only two were actively concerned. The others felt that the advance preparations they had made were adequate, although new uncertainties had now been introduced by the latest rise in bill rates. The picture thus was a mixed one.

In reply to a question by Mr. Wayne, Mr. Holmes said that CD runoffs at New York banks as a group currently were at a rate of about $130-$200 million per week. September 15 maturities were about $550 million at New York banks and about $1 billion plus in the country as a whole.

Mr. Hayes remarked that some banks recently had reported that their CD losses had stepped up a bit.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period August 23 through September 12, 1966, were approved, ratified, and confirmed.

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

Mr. Koch made the following statement on economic conditions:

> Having been away from the office for four weeks, my only excuse for presuming to report to you on the domestic economic scene this morning is that there may be less likelihood than usual that I will be misled by transitory day-to-day developments. By necessity, I must look at the forest rather than the trees this morning.
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> There is one specific new development, though, that I will have to comment on explicitly, and that is the fiscal program announced by the Administration last week, even though it will take more analysis and, indeed, events themselves to specify all of the effects of such a program on the economy.
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> Needless to say, increased fiscal restraint is better late than never and is an important step in the right direction. But important as this current step is, assuming implementation of both its tax and expenditure aspects, its effects are likely to be moderate in amount and spread out in time.

There seem to me three main aspects of the announcement. First, cuts in Federal spending are likely to be little more than, if even equal to, the increases made by Congress in the President's requested Budget expenditures. Second, the temporary suspension of the investment tax credit privilege may produce marginal cutbacks in business capital spending, possibly rather promptly for such short-lead time items as trucks, office equipment, and the like. But its more important impact will likely be in reducing new orders in the booming machinery and equipment industries and possibly some concomitant effects on wage pressures and prices in those industries. The effects of the suspension of accelerated depreciation will no doubt be more delayed than those of the investment tax credit.

Third and finally, the sleeper in the announcement, and what might turn out to be its most important revelation, is its oblique references to continuing and increased defense spending. When I left town several weeks ago, the most critical element in one's evaluation of economic prospects was his view as to likely defense spending. The sentences in the President's fiscal announcement regarding Vietnam and defense spending have been the first official pronouncements on the subject for some time.

They suggest that our earlier estimates on such spending have probably been under- rather than over-estimated. As you will remember, the official Budget document projected a leveling off of defense spending about mid-year and in our chart show last winter we projected increases in the third and fourth quarters of \$2-1/2 and \$2 billion, respectively, expressed at annual rates. Now we are raising our projections of each of these quarterly increases to about \$3-1/2 billion.

Other fragmentary bases for these increased projections are the rapid increase in actual defense spending in August, continued increases in defense orders, and further rises in draft calls. All of this means that even if the President's new fiscal program is adopted in its entirety as outlined last week, the over-all Federal contribution to economic activity will likely continue to shift to a more stimulative position over the rest of this year, and probably into next year unless further tax measures are adopted.

If it were not for the war, it is now clear that the economy is showing characteristics common to the late phases of a business expansion. Production of business equipment is now 85 per cent above its 1957-59 average while output of consumer goods is up only 45 per cent. Over the past year, business equipment output has risen 18 per cent compared to 5 per cent for consumer goods. This spring an acceleration of business inventory accumulation was added to the boom in plant and equipment spending.

Tight money is producing an even larger and more abrupt drop in residential construction than was considered likely only a few weeks ago. Other consumer spending, though, has picked up again recently as disposable personal incomes have risen, reflecting continuing sharp gains in employment, larger transfer payments, higher wages, and lower tax payments.

Prices continue to rise, although still not as sharply as might have been expected in the current state of economic conditions. The pace of wage advances has quickened; witness the recent 5 per cent per year increases for both the airline machinists and the telephone workers.

It is probably in part because of the length and lopsided character of the current economic cycle that none of 20 leading economists recently replying to a questionnaire from the New York Times called for more monetary restraint at this time. Indeed, although all of them agreed that Federal Reserve policy to date had been appropriate, a minority of them felt that some easing would now be desirable.

The current age and character of the cycle is also a partial answer to the weak stock market, although I suspect that this is due more to the host of uncertainties that currently face the saver and investor. Participants in the stock market have also been strongly affected by rising interest rates and the developing credit squeeze.

A further word on the recent course of prices. There has been some talk suggesting that the steam may have gone out of the rise and that, in any case, what rise has been taking place has been due to supply situations in particular areas rather than to excessive aggregate demand.

I don't agree. Food prices continue much stronger than had been anticipated. The rise in the industrial component of the wholesale price index has tapered off this summer, but it is still too early to judge whether this is the beginning of a new trend. Prices of some sensitive materials have actually declined, but they were the ones that had shown the spectacular increases earlier and they are not particularly important in total industrial costs. Although the labor cost situation in manufacturing continues to be better than it was in the late fifties, the favorable factors of moderate long-term wage contracts and stable consumer prices have about run their course.

In conclusion, if one could exclude the war, I would be joining the coterie of economists I mentioned earlier in suggesting that with the boom now so old and lopsided we should ride out its lingering and lagging distortions and inflationary effects. But with the war prospects still as disturbing as they are, inflation and even worse distortions in the structure of spending are likely to be our problem for many months, or even quarters, to come.

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

The two main indicators of the U.S. balance of payments position have been pointing in opposite directions since mid-year. This has not caused any serious confusion; but it has raised some interesting analytical questions, and has required that this Committee's directive refer to an "underlying" deficit rather than simply to a deficit.

On the liquidity basis of calculation there was a continued large payments deficit in July-August, whereas the balance measured by official reserve transactions swung into substantial surplus. The difference resulted primarily from the fact that a few large U.S. banks borrowed more than $1 billion from the Euro-dollar market through their foreign branches in the space of only two months. Such inflows of foreign liquid funds improve the official settlements balance but do not affect the liquidity balance; they are regarded as financing the liquidity deficit, rather than as reducing it.

Given these two superficially conflicting indicators, a judgment that the over-all payments position is one of underlying deficit rests on the expectation that the liquidity deficit will persist while the recent heavy inflow of foreign liquid funds will slacken.

Two main considerations lie behind the view that liquid inflows will taper off. First, there is reason to think that the scramble by U.S. banks for Euro-dollar funds is to a large extent defensive and temporary. This is one way in which the banks have been adjusting to increases in reserve requirements and preparing for the possibility of large CD runoffs in September; they are unlikely to want to rely for long on a continuing massive inflow of very short-term foreign money, for which they must pay upwards of 6-1/4 per cent. Second, even if U.S. banks do continue to bid aggressively for foreign liquid funds, it seems unlikely that the supply of such funds to them can long continue even at the August rate, which was only half that of July. Recent flows have been affecting European exchange rates, official reserves, and money markets in ways that will tend to reduce the flows. Also, distrust of sterling, especially in July, greatly stimulated or facilitated flows out of sterling into dollars. A favorable turn in market sentiment towards sterling, of the sort that this Committee and the British authorities are now hoping for and working toward, would tend to reduce or reverse that flow, as happened in the autumn of 1965.

For all the other international transactions that together produce the liquidity deficit, the expectation remains, as before, for little net change in the months ahead. The liquidity deficit was at an annual rate of roughly $2-1/2 billion to $3 billion in July-August, or about the same as it would have been in the second quarter of the year if there had not been some large, once-for-all shifting of foreign assets from "liquid" to technically "nonliquid" categories. There may have been some further deterioration on current account since mid-year; the July trade figures were very disappointing, with imports up sharply further. But there has probably been an offsetting reduction in net outflows of U.S. capital; we know that reflows of U.S. bank credit in July were large.

In the months ahead, I would expect the trade deterioration to slow down. Exports of raw cotton should have turned up sharply since August 1 when the U.S. price was reduced. More broadly, demand in foreign markets that are important to us is generally becoming even more buoyant than before. And some slowing of the import advance may result from the economic upswing that is now gathering momentum in Japan, and in Italy and France, which might make those countries less eager to sell here even if aggregate U.S. demand remains excessive.

But while there may be only modest further deterioration on current account, there are also only modest possibilities of further improvement on capital account, even with credit conditions here continuing very tight.

So the liquidity deficit may stay in the $2-1/2 billion to $3 billion range for the rest of the year, reduced perhaps by some debt prepayment receipts, but increased perhaps by another waiver of year-end debt service due from the U.K. This would bring the liquidity deficit for the full year to something over $2 billion in the published figures, or more than $2-1/2 billion aside from the shifts of foreign official and international assets from liquid to nonliquid forms.

Probably a large proportion of this year's liquidity deficit will have been financed by inflows of private foreign liquid funds. In other words, the official settlements deficit for the year will probably be small, perhaps as small as $1 billion; it was about zero, seasonally adjusted, in the 8 months through August. We will probably have drawn down our gold stock during the year by somewhat more than the $1/2 billion so far used. We will have used up about $1/2 billion of our IMF position, leaving only about $300 million to go before we get into the credit tranches where the Fund would begin to give us specific policy advice. On the other hand, U.S. liquid liabilities to foreign official holders will probably not have increased during the year, and may even have been reduced somewhat.

For 1967, international visibility is even more limited than domestic visibility. It will, of course, be very easy to achieve a further deterioration in our payments position. On the other hand, I think it is still barely possible that we might achieve some improvement by recovering some of the ground lost this year on current account. With foreign demand buoyant and inflation abroad widespread, improvement may in some ways be easier from a purely economic point of view in 1967 than it was in the early 1960's.

