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 10, 1968, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Galusha
Mr. Hickman
Mr. Kimbrel
Mr. Maisel
Mr. Mitchell
Mr. Morris
Mr. Robertson
Mr. Sherrill

Messrs. Bopp, Clay, Coldwell, Scanlon, and Treiber, Alternate Members of the Federal Open Market Committee

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

Mr. Holland, Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Messrs. Axilrod, Hersey, Kareken, Reynolds, Solomon, and Taylor, Associate Economists
Mr. Coombs, Special Manager, System Open Market Account

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

Mr. Bernard, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Messrs. Eisenmenger, Sternlight, Eastburn, Parthemos, Baughman, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, New York, Philadelphia, Richmond, Chicago, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York
Mr. Geng, Assistant Vice President, Federal Reserve Bank of New York
Mr. Shotwell, Senior Economist, Federal Reserve Bank of Cleveland

Chairman Martin welcomed Mr. Morris, noting that this was the first meeting of the Committee the latter had attended since he had assumed office as President of the Federal Reserve Bank of Boston and had been elected as a member of the Committee.

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee held on August 13 and 19, 1968, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee held on August 13 and 19, 1968, were 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 13 through September 4, 1968, and a supplemental report covering the period September 5 through 9, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the French had sold to the United States another $80 million of gold at the end of August, bringing to $375 million the total of such sales since the French crisis began. As a result, the Stabilization Fund remained well supplied with gold and no reductions in the Treasury gold stock were in prospect. In addition, the agreement reached in Basle this past weekend on the sterling balance arrangement should help considerably to limit gold purchases from the United States by countries in the sterling area. The agreement would tend to lock the sterling area countries into their present holdings of sterling, limiting diversification of their reserves to gold and dollars.

On the London market, Mr. Coombs continued, the price of gold had risen since the August 13 meeting of the Committee by about $1 to the $40 level, mainly reflecting market rumors of a mark revaluation and the recent developments in Czechoslovakia. There seemed to be a number of sell orders in the market at a price just above $40 which were keeping a ceiling on price movements,

and that situation might continue for some time. On the other hand, the recent French action abolishing exchange controls seemed likely to bring additional buying pressure from France, limiting the extent to which the price might fall.

On the exchange markets, Mr. Coombs said, the main recent development had been the wave of speculation on a revaluation of the mark, the largest speculative wave in some time. Rumors of revaluation seemed to have been initiated by several articles in the British press in late August, at the time of a meeting between Economics Minister Schiller of Germany and Chancellor Jenkins of Britain. Since then the German Federal Bank had taken in roughly $1.7 billion in the spot market but had managed to swap out $1.5 billion, thus rechanneling most of the money back to the Euro-dollar market. That had been useful in protecting the Euro-dollar market from a squeeze and it did not particularly inconvenience the Germans since there were no effects on the domestic financial situation in Germany.

Both the German Government and the Federal Bank had denied any intent to revalue, Mr. Coombs noted. However, the market remained skeptical, particularly because of repeated suggestions in the world press that the British, French, and U.S. Governments had been urging the Germans to make such a move. If in fact the British or French Governments had taken such an initiative they

might find it to have been rather costly; Germany could readily handle the inflows of hot money, but the outflows from London and Paris might subject both sterling and the franc to dangerous new strains. Since the revaluation rumors started in late August, the British had lost nearly $275 million and the French over $300 million. In both cases, part of those outflows had to be financed by new drawings on the Federal Reserve swap lines, amounting to $100 million by the Bank of England and $166 million by the Bank of France.

In the case of sterling, Mr. Coombs observed, some counterbalance to recent speculative pressure might be provided by the announcement of the new sterling balance credit package negotiated last weekend. Yesterday and today the sterling rate had been appreciably stronger. No reflow had developed, however, and it seemed likely that the market would remain cautious until announcement of the August trade figures next week.

In the case of the French franc, Mr. Coombs continued, the announcement last Wednesday (September 4) of the complete removal of exchange controls came as something of a surprise to the market. The timing of that move could not have been worse, coming as it did in the midst of speculation on a mark revaluation, and the market had construed it as a mixture of official bluff and a confession that the exchange controls were not working. The Bank

of France lost $165 million last Friday and another $70 million yesterday, and the franc was on the floor again today. In conversations at Basle last weekend a number of European central bankers had indicated that they thought there was a reasonably good chance that the position of the French current account would improve in coming months, with French industry absorbing part of the cost increases they were experiencing. However, there was widespread concern that the capital outflow would continue. The French had lost $3 billion since the crisis began and continuing heavy outflows were likely to bring the situation close to the breaking point.

Against that general background of fear and uncertainty in the exchange markets, Mr. Coombs said, he had heard with some dismay suggestions in U.S. Congressional circles that the question of a broadening of the exchange margins should be raised at the International Monetary Fund meeting later this month. There was already the prospect of serious trouble in the exchange markets this fall, and such proposals for widening the exchange margins could dangerously aggravate the speculative pressure now building up.

By unanimous vote, the System open market transactions in foreign currencies during the period August 13 through September 9, 1968, were approved, ratified, and confirmed.

Mr. Coombs noted that two drawings by the Bank of England would mature soon--a $200 million drawing on October 1, 1968, and a $100 million drawing on October 8. It was possible that the British would be able to repay one or both drawings at maturity, particularly if the August trade figures to be published next week were encouraging and some return flow developed in consequence. However, he thought the chances were against their being able to repay the drawings and recommended renewal if requested by the Bank of England. Both would be first renewals.

Renewal of the two drawings by Bank of England was noted without objection.

Mr. Coombs then noted that the System's $700 million swap arrangement with the Bank of France would reach the end of its three-month term on September 27, 1968. In a conversion in Basle last weekend an official of the Bank of France had suggested, cautiously and indirectly, that the Bank might be interested in having the arrangement put on a longer-term basis than three months. As the Committee members knew, all of the System's other swap arrangements were on a full-year basis; and it was his impression that the Bank of France officials had been inclined all along to keep in step with the others. It would be useful, he thought, to lengthen the term of the French swap line if there was a possibility of doing so. Accordingly, he recommended that the Committee

approve renewal either for three months or--if there was a firm indication from the French that they wanted to lengthen the term--for a longer period, up to a full year.

In reply to a question by Mr. Maisel, Mr. Coombs said it seemed clear that the Bank of France's earlier insistence on limiting the term of the swap arrangement to three months had been in accordance with instructions of the French Government. However, the French position had changed in a great many respects as a result of recent events.

In reply to a question by Mr. Bopp, Mr. Coombs said that one possibility would be to renew the French swap line for three months--so that it would mature in December, when the System's other lines did--and lengthen the term at the time of the December renewal.

Mr. Hickman recalled that when the French swap line had been enlarged in July he had asked whether the French understood that the swap was a two-way street. There was still some question in his mind on that score, and he thought there should be discussions at some point to make it clear that the System, as well as the Bank of France, was entitled to draw on the line.

