MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, September 12, 1967, at 9:30 a.m.

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

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

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

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

Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Adviser, Division of International Finance, Board of Governors

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

Mr. MacDonald, First Vice President, Federal Reserve Bank of Cleveland
Messrs. Eisenmenger, Eastburn, Mann, Brandt, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Cleveland, Atlanta, Kansas City, and Dallas, respectively
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on August 15, 1967, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on August 15, 1967, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period August 15 through September 6, 1967, and a supplemental report for September 7 through 11, 1967. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that there had been no change in the Treasury gold stock this week, and that in view of the current level of the Stabilization Fund's holdings it was probable that there would be no reduction in the Treasury's stock over the next month or so. On the London gold market, demand had eased off from the very high levels of July while South African deliveries had risen. The position of the London gold pool was about the same as at the time of the previous meeting of the Committee, with a balance of about $30 million available for use before it would be necessary to call for additional contributions. The latest developments in the Far East were having some effect on the gold market; demand had risen in the last few days and the pool had experienced some losses this morning. All in all, the situation in the gold market remained delicate.

In the sterling market, Mr. Coombs continued, the much improved trade figures for July that had been released on the day of the Committee's last meeting had been very helpful in quieting down the scare stories about imminent or eventual devaluation of sterling and in checking the erosion of confidence in the pound. As a result, the British reserve drain had been reduced from a monthly rate of about $800 - $900 million in July and early August to a rate of about $400 million since mid-August. The trade figures for August were due to be published tomorrow. Unless they showed a serious deterioration, he thought the

Committee could continue to assume that the British problem was not that of an overvalued currency and a basic payments deficit, but rather a combination of seasonal and confidence factors which were being greatly aggravated by interest arbitrage flows out of sterling to the Euro-dollar market. For the past three weeks, for example, all of the British reserve losses had been attributable to a run-off of maturing forward contracts which could not be renewed because the foreign investors could reinvest more profitably in the Euro-dollar market than in London. To correct that situation the Bank of England needed to take some action to raise short-term rates in London. If despite the obvious political difficulties such action were taken, it might then be possible to put together a package of measures which--while individually rather minor--in combination might reverse the current outflow of funds from London.

What he had in mind, Mr. Coombs observed, was that after the British had raised their domestic short-term rates by, say, 3/8 or 1/2 of a percentage point, the Federal Reserve and the U.S. Treasury might enter the market to buy sterling on a guaranteed basis under agreement with the Bank of England, in an effort to nudge up the spot rate. The Bank of England might simultaneously operate to reduce the forward discount on sterling, and the Bank for International Settlements might, as it had on previous occasions, draw on its swap line with the System and intervene in the Euro-dollar market in order to reduce rates there slightly--perhaps by 1/8 or 1/4 of a percentage point. In combination, those measures might bring about a return flow of money to London and some covering of short positions, which had again reached massive proportions.

Meanwhile, Mr. Coombs continued, sterling remained in an extremely vulnerable position. He had been trying to insure that an unduly large share of the burden of credit assistance to the British did not fall on the Federal Reserve, and he had made some progress on that score at the BIS meeting last weekend. Both the British and the continental representatives agreed that sizable British drawings of cash under the sterling balance credit arrangement were desirable to balance out earlier heavy drawings on the System. Also, there was some hope that British drawing privileges under the sterling balance credit arrangement would be liberalized, thus enabling the British to draw still more from continental sources and further relieving pressure on the Federal Reserve. As a result, even if the British ran a deficit during September of $400 to $500 million he would hope that any further drawings they made on the swap line with the System would not be heavy.

Mr. Coombs said that he was convinced that what the British needed now was not additional central bank credit. At present their debts of $1.4 billion amounted to roughly 50 per cent of their reserves.

More than $1 billion was still available to them under existing facilities but the big question was whether they would be prepared to mortgage a much higher percentage of their reserves. Looking to the future, he thought that sterling might squeak through the next few months and show some recovery after year end when seasonal forces favored the pound. This would depend, however, on several conditions being fulfilled. If the British did not suffer any further bad luck such as the Middle East crisis and the closing of the Suez Canal, if their trade figures did not show any deterioration and perhaps reflected some progress, if they were relatively cautious in connection with reflationary measures, if their short-term interest rates moved up somewhat, and if too much pressure was not put on their rate relationships as a result of heavy borrowings in the Euro-dollar market by New York banks--then, the British might pull through.

Mr. Coombs then noted that at the latest BIS meeting there were developments of interest to the Committee with respect to two other currencies. First, a representative of the Bank of Italy, which had taken in $400 - $500 million over the summer, indicated that the Bank would like to have the Federal Reserve make a drawing on the swap line to buy some part of those dollar accruals. Secondly, Japan's external position had shifted into deficit in the first half of this year, and a representative of the Bank of Japan had indicated that they might want to make a drawing on the swap line toward the end of 1967 or early in 1968. The Japanese had already launched a corrective program and their record over the past 10 or 15 years in correcting deficits was extremely good. If they did draw on the swap line he thought they could be relied on to repay their drawings within the usual schedule.

Mr. Mitchell remarked that he gathered from Mr. Coombs' last comment about sterling that the recent heavy borrowings in the Euro-dollar market by U.S. banks had hurt the British.

Mr. Coombs replied that he did not think that was the case. The $1 billion or so which New York banks had borrowed through their foreign branches in July and August had been roughly counterbalanced by the supply of dollars resulting from the U.S. deficit and by movements of funds into the Euro-dollar market from Germany, Switzerland, and to some extent France. His concern was that the equilibrium in flows that had emerged largely by coincidence in July and August might not persist in the fall; there might then be a tendency for the countries that recently had been supplying funds to repatriate them and for conditions in the Euro-dollar market to tighten. Under those circumstances, if the New York banks continued to draw in funds from that market at the July-August rate they would be putting pressure on sterling. So far the British had done nothing to defend themselves against such pressures; the question was whether or not there was anything they could do.

By unanimous vote, the System open market transactions in foreign currencies during the period August 15 through September 11, 1967, were approved, ratified, and confirmed.

Mr. Coombs then noted that two drawings by the Bank of England on its swap line with the System would reach the end of their three-month terms soon--one of $100 million maturing September 27, 1967, and one of $125 million maturing September 29. Also, a System drawing of $33 million on the Swiss National Bank would mature on October 3, and a System drawing of $15 million on the Bank for International Settlements would mature on the same date. He saw very little chance that any of those four drawings would be paid off at maturity, and he recommended that they all be renewed for further periods of three months if necessary. Each would be a first renewal.

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

Chairman Martin then reported briefly on the recent meetings on international monetary reform of the Ministers and Governors of the Group of Ten, which he had attended along with Messrs. Daane and Solomon from the System. He said that at the outset of the earlier meeting, which had been held in London on July 17 and 18, it had not been clear that it would be possible to arrive at a framework acceptable to all. After a long discussion the group had almost reached agreement on a "harmonization" principle proposed by the Italians, which would call for proportionality, after a point, in each country's use of gold and foreign exchange on the one hand and of the new drawing rights on the other. However, the French had indicated that they wanted to study the matter further. As a result that meeting had adjourned without agreement, but on the understanding that the Deputies would attempt to arrive at some judgment regarding the Italian proposal. The Deputies then met in Paris on July 27 and 28, and reached the almost unanimous conclusion that the harmonization principle was more complicated and less practical than an "average use" principle.

When the Ministers and Governors met again in London on August 26, the Chairman continued, the Italians indicated that they disagreed with the consensus of the Deputies and that they still strongly favored the harmonization principle. Indeed, even after the meeting was over Governor Carli of the Bank of Italy remained unconvinced that the Deputies were right. However, although he had been primarily responsible for the Italian plan in the first place, Governor Carli helped persuade the Italian Finance Minister to go along with the average use principle. Unanimous agreement was finally reached at 10 p.m., at the end of a long session that had begun twelve hours earlier, on a plan providing for a 70 per cent average use principle on a five-year basis. This involved a small compromise on the part of the U.S. representatives, who had advocated a figure of 75 per cent. Another compromise was involved in the U.S. acceptance of an 85 per cent requirement for decision-making, which gave the Common Market countries veto power if they voted as a bloc. However, Secretary Fowler won unanimous support for the proposition that, while any proposals for review of IMF procedures--which had been actively sought by some European countries--would be studied carefully, decisions on such matters would not be a precondition for putting the new drawing rights plan into effect. It was particularly important that the French Minister of Finance agreed with that proposition.

In general, Chairman Martin observed, the new drawing rights were intended to have equal standing with gold and foreign exchange, and to be carried as reserve assets on central bank balance sheets. But, as he had indicated in the press conference on August 29, they would have to earn their way, growing in international acceptance as a tree grows. The basis had been laid, however, and the agreement represented a major breakthrough.

In his judgment, Chairman Martin said, Secretary Fowler had done an extremely good job in leading the U.S. delegation and had been supported effectively by Under Secretary Deming. They, in turn, had made gracious comments about the assistance from the Federal Reserve. Since his (Chairman Martin's) contribution had been limited to moral support, all of that assistance had been rendered by Messrs. Daane and Solomon. Everyone in the System had reason to be pleased with the work they had done in the Deputies' meetings leading up to the sessions of the Ministers and Governors. It was clear that the Federal Reserve had played a useful role in the negotiations.

The Chairman noted that the full text of the outline plan for monetary reform agreed upon by the Group of Ten had been published in today's New York Times. Also, he would ask the staff to supply a copy of the plan to each member of the Committee, and he knew that Messrs. Daane and Solomon would stand ready to answer any questions the members had. The Executive Directors of the International Monetary Fund had approved the plan yesterday. It would be formally considered at the meeting of the Fund in Rio de Janeiro later this month, and he expected no difficulty--nor, he understood, did Mr. Schweitzer of the IMF.

The Chairman then invited Mr. Solomon to comment further.

Mr. Solomon said he would add a word or two to what Chairman Martin had said about the London agreement on international liquidity. In some respects the language of the agreement had an "Emperor's new clothes" quality. The outline provided for a facility to create "special drawing rights"--rather than a "reserve unit." And that it was called a drawing right rather than a unit had been characterized as a concession by the United States and a victory for France.

The fact was, Mr. Solomon continued, that the new reserve facility was a drawing right in name and a unit in substance. It differed from existing IMF drawing rights in that it was directly transferable, whereas one used existing drawing rights in the Fund by purchasing other currencies with one's own currency. In the case of the SDR one transferred it just as one transferred gold--in exchange for the currency of the country to which it was transferred. It was difficult to imagine what characteristics of the SDR would be changed in order to transform it into a unit.

Mr. Solomon noted that the major restriction on the use of the SDR was the reconstitution provision--which stated that countries would not, during the first five years, use more than 70 per cent of the amount allocated to them. Hopefully that restriction could be dropped after the first five-year period. But aside from that provision, there was nothing in the presently-agreed plan that would inhibit the development of SDR's into a full-fledged reserve asset. In fact, he would think that the present blueprint could stand for 20 years and serve the world well without needing revision. Thus, what was agreed at London was, in his view, much more than a half-way house. The tree must grow, as Chairman Martin had said. That is, monetary authorities around the world must accustom themselves to it and must begin to treat it as a reserve. The point he wished to make was that there was nothing in the agreement that prevented such treatment.