Everything will depend on our ability to bring aggregate domestic demand into better balance with domestic supply potential. Given the opportunities open to us if we do this, and the dangers to our payments position if we do not, I see no case for easing up on monetary restraints until there is clear evidence that we are in fact well on the road toward making that kind of domestic adjustment.

Mr. Brill made the following statement concerning financial developments:

The staff reports already presented this morning bring into focus most of the major constraints and imperatives in formulating monetary policy. Mr. Holmes has described the still-nervous state of financial markets, which have been buffeted severely in recent weeks and now have to assess the import of major new fiscal and debt management programs in the midst of a period of peak seasonal banking pressures. The recent behavior of financial markets suggests a policy prescription perhaps best described as "tender loving care."

But Mr. Koch's analysis of the prospects for nonfinancial markets does not hold out much hope in the short-run for relief from price pressures, even with swift passage and implementation of the President's fiscal program. The cumulative impact of monetary restraint is undoubtedly spreading from housing into other expenditure areas, and by, say, early next year, the combination of monetary and fiscal restraints conceivably could produce an economic "over-kill"-- if it weren't for the increasing prospect of substantially higher Vietnam spending. Whatever fears one may have as to the lagged effect of monetary restraint on the private sectors of the economy, it would seem dangerous to formulate policy now on the assumption that additional fiscal restraint will be imposed in sufficient time and magnitude to offset further acceleration in defense spending.

Turning to the import of international flows for policy, one might conclude that whatever improvement (or perhaps I should say whatever slowing in deterioration) has occurred in our over-all international balance has been in large measure a function of the restraint on bank credit we have been exerting. This restraint has reinforced our efforts at limiting direct bank outflows of capital; it has increased the attractiveness of U.S. financial assets to foreign investors; it has encouraged U.S. businessmen to finance abroad a larger share of their overseas investment. Such results of monetary restraint on our international capital accounts have been essential in a period when our current account has continued to deteriorate. Given the still dismal international flow outlook as outlined by Mr. Reynolds, one doesn't see much basis from the international side for easing on the monetary reins yet.

Balancing these market, domestic, and international perspectives in an over-all appraisal of policy needs, I come to the conclusion that it is far too soon to be actively moving away from the System's posture of restraint, but that our efforts to maintain restraint should be tempered. Tempering is called for, first to avoid further jolts to financial markets as they try to develop new trading levels appropriate to changes in flows and in expectations that may be engendered by the new fiscal program and, second on the off-chance that our appraisal of fundamental economic conditions and prospects could be wrong, in its assessment of either the strength of demands or of the bite that is already resulting from policy actions to date.

In these circumstances, caution is called for. The appropriate policy posture can probably best be described as "passive restraint," a policy that permits financial indicators to ease if the source of the easing comes from the market, but which would maintain pressure if financial indicators suggest renewed strength significantly beyond that now forseen for credit demands at banks or in the capital markets.

In the few minutes remaining, I would like to spell out what this posture might mean for the banking and financial indicators we usually follow. At the outset we have to recognize that several factors, such as our new discount administration program and the Treasury's foreswearing of new agency issues and participation certificates, render some of the usual policy indicia difficult to interpret. For example, a decline to a shallower net borrowed reserve figure would not necessarily mean an easing in monetary policy. Indeed, it could well reflect an unwanted tightening, a failure of policy intent, if banks insist on making the kinds of portfolio adjustments we wish they wouldn't, rather than seeking accommodation at the window at the price of disturbing customer relationships. Alternatively, a shallower net borrowed reserve figure could signify reduced pressure of credit demands on the banking system as a whole, or that those banks continuing to meet strong customer loan demands are finding resources outside the discount window, either from other banks in the Federal funds market, or from foreign branches, or elsewhere. Conversely, a rise in the net borrowed figure that brought more banks within the purview of discount window administration might be welcomed as the first step toward our objective of achieving some redistribution of the brunt of monetary restraint, without intensifying the over-all degree of restraint.

The ambiguity of alternative marginal reserve figures can be dispelled if interpreted in terms of concomitant developments in Federal funds and other money markets, and in light of the information becoming available on the composition of bank credit growth. But because a particular net borrowed reserve figure can have such widely different analytic meanings, it is not appropriate now as a policy target.

We'll probably come closer to our basic policy objectives in this period by keeping our sights on financial prices and aggregate credit figures rather than on marginal reserve measures. In considering aggregate targets, let me say just a word about our September projection for the bank credit proxy and its relationship to the draft directives[1] submitted by the staff. The projection for September of virtually no growth in the proxy on a seasonally adjusted basis assumes that, on average over the month, CD's would run off by about $1 billion more than the $1/2 billion reduction to be expected on seasonal grounds. It also assumes that Government spending will continue to rise so fast that even with high September tax collections, Government balances will, on average, be reduced about $1-1/2 billion more than seasonal. While the CD run-off

1/ Appended to these minutes as Attachment A.

and the spending of Government balances will likely result in a rapid rise in private demand balances, total bank deposits--the credit proxy--would show very little change for the month. But the shift in deposit structure would produce a substantial rise in reserve needs.

Whether the contraction in CD's is held to the $1-2 billion range depends very much on what happens to rates on alternative investments, particularly to Treasury bill rates. The outlook is not encouraging. Treasury financing needs are rising swiftly, and the Board staff's latest estimates of fourth-quarter needs are staggeringly high. As market participants begin to realize this, and take into account that new agency and participation certificate financing is foresworn and direct long-term financing impossible under the 4-1/4 per cent interest rate ceiling, upward pressures on bill rates already evident in recent weeks will increase and CD's will become even less attractive. Yesterday's bill auction suggests that the market is already alert to the Treasury financing dilemma.

At what point in the rate structure, and at what level of flows, a new balance is struck between bill rates and CD's is anyone's guess. The two-way tug of bank-customer relationship cannot be ignored. The staff assumed, for the purpose of the blue book, that a rise in the 3-month bill rate into the 5.30-5.40 per cent range would still be consistent with only a moderate run-off in CD's, but this is sheer conjecture. Because there is the danger of too rapid an adjustment in short-term rates, bringing with it too rapid a contraction in CD's, and thereby renewing upward pressures on the long-term markets we have been hoping to shelter, I would urge that the bill rate be given a high priority among the money market conditions to be maintained at around current levels, to use the terminology of draft directive "A."

We have to recognize that operating under this directive, in the circumstances postulated of bill rates tending to move up sharply and CD's tending to run off rapidly, would probably result in increased reserve provision, taking operations of the window <u>and</u> the Desk combined. But we shouldn't get too exercised about it, particularly if a larger share

> of the reserves than usual comes through the window. Expansion in bank credit over the summer (May through August) has been contained to about a 4 per cent annual rate, less than half the 1965 rate, and August saw an actual credit contraction. Even if an average credit growth rate in the 4 to 6 per cent range is about the appropriate degree of monetary restraint to achieve, there is no need to force the expansion in the one month of September to be held to the nominal amounts now projected by the staff. Certainly, a shift in the public's preference as to the form of bank deposit it wants to hold should not be the occasion to force another contraction in bank credit. The price of orderly adjustments in financial markets and bank credit may be some temporary generosity in reserve provision.

Mr. Robertson entered the meeting during the course of Mr. Brill's statement.

Mr. Mitchell remarked that he agreed with Mr. Brill's analysis except for the concluding part. It seemed to him (Mr. Mitchell) that a process of disintermediation by banks was underway and, accordingly, that the bank credit proxy could be allowed to decline without much concern. To undertake to make bank credit grow would, in his judgment, be contrary to the policy the Committee had been following. He had prepared a statement on that point which he would make later in the meeting.

Mr. Ellis noted that in the two draft directives alternative A was labeled "No further firming, with qualifications," and alternative B was labeled "Firming to the extent feasible, with qualification." He questioned the accuracy of those labels. In particular, the qualification in A appeared to be directed toward easing, which suggested that three alternatives were contained in the two directives.

Mr. Brill commented that he did not read alternative A to call for operations directed toward easing, but rather for accepting any tendency toward ease that might develop in the market. Accordingly, he did not think it could properly be called an "easing" directive. Alternative B called for firming at the initiative of the System.

Mr. Hickman noted that the proviso clause of alternative A ran both ways; it called for further firming if bank credit expanded substantially more than seasonally expected, as well as for easing if credit expansion was no more than seasonal.

Mr. Shepardson said he would question the formulation of the second part of the proviso, reading "if bank credit expands no more than seasonally expected, some easing of money market conditions shall be sought." He would prefer language reading "if bank credit expands less than seasonally expected . . . ."

Mr. Brill observed that the Board staff expectation was for substantially no change in the credit proxy in September--the range given in the blue book was plus or minus 1 per cent, at annual rates. He personally felt that some increase would be more appropriate to the needs of the economy.

Mr. Mitchell observed that an increase in bank credit was not necessarily appropriate if the economy was being financed outside the banking system. At a time when banks were reducing the degree of their intermediation, a rise in bank credit could mean a tremendous increase in the money supply. Under such circumstances a money supply target would appear more appropriate.