In reply, Mr. Coombs remarked that the present situation was a delicate one, in which Bank of France officials apparently were trying to take advantage of existing circumstances in an effort

to bring their swap facility with the System into line with those of other central banks. An effort by the System to press for a formal understanding would risk slowing down that process. At the same time, by using the swap line themselves the French were building up a moral commitment to permit drawings by the System if the tide turned the other way.

Mr. Mitchell asked whether Mr. Coombs was saying the French were not prepared at present to treat the swap line as a reciprocal arrangement.

Mr. Coombs replied in the negative. His point, he said, was that it probably would not be desirable to seek additional formal commitments from the French at this time. Drawings under the swap arrangements were not completely automatic; both parties retained full freedom with respect to them. In the recent past the System had found the swap line with the Bank of France essentially useless because the French had taken the position that their surplus was structural and, accordingly, that the United States should either sell gold or draw on the IMF rather than engage in short-term financing under the swap line. Now that the French had been forced to draw on the swap line it would be acutely embarrassing for them to refuse to permit the System to draw on it. The best hope, he thought, lay in an informal rather than a formal understanding.

Mr. Mitchell remarked that the System was not likely to be in a better bargaining position later than it was now. He did not particularly care whether the understanding was formal or informal but he thought it should be made clear to the French that the swap agreement was reciprocal.

Chairman Martin said he did not think the French were under any illusions on that score. He was inclined to share Mr. Coombs' view that pressing the matter at the moment might create difficulties.

Mr. Daane concurred in the Chairman's statement, and also in Mr. Coombs' earlier observation that the Bank of France had been willing to cooperate with the System all along. He favored giving Mr. Coombs the authority to renew the swap line for a period longer than three months if agreeable to the French.

By unanimous vote, renewal for a period of up to one year of the $700 million swap arrangement with Bank of France, maturing September 27, 1968, was approved.

Chairman Martin then invited Mr. Robertson to report on developments at the meeting in Basle over the past weekend.

Mr. Robertson said his report would be brief, and perhaps Messrs. Hayes, Coombs, or Solomon, who had also been in Basle, would have supplementary comments. The bulk of the discussion at the meeting had been devoted to the sterling balance credit package which, as the members knew, had been agreed to.

At the meeting, Mr. Robertson continued, Governor O'Brien of the Bank of England had reported on the results of the British consultations with the sterling area countries. In those consultations, each of the 40-odd sterling area countries had been offered a dollar-value guaranty on all but 10 per cent of its official sterling reserves, in exchange for an undertaking to hold substantially the same portion of sterling in its total reserves as it did now. Apparently the British negotiators did not succeed in imposing a charge for the guaranty--or, what amounted to the same thing, a lower interest rate in guaranteed sterling. Each such agreement was legally binding for three years, with specific provision for two-year extension by mutual consent. The British had completed negotiations on that basis with thirty countries holding about 80 per cent of official sterling balances. The only large sterling holder that had not yet signed up was Malaya. Agreement with that country, and with the others remaining, was expected soon.

As the Committee would recall, Mr. Robertson observed, the British had also undertaken to persuade sterling holders to deposit a part of their dollar holdings--as well as increases in dollar holdings from future diversification out of sterling--in the Bank for International Settlements, in order to make the scheme partly

self-financing. It was reported that to this date $180 million had been deposited with the BIS.

Mr. Robertson commented there had been considerable wrangling over the question of making up the $200 million shortfall resulting from the unwillingness of the French Government to participate. In addition, Belgium, Switzerland, and Japan had found it necessary to reduce their shares below the amounts envisioned in July. Germany, Italy, the three Scandinavian countries, and the United States had increased their shares, and the BIS had taken a share. The United States had agreed to raise its share by $100 million, to $650 million.

Under the agreement, Mr. Robertson said, the Bank of England would be entitled to draw some $600 million right away and would use the proceeds to repay short-term credits that had been provided in November 1967 and March 1968. In the case of the United States, all of those claims were held by the Treasury.

Mr. Robertson noted that the only important change in the detailed provisions of the agreement was that the so-called "revaluation clause" had been dropped. As in the System's swap agreements, such a clause protected the debtor in the event that the creditor appreciated its currency. Some of the continental countries, led by Germany, insisted that the provision be eliminated and the British were not prepared to fight.

On the question of policy regarding South African gold, Mr. Robertson continued, there had been a minimum of discussion at this meeting. It was agreed to avoid a firming of positions until after Chairman Martin had had a chance to chat with Governor de Jongh of South Africa's Reserve Bank. From informal conversations, it appeared that views were coming together on limited purchases of newly mined gold by the IMF when the market price was at $35 or just below. Whether South Africa would accept that arrangement and agree in turn to market its gold in an orderly manner and to cooperate in other ways was uncertain. In any event, he had not heard at this meeting, as he had in July, of any interest by European central banks in buying gold directly from South Africa.

Mr. Hayes said he had only a few observations to add. First, both in the formal sessions and in informal discussions several central bank governors had raised the question of whether the sterling balance arrangement would prove useful if the British did not achieve significant improvement in their balance of payments. Governor O'Brien had noted that he agreed on the importance of Britain's taking the internal measures necessary to restore the position of sterling, and had indicated that he would write a letter to the Chancellor of the Exchequer stressing the importance of Britain's living up to its commitments in that connection.

Secondly, Mr. Hayes remarked, France's unwillingness to participate in the arrangement was clearly resented by the governors from the other Common Market countries; at one stage the latter were even discussing possible means of forcing the French to do their share. Third, although the sterling area countries thus far had deposited only $180 million with the BIS, both Governor O'Brien and others had expressed the opinion that such deposits would increase substantially over the next few months.

Finally, Mr. Hayes said, there was a continuing sense of urgency at the meeting with respect to the gold problem. He thought the procedure Mr. Robertson had outlined was quite acceptable to the Basle group. However, there was sentiment to the effect that the matter would have to be settled promptly--perhaps at the time of the Bank and Fund meetings--if the gold situation were not to be a disruptive influence in international financial markets.

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 13 through September 4, 1968, and a supplemental report covering September 5 though 9, 1968. Copies of both reports have been placed in the files of the Committee.

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

The period since the last regular meeting of the Committee has seen a tug-of-war in the financial markets between expectations and reality. The general market expectation in early August was that credit conditions would ease significantly further in the wake of the tax surcharge, probably with the aid of overt action by the Federal Reserve. This expectation led dealers in Government securities to build inventories to unprecedented levels, pushing interest rates down in some cases far below day-to-day financing costs. By the time of the August 13 meeting, some doubts were beginning to creep in about how soon and decisively the System might act and short-term rates were starting to move back up, but there was still the expectation of easier conditions later on, and intermediate- and long-term Treasury issues held their own.