Thus, Mr. Solomon concluded, one came back to the elementary proposition that a thing would be accepted as money if it was accepted as money. He would repeat that there was nothing in the agreement to prevent the full acceptance of SDR's as international money and, in particular, as a good substitute for gold.

Chairman Martin then invited Mr. Daane to comment on the recent Paris meeting of Working Party 3 that he had attended.

Mr. Daane noted that he had not attended a WP-3 meeting for several years and had found this one, which lasted for a day and a half, to be extremely interesting. In particular, he had been impressed by the way in which the participants were finally beginning to grapple with the central problem of reconciling balance of payments aims of the individual countries. Much of the time was devoted to a review of the internal policies of France, in the course of which there was considerable criticism--largely by other Common Market countries--of the French program to speed up their economy. A good deal of skepticism was expressed concerning the French projections indicating a 4 per cent growth rate in production. It became clear during the discussion that one reason the French did not want to adopt more expansive domestic policies was that they were highly conscious of their balance of payments positon; they wanted to remain a surplus country.

The rest of the meeting, Mr. Daane said, was devoted to discussion of the longer-run aims of other countries. It became apparent that all countries sought surpluses on current account. The U.S., Britain, and others made cases for enlarging surpluses on current account, and the Japanese spoke in terms of more than doubling their reserves over the next five years. The Common Market countries indicated that they thought it was their "duty" to run current account surpluses. No conclusions were reached, and the subject would be discussed further at the next meeting.

Obviously, Mr. Daane continued, all countries were reluctant to relinquish reserves. That underscored the need for the new reserve asset to help meet the desires for reserves. He thought the incompatibility of the various national aims was quite clear.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period August 15 through September 6, 1967, and a supplemental report for September 7 through 11, 1967. Copies of both reports have been placed in the files of the Committee.

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

> Since the last Committee meeting, as the written reports indicate, money market conditions remained comfortable during a period of Treasury financing. The Federal funds rate averaged a bit below 4 per cent, with brief periods of ease and firmness, reflecting the shifting distribution of reserves between money center and country banks. Interest rates on Government securities, both short- and long-term, moved higher early in the period and subsequently declined before reversing direction again in recent days. On balance the three-month Treasury bill rate closed the period about 17 basis points above the level prevailing at the time of the last meeting. In the coupon area, yields on Government securities maturing in up to about 5 years rose from a few to as much as 20 basis points, while yields on most longer-term issues declined slightly. Pressures in the corporate market relaxed somewhat toward the close of the period as the calendar of new issues receded from its earlier high point, but many market participants are anticipating a further build-up soon. In the municipal market on the other hand, where the calendar remained heavy, yields on new issues rose by about 10 basis points, just about offsetting the declines that followed the President's tax message.
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> Open market operations, designed to maintain an even keel during the Treasury's cash financing, were relatively limited in scope. Matched sale-purchase agreements were used twice during the period to temper excessively easy money market conditions. Labor Day reserve needs were met by outright purchases of $300 million Government securities, including the purchase of about $50 million coupon issues, and through repurchase agreements. Over the past three working days operations were once again complicated by an unexpectedly sharp decline in the Treasury's cash balances, which required offsetting open market

operations. The Treasury in fact had to borrow $153 million directly from the System over the weekend on a special certificate, the third such borrowing this year. After yesterday's 11 o'clock call we received new Treasury estimates that indicated they would again have to borrow, beginning tomorrow through at least September 18. Our own estimates are not quite so pessimistic, but if the Treasury numbers are borne out, average free reserves for the week ending September 20 would be nearly $1/2 billion above the level we were estimating yesterday morning. With this in mind we bid in yesterday's auction to redeem $100 million of our Treasury bill holdings maturing on September 14.

As far as the proviso clause of the directive is concerned, the credit proxy in August behaved about as anticipated at the last meeting, with September now being projected at an annual growth rate of 9 - 12 per cent. While this is 2 to 3 percentage points above the rate anticipated at the time of the last meeting, the proviso clause was not brought into play because of the predominance of even keel considerations over most of the period, while the unexpectedly sharp decline in the Treasury balance last week caused enough problems for open market operations.

The direct Treasury borrowing from the System was necessary even though $2-1/2 billion in cash was raised with an offering on August 17 of a 5-3/8 per cent note priced at a discount to yield 5.40 per cent. With most Government securities dealers hoping for a longer maturity and a 5-1/2 per cent coupon, the offering attracted only routine interest. Dealer underwriting was below normal and dealer allotments amounted to only about $290 million of the new issue. The new 5-3/8's declined in bid price to as much as 9/64 below the original issuing price in secondary market trading. The major underwriters were quick to dispose of their holdings and the new issue appears to be pretty well distributed. In the subsequent market rally the bid improved to 3/64 over the original issue price, but closed last night at 99-21/32 bid, about 4/32 below the offering price. While the Treasury offering was routinely successful in raising new money, the relatively poor secondary market performance has probably not particularly helped the Treasury in its major financing program over the rest of the calendar year. So far in the current half-year period the Treasury has raised or has made arrangements to raise about $8 billion in new money. While estimates vary, depending on tax, participation certificate, and other assumptions, an even larger amount may have to be raised before the year end, and the Treasury will obviously need all the underwriting it can get. While the bulk of the new money can probably be raised through issuing tax bills and increasing the regular bill cycles, the Treasury will have to be in the market almost continuously from the end of September on and may again run into temporary problems of an inadequate cash balance. Current Treasury plans tentatively call for an offering of $4-1/2 billion or so of tax bills late this month, with the auction scheduled for early October.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 15 through September 11, 1967, 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 presented the following statement on economic conditions:

After returning to the office from vacation, I am impressed and delighted by the developing strength of the economy during recent weeks. I say this even though some very recent statistics have been somewhat less strong than might have been expected, and despite the fact that an auto strike has begun. I am delighted both because the economy needed a prompt recovery from the lull of last winter and spring and because it conforms to the staff's earlier projections.

Having said this, though, I want to throw a word of caution into this morning's discussion of the likely future course of economic events. In the first place, the green book[1] projection only went through the fourth quarter and assumed no effective tax increase before the end of the year. There is no implication in the projection that the quarterly increases in GNP in 1968, when most likely a tax increase is going to be in effect, will equal the $20 billion rise of the fourth quarter. The increases in industrial production and new orders to date have been quite selective and due in part to special factors.

Also, a vigorous recovery, if it does occur, is likely to be different in some important respects from most earlier ones. It will be sparked mainly by further rises in consumer and Government spending and a change from sharp inventory liquidation to modest accumulation, rather than by a business investment boom in fixed capital. Most observers have felt for some time that business spending on plant and equipment would be an essentially neutral force in economic developments over the near-term future. The latest Commerce-SEC survey confirms this view.

The staff's projection of a large rise in GNP in the fourth quarter depends mainly on an assumed further sharp rise in consumption and personal incomes, the latter due both to increased employment and higher wages. This is probably a more firmly based assumption than usually characterizes most parts of models. In the longer run, of course, personal income and consumption will depend mainly on the strength of all other types of spending taken as a whole, but many of these in turn depend upon the trend in consumption.

It will also be noted that the staff's projection of a large increase in consumption occurs despite an assumed continued high personal savings rate. This also seems likely to me, particularly if a 1968 increase in individual income taxes is adopted fairly early in the quarter.

The strength of the nascent expansion also depends on the course of inventories and defense spending. It is by now an old story that a massive inventory down-drag was the main factor in dampening the rise in total GNP in the first quarter and that a reduction in the drag has been the main factor producing the larger increases in GNP in the second and third quarters. Some renewed accumulation

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

of inventories is a likely prospect for the fourth quarter and beyond. The rate will, of course, depend to a large extent on the course of aggregate final sales, but stocks of goods are still high historically in many manufacturing lines relative both to sales and to outstanding orders. Manufacturing stocks rose again in July but the rise can be explained mainly by special factors.

As for the likely future course of defense spending, it is comfortable for us to sit back and pat each other on our backs while watching the Administration now foresee a rise in such spending in fiscal 1968 up to $4 billion more than projected in the January Budget Document, knowing that our staff had been projecting such an increase for some time. But the technicians in the Defense Department and Mr. McNamara, himself, are not admitting that defense spending is likely to rise so much, assuming that military policy does not change significantly. They are doing their best to keep spending closer to the January projection.

Even if one grants that a vigorous economic expansion is still uncertain, he can be quite concerned by the threat of serious further wage and price inflation. This is a major threat, but the period of most rapid over-all price escalation may be over.

As I see the recent renewed rise in the total industrial price index, it is the result of an accumulation of a large number of fairly moderate, selective increases spread over a variety of products and industries. In part, these rises represent a catching up of prices with costs following a period during which demand factors inhibited producer inclinations to raise prices. To the extent that the recent rise has been a catching-up process, it may moderate in coming months. While one can expect further attempts to raise prices to offset higher costs, 85 per cent capacity use may not sustain all increases that are attempted, and the staff projects 85 per cent utilization of manufacturing capacity for the fourth quarter. This rate is not likely to be exceeded in early 1968.

The farm and food price picture has also shifted again following the sharp run-up in May and June. These prices rose less than seasonally in July and then declined substantially at wholesale in August. Prospects for increased supplies of grains and a sustained relatively large volume of livestock and products this fall suggest only moderate further upward movement in retail food prices in the near-term future.

If food prices show only a small rise, this should put less upward pressure on the over-all consumer price index and hopefully on some wage demands. Although most wage increases will probably continue for some time at least to exceed the increases in productivity, the rise in unit labor costs may be less steep in coming months than it has been over the past year. Productivity seems to be on the rise again and as output expands, fixed costs per unit of output will decline. I am impressed by the fact that almost all economic forecasters predict rising corporate profits from here on out despite expected higher variable costs.

So far I have mentioned only obliquely perhaps the most important single economic event that has occurred since the last meeting, namely, the beginning of the long expected auto strike. This has been intentional, for the judgment of the staff, with which I agree, is that the strike is likely to be relatively short, selective, and to have only a small effect on the course of the over-all economy. There is some justification for this view in the history of the 1964 strike. But there is a chance that the strike will be prolonged and/or widespread, a development that could have a depressing effect on over-all fourth-quarter activity. There is, of course, also the possibility that a generous auto settlement will set the pattern for an even higher round of wage increases in the future than has characterized the recent past.

Although I agree with the staff consensus that economic expansion is gaining in strength, I guess I am not quite as confident about its vigor as the latest green book projection suggests. Nevertheless, I still feel that recent economic developments and their likely prospects suggest that it would be the better part of wisdom to get a sizable tax increase on the books as soon as possible.

I have little doubt that the economy will expand quite strongly over the winter. But we need sizable increases in GNP for a while to make up for the first half's lull. And I'm afraid we have to accept some further price and wage increases, a large portion of which will have been borne out of the past. On balance, it still seems to me too early in the recovery to firm credit conditions further lest in so doing we jeopardize the full realization of the expansion.

Mr. Brill made the following statement regarding financial developments:

I suspect we are now on the verge of witnessing a rare economic phenomenon--economic activity heating up and financial markets cooling off. Let me hasten to add that the cooling off I have in mind is mainly in long-term rather than short-term markets, and is likely to be more of a stabilizing rather than a significant easing in pressures. And it should also be added that the evidence on the surge in economic activity is stronger than the clues we have on changes in financial market tensions.