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:

> Business developments since the last meeting indicate that the economy is still growing at a rapid rate and is likely to continue to grow at a rate generating inflationary pressures well into 1967. Important elements of strength include business plant and equipment expenditures, rising durable goods order backlogs, and sizable additions to inventories, besides vigorous consumer spending plans and strongly rising government outlays. The only significant area of weakness in the economy continues to be residential construction, but the prospective release of resources in this sector does not appear large enough to offset the excessive pressures generated elsewhere in the economy. While a few of the key price measures have recently been moving up at a slightly slower pace than earlier in the year, the outlook continues to be inflationary, as cost factors become increasingly important.
>
> As for the balance of payments, it appears that the July-August deficit averaged roughly $2.6 billion at an annual rate--close to that of the second quarter, after adjustments for special transactions. The major adverse factors, as has been true now for some time, are the shrinking trade surplus, reflecting a very rapid rise in imports, and increased expenditures connected with Vietnam. Some of the capital accounts show a distinct improvement, due no doubt in large measure to

tight credit conditions in this country; and the same conditions have caused a sharp rise in private foreign holdings of dollars, thus bringing important temporary relief to the dollar in foreign exchange markets and mitigating for the time being the drain on our gold stock.

A distinct slowing in the rate of expansion of bank credit is noticeable in the statistics available for August and early September. We find considerable evidence, both in the credit figures and in the atmosphere of the credit markets, that the System's restrictive credit policy is at last becoming increasingly effective. Through the first eight months of this year the credit proxy has grown at an annual rate of just over 6 per cent compared with 9 per cent a year ago. Business loans apparently experienced an actual decline in August, whereas their rate of gain in the previous seven months had been 22 per cent. If the August drop is confirmed by the final data, it would be the first monthly decline in business loans since May 1961. Recent developments in the bank credit proxy are likewise encouraging. Our own data suggest a September increase of about 2 to 4 per cent after including foreign branch funds; and this would be on top of a 2 per cent decrease in August, or a 0.4 per cent increase including foreign balances. Money supply also shows a growth rate of only 1.7 per cent for the first eight months of the year.

Since our last meeting the credit and capital markets have been marked by convulsive movements and an atmosphere of great uncertainty. At the nadir of the bond market about two weeks ago there is no doubt that the financial community was experiencing growing and genuine fear of a financial panic. This fear seemed to stem mainly from the conviction that credit demands would remain very strong (with corporate and government needs for funds unabated), that fiscal policy was making no contribution toward a dampening of the economy, that the agency financing program was actively stimulating higher interest rates, and that the Federal Reserve System was determined to push its restrictive policy ruthlessly. Under these circumstances, I believe that our System statement had a useful calming effect, while at the same time properly underlining our concern over the rapid growth--at least until very recently--of bank credit. But of greater benefit to the markets was the news that at long last the Administration was favorable to some degree of fiscal restraint and a more restrained policy with respect to agency financing. I am not convinced that the near-term impact of the proposed fiscal measures will be sufficient or that the specific tax and depreciation measures are either the most efficacious in reducing excessive demand or helpful to the economy in the long run. While there is of course ground for encouragement in the move in the direction of a more restrictive fiscal policy, we must probably accept the likelihood of continued doubts and uncertainty in the money and capital markets. The stock market's sharp decline has in itself greatly exacerbated this uncertain atmosphere. We can be thankful, however, that overexpansion of stock credit does not seem to be a valid concern at this time.

In considering policy for the next three weeks, I think we should give considerable weight not only to this general unease in the financial markets but also to the unusual short-term pressures over the next few weeks expected to stem from run-offs of certificates of deposit combined with seasonal tax and dividend requirements and the forthcoming interest payment period for savings institutions. On the international side we must recognize that sterling is still viewed with suspicion, though we can legitimately hope for a real turn-around in sentiment if the current program for strengthening international credit arrangements catches the imagination of market participants all over the world. All of these current uncertainties, together with the rather strong evidence we now have of a slowdown in credit growth, lead me to feel that we should not press for a more restrictive policy at this time. It would also seem poor timing to tighten further in the face of the Government's fiscal proposals. I would think that the Manager should be instructed to try to maintain about the present level of restraint as measured mainly by money market conditions, with ample leeway to adapt his operations to market and credit developments. I would think that the net borrowed reserve level should be of subordinate significance.

As for the discount rate, I believe the System missed a good opportunity in mid-July for a moderate increase that would have brought the rate closer to market realities. In the meantime market rates have risen further, but at the present time, the same factors that argue strongly against any open market policy tightening also argue with equal force against a discount rate rise. I certainly would like to sit back for a little while and observe how effectively the new Administration program is in dampening inflationary expectations. I reach this conclusion even though the period during which we shall be free from even-keel restraints will not last many weeks longer. I would still hope that we could move on the rate before too long.

Turning to the directive, I prefer the first paragraph of alternative B to that of A because I think it is too soon to abandon our posture of resisting inflationary pressures and strengthening efforts to restore payments equilibrium. I would be willing to substitute the words "continuing to restrain" for the word "restricting" in the last sentence. For the second paragraph I would propose a new and simplified wording which is probably closer to alternative A than to B but which makes clear our intention to maintain both firm and orderly conditions, with a suitable proviso for unusual liquidity pressures or significant deviations of bank credit from current expectations.

Specifically, I would propose the following second paragraph:

> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm but orderly conditions in the money market; provided, however, that operations shall be modified in the light of unusual liquidity pressures or of any apparently significant deviations of bank credit from current expectations.

Mr. Ellis remarked that having reported at the Committee's last meeting that residential contracting in New England had not revealed the slowdown being reported by the banks, he should now report that the data covering July revealed a 43 per cent drop below July 1965. All listed categories of residential buildings had a smaller contract volume than a year ago, although the 83 per cent drop in apartment house contracts was outstanding. Seasonally adjusted manufacturing activity expanded further in July with most of the rise occurring in the durable goods industries. Preliminary returns in the Boston Reserve Bank's follow-up survey of capital spending by manufacturers in New England confirmed their spring reports which indicated a sharp expansion of outlays.

In the days immediately following the Reserve Banks' September 1 letter to member banks concerning business loans and borrowing at the discount window, Mr. Ellis said, he had held conferences with top managements of each of the reserve city banks in his District. Each gave enthusiastic endorsement to the concept of loan curtailment, and each detailed the efforts it had been extending to such an end. One bank, having run up business loans by the end of April by a total of 20 per cent, had a target of absolute contraction of 10 per cent by year end. None of those banks had borrowed at the Reserve Bank in any volume for the past three weeks and all were striving mightily to stay out of the discount window. Each had analyzed its certificates of deposit to "guesstimate" possible attrition and each had made plans to stay out of the discount window. None of the First District banks, large or small, had volunteered that they were eligible or sought to be eligible for any special treatment under the terms of the special program. Borrowings, primarily through

Federal funds or CD's, of the eight largest banks ranged in August from a low of 94 per cent of required reserves to a high of 230 per cent. The comparable figure for eight New York City banks, taken together, was 192 per cent.

Turning to monetary policy, Mr. Ellis judged that economic events since the Committee's last meeting supported a conclusion that the economy remained tilted toward inflation as it expanded rapidly, with continuing pressures on available resources. The next most visible signs of that condition probably would appear in the labor negotiations of the next several months.

In the fiscal arena, Mr. Ellis continued, it was now known definitely that no tax restraint on corporate or individual spending might be anticipated for the rest of this year, although order backlogs for new equipment might shorten as the rate of new orders was restrained. In that connection, he enjoyed reading the Board staff's analysis of the probable effects on the economy of the Administration's proposals to suspend the investment tax credit and accelerated depreciation.1/ In the debt management arena, the revised program of Treasury financing should provide more confidence to the securities market that the debt would be managed better.

1/ A memorandum on this subject by Eleanor Stockwell of the Board's staff, dated September 11, 1966, was transmitted by Mr. Brill to the Board of Governors and the Reserve Bank Presidents prior to this meeting, and a copy has been placed in the Committee's files.

In the monetary arena, Mr. Ellis observed, he would suggest that a one-month decline in the credit proxy and in business loans should not lead the Committee to push the panic button and change its policy. That development should be viewed in a longer-run perspective, including the preceding growth and the further expansion that was virtually assured for September and the rest of the fall. Personally, he was not moved by the fact that there had been a one-month decline. The fiscal program announced by the Administration would not restrain inflation for the rest of the year. Accordingly, he would suggest that this was not the time for the System to ease its policy posture.

Mr. Ellis agreed with Mr. Brill that shallower net borrowed reserve figures could have the meaning the latter had suggested. But they also could mean that the Committee had eased policy and was providing reserves a little more freely, and the market was likely to so interpret them. In fact, the staff had projected a September shift from CD's into demand deposits with such a surge as to expand demand deposits faster than in any previous month this year. That obviously explained the expected acceleration in required and total reserves to growth rates of 7 and 9 per cent, respectively, in contrast to their August declines. He recalled that at other recent Committee meetings there had been discussion of the question of how much of the increase in reserve requirements made by the Board should be supplied through open market operations, but he noted that there had been no discussion of that question around the table thus far this morning.

Presumably, Mr. Ellis said, borrowings would have to average in excess of $800 million--perhaps near $900 million--if net borrowed reserves of $500 million were to be achieved. At such a level of borrowing even the largest banks probably would be having recourse to the discount window, and that would enable further conversations about the trend of lending.