The discount rate reduction of 1/4 point, initiated on August 15, was both a relief and a disappointment in these circumstances. It relieved the concern of some that no early easing action would be taken, and this relief may well have averted a major congestion in the markets and back-up in rates. But the move was also a disappointment to some who had hoped for a bigger change and greater alacrity in adopting the new rate, which could have signaled still greater easing to come. As it was, the move was taken as a kind of "holding operation", tending to confirm that some relaxation was appropriate in the credit markets after passage of the tax surcharge but that a major easing was not yet in order.

Open market operations in the past several weeks have in effect been directed at supporting this "middle-of-the-road" response to the discount rate change--thereby seeking to facilitate an orderly adjustment, to the new rate. This meant neither offsetting the impact of the rate change nor seeking to reinforce its effects in a way that might fan expectations of further moves to come shortly. In steering this middle course, operations were continuously conditioned on the one side by a tendency for bill rates in the three-month area to push up to and beyond the upper end of ranges contemplated by

the Committee, and on the other side by indicators of bank credit growth that also tended to exceed expectations.

To some extent these two considerations tended to offset or neutralize one another, although we would find it difficult and perhaps not too meaningful to develop a "rate of exchange" or "trade-off" between basis points in excess of a bill rate range and percentage points in excess of a credit growth range. Yet the problem of priorities was there--and it may very well be with us in the period ahead, too.

Certainly, the recent period illustrates again the difficulty of specifying mutually consistent ranges for a set of financial variables which have some points of linkage but also respond to various special influences. Even within the area of Treasury bill rates, for example, it is interesting to note that while three-month bills rose in yield over the period since mid-August, rates on six-month and longer bills were lower during most of the period than at its start.

As the market has sought to "find itself" in recent weeks, a critical point has been the level of dealer financing costs, and this is likely to remain of considerable significance in the weeks ahead. In turn, day-to-day financing costs tended to be closely linked to the Federal funds rate. Through most of the period since the August 13 Committee meeting--and consistently from August 19 onward--the effective Federal funds rate has been 6 per cent or under. By comparison, in the several weeks preceding the August 13 meeting, the most common funds rate was 6-1/8 per cent.

The typical rate might have drifted even lower in the recent interval--say to 5-3/4 per cent--but for the persistently heavy basic reserve deficiency of money market banks. In turn, that deficiency or maldistribution of reserves has in large measure reflected the continuing high level of dealer inventories, which obliged the dealers to depend heavily on financing from major money market banks and obliged these banks to bid steadily in the funds market. From August 12 to September 6, dealer inventories declined about $550 million--but at $5.1 billion they remain very high. Of particular concern, holdings of over-5-year issues, which bulged sharply in the Treasury's August financing, declined not much more than $100 million and are still at an exceptionally high level of about $950 million.

Although financing costs are high, dealers have been willing to retain large positions in the expectation that softer business news, weaker credit demands, and perhaps additional Federal Reserve moves toward ease lie ahead. Against these expectations, developments through mid-September may be particularly critical. If credit demands around the tax date are light and regular monthly indicators appearing around that time suggest softer business, then some investor buying may lead to lower dealer inventories at steady or declining interest rates. On the other hand, if credit demands and business indicators are strong, dealers may seek to reduce inventories but find investors apathetic at current rates. An inventory reduction could still be accomplished, although at some cost in terms of lower prices. In either set of circumstances, the process of orderly inventory reduction would probably be aided by the maintenance of financing costs at close to present levels--perhaps a little lower but not too much too soon. This would entail financing costs high enough to encourage some inventory reduction but not so high as to stimulate attempts at rapid reduction under what could become adverse circumstances.

The achievement of interest rate and credit growth objectives in the next few weeks may be affected not only by trends in dealer inventories and financing costs but also by the profile of expected reserve supplies and needs. A large bulge in reserves is projected through about mid-September, partly due to a sharp reduction in Treasury balances with the Federal Reserve. Later in the month, reserves will be absorbed by the rebuilding of Treasury balances to more normal levels, along with other market factors. In absorbing reserves through System operations in the next few days, it may be particularly difficult to keep short-term interest rates from rising without at the same time permitting more credit growth than might be desirable. Indicative of this, the average three-month bill issuing rate rose to 5.25 per cent in yesterday's auction. Later in the month, the process of replenishing reserves might conceivably bring rates down considerably, especially if banks and other investors have become more active buyers and succeed in reducing dealer inventories. Hence a wide latitude in interest rate ranges would seem to be appropriate.

> Finally, it should be mentioned that particular latitude may be needed in marginal reserve measures, too, with the new rules for reserve accounting due to take effect September 12, and new behavior patterns of the banks still to be worked out, observed, and analyzed.

Mr. Mitchell asked whether current market expectations were based on a view as to how much of a back-up in bill rates the System was prepared to accept, and whether, for example, dealer attitudes concerning their inventories might tend to change if the three-month bill rate rose above the 5.35 to 5.40 per cent area.

Mr. Sternlight replied that to his knowledge the market did not have any firm views concerning an upper bill rate limit, although if bill rates rose beyond some point current market expectations no doubt would change. It was a matter of judgment as to where that point might be, but he thought the market would take reasonably well in stride an increase in the bill rate to around 5.40 per cent, particularly if that increase was associated with temporary tax-date pressures. If the rate approached 5.50 per cent, however, expectations might well become unsettled.

Mr. Hickman inquired whether his impression was correct that Mr. Sternlight thought the blue book[1/] projection for bank credit in September--expansion in the proxy plus Euro-dollars at a 7.5 to 10.5 per cent annual rate--might be incompatible with the

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

5.05 to 5.35 per cent range given for the bill rate, and that the Desk accordingly would like to have latitude to allow the bill rate to exceed 5.35 per cent temporarily.

Mr. Sternlight replied that 5.35 per cent appeared to him to be a reasonable upper limit for the probable range of bill rate fluctuations. However, it was always hazardous to make such predictions; a few weeks ago, for example, he had thought the bill rate was not likely to exceed 5.20 per cent, but events had proved him wrong.

In response to a question by Mr. Daane, Mr. Sternlight said that while his best judgment was that the blue book range for the bill rate was reasonable, it was possible that the 5.35 per cent upper limit might be exceeded temporarily around the time of the mid-September tax date.

In response to a further question by Mr. Galusha, Mr. Sternlight expressed the view that longer-term interest rates were not likely to be significantly influenced by money market developments in the coming period so long as the bill rate did not rise above 5-3/8 per cent or so. The more important influences in the days ahead were likely to be business news, including various business indicators for the month of August, and the volume of credit demands around the tax date.

Mr. Maisel said he understood that the weekly data underlying the September projection of the proxy series suggested that the increase in bank credit through the tax date would be rather small, and that the projection assumed that the Desk would be absorbing reserves released by the decline in the Treasury balance in that period. He asked how much growth in bank credit might be increased if the Desk did not attempt to mop up all of the reserves that were being released.