But I do think these clues add up to more than a trivial argument. In the capital markets, for example, corporate bond yields have edged lower over the past two weeks as the corporate calendar has lightened. The volume of public offerings definitely scheduled for September totals only about half the monthly average during the spring and summer. Of course, the calendar is highly elastic, and reports abound of additional borrowers poised for the first easing opportunity to bring forth new issues. Moreover, the municipal calendar is quite large for September, and the potential backlog there, too, is said to be sizable.

But the corporate calendar could expand substantially and still not be as far out of line as has the volume of flotations in recent months. And the fact that many of the names associated with the corporate and municipal backlog have been bruited about for some time, and still remain potential, suggest that there may be more of a floor under future long-term rates than renewed upward pressures.

The other bit of evidence of moderating pressure in the financial system is the sharp contraction in business loans in August, a decline which about offsets the large July increase. So far this year, business loans have expanded only half as much as in the comparable months of 1966 and 1965. Corporate needs for bank funds have been reduced by the lower rate of inventory investment and by the tremendous flow of capital market and commercial paper financing; these have more than offset the financing needs arising from the drop in profits and the higher flow of current tax payments.

Now these latter two factors are likely to be changing direction. Profits should be doing better in the fourth quarter; our GNP projection would put fourth-quarter profits slightly above last year's peaks. But corporate tax payments over the balance of the year are expected to be little changed from the comparable months of 1966. Thus, even with some easing in capital market financing and some rebuilding of inventories, business demands for bank credit could continue at a moderate pace. Recent reports that some bankers are trimming their expectations for fall loan demands, and recent reductions in short-term CD rates--while partly explainable on other grounds--are at least not inconsistent with this loan outlook.

Obviously, one month's bank loan developments and one or two weeks of reduced pressure in capital markets are hardly sufficient for establishing broad financial trends. But I would guess--without the benefit of a rigorous flow-of-funds analysis--that if financial markets behave in a manner consistent with what the staff projects for basic economic forces in the green book, the course of longer-term interest rates over the next month or so would be fairly flat. And although short rates will be under pressure from the financing the Treasury will have to announce shortly, the rise could be limited by generous tax and loan privileges and some accommodating reserve provision to ease markets over the bank underwriting period.

Unfortunately, financial markets don't always move consistently with current economic forces, as we observed earlier this year, when market pressures arose from the reaction to last year's developments and to emerging fears of a replay later this year. Markets are still hair-trigger sensitive. Any authoritative suggestion that fiscal restraint might not be forthcoming or, in the event, might be too mild, could easily end the still tenuous rate stability.

Similarly, any development suggesting that Federal Reserve policy was tightening could set off a strong market reaction. While current bank loan demands may be below par, many borrowers are reportedly trying to pin down bank funds for the future, by seeking term loan commitments, refurbishing credit lines, and so forth. These loan demands could turn into a precautionary scramble for current, as well as future, funds. Banks don't have too much room for maneuver on the liability side, at least from domestic sources. Some large banks are reportedly at or close to the ceiling on longer maturities of large CD's, and the recent interest rate survey indicates that the bulk of large banks are at the ceiling on consumer CD's and savings accounts.

For the other institutions, there is some indirect evidence that the construction pickup under way over the past year is beginning to result in a larger volume of completed homes and, therefore, a growing current need for permanent financing. Takedowns on earlier mortgage commitments are apparently reaching a volume closer to current savings inflows, for the S&L's are beginning to tap the Home Loan Banks again and to draw on their liquid asset reserves. So far this activity has been mild, but it is a major change in flows from earlier this year, when heavy S&L repayments to the Home Loan Banks permitted substantial Federal debt retirement.

It seems to me, therefore, that despite the modest reduction in financial market tension, and the recent slack in business loan demands, it would be difficult to achieve even a mild snugging up on policy without running the risk of an exaggerated reaction through the financial system, with the ultimate impact again concentrated on the housing sector. The army of "Fed watchers" that has arisen since last year would raise the alarm over even so gentle a nudge as might be involved in keeping Federal funds above 4 per cent consistently, and letting the free reserve range drop by about $100 million.

There are risks in inaction, too. The longer we accede to the buildup in inflationary momentum, the wider the price advance becomes and the more likely it will be embodied in further wage demands. And it may be that even when fiscal action does come, it will be too mild and will have to be supplemented by monetary restraint. To be effective in time, in this event, probably would require our beginning to move overtly toward restraint now.

Thus, policy decisions today rest on a very fine balance of economic risks. My own assessment comes out--narrowly--on the side of waiting, recognizing that we may not have any better basis for taking action three or six weeks from now. But I cling to the hope that two major economic uncertainties--the duration and impact of the auto strike, and the likely shape of tax legislation--will be clarified fairly soon. I'm not that sure of a short strike, nor that pessimistic about Congressional tax action, to feel that the risks of financial turmoil are worth taking at this juncture.

In recommending a "no change" directive, I should add that my qualms about delay are not assuaged by the inclusion of a one-way proviso.1/ Backing into mildly tighter money market conditions, if bank credit should

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

rise faster than is consistent with an already inflationary GNP, is hardly an effective stabilization policy. I would personally prefer a positive program of action--or inaction.

Mr. Hayes referred to Mr. Brill's suggestion that the Committee wait three or six weeks before deciding whether to change policy, and asked whether Mr. Brill did not agree that even keel considerations would be highly important at those times.

Mr. Brill replied that even keel considerations undoubtedly would be important at the time of the Committee's meeting six weeks from now. However, he was not sure that would be the case at the time of the meeting three weeks hence, unless the Treasury's expected offering of tax bills in late September was of sufficient size to require an even keel.

Mr. Hayes rejoined that while the Treasury's plans were still somewhat uncertain he had the impression that even keel considerations would be significant for most of October and November. With respect to the size of the cash offering of tax bills to be announced later this month, the Manager had reported that the Treasury tentatively planned a large offering--about $4-1/2 billion.

Mr. Mitchell asked whether, in light of Mr. Brill's presentation today, the Manager would give his assessment of the alternative sets of money market conditions set forth in the blue book[1/] as possible goals for open market operations in the period ahead. In particular, did Mr. Holmes agree with the observations on pages 7

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

and 8 of the blue book[1/] concerning the possible consequences of seeking firmer money market conditions?

Mr. Holmes noted that three alternative sets of money market conditions were described in the blue book, of which one involved no change from prevailing conditions and one was associated with a policy decision to firm. The third--which was described as intermediate--was suggested as a set of conditions that might be permitted to develop if growth in bank credit exceeded projections and brought the proviso clause of a "no change" directive into play. On the whole, he agreed with the judgments in the blue book that the financial markets were in a highly sensitive condition now--as they often were--and that there were some risks in seeking firmer conditions. However, he thought there was room to move toward slightly firmer money market conditions. If the Committee was

1/ The passages on pages 7 and 8 referred to read as follows: "Because market participants are very sensitive to the possibility of a change in monetary policy at this juncture, the tighter stance would probably be quickly detected and translated into sizable expectational rate increases, especially in the intermediate- and longer-term maturity range. How far and how long such market adjustments might run would depend in good part on the intensity of the discussions likely to follow as to implications for further monetary policy action, disintermediation, Regulation Q, and changes in the mix of fiscal and monetary policies.

"The possible effect of any such firming of market conditions on bank credit growth might well be perverse in the first few weeks. Banks may increase efforts to capture such CD funds as they could while rate ceilings permitted and also to accelerate inflows of Euro-dollars. Subsequent moderation of bank deposit expansion might prove either gradual or abrupt, depending upon how tightly CD rates crowded up against Regulation Q ceilings."

inclined to make such a move, in recognition of the risks it might call for a probing operation in which the Desk would pull back if firming actions led to undesired reactions.

Mr. Maisel asked whether the risks Mr. Holmes had in mind were primarily of sharp upward movements in interest rates, or whether he was also thinking about the risk that it might prove necessary to supply reserves at the rapid rate of, say, December 1965 and December 1966.

Mr. Holmes replied that in his judgment there was a risk of both a rise in rates and an accelerated growth in bank credit. If precautionary borrowing developed as a result of a general feeling that monetary policy was being tightened and would be tightened further, bank credit might well spurt but he thought that any such reaction would be temporary.

Mr. Brill noted that the initial reaction to a firming of policy might be an expansion of bank credit beyond that based on reserves supplied at the System's initiative, as banks pulled in time deposit funds by raising CD rates to their Regulation Q ceilings.

Mr. Mitchell observed that such a development would represent a rechanneling of funds; that is, an increase in bank intermediation.

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

> The most recent balance of payments data show some improvement from the substantial deficits that had prevailed in late 1966 and the first half of 1967. The official settlements measure has shown a surplus since

mid-year as the inflow of Euro-dollars from branches to head offices has resumed, and this may be related in part to the difficulties of sterling this summer.

But there has apparently been an improvement beyond this. The deficit on the liquidity basis has also declined since mid-year, and this does reflect Euro-dollar flows--since liabilities of head offices to branches count as liabilities to foreigners. Since there have been few special transactions this summer, the underlying improvement is even better. We know nothing about the transactions that account for this improvement. All we know is that certain unusual transactions of the second quarter may not have continued in the summer--for example, enlarged remittances to Israel and a pre-season movement of U.S. tourists to Canada in the second quarter.

It may be useful this morning to step back from the most recent developments and take a look at the balance of payments in a longer time perspective. The underlying deficit has been disturbingly large over the past year. How does the balance of payments compare with what it was before the voluntary programs were inaugurated?

To provide an answer to this question, I propose to compare the balance of payments over the past year--that is, the four quarters of fiscal year 1967--with the annual average over the three years 1962-64.

We find that the balance of payments deficit over the past year--from mid-1966 to mid-1967--is not very different from what it was on average in 1962-64. On the official settlements basis, the deficit over the past four quarters was $300 million smaller than in the earlier period. On the liquidity basis, the published figures show an improvement by almost $1 billion from 1962-64, but if we add back in the investment of dollar balances by foreign monetary authorities in long-term time deposits, we find that the deficit in the past year was about $400-$500 million larger than in 1962-64.

In very broad terms, then, there has been no improvement in the over-all balance of payments since 1962-64.

What has happened to the components of the balance of payments over the period? The most striking and unhappy fact is that the merchandise trade surplus has shrunk by $1-3/4 billion. The tendency toward an <u>increasing</u> export surplus evident earlier in the 1960's has been reversed since 1964. One may derive some comfort from the observation that the surplus from mid-1966 to mid-1967 was temporarily depressed, reflecting as it did excess domestic demand in

1966 and then recession in Europe. In recent months, the surplus has been a few hundred million dollars higher than in 1966-67. Nevertheless, one can't help concluding that the trade surplus is disappointingly small.

The balance on goods and services--the so-called current account--has deteriorated by almost as much as the merchandise trade surplus--$1-1/2 billion. An increase in net military expenditures of $0.7 billion was offset by an equal increase in net investment income. It seems fair enough to say that the balance of payments might have <u>improved</u> by $3/4 billion in the absence of the Vietnam war. But a significant deficit would still have remained, assuming the same domestic economic conditions that have prevailed. Thus, it is difficult to say that equilibrium would exist in the absence of the enlarged military expenditures in the Far East.