Mr. Ellis noted that Mr. Koch had referred to three parts of the President's recent message. But there was a fourth part also; namely, the President's request that the Federal Reserve work with the commercial banks to help hold down, or lower, interest rates coupled with action by the Congress authorizing the Federal agencies to regulate savings rates. That made it inappropriate at this time for the System to take the long overdue action of bringing the discount rate into line with related market rates. It would seem feasible, however, to maintain a target of $500 million for net borrowed reserves, hoping that data revisions subsequent to termination of operations would begin to be on the plus as well as the minus side. And, with confidence somewhat restored in the securities market, it should be feasible to attend more to reserve objectives rather than market objectives. Rather than backing away from reserve objectives, the Committee should cling to them as much as possible in September.

Mr. Ellis thought that alternative A of the draft directives contained an unfortunate change of wording at the close of paragraph 1. It spoke of "accommodating moderate growth in the reserve base" when staff projections suggested September growth in total reserves would tie for second place in monthly growth rates this year. The second paragraph called for easing in monetary policy if credit expansion was strictly seasonal or fell short of the seasonal pattern, no matter how shaky might be the ability to construct up-to-date seasonal adjustment factors. Alternative B kept faith with the System's promise to use monetary policy to restrain inflationary credit expansion, and would be his preference. However, he disagreed with the label put on it; he did not think it was a policy of "firming to the extent feasible," because the Committee could firm much more than suggested by the language of the draft. He would describe it as "firming if credit expansion accelerated." The second paragraph called for "supplying the minimum amount of reserves consistent with the maintenance of orderly money market conditions." That surely should be the Committee's objective; it would not want to supply more reserves than those required to maintain an orderly market. He liked Mr. Brill's phrases, "tempered restraint," and "with tender loving care," and he thought they described alternative B.

Mr. Irons commented that most areas of the Eleventh District economy had advanced over the summer but probably by a bit less than nationally. Employment changes in most categories had been of about seasonal character, although some were above seasonal and some below. Changes in industrial production were relatively minor in the latest month. The total index had shown no significant change in the last few months relative to a year ago, continuing to run at a level 9 per cent higher. Retail trade, as measured by department store sales, rose about 4 per cent during the past four weeks and also continued to run 9 per cent above 1965. Agricultural conditions were highly favorable; farm prices were up 8 per cent over the past eight months, with most of the increase in cattle prices. Rains had been excellent and grazing lands were in the best condition in some time.

In the financial area, Mr. Irons said, loans at District banks were down in July and August, with most of the decrease occurring in nonbank financial loans and "other" loans. Commercial and industrial loans had advanced slightly. Deposits were down sharply, largely because of a decline in Government deposits. Negotiable CD's were down about $10 million, and it was expected that two, or possibly three, of the largest banks would be interested in special assistance at the discount window. Other banks did not appear overly concerned at present about CD runoffs. Average borrowing at the Reserve Bank was up a bit in the latest period, to $42 million from $32 million in the preceding period. Banks continued to use the Federal funds market most of the time to make their adjustments, although on any one day one or more of the large banks might find it necessary to come to the window. On the whole, the increase in both total loans and commercial and industrial loans at member banks and weekly reporting banks in the District had not been as large as nationally.

The national economic picture had been covered adequately in the green book1/ and in the discussion so far today, Mr. Irons said, so he would not dwell on the subject. His general recommendation for policy over the next three weeks would be to maintain the current or recent degree of restraint without attempting to bring about any further intensification, for the several reasons indicated by Mr. Hayes.

Mr. Irons believed that the level and movement of interest rates and other measures of market conditions might provide a better guide for policy now than net borrowed reserves, particularly in light of the large revisions in the preliminary figures for the latter recently. Interest rates had already reached extremely high levels and on one or two recent occasions money market conditions were verging on disorganization. In his judgment, further upward pressures on interest rates and further restraint on the availability of reserves relative to demand were not desirable. There had been some signs recently of a dampening tendency in bank credit expansion, and

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

he felt that monetary policy was biting. Banks were under pressure to meet their loan commitments and to reduce the aggregate of their loans outstanding. The System should provide reserves for seasonal loan growth and, possibly, for some nonseasonal growth through open market operations and the discount window. And the System should stand ready to use the discount window to alleviate any unusual pressures arising from CD runoffs or other deposit losses. He would not favor a change in the discount rate at this time and he preferred alternative A for the directive.

Mr. Swan reported that while over-all business activity in the Twelfth District was still strong the latest fragmentary data certainly gave no signs of a further upward surge. August employment data for California and Utah--the only two States for which such data were as yet available--reflected little change in nonagricultural employment and a further increase in unemployment. The California unemployment rate had shown successive monthly increases from the low of 4.6 per cent reached in May, and in August was 5.2 per cent. Aerospace employment in California increased again in August, but only by 2,900 as compared with a rise of 8,400 in July. Lumber and plywood production continued to exceed orders and prices slipped down again in August. Both residential and nonresidential building contract awards dropped sharply in July. Total construction contracts declined only slightly, but that was because two very large heavy construction contracts were awarded in the month.

With respect to banking developments, Mr. Swan said, total credit at weekly reporting banks increased in the two weeks through August 24, but the rise was due entirely to an increase in security holdings. Loans were down; indeed, business loans had declined for five consecutive weeks, and preliminary figures for the week ending August 31 suggested another decline. There appeared to be a little tightening in the reserve positions of the major banks recently, with some increase in borrowing at the Reserve Bank in the last week of August and the first week in September, but the rise certainly had not reached what one would call major proportions.

As to policy, Mr. Swan said his views were much the same as those he had expressed at the preceding meeting. He liked Mr. Brill's phrase, "passive restraint." In view of the lack of increase in bank credit and reserves in August, the market uncertainties that still existed, and the current attempt to assess the Administration's fiscal program, it seemed to him that the Committee should again seek to maintain about the present money market conditions--recognizing that, as had been indicated, the net borrowed reserve figures could vary considerably depending upon the factors affecting them. He would allow the Manager considerable flexibility in day-to-day operations, with some attention to be given to short-term interest rates. While movements in aggregates as well as in the marginal reserve measures should be considered, he would leave room for a considerable margin in the outcome. Despite the change in the staff's projection of the bank credit proxy for September, he thought that an increase on the order of 5 or 6 per cent, such as had been anticipated three weeks ago, was still a fairly reasonable limit before some positive action should be taken. That conclusion led him to favor alternative A for the directive, at least if it was interpreted in the sense of its caption, "no further firming, with qualification." However, he had a question similar to one already expressed regarding the last clause, reading "if bank credit expands no more than seasonally expected, some easing of money market conditions shall be sought." He would prefer language that was symmetrical with that in the preceding clause, such as "if bank credit expands substantially less than seasonally expected . . . ."

Mr. Swan concluded by noting that he agreed a change in the discount rate would not be appropriate at this time.

Mr. Galusha reported that the Ninth District economy continued to expand and about in the pattern of the national economy, and the general outlook remained good. Especially good was the outlook for agriculture. In fact, it was so good that anticipated and feared pressures on the major banks to finance commodity dealers probably would not develop. Farmers, anticipating higher prices, were apparently going to hold their crops themselves; and their cash position was good. The combination of cash, the shift in the U.S.

Department of Agriculture policy, higher commodity prices, and the generally low level of tax sophistication made him quite dubious that any downward shift in agricultural spending for capital goods would be caused by the Administration's fiscal program just announced. Only in the lumber industry was the outlook poor. Unless residential construction picked up, that industry would go through a decidedly trying period.

The District's savings and loan associations appeared to have gotten through July relatively well, Mr. Galusha said, having lost a disproportionately small amount of share capital. Nor had mortgage lending and residential construction declined as much in the District as in the nation. The large District banks apparently were doing better in rolling over their maturing CD's than were the money market banks. According to his information, New York banks were losing about 50 per cent of their maturing CD's; Ninth District banks were losing between 25 and 30 per cent.

All he could report about the response to the new approach to discount administration, Mr. Galusha continued, was that he had not heard a peep from the banks. Possibly Ninth District banks--like those in other Districts--were anxious to get by as best they could on their own. In any event, the Minneapolis Reserve Bank had not yet had a chance to implement the System's letter.

Turning to the question of open market policy, Mr. Galusha remarked that, as had already been indicated, the big news was the President's proposal of last week. He was greatly pleased that a shoe had been dropped, although as an old tax man he was not thrilled by its size or its style. The reasoning of Miss Stockwell's memorandum, with which he agreed wholeheartedly, must have not been shared widely. Apart from the public posture impact, the real effect of the announcement would be minor. It was apparent, therefore, at least to him, that any monetary response to the President's proposal was some way off--perhaps a good long way off. At the very least the Committee would have to be sure about what was going to happen.

Yet, Mr. Galusha continued, if easing any now would be unwise, so would tightening further. It was reasonably clear that the economy was accelerating again. Indeed, the fourth-quarter increase in GNP might well be greater than the fourteen-odd billion dollars the authors of the green book were presently expecting. Then, too, with what Congress had been appropriating for nondefense expenditures, the forecasters' computers might soon be reading "tilt." But whatever the economic outlook might be, the Committee would, in his judgment, be very poorly advised politically to go further at this time. And he, for one, was still a little apprehensive about the results the Committee's new approach to monetary policy--as it continued to evolve through this fall--was going to produce.