Mr. Sternlight replied that he was not prepared at the moment to make a firm estimate of the increase. In that connection, he would note he felt rather uncertain about the bank credit projection for September given in the blue book.

Mr. Swan asked whether Mr. Sternlight thought the blue book projection was on the high or low side.

Mr. Sternlight replied that his uncertainty about the projection was simply a consequence of the relatively large "misses" that had occurred recently. The New York Bank staff was projecting a somewhat smaller growth rate in the proxy than that reported in the blue book, but he did not want to suggest that the Bank estimate was more likely to be realized.

Mr. Brimmer asked Mr. Sternlight whether the market was likely to interpret a growth rate of more than 10 per cent in the proxy as a signal that policy was being eased significantly.

Mr. Sternlight said that was a difficult question to answer since, unlike interest rate fluctuations, short-run changes in the rate of bank credit growth were not highly visible to market participants. Of course, if participants were to get the impression that the System was supplying reserves at a rapid rate, they might conclude that the monetary authorities were not overly concerned about the pace of credit creation. He did not know, however, what specific rates of reserve expansion and credit creation would produce such a market reaction.

Mr. Morris asked whether there were any indications of the volume of borrowings New York banks expected around the tax date and whether the Desk anticipated any problems in that connection.

Mr. Sternlight replied that at this point he had only fragmentary indications, which suggested that the banks thought such borrowings might be light to moderate. At the moment, no unusual pressures were expected from that source.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 13 through September 9, 1968, were approved, ratified, and confirmed.

The Chairman 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. Keir read the following statement after noting that it had been prepared by Mr. Brill, who had been unexpectedly called away:

> There are probably worse ways of making a living than being a short-term economic forecaster, but at the moment I can't think of any. Perhaps I should intensify my search for alternative occupations, for if much more "good news" comes rolling in, I'll have to turn in my union card.
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> Before joining the stampede of those developing skepticism about the efficacy of fiscal policy, however, we should review what we expected of the package of fiscal restraint, when we expected it, and what has actually been happening since mid-year in the whole spectrum of GNP expenditures. And in this review, it is most important not to lose sight of one central fact, namely, that aggregate activity is slowing. We are stepping down from a 6 per cent rate of growth in real GNP during the first half to a pace that is much slower. Whether the current rate of growth turns out to be 1-1/2, 2, or even 3 per cent, is less relevant at the moment than the fact that it is substantially slower than the pace earlier this year.
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> True, most of the slowing is attributable to the shift now going on in inventory behavior, and that largely reflects the effect of reductions in steel inventories accumulated in anticipation of a strike. To some extent, also, it is the result of the clearing-out of 1968 auto models while plants are gearing up for next year's models. But it was this inventory buildup, particularly in steel, that contributed so significantly to the rise in activity and the pressure on resources last spring. If we were concerned then by the drain on resources from inventory demands, we should now experience some sense of relief that this particular source of pressure is behind us.
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> And it is worth noting that, so far in this period of reduced inventory demands, there has been no surge

of activity in other areas to offset the decline in steel production. Abstracting from the July-August changes in steel production, there was little net change in industrial production in July, and the partial data available suggest little net change in August either. This two-month stability in industrial output comes after a first half in which output (excluding steel) rose by 2 per cent.

Recent sluggishness in industrial production is mirrored in the manufacturing employment figures, which showed little increase in either July or August, and by an edging down in the workweek in manufacturing. The decline in the over-all unemployment rate in August appears to have reflected withdrawals from the labor force--mainly of youngsters--rather than any surge in employment opportunities. Over the longer period since the start of the year, growth in the civilian labor force has fallen substantially short of its usual pace, and this has kept the unemployment rate low.

There are also signs of easing in the results of the latest survey of anticipated plant and equipment expenditures. It is some comfort to know that the task of restoring stability will not be complicated by resumption of an investment boom. Businessmen are responding to continued moderate rates of capacity utilization by trimming plans for plant expansion; the rise in capital outlays over the balance of this year is now projected by businessmen to be minimal and much smaller than they had anticipated last spring. Thus, we are getting moderation in several elements of business activity, not yet reflecting the impact of fiscal restraint, but rather conditions and trends extant before mid-year.

There are also some signs of moderation in the Federal contribution to expansion. The evidence is as yet scanty, but what is known about spending so far in the third quarter appears consistent with the significant slowing projected in the green book.[1/] It should be noted that, having been burned so often in this area of forecasting, our projections of Federal spending are deliberately generous and tend to be somewhat higher

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

than most around town. With the recent changes in signals on such matters as troop strength in Europe and missile programs, and with some non-defense programs like CCC and Medicaid out-running budget estimates, such generosity in forecasting seems advisable. Even with this generosity, however, the probabilities are for a substantial reduction in the Federal stimulus to economic activity this fall.

Of course, little, if any, of the moderating now evident in business and Federal demands reflects the recently enacted fiscal restraint. But then again, we didn't expect it this soon. It would have been foolhardy to expect to see evidence of fiscal restraint enacted in June appearing in the Daily Treasury Statement for August, or in the July inventory figures, or in August business plans for spending on fixed capital.

We did, however, expect by now to be able to observe some impact on the consumer sector. You will recall that our expectations were for a consumer adjustment to the enlarged tax bite that would involve maintaining consumption at the expense of savings, either by increased dissavings, i.e., incurrence of debt, or by contraction in the flow of savings to institutions and markets. A substantial drop in the saving rate does seem to be underway, but our projections seem to have gone wrong in two respects. Both the rise in incomes and the drop in the saving rate appear to have been a bit larger than we had projected. The differences are small, but in combination are resulting in a rise in consumer spending this summer at a rate some $3 to $4 billion more than we had anticipated. I don't want to deprecate the significance of this miss, for it raises important questions about prospects for subsequent quarters. If consumer spending continues as strong as it has been recently, business inventory demands could snap back, and the effects of further reductions in steel stocks could be more than offset by rebuilding of consumer goods inventories. It might even occasion some re-evaluation of plant capacity decisions. In combination, such developments could significantly modify the over-all outlook, influencing economic psychology and particularly the prospects for moderation of price pressures.

The possibility of this alternative outcome must be given careful consideration. One of the first rules for survival as a forecaster is to avoid getting so wedded

to a particular forecast that one is blinded to emerging evidence to the contrary. The second rule, however, is not to go off half-cocked because of a short-run deviation from the projection of a volatile series. The staff has tried faithfully to observe both rules. Re-assessing the implications of recent data--including the apparent maintenance of retail sales in August at about the high July level--we are not yet convinced that the available evidence warrants a significant change in our expectation for further slowing in economic activity. The full impact of the restraint package on both Federal and business spending is still mostly ahead of us, as is the full impact of higher personal taxes--and particularly the retroactive payments that will be required early next year. I don't think we are giving fiscal restraint a fair test by discounting its potency solely on the basis of consumer behavior in July and August.