The $1-1/2 billion deterioration in the current account from 1962-64 was largely offset by an improvement in the balance on private capital account attributable to the interest equalization tax and the Federal Reserve voluntary program. The biggest swing is in bank loans to foreigners, which averaged $1-1/2 billion per year in 1962-64 and were cut back virtually to zero in the past year. Net purchases of foreign securities by Americans, which were already falling during 1962-64 because of the IET, were $350 million less in 1966-67 than the average in the earlier period. The reduction in these forms of private capital outflow of almost $2 billion--attributable to the Federal Reserve program and the IET--was partially offset by an increase in direct investment outflows. The flow of direct investment, even after subtracting that portion of it financed abroad, was $800 million per year <u>larger</u> in the past year than in 1962-64, before the Commerce program was instituted.

All in all, then, the private capital account improved by about $1.2 billion, offsetting most of the reduction in the surplus on current account. Meanwhile, Government grants and loans increased about $200 million and other elements in the balance of payments improved about $400 million.

What can we conclude from this look at what appears to be a chronic balance of payments deficit--a deficit whose components shift around but which shows a disturbing tendency to persist?

First, we may deplore the deterioration in the merchandise trade surplus. Some part of this deterioration reflects last year's excess demands in the United States and may be regarded as transitory. But our price level is now on an upward tilt and that will certainly not help our competitive position. One not very startling conclusion from all this is that the domestic case for the tax increase is strongly reinforced by balance of payments considerations. In contrast with the earlier 1960's, domestic and balance of payments considerations point in the same direction.

Secondly, however, we must recognize that if Europe were not in a slump, our exports would no doubt be significantly higher. We estimate that, if Europe, including the U.K., were at full employment this year, our exports might be \$1 to \$2 billion larger than they are.

If nothing else were changed this additional amount of exports would be enough to put us a good part of the way back toward equilibrium. But we can't assume that all else would be unchanged. For example, if Europe were at full employment, European interest rates would be higher and capital outflows from the United States might be larger. Nevertheless, it is fair to attribute a significant part of the shortfall from balance of payments equilibrium this year to the European slump.

Third, we have noted that while some forms of capital outflow have been reduced sharply under the influence of balance of payments programs, direct investment has gone the other way. There is thus a good case for tightening the Commerce program. Direct investment is probably the form of capital outflow least susceptible to the influence of monetary policy. Given this fact and the success of the IET and the Federal Reserve voluntary program, it is reasonable to say that balance of payments considerations do not call for a tightening of monetary policy at the moment, as long as the President's fiscal program appears likely to be enacted. This observation is reinforced by the still-precarious position of sterling, which would be adversely affected by a significant further advance in short-term interest rates here.

On the basis of this review, the road to balance of payments improvement appears to have three elements: recovery in Europe; avoidance of inflation here; and a tightening of the Commerce Department program on direct investment. The right combination of these three developments could move us a long way toward equilibrium. And any reduction in miliary expenditures abroad--if and when it comes--would be gravy.

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

> The economic expansion continues to pick up speed, about in line with our earlier expectations. Even the auto strike--as long as it is confined to one producer at a time, as seems probable--is unlikely to slow the advance appreciably. There will be a temporary dampening of the advance, but after the settlement of the strike we are likely to see an extra bulge of activity that will add inflationary fuel to what is already foreseen as a period of excessive pressures.
>
> The statistics suggest that July was a strong month and that August was probably even stronger. The mild dip in plant and equipment spending appears to be over and an upturn seems likely. The drag from the inventory adjustment is no doubt a thing of the past; only durables manufacturing shows an appreciable excess of inventories, and I believe that this will be absorbed through a rise in sales rather than further inventory liquidation. Even with the most conservative estimates as to the further growth of Federal Government spending, our projections through mid-1968 point to a greatly excessive rise in total demands in the absence of a substantial and prompt tax increase.
>
> Recent price developments have been decidedly disturbing, suggesting an acceleration of pressures. The August report of the National Association of Purchasing Agents and the fourth-quarter report of "Businessmen's Expectations" by Dun & Bradstreet show a shift toward greater concern over prices among purchasing executives. The price indices are already moving up sharply, and price increase announcements are becoming much too frequent for comfort. Even on the most optimistic assumptions as to the speed-up of productivity gains, cost-push pressures must be expected to add to the upward movement of prices.
>
> There is nothing very new in the balance of payments situation. While the August figures for the underlying liquidity deficit were somewhat better than July, and the third quarter may well show a good improvement over the second, the deficit remains much too high. The trade surplus has been only moderately satisfactory, and the

outlook for this major payments factor is discouraging as we move into a period of accelerating domestic activity. The official settlements balance has, of course, benefited from the recent sharp upsurge of Euro-dollar takings of American banks from their overseas branches. This latest steep rise of Euro-dollar borrowings occurred despite much easier money market conditions in this country than during last year's sharp increases. The recent very narrow interest differential between U.S. banks' CD rates and Euro-dollar deposit rates is undoubtedly an important factor in this year's renewed upswing, but the much greater readiness of U.S. banks to take advantage of dollar deposits available in the Euro-market has also played a part.

As for the area of credit and monetary variables, I must confess that I find it hard to evaluate this year's developments, especially in the light of last year's severe liquidity squeeze and the actual shrinkage in bank credit for a few months last fall. However, it does seem clear that bank credit expansion in July and August was on the generous side, as indeed it has been for the eight-month period since the beginning of 1967. The same comment would apply to the money supply. Fortunately current estimates suggest some slowing in bank credit growth in September, but I am not at all sure that the slowdown is sufficient. I am impressed by the substantial restoration of liquidity this year in several important sectors of the economy. With bank loans other than security loans rising only about half as rapidly as total deposits, loan-deposit ratios of commercial banks have moved down significantly, and there is a good chance that this tendency will continue over the coming months, with the banks taking on a substantial portion of the heavy prospective Treasury borrowings. Over-all liquidity of the nonbank public has been moving up strongly in relation to GNP since late 1966, with money supply and bank time deposits a major factor in this rise. The evidence suggests, however, that the recent gains in over-all private liquidity have been lodged principally in the consumer sector, whereas business corporations have made less progress toward rebuilding their liquidity.

With inflationary pressures clearly increasing, with our international position remaining very unsatisfactory, and with bank credit tending to grow too rapidly, the desirability of some modest move toward less monetary ease seems to me clearly indicated. Since even-keel considerations are likely to be important during much of the fourth quarter, today is probably a good time to make such a shift. However, I stress the word "modest" because I believe that, in the current state of the financial markets, there is clear danger that any overt move toward restraint could set off an unduly sharp upward adjustment in interest rates. We must also have in mind the possible adverse effects of any substantial interest rate adjustments on sterling--which is in a decidedly delicate state--although there are possible courses of action open to the British to mitigate such effects. Finally, I would hate to see an excessive rise in interest rates interfere with the vitally needed action on higher taxes.

What I have in mind is an effort to probe toward less ease, with borrowings of around $150 million--which might mean free reserves below $200 million--and with Federal funds trading at or slightly above the discount rate. In "snugging up" along the lines I propose, I think the Manager would have to be mindful of market reactions and should be ready to let up on the pressure if these reactions are too precipitate.

The wording of the directive should be modified to give expression to this new policy of modest and tentative tightening. For this purpose I would suggest using alternative B, but with the substitution in the second paragraph of the words "moving cautiously toward" for the word "attaining". I believe this modification would greatly reduce the risk of unduly sharp market reactions discussed on page 7 of the blue book and would, I hope, have expectational effects more closely resembling those described in the last paragraph of page 8 of the blue book.[1/]

Mr. Francis commented that it became increasingly evident that the economy was facing excessive demand for economic product. In the first half of this year final demand rose at an 8 per cent annual rate, about twice the rate of increase in the productive

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1/ The blue book passage on page 8 referred to read as follows: "The expectational impact of such a shading in market conditions is likely to be less than if firmer money market conditions are sought. While there may be some risks in such a course, the odds are that no significant disintermediation is likely to be triggered by so slight an adjustment, and long-term rates also may show only a minor response."

potential. More recently, the best evidence indicated that demand growth had been accelerating. Personal income rose at a 9 per cent rate from May to July and retail sales at an even higher rate. Consumer prices had risen at a 4 per cent rate since March.

Current and prospective excessive demand developments were not surprising, Mr. Francis said, in view of recent and prospective fiscal conditions and recent monetary expansion. The high employment deficit was estimated to be about $12 billion for all of this year, and it was projected to be at about a $15 billion annual rate in the first half of 1968. If a tax increase was enacted in the amount proposed but effective January 1, the deficit would be at about a $5-1/2 billion annual rate, less stimulative than during 1967 but about $13 billion more expansionary than in the 1963-65 period. The restoration of the investment tax credit last spring was now likely to become effective just as the economy faced a problem of excessive total demand. The money stock had increased at a 9 per cent annual rate in the past six months, the fastest for any six months in more than twenty years. Money plus commercial bank time deposits and commercial bank credit had gone up at 13 per cent rates over the past six months, about double the trends since 1957. Seldom before had there been such a juxtaposition of extreme ease in both monetary and fiscal measures. Those fiscal and monetary stimulations were probably operating with a lag, so that soon there would be acceleration in growth of both total and final demand and sharper price increases.

Mr. Francis remarked that the current or potential excessive demand had evidently been recognized by the Administration in its call for the 10 per cent tax surcharge. The Administration recognized that, under existing conditions, Government demand for loan funds plus private demand in excess of planned saving would result in inflation. All members of the Committee wished to do everything possible to foster adoption of sound fiscal policy. At the same time, a monetary policy was needed which would help to avoid excessive total demand. Those two objectives were not inconsistent. Monetary restraint required marked restriction of the rate of increase of money and credit; but that was consistent with support of fiscal restraint measures. There seemed to be widespread public belief that the Federal deficit was a major determinant of high interest rates. If higher interest rates developed over the next few months as the debate continued on the tax proposals, that should further highlight the need for fiscal restraint to limit interest rates. Accordingly, it seemed to him that the tax issue need not inhibit the appropriate limitation of expansion of money and credit. And the Committee should bear in mind that even if the tax proposal was adopted as recommended there would still be an extraordinarily stimulative high employment deficit which should appropriately be matched by monetary restraint.

If the System went on for the next several months supplying sufficient reserves to keep the money market easy, Mr. Francis said, it would extend further the recent unprecedented period of rapid monetary and credit expansion. Such a policy would feed and extend the imminent excessive demand and price inflation. The Committee should so manage the expansion of money and credit that the total loan funds made available to meet Government and private demands would not exceed planned saving. He suggested that the Committee moderate significantly the recent expansionary trend of money and credit, recognizing that appropriate adjustments could be made when and if fiscal stimulus was moderated.