Mr. Galusha came out for the status quo and, more particularly, for a net borrowed reserves total equal to the average of the past several weeks. Nor would he worry much about changes in interest rates, slight or sharp, which were--in the Account Manager's judgment--produced by changes in expectations. Over the next few weeks expectations could be quite volatile. In sum, he was for alternative A of the directives.

Mr. Scanlon reported that during August and early September labor markets in the Seventh District continued to be extremely tight and inflationary pressures remained dominant. Shortages of labor, skilled and unskilled, continued in virtually all District centers. Help-wanted ads remained at a very high level and unemployment compensation claims had declined further. Relaxation of hiring standards--in terms of experience, education, and criminal records--had not solved labor shortages. Prices had continued to rise. Early September saw an unusually heavy flurry of price increases and it now appeared that food prices would not decline as much in the next few months as had been expected earlier.

Scattered reports indicated some cutbacks in capital outlays for 1967, Mr. Scanlon continued. In most cases those represented completion of major programs started earlier. On the other hand, deliveries of capital goods had been delayed and some construction projects had been postponed because of inability to obtain either reasonably firm bids or adequate financing. Barring a change in the general outlook, most of those projects presumably would be reactivated next year. Although orders for some types of capital goods declined in July, order backlogs had increased further. There appeared to be no basis at present for calling a "turn" in the capital goods boom.

Mr. Scanlon reported that steel operating rates were rising gradually but supplies should be adequate without pressing facilities to the extent reported last spring. Surveys indicated that more steel consumers intended to reduce inventories than raise them in the months ahead. Auto inventories were reduced sharply in August but remained high relative to past years, and production schedules indicated that they would rise further during September.

Mr. Scanlon said that there was a sharp decline in the pace of credit growth at major District banks in August, in line with the national experience. but no indication that that was the beginning of any extended period of easier demand for funds. The contraseasonal decline in loans could be attributed mainly to the further paydown of loans to finance companies and the large volume of new capital issues, a portion of which might have been used to retire bank loans. Commercial and industrial loans in the District continued to rise, but by somewhat less than in the same period of other recent years. Real estate loans had been rising, but less rapidly than last year.

Consumer loans had declined recently. Total bank credit in the District had risen much more since mid-year than in the same period a year ago.

Recent rates on Federal funds of 6 per cent and over might indicate an unwillingness by banks to submit to the discipline on commercial and industrial loans expected to accompany use of the discount window, Mr. Scanlon said. However, he would expect the current rate differentials to bring more banks to the window.

Mr. Scanlon observed that figures for August confirmed the more moderate rate of expansion in money and credit projected at the last meeting of the Committee. He thought that for the present the Committee should attempt to maintain very moderate rates of growth in money and credit. If that implied reduced reserve availability, he would favor such measures short of inducing disorderly conditions in the money and capital markets. As to the discount rate, his views paralleled those of Mr. Hayes. In particular, he believed it was essential to retain rate flexibility, both up and down. Unless the Committee was flexible on the up side it was restrained when easier credit and lower rates were needed.

Mr. Scanlon favored maintaining about the present degree of restraint for the period immediately ahead, but would give the Manager sufficient latitude to operate should liquidity pressures become acute. He had some difficulty in selecting the directive that would accomplish that objective. On balance, however, he would favor alternative B, which he interpreted as Mr. Ellis had.

Mr. Clay observed that the period since the last meeting had been one of marked financial changes. It also had been a period of public pronouncements concerning planned fiscal policy and debt management changes. Some expectational effects of those public policy actions had been immediate in the financial markets and others might follow. The basic impact would take longer to work itself through the economy and financial structure, once those programs had been worked out and implemented. The fiscal program relative to business capital outlays required Congressional action for implementation, although the retroactive feature might have some relatively prompt effect on new orders for business equipment. Whatever the meaning of the announced screening of Federal outlays--and that was not clear at this time--it had to be recognized that Federal outlays would be accelerating in the months ahead. Moreover, direct Treasury financing would be affected by those expenditures as well as by the planned curtailment in agency financing.

The basic economic situation did not appear to Mr. Clay to have changed. With variation among sectors, the economy still was trying to do more than it could do in an orderly way. Despite some easing in sensitive materials prices, at least for the present, over-all pressure of demand on resources with upward pressure on prices continued. In fact, recent developments on the wage-cost front raised the possibility of more, rather than less, price inflation. Apart from the economic policy issues now being debated, the overriding consideration was the growing volume of expenditures related to the South Vietnam war.

Despite the indications of public policy actions, Mr. Clay remarked, the System would need to continue to formulate monetary policy according to the economic and financial developments that unfolded. Any change in policy should depend on whether forthcoming evidence justified such change. For the present, the appropriate approach appeared to him to be a continuation of the current policy of monetary restraint. In view of the public attention focused on recent economic policy statements, it was important that the market not be misled into believing that Federal Reserve policy had been eased. If recent evidence of curtailment of bank credit expansion continued in the weeks ahead, that would become a significant factor to be taken into account in future policy formulation.

Mr. Clay observed that the guidelines for a continuation of the present policy of monetary restraint were not easy to delineate. If member bank borrowing expanded substantially, an increase in net borrowed reserves considerably above the current target would be consistent with present policy. Also, some increase in money market rates in connection with possible forthcoming money market pressures would not be out of line with the current monetary policy posture. The Federal Reserve discount rate continued to be inappropriate to the present economic situation and current monetary policy.

Alternative B of the draft directives appeared to Mr. Clay to be satisfactory. Perhaps it should be said, however, that the goal was the maintenance of the present degree of monetary restraint. Alternative A seemed to carry the connotation of easing rather than simply of no further firming.

Mr. Wayne said that responses to the Reserve Bank's latest survey indicated a small increase of uncertainty among both businessmen and bankers in the Fifth District. Reports from producers of durable goods suggested a continuing but still slight downward shift in new orders, backlogs, and hours worked, while returns covering nondurable goods remained mixed and showed little or no trend. Prices and wages in manufacturing had on balance continued to rise. Textile demand remained generally strong, but soft spots in certain light cottons and blends continued to cause concern and in the trade reports were being increasingly related to imports, which had risen rapidly this year. Automobile sales remained down slightly, and there were signs of a slower pace in construction even though contract award values had been rising since

April and were now above last year's level. Unemployment rates continued at or close to historical lows and employment had continued to rise. Prices received by farmers through mid-August were well above year-earlier levels, but prices paid reached new record highs. Seasonally adjusted business loans, total loans, and total bank credit fell more in August at District banks than in the nation as a whole.

Mr. Wayne commented that thus far banker reaction to the discount administration policy announced in the System's letter of September 1, 1966, had ranged from approval to resignation to the inevitable. There had been no adverse comments nor had any of the banks asked for special considerations referred to in that letter.

The national economy continued to show evidence of overspending despite a reduced pace in some areas, Mr. Wayne observed. On balance, inflationary pressures were probably a little stronger in August than in earlier months. Prices continued to rise although a few divergent trends were beginning to show. The latest data available on inventories indicated that they were behaving in a manner typical of inflationary periods and in a way almost certain to cause trouble later. Capital outlays remained at a very high level but there had been a few signs which indicated that the pace might be starting to taper off.

With respect to policy, Mr. Wayne said, the Committee had had almost no room for maneuver even before the President made his fiscal proposals last week. Now, it seemed to him, there was even less. Obviously, an increase in the discount rate or significant tightening in any other form would be a flagrant rebuff to that move toward fiscal cooperation which the Committee had sought for a long time. On the other side, there were no valid reasons for any easing of restraint. The fiscal proposals were not yet law and there was no evidence of "any easing of inflationary pressures." To him that suggested that the Committee should follow a very strict "even keel" policy while Congress acted on the proposals and, unless there were urgent reasons to the contrary, until the initial effects of the measures could be evaluated. He would expect the short-run effects to be salutary, because they helped to clear the air respecting the objectives of fiscal policy and should therefore have a settling and strengthening effect on the bond market. Except for those announcement effects, the results of the proposed measures were likely to develop slowly and uncertainly. The initial impact would be on corporate profits and capital investment, both of which fluctuated widely and which might now be approaching their peaks irrespective of the proposed tax changes.

In the meantime, Mr. Wayne thought the Committee faced a very difficult problem in implementing monetary policy in the next week or two. The large flows of funds over the tax and dividend dates, the prospect of a sizable runoff of CD's, the banking system's reactions to the System's policy announced on September 1, continuing large demands on the capital market, and the volatile reactions of the financial market as the fiscal proposals were debated and acted upon--all of those impinging on a market already nervous and unsettled would provide a very turbulent environment in which to carry out any policy. He could see no alternative but to give the Manager wide discretion and ask him to follow as closely as possible the same policy the Committee had been pursuing in recent weeks. It was very likely that the Manager would often have to give first consideration to market conditions but, subject to that, he should attempt to maintain about the same level of reserve availability as had prevailed in the past month.

A directive as proposed by Mr. Hayes seemed consistent with Mr. Wayne's idea of a desirable posture for the next three weeks and perhaps longer.

Mr. Shepardson said he thought the economic situation had already been clearly described today. While there were some conflicting indications, most of the evidence still indicated a strong, booming pace of economic activity. The President's program introduced an element of uncertainty since one could not know how it would be implemented, and how quickly. All of which, it seemed to him, called for maintaining a policy position as nearly like the present position as possible. He did not think the Committee should be unduly influenced by a one-month downturn in bank lending, in the face of the preceding long-protracted uptrend.