Nevertheless, since consumer spending is such an important element of GNP, since it is continuing stronger than had been anticipated, and since this could cause changes in the outlook for other areas of the economy, it seems to me that the best policy for monetary authorities at this juncture would be to play it safe and sit still for a while. Sitting still would involve, as I see it, not permitting tensions in financial markets to re-emerge, but at the same time would not involve pushing aggressively for any further ease. This is the policy intended in the draft directive submitted to the Committee.[1/]

Mr. Axilrod made the following statement regarding financial developments:

With the economy seeming to show somewhat more strength than many expected this summer, but with the third-quarter data still fragmentary and the fourth quarter just coming into view, it is reasonable to ask whether financial markets provide any clues as to where the economy has been or is going. The staff during the past couple of months has had to revise upwards both estimates of third-quarter GNP and bank credit flows.

1/ Appended to this memorandum as Attachment A.

One question to be asked is whether the strengthening of bank credit is reflective of even more strength in GNP.

No one can be very certain of an answer to that question, but on balance the factors enlarging bank credit do not appear to be strongly GNP-related. Maybe GNP will turn out to be stronger than we have projected, but the large July-August expansion in the bank credit proxy--and the slower but still fairly substantial rate in the September-October projection--are not themselves indicative of fundamental economic strength.

The composition of bank credit is the principal evidence. From the end of June to the end of August, the outstanding total loans and investments of banks accelerated sharply, showing an increase of almost $12 billion. But this acceleration was not reflected to a significant degree in business, real estate, or consumer loans. Rather, about two-thirds of the total rise in bank credit represented increased bank holdings of U.S. Government securities, municipal securities, and loans to brokers and dealers. The figures do indicate that bank credit has helped finance U.S. Government outlays, but this had been in the main allowed for in our earlier estimates; and insofar as GNP is concerned, growth in these outlays, as Mr. Keir has mentioned, appears to be slowing.

Probably the main unanticipated element in the bank credit expansion has been the rapidity with which banks have acquired State and local government and Federal agency securities (including PC's). During the second quarter, banks were small net sellers of these securities; in sharp contrast, in July-August, they were net buyers to the extent of $2 billion. To help finance these acquisitions, banks very quickly issued sizable amounts of new large-denomination negotiable CD's. Most recently banks have not been especially eager to issue new CD's, although outstandings continue to creep up. Banks have financed their investments not only through the CD route, but also through even shorter-term borrowing in the Euro-dollar and Federal funds markets.

This willingness to borrow short and invest relatively long reflected the generally prevailing market expectations that interest rates would be declining on balance over the next several months. This attitude affected not only bank investments, but persuaded Government security dealers to build up and maintain

sizable inventories and also led municipal and corporate bond underwriters to bid aggressively for new issues coming to market. The borrowing needs to hold the securities acquired, especially of U.S. Government security dealers, have been another important factor keeping bank credit expansion on the high side of, or above, expectations--with the unwinding of these security market positions not coming as rapidly as anticipated.

While explaining away much of the bulge in bank credit expansion on expectational grounds--reflecting, in technical jargon, a one-time and temporary shift in banks' demand curves for certain types of assets--it is probably fair to say that consumer and business loans of banks as we measure them were on the high side of our earlier estimates in July-August. With regard to consumer loans, this certainly appears to reflect the recent spurt in consumers' real demand for goods and services. Business loan growth in July-August was about the same as the second-quarter average, but this would appear to reflect in large part the tax payments that had to be made in mid-July in conformity with the fiscal legislation. There was still some demand to finance growing business inventories, but these inventories were, from other evidence, growing at a considerably slower pace than in the second quarter.

Bank credit is, of course, only one part of the total credit picture. We are struggling manfully toward obtaining a reliable, seasonally adjusted, monthly measure of total funds raised in credit markets, but we have not quite achieved it yet. Probably the best that can be said at this point is that the July-August bank credit surge does not appear to reflect an equivalent surge in total credit. At least some of the bank credit flow does appear to represent a rechannelling of funds that might otherwise have gone directly into, say, Treasury securities, and even into municipals and business credit. Corporate demands on the capital market have dropped off very substantially, and the increase in outstanding mortgage credit has likely been no faster than in the second quarter and probably less--although the rate at which thrift institutions have made new mortgage commitments has picked up a bit.

With much of the recent buying or holding of intermediate- or long-term securities that have come to market based on expectations and financed with short-term

borrowing, the market is, of course, sensitive to the likely trend of short-term interest rates. The recent upward movement of longer-term yields--which has brought municipal and corporate bond yields 15 to 35 basis points above their August lows--in part represents a weakening of confidence in the rapidity with which, or extent to which, short-term rates are likely to decline.

Although a monetary policy of no change seems to be desirable while both the economic outlook and the exact significance of recent credit developments hopefully become clearer, the Committee could again be presented with the difficult problem of defining "no change." Within the context of a "no change" directive, it is quite possible that short-term interest rates could rise, at least temporarily, and lead to some further moderate rise of long-term rates. Perhaps some or much of this is already behind us. However that may be, it would not seem particularly desirable in this period, which is free of even keel constraints, to fight temporary upward pressures on market rates at the cost of large scale reserve injections. It still seems important, however, to keep any such rise from becoming cumulative and perhaps leading to market miscalculations, or premature interpretations, as to the longer-run intent of policy. While judgment of market psychology is more a matter of that much abused "feel and tone" than of specific interest rate levels, it could be that if any further rise in bill rates was kept in the order of blue book indications, this might be consistent with an orderly working off of inventories by dealers and an accompanying reduction in bank credit demands.

To avert too much of a retracing of the interest rate declines that occurred after enactment of fiscal restraint might require a rate of bank credit expansion in a 7 - 10 per cent annual rate range during this and the next month. If a lower rate of expansion develops, it could mean that credit demands are weaker than expected or that banks are less able to rebuild investments because time and savings deposit flows do not come up to expectations.

Mr. Mitchell asked whether Mr. Axilrod was attributing the recent high growth rates in the bank credit proxy primarily to

intermediation, even though growth of demand deposits had also been fairly rapid, particularly in July. On another point, he (Mr. Mitchell) was not sure whether Mr. Axilrod considered the current levels of dealer and bank inventories of securities to be dangerously high.

With respect to the first point, Mr. Axilrod commented that he had not meant to suggest that growth in bank credit was simply just a matter of intermediation. Although bank credit growth certainly looked as if it would be a higher proportion of over-all credit growth in the third quarter than had been the case earlier, he also suspected that total credit growth in the current quarter might turn out to be somewhat larger than in the second quarter. On the second point, he thought the large increase in inventories of securities in the hands of dealers and other active market participants reflected an effort by the market to anticipate a downward interest rate trend. In recent weeks the market had come to wonder whether it had overestimated the prospects for an easier credit policy and weaker business. As a result, with day-to-day financing costs remaining relatively high, there had occurred some general back-up in market interest rates, partly reflecting efforts to clear out some of the overhang of corporate, municipal, and Government securities that had not yet been put in the hands of ultimate investors. While there were still some

risks of an over-reaction as the market adjusted its technical position, he thought the odds were against the development of a major problem. Like Mr. Sternlight, he thought current expectations were not necessarily tied closely to particular rate levels.