Mr. Francis suggested a greater move toward monetary restraint than those discussed by the staff in the blue book in order to achieve marked reduction of growth rates of bank credit and money. In view of probable even keel considerations during the remainder of the year, this might be the last chance to change policy for some time. He preferred money market conditions as follows: some net borrowed reserves, Federal funds in the 4-1/4 to 4-1/2 per cent range, and a three-month bill rate of 4-3/4 to 5 per cent. Long-term interest rates would probably rise from current peak levels, but higher rates seemed essential if planned investment and planned saving were to equate. Any further expectational rise in interest rates fostered by the change in monetary stance would probably be temporary.

In addition, Mr. Francis favored a proviso clause that would require still more restraint if the bank credit proxy appeared to be rising faster than an 8 per cent per year rate in either late September or October. The limitation by appropriate monetary action of excessive demands, inflation, speculation, and further deterioration in the U.S. balance of payments appeared to be more crucial than any temporary hardships of the Treasury, financial intermediaries, and long-term borrowers resulting from higher interest rates.

Mr. Patterson reported that the latest information available for the Sixth District indicated that industrial activity was about to complete the adjustments that began early in the year. With manufacturing employment turning upward, the prospects were for further gains unless strikes kept down the job total. Consequently, additional improvement in District business activity was almost certain, although there was no evidence that the expansion was about to take on boom proportions. He viewed national economic conditions similarly.

Residential construction in the District was also likely to rise further on the strength of recent contract data, Mr. Patterson said, but perhaps not as much as previously expected. Only a few mortgage market participants had been contacted on the current survey. Those had been mortgage bankers in Georgia where housing demand had been generally good. Commitment volume was holding up reasonably well at present, but there was some reluctance to enter into long-range contracts for forward delivery. Demand for mortgage loans from prospective home buyers was still good. High discounts continued to impede resales. However, other terms and conditions had not changed to the point of significantly reducing mortgage loan demand.

In the banking area, Mr. Patterson continued, credit demands were still modest. Both business and total loans had declined for six straight weeks. However, most major banks expected business loan demand to be stronger over the next three months. Banks seemed well prepared to meet such an eventuality, unless lending demands were spectacular.

In those circumstances, Mr. Patterson felt there was no need to be as stimulative as the System had been for much of this year. Recently publicized studies of the lagging effects of monetary policy provided further support to that position. On the other hand, a restrictive policy was not justified by the weight of the economic and credit data. Thus, what he would like to see the Committee set as its objective was a <u>gradually</u> slower growth in reserves, the credit proxy, and the money supply.

At the present time, Mr. Patterson said, some of the measures that usually guided the Committee had already slowed down or were expected to do so in September. Still, he would hope that the Committee could go on record today on making or confirming a minor move toward less ease, if the Treasury calendar permitted it. For the directive he favored alternative B with the amendment proposed by Mr. Hayes and with a continued exclusion of any reference to coupon issues.

Mr. Bopp noted that so far this year, monetary ease had produced substantial increases in bank reserves, bank credit, and the money supply. The resulting rebuilding of liquidity on the part of businesses and consumers had been beneficial, considering the adjustments going on in the economy. Now that those adjustments were nearing completion, the Committee faced the critical question of how strong the economy would be when the full impact of monetary ease was felt. Whether the policy of substantial ease should be moderated now depended, therefore, on judgments about the future more than on current developments.

As he analyzed the flow of current information on the national economy, Mr. Bopp said, he found that clues to the future were hard to come by. Recovery was proceeding but there was not yet a sharp step-up in the rate of economic growth. Similarly, in the Third District neither July nor August appeared to have raised a major ground swell of economic change. Unemployment rates edged downward in August and new claims for unemployment insurance dropped slightly. Manufacturing output followed the national pattern, as did consumer credit--both showing slow increases.

Mr. Bopp saw some evidence on the financial side of a stronger demand for loans ahead, at least locally. The Reserve Bank's August survey of major commercial banks in the Philadelphia area indicated that the majority believed loan demand now was moderately stronger than three months ago and all expected it to be still stronger during the next three months. But only a few banks had already acted on those anticipations by increasing interest rates and tightening other lending terms.

The automobile strike had introduced some uncertainties which were virtually impossible to weigh, Mr. Bopp remarked. Because it would slow the economy somewhat for a time, any strong surge in the economy would be pushed further into the future. He was inclined, however, not to seize on that as a strong reason for postponing action on the monetary front. One reason for that position was that there already were cost pressures on prices. In recent weeks a rash of wage and price increases had been announced. More increases which monetary policy could do little about were now in the making. But continued growth of money and credit at the rates of the last six months would further increase the risk of demand pull.

Another reason for not postponing action, Mr. Bopp continued, was that it seemed increasingly likely that a tax increase could not become effective until the beginning of 1968. There was even a good chance that Congress would not go along with the President's request for a 10 per cent surcharge. Thus, in the near term, monetary policy could look for little help from fiscal restraint. A third reason was that prospective Treasury financing would leave very few, if any, open slots between now and the end of the year for decreasing the degree of monetary ease.

Therefore, although there was still much uncertainty about the degree and timing of any inflationary upsurge, Mr. Bopp was inclined to take the present opportunity to move toward somewhat less ease. His main interest was in a slower growth of money and credit during the next few months than had been the case in the past few months. Ideally, to accomplish that the monetary accelerator should be gradually released. However, even keel considerations meant that the slowing down of the rates of growth of the money supply and bank reserves must proceed less smoothly than the Committee might like.

Mr. Bopp's preference, therefore, was for definite action toward less ease. He thought that would best be achieved by alternative B of the draft directives, modified as suggested by Mr. Hayes.

Given the state of capital markets, Mr. Bopp said, one risk in that course was of a large increase in interest rates and resulting disintermediation. But the lighter calendar of corporate issues during the next few weeks decreased that risk somewhat. In addition, the heavy inflow of funds into thrift institutions thus far this year provided some insurance that, even if disintermediation were to begin to occur, there still would not be a credit squeeze like that of 1966. However, if the market reaction was in fact severe, the Desk should retreat toward the intermediate position outlined in the blue book.

Mr. MacDonald commented that the economic news was mixed, but on balance it appeared to be favorable. Until the automobile strike was settled the news would continue to be spotty, although it clearly was only a matter of time before expansionary forces became dominant. Nevertheless, the recent behavior of prices cast an ominous shadow over the economy.

The Fourth District had shown modest recovery from the inventory adjustment and strikes in the rubber and construction industries, Mr. MacDonald noted, but activity had since been sharply curtailed by the automobile strike. During the first six months of this year, the decline in manufacturing employment in the District was three times as severe as in the nation. In July, however, District indexes of manufacturing activity in major metropolitan areas moved upward, along with the national indexes. Moreover, nonmanufacturing employment in the District rose in July after three months of significant declines. Steel production, which had declined relatively more in the District than in the nation, began to recover in August, stimulated by the early start in the production of 1968 model autos.

Mr. MacDonald remarked that the course of regional business developments was revealed clearly by the Cleveland Reserve Bank's monthly surveys of large manufacturers. Beginning late last year, the surveys showed marked deterioration in key economic indicators and in sentiment. The deterioration was stemmed in June, and significant improvement occurred in August.

As for monetary policy, Mr. MacDonald did not believe this to be an opportune time to make a pronounced change, with business developments mixed and with the tax program indefinite. The Cleveland Reserve Bank continued to feel, however, that bank credit growth should not exceed 6 to 8 per cent. That being understood, he could accept either of the alternative directives proposed by the staff, but would prefer alternative B with Mr. Hayes' proposed amendment.

Mr. Sherrill said that he favored alternative A of the draft directives. The objectives of orderly financial markets and the attendant safety of financial institutions seemed more important to him under present circumstances than any modest gains that might be achieved by a slight tightening of money market conditions. With the President's fiscal policy recommendations now before Congress, there was some hope that a balanced program of public policies would be in effect in late 1967 or early 1968. Moreover, even a small increase in short-term interest rates at present could result in a serious problem of disintermediation, and in his judgment the potential gains from firming somewhat were not sufficient to warrant running that risk.

Mr. Brimmer said that he, too, favored alternative A for the directive, although he recognized that the prospect of further price increases was a real one. The most important consideration at the moment was the need to encourage fiscal action, which the members of the Committee had favored for some time. In his view any shift toward firming now would lead to rapid reactions in financial markets that would have seriously adverse effects on Congressional attitudes toward the President's program and would jeopardize its enactment. While he was not at all sure how soon Congress would act and how much of a tax increase would be approved, he thought it would be a serious mistake to reduce the chances of favorable action by firming monetary policy now. Moreover, Chairman Martin was scheduled to testify on the tax increase in hearings before the House Ways and Means Committee this week, and a move toward restraint by the Open Market Committee today, even if it was a modest one, could well complicate the discussion of the relations between fiscal and monetary policy that was likely to develop at those hearings.

In sum, Mr. Brimmer said, he thought the advantages of waiting a little longer before deciding whether to firm policy, to see how the tax bill progressed in Congress, outweighed the risks. In his judgment there would be ample opportunity to change policy later in the year if that appeared desirable; he would not be averse to acting, if necessary, in a period when even keel considerations might normally be important.

By way of digression, Mr. Brimmer said, he would note that the reserve projections indicated that the System would have to supply a substantial volume of reserves later in the year. He would suggest, as he had on past occasions, that consideration be given to meeting part of that reserve need not by buying securities but in connection with a modification of the structure of reserve requirements.

In a concluding observation Mr. Brimmer agreed with Mr. Brill that it would be undesirable at this point to back into a firmer policy through implementation of the proviso clause. Accordingly, he would suggest that that clause be deleted from alternative A.

Mr. Maisel remarked that the economy and the bank credit situation appeared to be developing just about as expected. The total expansion of the credit proxy and money supply had been high but those rates of expansion had been accompanied by almost record-breaking interest rates.

It was generally recognized that there were two basic reasons for those seemingly perverse movements, Mr. Maisel said. First, the individual units of the economic system had been frightened by their experience last year and they had determined to build up their liquidity. The rules of the game played by corporate treasurers were changed. Points were no longer scored for the amount of interest saved--instead, the treasurers were judged on their ability to insure future funds. It might be quite some time in the future before the ratio of money supply to the GNP began falling again as it had over most of the past 15 years. Individual economic units were willing to pay higher amounts to insure future liquidity. Bank balances were no longer considered a useless good to be reduced as much as possible in favor of real goods.

The second factor, Mr. Maisel continued, was clearly the increase in the public debt. The flow of funds projections for the current period had shown most of that debt being financed by banks, and bank credit expanding to the same extent. Those projections were in the process of being fulfilled. They appeared very accurate to date.

Mr. Maisel went on to ask whether there were any good reasons for desiring to make a specific change in policy at the present. Should the Committee want to raise interest rates rapidly enough to force the public debt out of the banks into the hands of individuals? Where would demand be cut and how would it affect the cost of living, wages, and prices? He saw no logical reason for wanting to change policy in that manner at the moment.

The credit growth was in accordance with the needs of the economy to expand back to full capacity, Mr. Maisel said. If there was to be excess pressure, it was likely to appear first in consumption and defense goods not readily affected by monetary events. It was necessary to do as much as possible to obtain the tax increase, and not to let Congress say, "The Federal Reserve is running the economy. Why should we move?"