Mr. Shepardson said that, like others, he thought the draft directives were mislabeled. Alternative A seemed to him definitely to be an easing directive, and he considered inappropriate some of the changes suggested in its first paragraph. Alternative B more nearly contemplated maintaining the present policy position, and it was worded in a way that would give the Manager the necessary degree of leeway. The final clause, calling for seeking still greater reliance on borrowed reserves if bank credit expanded more than seasonally expected, seemed to him to be proper. Basically, over the coming period the Committee should try to maintain the present degree of restraint without either firming or easing. The directive Mr. Hayes had suggested went a long way in the same direction, and it might be preferable to the staff's alternative B.

Mr. Mitchell presented the following statement:

> In the current financial environment the directive properly emphasizes the "maintenance of orderly money market conditions and the moderation of unusual liquidity pressures."

A major reason for this concern over liquidity pressures is that so long as interest rates on market instruments are higher than Regulation Q ceilings there will be a trend toward "disintermediation"--that is, toward a run-off of negotiable CD's at banks. In addition to our concern over liquidity pressures, we must understand the implications for monetary policy of such a run-off in CD's.

We start with the fact that, today, yields on market instruments attract investors holding maturing negotiable CD's; *i.e.*, investors are responding to the current pattern of interest rates by reducing their claims on banks and increasing correspondingly their holdings of short-term securities.

What appears to be happening is thus a reversal of the process that occurred when Regulation Q was raised at the beginning of 1962 and negotiable CD's increased rapidly. Perhaps all that is necessary for an understanding of the problem at hand is to reverse the signs on the analytical and policy conclusions reached four years ago. At that time, it was concluded that a shift of the public's claims *toward* bank time deposits and away from securities and nonbank financial institutions tended to absorb bank reserves and required offsetting open market purchases by the System.1/

Under present conditions, holders of negotiable CD's who do not wish to renew will probably purchase

1/ We also observed, four years ago, that the term structure of interest rates was affected by the shifts, even if the System accommodated them--for banks tended to acquire longer-term obligations than the public gave up when it switched to time deposits at banks. Such market impacts were regarded as desirable at that time, helping to hold up bill rates and to hold down yields and increase the availability of funds in the municipal, mortgage, and other longer-term markets.

short-term agency issues, municipals, commercial and finance company paper, and bankers' acceptances. To the extent banks hold these types of paper, we can cut through the intervening analysis and simply imagine that banks redeem maturing CD's by handing over such short-term assets, thus reducing both their assets and liabilities.

Assuming that 100 of maturing CD's were paid in this way, the results would be as follows:

Bank assets	-100
Time deposits	-100
Money supply	No change
Total reserves	No change
Required reserves	- 6
Excess reserves	+ 6
Public's holding of securities	+100

Although bank credit and bank deposits would appear to contract, total credit available to the economy would not be affected nor should there by any further impact on interest rates, in this example. All that has happened is a reshuffling of assets between the banks and the public with attendant effects on the distribution of total credit availability and the shape of the yield curve about the reverse of those that accompanied CD expansion (see footnote, page 57). In short, there will have been a shift away from intermediation by the banks.

However, the situation with respect to excess reserves is unstable; unless they are absorbed by the System, they provide the basis for net credit and money supply expansion.

In order to check on this short-cut reasoning, it is useful to examine the process under the more realistic assumption that those holding maturing CD's take the proceeds initially in the form of demand deposits, which they in turn use to purchase the short-term obligations they wish to hold. I have done this and find that the conclusions are unchanged once the transitional churning is over.[1]

The net result of a switch from CD's to market instruments is, in the absence of offsetting action by the System, to increase the over-all supply of credit and money and to reduce average level of interest rates. So long as individual banks in the course of reducing their

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1/ Assume that 100 of CD's mature. The first step is that the holders receive either a credit to their demand account in the issuing bank or a check which they deposit in their own banks. In any event, the banking system finds 100 of its deposits shifted from time to demand status, with an immediate impact on required reserves, in addition to churning of reserves among banks as checks on banks that redeem CD's are deposited in other banks.

But since the former holders of CD's intend to acquire higher yielding assets rather than additional cash balances, we must assume that the new demand deposits will quickly be used to purchase short-term securities. Since the supply of such securities much be assumed to be uninfluenced in the short run by these developments, the securities will presumably be purchased from existing holders, and the demand deposits pass to the sellers of securities. At the same time, banks as a whole find themselves under reserve pressure because time deposits have been converted to demand deposits. Assuming total reserves to be held constant, the banks will begin to dispose of assets in order to adjust their reserves. As banks sell securities, they reabsorb demand deposits, thereby reversing the increase in both required reserves and demand deposits that accompanied the switch from CD's to market instruments.

The switch of 100 from time to demand deposits increased required reserves by, say, 9 (assuming the average reserve requirement on demand deposits at the banks involved to be 15). In order to reduce required reserves again, banks need to lower their demand deposits by only 60, which means they must dispose of only 60 of securities. It should be recalled that the former holders of CD's will be in the market purchasing 100 of short-term securities. To reach complete parity with the short-cut illustration itemized earlier, the System would now have to be motivated to absorb 6 million reserves in order to reduce demand deposits by 40, back to their original level; and the total of 40 securities sales by the banks and the System to accomplish this adjustment would equilibrate the buying being done by former CD holders.

assets did not cause security markets to become disorderly, the System would want to absorb the excess reserves released by the reduction in CD's.

What is the implication of this analysis for the aggregate measures upon which policy operates? To be specific, assume a decline in negotiable CD's of about $2 billion; then apart from the disturbances in security markets arising out of adjustments by banks to the loss of deposits, the aggregates will be affected as follows if the System acts to absorb the $120 million in reserves that are released as CD's decline:

1.	Bank credit (proxy)	-$ 2 billion
2.	Public holdings of securities	+ 2 billion
3.	Money supply	No change
4.	Total reserves	-$120 million

This decline in bank credit and total reserves would not per se represent a tightening of policy. If the market consequences of the changed distribution of credit availability go beyond the bounds consistent with current policy, we may want to take account of this in our operations. But these are distinctions that it is important to recognize, and to communicate, in order to be clear first to ourselves and then to the many observers and critics of monetary policy.

Mr. Mitchell added that he preferred alternative B to A for the directive. However, he would delete the last clause of the first paragraph, reading "by restricting the growth in the reserve base, bank credit, and the money supply." He thought the clause was inappropriate at this time because, as his analysis indicated, there was likely to be a basic inconsistency in the three measures cited. In the second paragraph, he would insert the words "firm and" before "orderly money market conditions." He did not like the proviso clause because it was written in terms of bank credit, whereas he felt that the focus should be on money supply. Others might prefer an interest rate target. In any case, the Desk could operate properly without the clause, and he would prefer to see it deleted.

Mr. Daane said he favored maintaining the current degree of restraint and, to use a phrase Committee members had employed in the past, "watchful waiting." He would give the Manager flexibility to carry out the spirit of the Committee's intentions.

As to the draft directives, Mr. Daane said, he agreed that there was a flavor of easing in alternative A that was not appropriate at present. He would accept the first paragraph of alternative B with Mr. Hayes' amendment to the last clause. Alternatively, he would have no great objection to deleting the last clause of the paragraph as Mr. Mitchell suggested. For the second paragraph he preferred Mr. Hayes' suggested language.

Mr. Maisel said he could agree with much of Mr. Mitchell's analysis but he differed in the interpretation of the current state of the monetary variables. If one considered the period since September 1965, and more particularly that since January 1966, most such variables--with the exception of bank loans and possibly total loans--appeared to be running considerably below a normal growth rate. The degree of monetary restriction had been substantially greater than might have been thought, and it would appear desirable to return to something closer to normal growth rates.

Mr. Maisel noted that he had expressed the hope on previous occasions that weekly net borrowed reserve figures would vary more than they had in the past. That goal appeared to have been attained recently, if only as a result of large revisions in the preliminary figures. He agreed with Mr. Hayes' conclusion that the net borrowed reserve figures should be subordinated now.

Mr. Maisel thought it was important to accept Mr. Mitchell's suggestion for deleting the reference to the reserve base, bank credit, and the money supply from the first paragraph of the directive. For the second paragraph he would prefer a modified version of Mr. Hayes' proposal. It would be best, he thought, to avoid referring to expectations, particularly since there was a difference between the Board and New York Bank staff projections. He would call for operations to be modified "in light of . . . any apparently significant deviations of money and bank credit from a normal seasonal growth pattern." By "normal" for bank credit he meant a 4-6 per cent growth rate in the credit proxy.

Mr. Brill commented that the difference between the projections at the Board and the New York Bank did not reflect any basic disagreement on the outlook for bank credit. They were mainly definitional; the Bank's projection included the credit expansion expected as a result of a continued pull-back of funds from foreign branches, which was not allowed for in the Board's projection.

Mr. Hayes said he was a little puzzled by Mr. Maisel's use of the term "normal seasonal growth pattern," which seemed to call for no growth on a seasonally adjusted basis. In any case, he would prefer not to pinpoint an operating target in that manner.

Mr. Maisel replied that, as he had indicated, he had a 4-6 per cent growth rate in mind as normal for bank credit.

Mr. Mitchell commented that with a reduction in bank intermediation underway such a growth rate in bank credit was likely to have strong inflationary effects. He thought it would be better to refer to total credit than to bank credit alone.