Mr. Hickman observed that the market would be watching developments closely over the next few days for clues to today's policy decision. It seemed clearly desirable to avoid triggering any change in expectations.

Mr. Solomon then made the following statement on international financial developments:

> My presentation will be brief this morning.
>
> It is fortunate but also fortuitous that the period of sharply reduced U.S. trade surplus beginning about a year ago has also been a period of enlarged capital inflow to the United States. In the absence of the heavier inflow of foreign capital, the U.S. balance of payments would have been considerably more adverse. It may be useful therefore to focus for a moment on this enlarged capital inflow.
>
> It takes the form mainly of foreign purchases of U.S. corporate stocks. Until last year foreigners had been purchasing U.S. equities at a rate of less than $200 million per year. Beginning just a year ago, foreign purchases of U.S. shares stepped up to an average rate of $100 to $150 million per month--or an annual rate of something like $1.5 billion.
>
> This phenomenon is striking and for a number of reasons. First, it occurred right through a period when confidence in the dollar was supposed to have been weakened by the enlarged payments deficit and the sterling devaluation. Apparently long-term investors abroad were not strongly deterred from investing in Wall Street by the international monetary crisis. It is true that foreign purchases of U.S. equities fell off a bit in

March and April of this year, but even in those months such purchases were higher than they had been in earlier years. Incidentally, private holders of liquid dollar balances also went right on adding to their holdings during the international monetary crisis of late 1967 and early 1968.

Another remarkable apsect of the foreign capital inflow is that it coincided with a large increase in offerings of U.S. securities by American corporations in Europe--mainly convertible debentures. In complying with the more stringent balance of payments program announced January 1, U.S. corporations have sharply increased their security issues in Europe. These issues amounted to $1.1 billion in the first half of this year, compared with only $190 million in the first half of 1967. When the new balance of payments program was announced, many observers thought that the efforts of American corporations to finance their direct investments by issuing securities abroad would backfire in the sense that foreigners who bought new American issues in the Euro-bond market would sell existing holdings in the United States--with no net benefit to the balance of payments. As it turned out, foreigners not only failed to engage in this sort of substitution; they increased their purchases of U.S. equities in Wall Street while taking greatly enlarged issues of U.S. corporate securities in Europe. The issuance of U.S. corporate securities in Europe may have whetted European appetites for such securities.

It is tempting to attribute the heavier inflow of foreign long-term capital to the recent disturbances in France. There is no doubt that the French "events" (as they are called) had a profound impact all over Europe--reminding Europeans that their new-found political stability may be somewhat fragile. It would not be surprising if one reaction to this reminder was a decision by Europeans to invest more in the United States, with its remarkable record of political stability. It may be that there has been some step-up of foreign purchases of American stocks in recent months. But the fact is that it all began many months before the French disturbances.

More important, with growing incomes in Europe, there has probably been a shift in preferences toward

> equities generally. This is confirmed by the strong showing of most European stock markets. But these markets are thin and it is not surprising that, if they are seeking equities, European investors would turn to the broader and deeper U.S. market. In these circumstances intensive sales campaigns by U.S. mutual funds in Europe may also have been a significant factor.
>
> This process has gone on through July. We don't know what happened in August, but the over-all payments position worsened, as reported in the green book. But I shall, for today, skip the sermon that we international types find it necessary to deliver at regular intervals.

Mr. Daane asked Mr. Solomon if he had any view as to the sustainability of the capital inflows.

Mr. Solomon replied that he did not really know how long the sizable net inflows might continue, although he would guess they might persist for some time. Since such capital movements were little understood, they were very difficult to predict. Obviously, they were welcome while they lasted, but they were not a substitute for a U.S. trade surplus.

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 underlying economic picture has changed very little since our last regular meeting four weeks ago. We had all been expecting a slowdown in the rate of economic expansion; I think we are now beginning to see some evidence of such a development, although the signs are somewhat mixed and considerable strength exists in some key sectors. The latest survey of plant and equipment spending points to a slower pace, as does the lower rate of inventory accumulation. On the other hand, in several areas signs of a slower pace have not materialized.

Housing starts made a suprisingly strong showing in July. Given the improved competitive position of the thrift institutions, it seems highly likely that the trend in housing will be up from the lows reached at midyear. Even more impressive has been the liberality with which consumers have been spending. As we knew a month ago, retail sales in July were apparently very strong; there is so far no evidence of a dip in August. On balance, it appears that consumers have been more willing to cut into savings than either the Board staff or the New York Bank staff had expected. Thus, it seems likely that the effects of the readjustment in steel are being cushioned by the strength elsewhere, particularly by consumer spending. It seems very likely, therefore, that the slowdown in the third quarter will be less marked than some of us had expected at our last regular meeting.

What this means for late 1968 and early 1969 is naturally more obscure. A stronger-than-expected third quarter does not rule out a subsequent further slowdown as the tax surcharge really begins its bite. On balance, however, the stronger third-quarter performance does, it seems to me, weaken the chances of a cumulative interaction in which we might move from the kind of slowdown that we all want into an out-and-out recession. The longer-run implications of the Czechoslovakian crisis cannot be assessed precisely. But it must be obvious that there is less chance for a sizable cutback in non-Vietnam defense spending. The mid-year Federal Budget Review suggests that Federal spending may be higher than earlier projections indicated.

We continue to be a long way from the kind of moderation in price pressures that we have been seeking for so long. At the consumer level, it is particularly striking to see the consumers' price index rise in July at a 6 per cent annual rate for the second month in a row. Certainly, it would have been rash to expect any quick reaction of prices to a slowdown that seems to have been more moderate than we had expected earlier. But it is disturbing that inflationary pressures are so persistent and so strong.

Some comfort can undoubtedly be derived from the slowdown in wholesale prices. The rise in industrial wholesale prices has been negligible since April in contrast to the 4 per cent rate of advance in earlier months of this year. However, the extent of the slowdown

is certainly overstated in these comparisons, especially because of the earlier run-up in copper prices and the subsequent reaction.

On the international side, our underlying balance of payments deficit continues to be very large. While estimates for 1968 still involve a lot of guesswork, our staff's best estimate points to a $3.7 billion deficit, as against $4.8 billion in 1967. The chief villian, of course, is the merchandise account. After two months of deficit, the trade balance showed a very modest surplus in July. During the May-July period, the severe deterioration of our trade position appears to have been offset by capital movements, as Mr. Solomon has pointed out in illuminating detail. Stock purchases by foreigners have been a major factor, but these capital movements have also been encouraged by firm monetary conditions in the United States. As a result the liquidity deficit either on a recorded or on an underlying basis showed a marked improvement. The weekly figures for August, however, suggested that the deficit has again become very sizable. One of the few bright spots in the balance of payments picture is the continued good performance of the official settlements balance, largely reflecting massive borrowings of Euro-dollars by the overseas branches of U.S. banks for head office account.