As Mr. Solomon had pointed out, Mr. Maisel continued, the Committee had to be concerned that it not undermine sterling. Abrupt action could lead to a much greater problem in the international financial area--one far greater than any other now faced. All of those points argued against making a policy change now. The biggest worry, of course, must be that because of a lack of communication the market might assume that the Committee had come to a decision to tighten and that, as noted in the blue book, bank credit might perversely expand at considerably higher rates.

Mr. Maisel thought that most members of the Committee would agree that an optimum program would be to let the market change its expectations so that interest rates would drop and at the same time total reserves would expand less rapidly, even with net reserves and borrowed reserves staying close to the levels of the past two weeks. He felt the Committee's chance of obtaining that sort of outcome would be best if it adopted alternative A for the directive, including the proviso clause. He, too, agreed that the Committee could think and act more flexibly under even-keel considerations. He thought it must plan for greater flexibility to move in the future. The Committee should not consider itself locked in for long periods by even-keel considerations.

Maintaining current short-term market conditions might well mean a lower expansion of credit than would a change, Mr. Maisel said. The market conditions he had in mind were essentially those described on page 8 of the blue book; they would include a Federal funds rate running slightly above 4 per cent on average, member bank borrowings near $100 million, and two-week averages of free reserves between $200-$250 million. He favored including a one-way proviso clause in the directive with an upper but no lower limit on bank credit growth. He believed with such a program the Committee could expect to see the rate of expansion in the credit proxy and the money supply start to decline. At the same time the chances for obtaining a better fiscal-monetary policy mix would be improved.

Mr. Daane remarked that he would repeat what he had said at the previous meeting of the Committee--that, other things equal, he would favor moving gradually toward less ease. Although the economic outlook was becoming increasingly clear, it remained true that other things were not equal; the tax program was under active consideration in Congress and the likely extent and duration of the auto strike were not known. In his judgment the market was extremely sensitive at present to any kind of move on the Committee's part, even a camouflaged one. He was not certain that the Committee could now engage successfully in the sort of probing operation that Mr. Hayes had suggested or that it could achieve the kinds of money market conditions described as "intermediate" in the blue book, since in the present state of market sensitivity it was likely that expectations would quickly outrun the Committee's objectives. He was also concerned about the risks of disintermediation to which Mr. Sherrill had referred.

He was not happy with that conclusion, Mr. Daane said, since he thought the Committee was overstaying its policy of ease. But in his view the question was one of timing, and this was not the time to move. He would go a bit further than Messrs. Brimmer and Maisel had on the matter of even keel. If policy was not changed now, and if the present portents for the economy were realized, in his judgment the Committee would have to accept the obligation to act later even in the face of even keel considerations.

In sum, Mr. Daane said, on grounds of timing he reluctantly came out in favor of no change in policy now and for alternative A of the draft directives. As much as he would like to see some probing toward greater restraint, he would be quite fearful of the possible consequences under present circumstances.

Mr. Mitchell said he agreed with the analyses of the current situation presented by Messrs. Hayes and Bopp. It seemed to him that in their policy recommendations the staff had turned their backs on their own analysis of the situation. They had projected the fourth-quarter rise in GNP at an annual rate of $20 billion, the highest rate he could remember and more than the economy could absorb. From that flowed some responsibility on the part of the Federal Reserve to deal with the problem of "easy money," which was the term the press was using to characterize the present posture of monetary policy. In his judgment changing that posture would help, not hinder, tax legislation. He agreed with Mr. Daane that the Committee had overstayed its policy of ease. Unlike the latter, however, he would not object to moving toward less ease now, employing caution in the manner suggested by Mr. Hayes.

Mr. Mitchell referred to Mr. Maisel's question as to whether there were any good reasons for a shift in policy now. In his (Mr. Mitchell's) view, one useful result would be a change in the attitudes of bank managements. Bankers were going to begin thinking about the problem of redundant resources in the weeks ahead, particularly if loan demands disappointed their expectations in some measure, and they might well act more aggressively than desirable. He would like to have bankers come to believe that their resources were not going to be redundant.

Mr. Mitchell favored alternative B for the directive with the modification suggested by Mr. Hayes, except that he would omit the word "cautiously" from the phrase "moving cautiously toward somewhat firmer conditions." Also, he was unhappy about the use of the variable bank credit in the proviso clause, and would favor dropping the clause entirely if some more meaningful variable was not substituted. The course of bank credit depended in large part on the competitiveness of the banking system; the Committee's real concern was with the flow of total credit, and many people thought that money flows were important. He would suggest a proviso clause referring to money and credit flows rather than to bank credit.

Mr. Wayne reported that business in the Fifth District continued generally strong but the Reserve Bank's latest information contained little substantive evidence of any significant step-up in the pace of activity except for a modest increase in textiles. Reports from the textile industry indicated a definite recent improvement in demand and a general expectation that the recent 5 to 6 per cent increase in many textile prices would stick. The industry, however, continued to operate well below full capacity. Trade reports also suggested that recent improvement in retail furniture sales might affect production schedules and increase the chance of the generally expected price increases of 5 to 8 per cent in the near future. The Bank's survey showed little improvement in orders, backlogs, and inventories in lines other than textiles and furniture, and conflicting trends continued to mark District construction. The latest data indicated that employment gains in the District this summer had lagged behind those for the nation.

The latest information on the national economy suggested to Mr. Wayne that acceleration was now under way but that some areas were still lagging. The earlier model changeover in automobiles had affected comparisons and several strikes obscured basic trends still further. But the new orders series showed less strength in July than earlier in the year and the latest survey of capital spending plans was slightly less optimistic than previous surveys. Recent increases in construction outlays had been substantial in dollar terms but cost increases accounted for a considerable part of that. Moderate increases in employment and industrial production and small declines in unemployment over the past two months perhaps constituted the most significant evidence of improvement. It was clear that much of the impetus for the current advance derived chiefly from the public sector and to a lesser extent from private consumption. Whatever its dimensions, it was also clear that the advance faced important hurdles in the road ahead, among which were major strikes, rising wage costs, the probability of higher taxes, and rising materials costs.

The main problems of the economy, however, were in the financial area and centered primarily around the Federal deficit, Mr. Wayne said. The new budget estimates released last month emphasized the giant dimensions of that problem and gave a new perspective on the dilemma it posed for monetary policy. Even if the deficit did not prove to be as large as last month's pessimistic figures indicated, it would nevertheless be enormous and far larger than was projected a few months ago. In fact, one discouraging aspect of the very large figures was that they had apparently created a pronounced apathy both in Congress and in large parts of the public by engendering a feeling that any feasible tax increase would not be large enough to have any substantial effect. In any event, any tax action which was taken would not come soon enough to be effective when most of the borrowing would have to be done, which was in the next three to four months.

Demands on the capital market in the period ahead would be very heavy, Mr. Wayne continued, although hopefully the corporate demand would taper off somewhat. The large amount of funds required by the Treasury would, of course, be provided, resulting probably in a further increase in bank credit. At the same time the economy would be feeling the effects of the rapid growth of bank credit and the money supply over the past six to eight months, and those effects might well be an acceleration of the price increases now spreading through the economy.

Mr. Wayne noted that over the past eight months the Committee had taken strong action to stimulate an economy which was soft and threatening to slide into recession. The verdict of history might be that the policy followed was too easy. But the Committee proceeded on the hope and expectation, supported by the President's recommendations, that fiscal restraint would be available if and when the economy revived and restraint was needed. For various reasons fiscal policy had provided and was providing more stimulation than was intended and the expected restraint had become more uncertain as to both time and amount. Faced with that situation it seemed to him that the Committee had to choose between continuing its present policy and hoping for some assistance from fiscal policy; or going it alone and making a start toward tightening monetary policy, which would supply another argument to those who opposed the tax increase. It was a most difficult decision since either alternative involved considerable risks in both the financial and the political areas. Reluctantly he had to choose a continuation of the Committee's current policy for the present as the lesser of the two evils. Accordingly, he would prefer alternative A, with the proviso clause, for the directive.

Mr. Clay observed that recent economic information supported the projection of a marked upturn in business activity in the coming months accompanied by a strong tendency toward price inflation. It further underscored the need for a lessening of public policy stimulation. Fiscal policy action was hoped for in accordance with the recommendation of the Administration, but the specifications of any program that might be enacted were uncertain. On the other hand, it appeared almost certain that the timing of such action would not be soon enough to provide assistance from fiscal policy for some months and that monetary policy would have to be formulated in the meantime without benefit from that source.

After exceptional bank credit growth spanning nearly ten months, Mr. Clay continued, some moderation in the rate of credit growth seemed clearly warranted. That view was bolstered by a recognition of some lag in the impact of monetary policy actions. Moreover, the Committee appeared to be in a situation in which the policy appropriate for achieving domestic economic goals also was appropriate in attempting to attain international economic goals. In a sense, such a policy would be in keeping with that adopted and implemented by the Committee last spring, to which modifications had been made in recent months largely under the pressure of Treasury financing in a market of extraordinary credit demands and high interest rates.

Presumably a monetary policy of less ease in terms of credit expansion would be reflected in upward pressure on interest rates, Mr. Clay said. The issue involved was not whether interest rates were likely to rise, but whether the benefits sought under such a policy outweighed the costs. One factor was the risk of financial disintermediation and its attendant effects. The record on that score thus far probably was distinctly more favorable than most people would have expected. While there was no way to know for certain at what point of market interest rate developments that might be a problem, there did appear to be room for further interest rate adjustment. Another factor that needed to be given consideration in the formulation of policy was Treasury financing. Apart from periods of financing operations, it probably should not be a controlling factor in policy adjustment. In any case, implementation of policy could be carried out in a cautious manner that would enable those various factors to be taken into account.

Mr. Clay thought a special factor of considerable importance in the immediate situation was that this period was one of very few in the months ahead when any shift in Federal Reserve policy would not be severely circumscribed by actual Treasury financing operations.

The case for some beginning action toward a less expansive monetary policy was strongly reinforced by that fact.

For the period immediately ahead, Mr. Clay believed it would be appropriate to think in terms of bank credit growth at an annual rate of 7 to 9 per cent rather than the 9 to 12 per cent projected by the staff. Guidelines might involve money market conditions such as those set forth on page 7 of the blue book.1/ That would accept the possibility of a 90-day Treasury bill rate of 4-1/2 per cent or more. Alternative B of the draft economic policy directives appeared satisfactory to Mr. Clay.

Mr. Scanlon reported that the gradual improvement in business activity in the Seventh District noted a month ago was continuing. Rising incomes and renewed confidence in further economic expansion doubtless would induce a further rise in retail sales, and an early end to attempts to reduce inventories. Because of lower farm income and prospects for only moderate growth of demand for producers' equipment, it was unlikely that the District economy would advance as rapidly as that of the nation in the months ahead.

1/ The passage in the blue book referred to read as follows: "If the Committee wishes to alter monetary policy in a firming direction, it may have in view a set of money market conditions entailing a Federal funds rate trading frequently at 4-1/8 per cent, member bank borrowings consistently between $100 and $150 million, and free reserves averaging in a $100 - $200 million range. Such a policy would exert upward pressure on bill rates, and the 3-month bill is likely to approach and perhaps exceed 4-1/2 per cent."