Mr. Holmes noted that figures on total credit were available only quarterly, in the Board's flow of funds accounts, and with a time lag so that total credit was not a workable operational guide for the Manager.

The go-around then resumed with remarks by Mr. Brimmer, who noted that at its meeting just three weeks ago the Committee had no expectaions of further assistance from fiscal policy. Now that it appeared that some assistance would be forthcoming, the general view around the table was that the Administration's program was not good enough. Personally, he thought the Committee should keep policy unchanged while observing developments with respect to the fiscal package--and he would emphasize that it was a package and not simply a collection of miscellaneous items. It was not possible to foresee the effectiveness or the timing of the elements, but there had been some effects already, as indicated by the Manager's comments regarding the postponement of agency issues. As he understood the plan, the Treasury proposed to sell a substantial volume of agency issues to Federal trust funds and to increase sales in the market of short-term

Treasury securities. Such operations might have a significant effect on money market conditions and would have to be taken into account in open market operations; the Committee might find itself engaged in some sort of an even keel operation. In any case, the monetary implications of the Administration's package were serious.

Mr. Brimmer recalled that two months ago he had said publicly that suspension of the investment tax credit might be helpful, and he continued to think so. At the same time, he thought the Committee should not be overly optimistic about the package, but should wait to see what happened. As to Mr. Brill's suggestion of a policy of "passive restraint," he (Mr. Brimmer) did not think the System should be passive; there were some difficult areas--especially in connection with the new discount administration program--that would call for active steps. However, if Mr. Brill meant simply avoiding active further restraint he agreed with him.

Mr. Brimmer said that he favored alternative A for the directive with the several modifications suggested by Mr. Hayes.

Mr. Hickman commented that the economy continued to move forward under forced draft, reflecting pressures generated mainly by business and defense spending. The rate of increase in consumer spending was rising in the third quarter, after declining in the second quarter, but would still fall short of the unusually rapid advance of the first quarter. Business investment outlays were exceptionally high, both absolutely and relative to personal consumption expenditures, but the rate of advance seemed to be moderating. Defense spending remained as the great unknown, with almost a complete absence of reliable information.

Recent price developments suggested to Mr. Hickman some moderation of inflationary pressures, although that might be temporary and illusory. Spot prices of raw industrials continued to decline, and now were about 13 per cent below their mid-March peak. The recent behavior of meat and wheat prices suggested that food prices probably would not move higher over the rest of the year. An additional straw in the wind was provided by Dun and Bradstreet's latest reading of businessmen's expectations, which showed a small decline in the percentage of businessmen expecting year-over-year price increases next quarter, the first time that had happened in two years.

Mr. Hickman observed that financial markets were nervous and uncertain, reacting in an extreme way to facts and rumors. For that reason alone, he would prefer not to make any change in monetary policy for the next three weeks. With most aggregate reserve measures lagging anticipated rates of growth, and in some cases actually declining, there was little doubt that the System's restrictive policy was taking hold. Most importantly, business loans declined during August, on a seasonally adjusted basis, which indicated--despite some special factors--that the excessive rate of expansion of bank lending was moderating. Other reasons for holding a steady course were the President's five-point plan to combat inflation announced last Thursday and the heavy run-off of CD's anticipated in some quarters during the next few weeks.

Although it might be academic now, Mr. Hickman said, he should report for the record that at the Cleveland Reserve Bank directors' meeting last week--before the President's announcement--there was considerable discussion about the effects of rescinding the investment tax credit, and the pressures that a rescission might generate on the demand for bank credit. The general conclusion was that elimination of the tax credit would have negligible short-run effects, and that its long-run effects would be highly questionable.

Mr. Hickman had a slight preference for alternative A of the staff draft directives, with the second paragraph as revised by Mr. Hayes. The words "current conditions in the money market" in the staff's draft troubled him in view of the sharp run-up in bill rates now underway. However, the exact wording of the directive was not too significant to him. As he had indicated, he favored "no change."

Mr. Bopp said that as he balanced various considerations bearing on policy for the next three weeks he found the weight falling on the side of no change. That conclusion rested on three points, no one of which alone was very persuasive, but which in combination suggested that the best course--for the present, at least--was not to tighten further through open market policy.

First, Mr. Bopp was not impressed with the likelihood that the President's new program would be very effective in relieving the burden on monetary policy. The tax measures would not have much effect for many months, and it remained to be seen what would be done on the expenditure side. Yet the fiscal program should help to some extent in restraining demand; and, although it would be unwise to try to lower interest rates, as the President suggested, it seemed desirable--for the time being, at least--not to take action which would raise them.

Second, it seemed to Mr. Bopp that the future effects of the System's new discount policy were still very uncertain. Conversations with large Philadelphia banks suggested that vigorous efforts had already been made to slow the growth of business loans. Most banks expected to hold such loans at about current levels or within the usual seasonal rise. The banks believed that they would be able to meet their loan demands by issuing consumer-type CD's, borrowing Federal funds, and selling assets--in that order. Borrowing from the Federal Reserve would be a last resort.

To make the new discount policy effective, Mr. Bopp continued, open market operations would have to move aggressively to force banks much more extensively into the discount window. If the attitudes of Philadelphia banks were typical, open market action might have to be vigorous indeed. The resulting effect on market rates could be drastic. Announcement of the new policy was favorably received. He would be inclined, therefore, to move cautiously in implementing the new discount policy and would not push open market policy so far as to force a materially larger volume of borrowing.

Third, Mr. Bopp observed, as the staff reports indicated behavior of total bank credit and the money supply had been more reasonable recently. He found little comfort in that fact in view of likely future demands for credit. On the other hand, it was increasingly important to be alert to the cumulative effects of restrictive policy actions already taken. For the time being an attitude of watchful skepticism seemed to be the most appropriate.

Mr. Bopp observed that the directive suggested by Mr. Hayes would accomplish the kind of no-change position he had in mind, with the deletion in the first paragraph proposed by Mr. Mitchell.

Mr. Patterson commented that in analyzing the economy every three or four weeks one might be reading more into figures than one should. But even allowing for strikes and seasonal quirks, some indicators for the Sixth District indicated a slowing down in the District economy's forward momentum. One such sign was the slackening in employment gains. Another was the decline in new car sales in July. A third was a reduction in residential building. Nevertheless, non-residential construction was still keeping the total contract volume ahead of last year. And over-all District business conditions were undoubtedly still on the upside. That he gathered not only from the behavior of longer statistical trends but from the Atlanta Bank's directors and other contacts.

The banking figures for the District showed some interesting new developments, Mr. Patterson reported. Starting in early August, total loans at the large banks had declined for four straight weeks. Business lending had also fallen off, even though reports showed loan demand remaining high. That curtailment of loans confirmed statements by bankers in recent conversations to the effect that they were eager to restrict the pace of their lending operations. Recent unfavorable deposit flows were probably partly responsible for that pressure. District banks usually lost deposits at this time of the year, but this year they lost 50 per cent more demand deposits from mid-July to the end of August than last year. Furthermore, they had gained little in the way of time deposits during the same period. Since the banks were dependent to some extent on an inflow of deposits from outside the District, pressures in northern money market centers were evidently being transmitted to the Sixth District.

Mr. Patterson remarked that District bankers, of course, were saying the same thing indirectly when they reported that large companies that had not borrowed from them for many years now wanted to make use of their standing commitments. Those conditions, and other national developments, suggested to him that tightened credit conditions had begun to take hold.

Mr. Patterson went on to observe that after having labored so long for that to happen, one might be tempted to say: "Let's pour on more of the same." But unless those trends were reversed and permissible rates on negotiable CD's raised, he did not believe the Committee's open market policy should become more restrictive, at least at this time. He was especially worried that the short-term financial markets might not stand too much additional strain. He was in the dark about how to translate that prescription into policy for the next three weeks. However, he thought the new discount rules made guidance by net borrowed reserve figures more difficult than ever. Since the System was so concerned with the trend of bank lending, he wondered if it might not be desirable, at least experimentally, to use seasonally adjusted bank loans as a principal guide, while taking account of changes in bank security portfolios, member bank borrowing, and conditions in money and securities markets. However, the "no change" directive was acceptable to him.

Mr. Lewis commented that various monetary indicators had shown a marked change in direction since early summer. Whether judged by bank reserves, money supply, or interest rates, a significantly different trend had apparently developed since about May or June. From May to August, the money stock declined at a 3 per cent annual rate after rising 6 per cent in the preceding year. Total member bank reserves and reserves available for private demand deposits similarly shifted from increases to decreases. Federal Reserve holdings of Treasury securities and changes in reserve requirements contributed net to effective reserves at only a 3 per cent rate compared with 8 per cent in the preceding year.

Likewise, Mr. Lewis continued, interest rates had gone up much more rapidly since May than in the preceding year. Yields on long-term Government bonds had increased at a 20 per cent annual rate since May compared with 10 per cent in the preceding year. Yields on commercial paper had gone up at a 39 per cent rate since May compared with 23 per cent in the preceding year.

Such a shift of monetary indicators this past summer seemed to Mr. Lewis to have been appropriate. Under conditions of essentially full use of available resources, of accelerating price increases, and of unusually stimulative fiscal policy, it seemed to him that monetary expansion was appropriately limited. Looked at in another way, it seemed likely that under the influence of high interest rates, price inflation, and a strong propensity to invest, the demand for money to hold had been declining and therefore the supply of money also appropriately declined.