The pervasive character of present international imbalances and the consequent extreme sensitivity of foreign exchange markets has again been underlined in recent days by the persistent rumors concerning revaluation of the German mark and the associated heavy speculative flows of funds into Germany. I think this underlines once again the high importance that must be attached to the containment of inflationary forces in the United States. Containment of inflation at home must be the chief means of improving our trade balance and bringing about a fundamental improvement in our balance of payments position.

At the meeting four weeks ago we were concerned about an excessive expansion of credit, and in fact the rate since then has accelerated. While Treasury financing and the improved competitive position of certificates of deposit no doubt contributed to the rapid rise, a continutation of anything like the recent pace would be unfortunate. The 7 to 10 per cent rate of advance projected for September is substanital. Indeed, such a growth rate seems to me to be too high following the excessively high rates of recent months.

Market sentiment has been relatively stable following the reduction in the discount rate. The moderate nature of the move, the timing of the action by the respective Reserve Banks, and the general conclusion that the reduction was primarily technical in character--all these factors have contributed to stability. Since our last regular meeting, the Federal funds rate has eased off from a level generally above 6 per cent to a range of 5-3/4 to 6 per cent. Rates on loans to Government security dealers have eased moderately, while dealer inventories continue to be very large. The three-month Treasury bill rate has been fairly stable at close to 5.20 per cent--the upper end of the range mentioned during our telephone conference on August 19.

Against a background of a business expansion that is moderating more slowly than had been expected earlier, continued inflationary pressures, a balance of payments situation that appears a bit worse than a month ago, and a rapid increase in bank credit in recent months, I see no reason for a further easing of credit policy at this time.

As we look ahead, we face the problem of reconciling our ideas about interest rates with our ideas concerning appropriate bank credit growth. Upward pressure on short-term interest rates may be quite marked in coming weeks. The expected run-down of Treasury balances, coupled with drawings on the swap lines with foreign central banks, will be supplying reserves in massive quantities to the banking system. These developments will call for offsetting sales by the System at a time when dealer inventories are very large. Unless we are willing to encourage a continued excessive rise in bank credit, I think we must be prepared to accept a higher level of short-term interest rates. In current circumstances, a rise of the three-month bill rate to 5-3/8 per cent, or perhaps a bit higher, should not be a cause for alarm.

In my opinion, preventing the rate on three-month Treasury bills from rising above its present level could be accomplished only at the expense of substantial easing in money market conditions, increased reserve availability, and some upward push in bank credit. I would be disturbed if bank credit were to rise even to the upper end of the range projected for September. On the other hand I would not be disturbed if the growth

rate were considerably lower, or even negative, for a month or two.

In terms of money market targets, I would favor a Federal funds rate range between 5-3/4 and 6 per cent and member bank borrowings between $400 and $600 million. The demand for excess reserves may prove to be unusually uncertain in the period ahead as banks adapt to the new lagged reserve requirements and related accounting changes; and net borrowed reserves should be permitted to fluctuate widely in response to the shifting demand for excess reserves.

As for the directive, I find it satisfactory except for the proviso clause which apparently would call for shading operations to the firmer side only if credit growth in September significantly exceeds 10 per cent. I would prefer to see some modification of operations if the rate climbs significantly above 7 per cent--the upper end of the range envisaged in the staff projection presented at the last regular meeting. Rather than including specific numerical targets in the directive, I would propose a revision of the proviso clause to direct that operations be modified if bank credit exceeds significantly a moderate growth trend. I would interpret a moderate growth trend as meaning a growth rate of about 6 to 8 per cent.

Mr. Francis remarked that excessive total spending, price inflation, and adversity in the balance of payments had evidently proceeded unabated up to the present time. A month or two ago there was great optimism by observers focusing on fiscal developments that the expansion in total spending might slow quickly and markedly from the 10 per cent annual rate in the first half of the year. For example, in the early August green book the staff projected a 4.7 per cent rate of increase in total spending from the second to the third quarter. The current green book indicated a 5.7 per cent rate of growth in GNP in the third quarter and a 4.2 per cent rate in the fourth quarter. In his opinion growth in

total spending at that pace, which compared with a 10 per cent rate in the first half of the year, would be desirable in order to achieve some moderation of the inflationary trend. However, he saw little likelihood that the projected moderation of demand would be achieved in the third or fourth quarter, and indeed, he did not expect that such moderation would develop in early 1969 unless the rapid rate of monetary expansion was reduced.

Mr. Francis noted that before the June 28 legislation the Federal Reserve had found it necessary to provide excessive monetary growth in an attempt to finance the Federal deficit while avoiding what were considered to be intolerable interest rate levels. A major reason for the legislation was to reduce the demand for credit in order that the rate of expansion of monetary magnitudes could be reduced. But now, more than two months after the effective date of the fiscal action, Federal Reserve credit, member bank reserves, the monetary base, and money continued to expand at historically high rates.

He was still hopeful that the fiscal program adopted in late June would exercise some restraining influence during the course of this fiscal year, Mr. Francis said. However, the likelihood that such restraint would be prompt or adequate had been affected by two developments. First, in July and August the increase in Federal Government receipts compared with a year

earlier was largely matched by an increase in Government expenditures. Second, the Federal Reserve System, in attempting to nudge interest rates down in advance of supply and demand conditions, expanded Federal Reserve credit in the area of $1-1/2 billion in July and August and might thereby have stimulated the economy, negating some of the effects of the fiscal action.

Making the most optimistic assumptions about restraint on future Government expenditures, Mr. Francis continued, it was estimated that the high-employment budget would be nearly in balance in the fourth quarter of this year and about $13 billion in surplus in the first half of 1969. Such a surplus would be about 1.4 per cent of estimated GNP compared with a $10 billion average surplus, or 1.7 per cent of GNP, from 1961 through mid-1965. From 1961 to 1965 the high-employment surplus was combined with an increase of money at a modest 3 per cent annual rate, and the result was a growth of total spending and real product much more rapid than growth of resources. Surely, it was not now desirable for total demand to continue to grow more rapidly than real resources.

Therefore, Mr. Francis believed the rapid rate of monetary expansion which characterized the first half of this year and which had continued unabated up to the present time should not be continued. In the last nine months Federal Reserve credit had grown at a 13 per cent annual rate, and the rate of growth had accelerated

during the period. Total member bank reserves, the monetary base, and the supply of money had also increased at high and accelerating rates.