In the auto industry's current wage negotiations, Mr. Scanlon said, those auto producers who were still operating were doing so without union contracts. The automobile people with whom he had talked cautioned that, with no contracts, almost any small incident could develop into a chain reaction which could close down additional sectors of the automobile industry. The industry apparently expected that under those conditions, all major manufacturers would be at least partially struck before labor peace was finally achieved. The expectations were for a four-week major strike and shorter wildcat strikes, but those, of course, were just guesses.

The tendency for labor markets in the District to ease apparently had been reversed, Mr. Scanlon commented. Many localities reported in August that employers anticipated difficulty in replacing workers returning to school as students or teachers.

Mr. Scanlon went on to say that the improvement in construction activity continued in the District, especially for apartment buildings. While mortgage funds were plentiful and maturities and downpayments restrictions had been relaxed, a preliminary roundup of residential mortgage developments in the major cities in the District revealed that mortgage rates were in process of upward adjustment, as would be expected. Apparently the demand for mortgages was rising quite rapidly. A recent meeting of the National Agricultural Credit Committee in Chicago revealed an interesting change in the mortgage field in recent years. Federal Land Banks, which certainly were not organized to make prime rate loans, because of their rate limitation of 6 per cent were now obtaining the cream of the farm mortgages; while insurance companies, which a few years ago were interested only in the prime low interest rate mortgages, were now handling mortgages with greater risks in order to acquire higher rates. But all in all, residential building activity was expected to rise further, even in the face of high and gradually rising interest rates.

Record crops of corn and soybeans were now virtually assured for Seventh District States, Mr. Scanlon continued. Early harvesting of the large corn crop, with new field-shelling equipment, was expected to overtax drying and storage facilities. Prices of both corn and soybeans were likely to be depressed, at least temporarily, by heavy marketings. If so, the decline in farm income in 1967 might be larger than had been expected earlier.

Mr. Scanlon said the major banks in the District appeared to have improved their liquidity positions very substantially. In the face of falling loans, they had continued to issue CD's, although somewhat less aggressively in the past week or so. Their Euro-dollar borrowing was still high. At the same time, they had shifted from heavy buyers to substantial sellers of Federal funds. Those developments suggested that they were in a fairly good position to meet additional loan demands, and responses to the August lending practice survey indicated that the majority of banks continued to expect demand to strengthen moderately this fall.

Total reserves, money supply, time deposits, and bank credit all continued to expand at rapid rates during August, Mr. Scanlon noted. For July and August, the annual rates of increase in those measures--total reserves excepted--exceeded the rapid rates of expansion experienced in the first quarter. The upward creep in interest rates implied some strengthening of total credit demand. In light of the bullish expectations for business activity in the remainder of the year, it was difficult to visualize any substantial reduction in credit demand.

Mr. Scanlon remained convinced, as he had been for some time, that reserves were being provided too rapidly and that the Committee might be setting the stage for excessive price rises at full employment in the not too distant future. He favored a less easy monetary policy, and for the directive would support adoption of alternative B as amended by Mr. Hayes, although he was agreeable to omitting the word "cautiously" as Mr. Mitchell had suggested. While in general he preferred a two-way proviso clause, the current situation made it unlikely that there would be any abrupt reduction in bank credit; therefore, a one-way proviso guarding against excessive credit expansion would be acceptable. He thought there was no need to change the discount rate at this time. The Committee had to continue to be alert to possible problems associated with disintermediation and it should continue to urge adoption of a less stimulative fiscal policy.

Mr. Galusha remarked that the story told by Ninth District statistics was the same as that told in the green book, so he would not comment on District developments this morning. He would like to point out, if not for the first time, that resentment about the archaic reserve structures in the U.S. banking system was growing--a resentment translated into legislative action in two Ninth District States, Montana and Minnesota. Those two States reduced reserve requirements this year for State nonmember banks. Nor should it be forgotten that in some States enforcement of reserve requirements was lax, to say the least. Increasingly, then, the cost of System membership was becoming more than a conversational gambit in banking circles. The System was going to lose more members. Changing reserve requirements for member banks was not all that needed doing, but certainly one could begin with the obvious.

Turning to monetary policy, Mr. Galusha said he thought it should remain unchanged for a while yet. It was not that he doubted a return to larger quarterly increases in money GNP, or that an increase in tax rates was essential. What he doubted, at this moment anyway, was that both an increase in tax rates and an increase in interest rates were necessary to avoid the reemergence of demand inflation next year. In his judgment, therefore, the Committee must wait until Congress had given a clearer indication of its intentions before changing policy.

A probing operation of the kind that had been suggested was not appealing to Mr. Galusha. To attempt to tell the market something, and then withdraw if they believed it with an almost certain enthusiasm which would be translated into sharp rate movements, would be disruptive indeed. Although he did not agree on policy with Mr. Francis today, he agreed with his spirit. When the Committee was able to move, it should do so in a reasoned, forthright manner.

In suggesting a policy of no change, what Mr. Galusha had in mind was that the Desk should continue in its efforts to maintain past money market conditions. Without any real hope of persuading anyone, he would urge, however, that in coming weeks the Desk pay less attention to, say, the Federal funds rate than to the bill rate, which in present circumstances was a much more important rate. It was unnecessary to dwell on the sharp movements the bill rate had undergone recently. The Committee should be very anxious, he believed, to avoid encouraging an outflow of funds from London, and forcing the British Government to increase short-term rates generally.

For the moment, then, Mr. Galusha thought that the Committee should rest easy, biding its time until it had a clearer idea of what Congress was going to do. In the meantime, it might consider what it would do if Congress did not oblige the President. As a preliminary, he would congratulate the staff on an unusually thoughtful and provocative assessment of the economy, especially in the listing of the risks inherent in the alternatives. Having said that, he would suggest that the staff develop more fully for the Committee the parameters of the risks. It would do no harm to rethink the implications of increased monetary restraint for the savings and loan and construction industries. The point had been made that, if Congress did not impose a surtax, the System would find itself in the decidedly awkward position of having to accept a general increase in prices or, by increasing interest rates, risk doing in the savings and loan and construction industries again. Perhaps that was right. But since there was an interest ceiling law now and there was not last year--or at least not until late September 1966--it was not obvious that an increase in interest rates would have the same effect as in 1966. The Committee should also be thinking now about what an increase in U.S. interest rates would mean for the position of the United Kingdom.

Mr. Swan reported that the economic situation in the Twelfth District was about the same as it had been a month or so earlier; activity remained at a high level but there were no general indications of an accelerating rate of growth. His area was one in which there had been a reduction in rates on savings and loan shares from 5-1/4 to 5 per cent at midyear, but there, as elsewhere, the recent rise in rates on Treasury bills and other short-term market instruments had had very little impact on inflows to savings and loan associations--or, for that matter, on inflows of time and savings deposits at commercial banks.

With respect to policy, Mr. Swan said he favored a modest move in the direction of restraint. Like some others who had spoken today, he continued to be concerned about the recent high rates of increase in reserves, bank credit, and the money supply, in view of the prospects for rapid economic growth and in view of the existing inflationary pressures. On the question of the implications of expected Treasury financings for policy actions later in the year, he was among those who felt that the present period was the last for some time in which the Committee would be able to move. He was not persuaded by the argument that the sensitivity of the market precluded a policy change now but that even keel considerations need not inhibit action later. In the face of a $4-1/2 billion tax bill offering in early October and a refunding in November, he did not think the Committee would have as much leeway to act later as had been implied. He, too, was concerned about the lack of prospects for action on the tax bill before the first of the year, and he certainly would not want to have the Committee take any steps that would discourage its passage. But he did not think that a modest move in the direction of restraint would be a critical factor in the decision of Congress; certainly a slight increase in monetary restraint would not be considered as a substitute for a tax increase. Like Mr. Mitchell he thought such an action could be interpreted as supporting a tax increase.

For the directive Mr. Swan favored alternative B with the revision Mr. Hayes had proposed. He did not concur with Mr. Mitchell's suggestion that the word "cautiously" be omitted from the revised language. To him the word implied that the Desk should pull back if the move toward somewhat firmer conditions resulted in an undesired reaction, and he would favor that course.

Mr. Swan said he sympathized with Mr. Mitchell's desire to find a better variable than bank credit for the proviso clause but did not have anything specific to propose. He would, however, suggest a reordering of phrases in the sentence in the first paragraph of the draft directive referring to the President's new fiscal program, so that the statement would read, "The President's new fiscal program calling for a sizable increase in income taxes, which would make a substantial contribution to balanced economic growth, is now before Congress."

Mr. Irons reported that employment in the Eleventh District continued strong during August, holding at about the July level, with seasonal strength evident in trade, services, and government employment. The District industrial production index was still showing the effects of the petroleum situation and continued at a high level. Production of durable and nondurable manufactured goods had been relatively steady, with offsetting minor changes. Total construction activity for the year to date was running 6 per cent higher than a year ago, but residential construction was down by about 8 per cent. Retail trade as reflected by department store sales was up 9 per cent in the last month and 4 per cent for the year to date.

Thus, Mr. Irons said, the business statistics for the District once again indicated that activity was strong but not surging. At the same time, one seemed to sense inflationary pressures in the District in connection with developments in wages and services, in comments regarding prices, and so on. There was a feeling that inflation was under way even though it was not precisely measured by the indexes.

With respect to agriculture, Mr. Irons continued, the recent rains would be some help although they were too late for the summer crops. Prices reported for farm products so far this year were about 10 per cent below a year ago and farm cash receipts were down about 12 per cent.

At District banks, Mr. Irons said, loans and demand deposits were down in the latest four weeks, but investments and time and savings deposits were up. Those changes to some extent reflected the availability of reserves and the somewhat less strong demands for business loans. Negotiable CD's outstanding had risen a bit. Borrowings from the Federal Reserve Bank were nominal and limited to country banks. Banks were meeting whatever reserve needs they had through purchases of Federal funds, but net purchases were running below the levels earlier in the year. The liquidity positions of District banks had improved.

Mr. Irons noted that the Dallas Reserve Bank had made a quick spot check on the mortgage situation in advance of the more general survey, in order to obtain some indication of prevailing conditions. From the contacts made it appeared that housing demand was very strong; only one or two respondents indicated anything less than marked strength. There was a general feeling that mortgage money was available if the borrower was willing to pay the price. However, the situation varied among types of lenders. For example, insurance companies were somewhat reluctant mortgage buyers, preferring to increase their holdings of corporate bonds. Interest rates were moving up after declining earlier in the year. Rates on conventional mortgages ranged from 6-1/2 per cent to as high as 7 per cent, and penalties on FHA mortgages were running about 4 or 5 points.

With respect to the national situation, Mr. Irons said that he was disturbed by the increasing number of signs that inflationary pressures were developing. Wage increases had induced some price increases and had caused a squeeze on profits that would exert further pressures on prices. The rapid expansion in the money supply and bank credit over the past several months had also contributed. The lack of help from fiscal policy posed a problem for the System that was likely to persist for a time, although he was not prepared to say when a tax increase might be enacted. Both consumer demands for goods and services and Government demands were strong, the employment situation was tight, and wages were rising. The auto strike posed a problem and the balance of payments situation remained unfavorable. There had been some improvement in the liquidity positions of financial institutions, although the degree varied by type of institution.