Since he saw no pause in the inflation, Mr. Lewis said, and since the fiscal situation appeared to be even more stimulative in the last half of 1966 than in the first half, he believed the Committee should continue in the near future about the same policy as that which had prevailed in the last three months. The turn of fiscal policy last week was, of course, immensely pleasing. He thought the Committee needed to study very carefully what might be the magnitude and timing of the effect.

With respect to discount rates, it had seemed to Mr. Lewis some time back that the rates should be raised. But, as circumstances had developed, that did not seem now to be of the first importance. The System had been able to achieve a considerable monetary restriction despite a discount rate far out of touch with the market. During the three summer months there was very little increase in borrowing from the Fed in spite of the rapid rise in market interest rates. So far as he could see, discounting could be kept within reasonable bounds in the course of normal administration of the window. While he disliked the windfall profit which accrued to those banks which borrowed from the Reserve Bank at 4-1/2 per cent and lent at 6 per cent or more, he believed it was sufficiently limited in amount and sufficiently dispersed among banks that it need not for the moment weigh very heavily in the System's considerations.

Mr. Robertson then presented the following statement:

> I think this is one of those times when it is particularly difficult to be sure of the ideal course for monetary policy to follow.
>
> Inflationary pressures are persisting, as the staff materials have underlined. Economic activity is expanding vigorously, bolstered by strong business investment outlays and growing Federal expenditures. Moreover, I take it that further escalation from added Vietnam outlays has to be considered as a possibility, even though we are still too much in the dark about such a development as of now to base current policy upon it.
>
> To counter these inflationary pressures, we now have the promise of help from a somewhat greater degree of fiscal restraint. However, it is very hard to judge just how much effective restraint the Administration package is likely to provide, and how soon. To a certain extent, over-bullish expectations may have been moderated by the very announcement of an official determination to achieve a more restrictive fiscal posture. But the actual effects on spending may stretch out over a number of quarters ahead.

Meantime, monetary policy has also become tighter, with lagged effects that must similarly be expected to stretch out over the quarters ahead. In the face of strong credit demands, we have managed to put bankers under enough pressure to slow down the rates of growth of bank credit, deposits, and the money supply. Our indicators of the cost and availability of credit are also signaling new degrees of tightness, and thanks to our new program of discount administration, we have some extra insurance that such tightness will prove better balanced than before.

Given what we have recently accomplished with the reserve pressures we have brought to bear, I think it is time to begin guarding against the possibility of substantially less than expected as well as greater than expected bank credit expansion. With this view, I was glad to see the staff draft directive A include a "two-way" proviso clause this time, and I hope we make that a part of whatever directive we adopt this morning.

In my view, our general objective for policy at this juncture would be to hold about the current degree of restraint. I think that would be our best posture as we wait for the combination of recent public policy steps to begin to have their effects. What money market signals these may give us in the interim is, I judge, open to some question. Since mid-August, net borrowed reserves and Treasury bill rates have moved in largely opposite directions, and I take it the staff is not at all sure this performance will be any more consistent in the weeks immediately ahead.

If member bank borrowings amount considerably higher as large banks seek discount window assistance to meet their September squeeze, I would again urge the Manager not to engage in open market purchases simply to reduce such borrowing, but instead to be prepared to operate so as to keep such injection of borrowed reserves from significantly easing money market conditions. But I do not think that any net borrowed reserve figure or particular money market rate can be a target for us in the present circumstances. I would rather take the money market and reserve conditions we have currently prevailing, and tell the Manager to increase those pressures somewhat if bank credit expands sharply more than seasonally expected, but also to be prepared to ease up somewhat on such pressures if bank credit should expand substantially less than seasonally expected.

> I think these views are most in accord with the language suggested in staff directive alternative A, if the words "substantially less" are substituted for "no more" in the second-paragraph phrase reading "if bank credit expands no more than seasonally expected"; and if the words "by tempering" are substituted for "while accommodating moderate" in the last clause of the first paragraph.

Chairman Martin remarked that, having just returned after an absence of two months, he obviously was insufficiently informed on recent developments to make a long statement. While on the side-lines during his absence he had been cheering for the System team and he thought it had done exceedingly well. He congratulated Messrs. Hayes and Robertson on the quality of their leadership in a difficult period.

He was impressed today, the Chairman continued, by the high degree of agreement on policy. The intent of the Committee seemed clear--there should be no overt action in either direction, and market conditions should be kept as stable as possible. The difficult question was how to compose a directive that would most effectively implement such a policy. Personally, he could accept either of the alternatives suggested by the staff, with or without various amendments that had been offered. As was often the case, the proposed directives were subject to different interpretations, depending on how one read the words. He had felt defeated over the years in the effort to develop directives that were understandable to the public and to the Committee and that worked. The Chairman then invited suggestions regarding the directive.

In the ensuing discussion the Committee agreed on a first paragraph for the directive consisting of that contained in the staff's alternative B, with the final clause deleted. Discussion of the second paragraph was concerned mainly with the choice between the proposals of Mr. Hayes and Mr. Maisel, or some modifications thereof. Specific questions considered were whether the proviso clause should refer to deviations of "bank credit", "credit", or either of these in combination with "money"; and whether the deviations should be considered from "current expectations" or "normal seasonal growth." The Committee concluded that the proviso clause should relate to "deviations of bank credit from current expectations", as proposed by Mr. Hayes, after taking note that the current expectations for bank credit movements included allowance for some prospective disintermediation.

Mr. Maisel commented that he understood the policy contemplated by the directive would be most accurately described by the label the staff had put on its original alternative A, namely, "No further firming, with qualifications."

> 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 is expanding vigorously, despite the substantial weakening in

> residential construction, with inflationary pressures persisting. Aggregate credit demands continue strong and short-term financial markets remain under strain. The balance of payments continues to reflect a sizable underlying deficit. In this situation, and in light of the new fiscal program announced by the President, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm but orderly conditions in the money market; provided, however, that operations shall be modified in the light of unusual liquidity pressures or of any apparently significant deviations of bank credit from current expectations.

Chairman Martin noted that Mr. Robertson had appeared on behalf of the Board before the Senate Banking and Currency Committee this morning regarding H.R. 14026, a bill that would, among other things, give flexible authority to all Federal supervisory agencies to set maximum rates on deposit-type accounts. The Chairman invited Mr. Robertson to comment.

Mr. Robertson observed that his testimony had been quite brief. He had said that the Board's views had not changed from the time of his testimony before the Committee on August 4, 1966; that the Board endorsed the bill, except for the one-year limitation of the effectiveness of its provisions that had been added by amendment in the House. He had indicated that the Board considered that limitation unwise (except with respect to a "sense of Congress" provision regarding a reduction in interest rates) and that the limitation might well thwart the effective use of the new authority. In response to the only question asked of him, he had expressed the view that the bill as written was better than nothing.

Chairman Martin then noted that a staff memorandum dated September 1, 1966 and entitled "Contingency planning for the U.S. Government securities and other financial markets" had been distributed to the Committee.1/ He invited Mr. Holland to comment.

Mr. Holland said that the memorandum had been prepared by Board staff members, in consultation with staff of the New York Reserve Bank and the Treasury, in accordance with the Committee's instructions at the previous meeting. The object was to bring up to date a similar contingency plan prepared a year ago when there also was concern about a possible sterling crisis. As in the earlier memorandum, the purpose was not to resolve basic issues of policy but rather to discuss a "holding operation" that would allow time for such policy decisions in light of the specific circumstances prevailing, and the approach was fairly general. The differences from the earlier contingency plan stemmed primarily from three main differences in underlying conditions: dealer bond inventories now were considerably smaller than a year earlier, credit conditions in general were considerably tighter, and there now were likely to be problems in markets for securities other

1/ A copy of the memorandum referred to has been placed in the Committee's files.

than U.S. Government securities. No formal action by the Committee was required today, but the staff would take account of any comments on the memorandum that the members might have.

No comments being heard, Chairman Martin suggested that the staff memorandum be kept on file for possible use in case of need.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 4, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

September 12, 1966

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 13, 1966

Alternative A
(No further firming, with qualifications)

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding vigorously, despite the substantial weakening in residential construction, with inflationary pressures persisting. Aggregate credit demands continue strong and short-term financial markets remain under strain. The balance of payments continues to reflect a sizable underlying deficit. In this situation, and in light of the new fiscal program announced by the President, it is the Federal Open Market Committee's policy to help to counter inflationary pressures and restore reasonable equilibrium in the country's balance of payments, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, and taking account of possible needs to moderate unusual liquidity pressures, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current conditions in the money market; provided, however, that if bank credit expands substantially more than seasonally expected, operations shall be conducted with a view to seeking some further firming of money market conditions; and, if bank credit expands no more than seasonally expected, some easing of money market conditions shall be sought.

Alternative B
(Firming to extent feasible, with qualification)

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding vigorously, despite the substantial weakening in residential construction, with inflationary pressures persisting. Aggregate credit demands continue strong and short-term financial markets remain under strain. The balance of payments continues to reflect a sizable underlying deficit. In this situation, and in light of the new fiscal program announced by the President, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying the minimum amount of reserves consistent with the maintenance of orderly money market conditions and the moderation of unusual liquidity pressures; provided, however, that if bank credit expands more rapidly than expected, operations shall be conducted with a view to seeking still greater reliance on borrowed reserves.