Mr. Irons noted that the System had supplied a very large amount of reserves in recent months. In view of the Treasury's financing plans, after the present period there was likely to be a need for even keel virtually for the rest of the year. In his judgment once the Committee got into an even keel situation it would be very hard to change policy. Accordingly, he believed the Committee should begin now to make an effort to place some check on its policy of aggressive ease. Although the attitudes in the market at present and existing rate relationships might pose some problems, he would favor drifting toward somewhat less ease, feeling one's way along the lines Mr. Hayes had suggested. He would be inclined to seek the intermediate set of money market conditions outlined in the blue book in order to achieve some degree of firmness and some lessening of the aggressive ease that the Committee had been encouraging.

In particular, Mr. Irons said, he had in mind a Federal fund rate ranging from 4 to 4-1/8 per cent, a bill rate of 4-1/4 to 4-1/2 per cent but more likely near the latter figure, member bank borrowings of around $100 million, and free reserves under $200 million, perhaps around $150 million. If there were any deviations he would prefer them to be on the firm side, unless there was evidence of undesired market reactions. He would prefer alternative B of the draft directives. He found Mr. Hayes' proposed revision acceptable, although he did not have strong feelings on the matter.

Mr. Ellis reported that those economic statistics covering recent trends of employment, production, or construction in New England suggested no major trend of movement. Those providing some hint of future trends, however, pointed toward expansion. For example, while the June manufacturing index gave some hint of improvement, in July its seasonally adjusted value turned downward by 1.9 points. On the other hand, July residential building contract awards in New England jumped 19 per cent between June and July after seasonal adjustment. Incomplete returns in the Boston Reserve Bank's regional capital expenditures survey provided the surprising finding that New England manufacturers had revised upward their 1967 spending plans by 5 per cent over the estimate made last spring. One-half of the respondents expected sales to improve in the fourth quarter of 1967 and 15 per cent expected declines. The outlook for next year was even more optimistic with three-fourths expecting sales gains against 6 per cent expecting declines.

Mr. Ellis' view concerning the proper course of monetary policy was based on a conviction that the economy would be thrusting upward during the fourth quarter, propelled by expanding consumer spending, by expanding capital outlays by business--both for plant and equipment and for inventory rebuilding--and by expanding outlays of government at all levels. That expectation was further conditioned by a belief that tight labor markets would make it virtually impossible to achieve a 90 or 91 per cent capacity utilization rate in the next several months without intolerable wage pressures.

That sequence of reasoning led Mr. Ellis to a concern that efforts to validate the desired spending levels by credit creation would create the classic condition of demand inflation well before the economy seemed to have reached the historical 90 - 91 per cent flash point for price increases based on past capacity utilization records. To the extent that even keel considerations were allowed to glue the Committee to the rate levels and market conditions necessary to finance the Federal deficit, even after the proposed tax increases might become effective, the Committee had to anticipate continuation of the 9 per cent or more rate of bank reserve expansion that had prevailed since December. He could not agree with those who believed there was no indication that the current expansion rates were creating any future problems. One obvious future problem was posed by the substantial liquidity buffers that corporations were erecting to insulate themselves from the impact of monetary tightness when and if that should occur. As a result the impact of policy tightening might be expected to fall even more unevenly and more heavily on other sectors of the market.

With an economy already showing the price and wage effects of an effort to produce both guns and butter, and with the Administration pleading with Congress to recognize the need to reduce private spending by taxation, it seemed incredible to Mr. Ellis that monetary policy should hold at the same throttle positions of net free reserves, rate of reserve creation, rate of bank credit creation, and rate of money creation that had characterized the first quarter of this year. But that was what the statistics revealed. Even without any determination to put on the brakes now, it did seem wise to let up on the accelerator. Certainly it could not be successfully demonstrated that the projected 9 to 12 per cent bank credit growth rate in September was a projection that the Committee should strive to achieve, especially if the strike against the Ford Motor Company broadened into a work stoppage with widespread effects on the economy. Such effects would likely be to weaken the demand for bank credit, just as resumption of full scale operations would likely stimulate credit expansion. In such a swing monetary policy should take up slack in anticipation of the job ahead.

Specifically, Mr. Ellis asked, what did it mean to "let up on the accelerator" or to lessen ease? As set forth in the blue book, a decision to alter monetary policy in a firming direction could involve Federal funds trading above 4 per cent more regularly; a slightly higher target for member bank borrowings, averaging above $100 million; and a $100 million reduction in the target for net free reserves.

Mr. Ellis noted that alternative A of the draft directives prescribed no change in money market conditions unless bank credit creation significantly exceeded a 12 per cent annual rate. Since that exceeded the 10 per cent growth rate prevailing since March, it might logically be classified as either continued ease or increased ease. Alternative B directed firming action to seek slower credit growth unless bank credit growth fell significantly below 9 per cent. That policy might logically be described as lessened ease and seemed most appropriate at this time. The change in language proposed by Mr. Hayes, as modified by Mr. Mitchell, added a useful note of caution and was a desirable improvement.

Mr. Robertson made the following statement:

> There are two particular uncertainties that need to be taken account of in our policy decision. The most important is the proposed fiscal program; passage of an effective program of fiscal restraint might well leave the way clear for an accommodative monetary posture. The other is the auto strike. We are not yet in a position to evaluate the extent of its effect on aggregate demand currently or on prices and costs once it is settled.
>
> In the absence of these uncertainties, I would read the economic and financial evidence before us today as warranting a moderate tightening of monetary policy. But those uncertainties do exist, and I do not think we are yet at a stage where we can or should base policy on our guesses as to the possible outcomes, either in Detroit or on Capitol Hill.
>
> I favor, therefore, essentially a monetary policy of "no change", as expressed in alternative A of the staff's draft directives. I am sufficiently concerned about the possibilities of over-strong credit expansion to favor keeping a proviso clause in the directive.

Chairman Martin thought it was encouraging that the Committee's discussion had been so full today. The staff's presentation had been excellent and members of the Committee had focused on the key problems.

Personally, Chairman Martin said, he felt quite strongly that it would be untimely for the Committee to make a change in policy at its meeting today, and that it should adopt a directive along the lines of alternative A. Obviously that was a matter of judgment, and questions of timing clearly were determining. Mr. Wayne's remarks on the subject had pointed up his (Chairman Martin's) own thinking. With fiscal policy strongly stimulative pending action on the President's tax program, the simple logic of the economic situation implied the desirability of changing monetary policy, as it probably had as much as two months ago. But the overriding need at this point was to get some restraint from fiscal policy through a tax increase, and in his judgment that would be less likely if Congress came to believe that adequate restraint was being exercised by monetary policy. The country was engaged in a major war, yet there had been an unfortunate tendency to underestimate the strains being put on economic resources by the hostilities in Vietnam. A "guns and butter" economy was not feasible; the country's resources were not sufficient for that.

He would not assert that monetary policy was not too easy, Chairman Martin continued, but he thought it would be foolish for the Committee, after having maintained its policy to this point, to launch a probing operation just before System testimony was taken on the tax bill. Such a modest operation would not result in any major gains; at the same time, its significance was likely to be greatly exaggerated, thus exposing the System to misrepresentation of its position on the question of the appropriate mix of fiscal and monetary policies.

In that connection, the Chairman emphasized the importance of preserving the confidentiality of the Committee's deliberations. He noted that the press was tending to focus on the fact that the Committee would be meeting on a particular date and was carrying a good deal of speculation regarding the decisions that would be taken.

Chairman Martin said that he did not agree with those who thought that even keel considerations would necessarily preclude a change in policy later in the year. Conditions might well develop that would require Committee action even though a Treasury financing was in process.

In conclusion, Chairman Martin noted that this was a time of intellectual bafflement and confusion such as had seldom been witnessed in the country's history. People were divided on many issues, and it was not surprising that views on appropriate monetary policy differed also. He was not certain that his judgment was correct but he had felt it important to set out clearly the considerations entering into it.

The Chairman then suggested that the Committee proceed to vote on a directive. He asked Mr. Holland to propose specific language for Committee consideration in light of the comments that had been made on the staff's drafts.

Mr. Holland suggested that the Committee vote on alternative A with the sentence in the first paragraph regarding the President's fiscal program modified as suggested by Mr. Swan.

Mr. Mitchell noted that the final sentence of the first paragraph, specifying the Committee's general policy stance, was formulated differently in the two alternatives. He preferred the formulation given in alternative B, even if the second paragraph was that of alternative A.

Mr. Holland then suggested that the language to be voted on include the version of the sentence in question that was given in alternative B, reading as follows: "In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes." There was general agreement with that suggestion.

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

The economic and financial developments reviewed at this meeting indicate that economic activity has strengthened and, despite the strike in the automobile industry, that prospects favor more rapid growth later in the year. Upward pressures on costs persist and average prices of industrial

> commodities have turned up following several months of stability. While there recently have been large inflows of liquid funds from abroad, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large, while most short- and long-term interest rates have fluctuated close to their highs of the year, under the combined pressure of heavy private security market financing and of recent and prospective Federal financing. The President's new fiscal program calling for a sizable increase in income taxes, which would make a substantial contribution to balanced economic growth, is now before Congress. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified as necessary to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Mr. Hayes said that he had cast his negative vote with some reluctance in view of the points Chairman Martin had made. He felt, however, that a cautious move toward somewhat firmer money market conditions could be accomplished without prejudice to the kinds of considerations the Chairman had noted.

Mr. Brimmer remarked that in voting favorably on the directive he withdrew his earlier objections to inclusion of the proviso clause.

Mr. Mitchell said he had voted favorably, despite the views he had expressed in the go-around, in light of the Chairman's statement. Mr. Swan's position was the same as that of Mr. Mitchell.

Chairman Martin then noted that the Committee had planned to consider today a policy paper dated July 11, 1967, regarding System lending of Government securities. He suggested that that item be held over to provide more opportunity for Committee Counsel to study the matter.

There were no objections to the Chairman's suggestion.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 3, 1967, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

September 11, 1967

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 12, 1967

ALTERNATIVE A

The economic and financial developments reviewed at this meeting indicate that economic activity has strengthened and, despite the strike in the automobile industry, that prospects favor more rapid growth later in the year. Upward pressures on costs persist and average prices of industrial commodities have turned up following several months of stability. While there recently have been large inflows of liquid funds from abroad, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large, while most short- and long-term interest rates have fluctuated close to their highs of the year, under the combined pressure of heavy private security market financing and of recent and prospective Federal financing. The President's new fiscal program calling for a sizable increase in income taxes, which is now before Congress, would make a substantial contribution to balanced economic growth. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to continuing economic expansion, while recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

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

ALTERNATIVE B

The economic and financial developments reviewed at this meeting indicate that economic activity has strengthened and, despite the strike in the automobile industry, that prospects favor more rapid growth later in the year. Upward pressures on costs persist and average prices of industrial commodities have turned up following several months of stability. While there recently have been large inflows of liquid funds from abroad, the balance of payments continues to reflect a substantial underlying deficit.

Bank credit expansion has continued large, while most short- and long-term interest rates have fluctuated close to their highs of the year, under the combined pressure of heavy private security market financing and of recent and prospective Federal financing. The President's new fiscal program calling for a sizable increase in income taxes, which is now before Congress, would make a substantial contribution to balanced economic growth. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

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