In Mr. Francis' opinion, any realistic chance of adequately restraining total spending depended upon reducing the rate of increase of those monetary magnitudes to about their long-term trends. However, if the System continued to supply reserves with the objective of pushing interest rates lower in advance of market conditions, the risk would be great that total spending would not moderate but rather accelerate as it did beginning in the second quarter of 1967. Under such a policy lower interest rates were not likely to be realized. He recognized that the staff had projected that money would increase only slightly in September and October. He hoped that their projections would be validated by adequate restraint in the creation of Federal Reserve credit.

During the next four weeks, Mr. Francis said, he preferred to allow some backing up of market interest rates if that was necessary to slow the growth of Federal Reserve credit, bank reserves, and money.

Mr. Kimbrel said there was little to report from the Sixth District to change his conclusion given at the last meeting that the District economy continued on a strong upbeat. Here and there, there were signs that that general trend could change, as it

undoubtedly would if United States economic activity slowed down as predicted. So far, however, isolated unfavorable developments in individual sectors of the economy seemed to reflect special circumstances rather than a general softening.

Reports from Sixth District banks reflected both the strong credit demands, stemming from high level activity in the area, and increased reserve availability, Mr. Kimbrel continued. Deposits rose substantially at both large and small District banks in August, with large-denomination CD's accounting for most of the growth at the large banks. Business lending at large banks was stronger than usual. Consumer and real estate loans also increased. District member banks were under less pressure for reserves, and borrowings averaged $32 million in August.

Nationally, Mr. Kimbrel remarked, the banking figures seemed to tell about the same story. In nonbanking finance, there seemed to be a fall-off in new corporate issues, but the total demand for funds remained high. He would not ordinarily associate the current level of the total demand for funds with a weakening economy.

Mr. Kimbrel observed that despite large demands for funds some rates had softened. Changed expectations were often given as a major cause. However, the extreme liberality of the System in supplying reserves in the past two months or so, despite the high

level of economic activity, had to be given a major share of the responsibility.

Under the circumstances of the Treasury's needs, the kind of System action taken might have been unavoidable, Mr. Kimbrel said. It could not be undone and the Committee should not attempt to do so. Nevertheless, he hoped the System would not continue to supply reserves at the July and August rates without clearer evidence of reduced credit demands stemming from weakening economic activity.

There were signs here and there that the long expected slowdown might be beginning, Mr. Kimbrel observed. Firmer evidence might be provided during September as to whether or not those indicators were signaling a general slowdown. Possibly the Committee would be able to tell whether or not a slowdown in economic activity was occurring if loan demands diminished after the September 15 tax date. For the present, he would like the posture of policy to stay where it was.

Under the circumstances, Mr. Kimbrel indicated, he could accept the directive as proposed by the staff with the hope that growth in bank credit would be no greater than projected.

Mr. Bopp remarked that, as practitioners of the art of central banking, Committee members were all aware that a good part of the art often lay in making compromises between conflicting

objectives and guides. The System had been doing just that in recent weeks, but not--in his judgment--with noteworthy success.

Opinions differed as to whether policy should be directed toward anticipating a serious slowdown and consequent increases in unemployment or continuing to deal with strong inflationary pressures, Mr. Bopp said. His own view was that overkill had been overdone. Current economic developments might well be telling the Committee that the slowdown would not be as great as some now feared and that policy should continue to deal with the continuing inflation--at least until the economic signals became clearer.

It was true that the tax increase would take time to work, Mr. Bopp noted, but the current strength of consumer spending had to be given some weight. In addition, the latest surveys of consumer buying intentions suggested a strengthening outlook for durables, and the likelihood of a decline in the saving rate seemed great. Given the fact that a decline of one percentage point in the rate would add about $6 billion to consumer spending, he found it difficult to be very bearish on that score.

In the area of capital goods, Mr. Bopp said, information on appropriations indicated that sights apparently were being raised; and although no great surge should be expected, there might be more strength than believed just a short while ago. And evidence was accumulating that exemptions from the ceiling on

Government spending would make it very difficult to hold back a strong increase from that source.

Mr. Bopp said he was impressed with the recent tendency for a slowing in increases in wholesale prices and he would welcome more of the same. Yet, the effect of large wage increases inevitably would continue for some time to put pressure on prices. He was also very sensitive to possible increases in unemployment, particularly in view of the social consequences that might ensue if they became very large. However, the System could not simultaneously meet a threat of unemployment and combat inflation. His option, for the time being at least, was to pursue the latter course.

Moving from the objectives to the guides of policy, Mr. Bopp believed that the System had not had much success in juggling policy between interest rates and money and credit aggregates. The recent reduction in the discount rate was being read primarily as a technical adjustment. Although bill rates declined for a while, they were now higher than at the previous meeting. Little progress had been made in reducing the overhang of dealer inventories.

At the same time, Mr. Bopp continued, the credit proxy and the money supply had grown more rapidly than expected. Even if the money supply leveled off and growth of the credit proxy slowed in September, as projected, the Committee was still left with average increases in recent months that were uncomfortably high.

Therefore, Mr Bopp said, in the next four weeks he would place primary emphasis on the credit proxy. He would prefer to see it at a rate somewhat below the 7 per cent lower limit projected in the blue book. However, if that triggered increases in rates to the point where the market believed policy had shifted fundamentally, he would be prepared to see the Desk act to counter such expectations.

Mr. Bopp indicated that he favored the directive as modified by Mr. Hayes.

Mr. Hickman commented that despite the recent surge in consumer spending, economic activity showed signs of moderating in some areas, including inventory investment and capital spending. The impact of the surtax on consumer spending appeared to have been cushioned thus far by a sharp drop in the rate of personal saving. Thus, the growth of GNP this quarter would probably be slightly larger than expected a month ago. Unless there was another sharp decline in the saving rate next quarter, economic activity probably would slow further if growth of investment outlays and Federal expenditures slackened, as was now expected. If economic activity moderated, as he anticipated, labor market tightness and price pressures should ease. Industrial wholesale prices had already leveled, and advances in consumer prices should slow somewhat in the future.

Economic activity in the Fourth District this summer had been somewhat more bearish than in the nation, Mr. Hickman noted.

Nonfarm employment had been level since February, and insured unemployment rose in August for the fourth consecutive month. As anticipated, steel production dropped sharply after the wage settlement, and a further contraseasonal decline was expected in September. In addition, according to returns just received from the Cleveland Reserve Bank's latest survey, manufacturers in the District continued to be moderately pessimistic about the business outlook. On the other hand, the District's construction sector had improved; nonresidential contracts had moved up for the first time since March, and residential contracts had apparently also turned the corner.

Financial markets were more active than usual in August, Mr. Hickman continued, chiefly because of the large Treasury financing, changing expectations about interest rates and monetary policy, major international developments, and the injection of a huge amount of bank reserves by the System. Bank credit and the broadly defined money supply showed excessive rates of gain in August. Although those measures were expected to moderate in September, each would still show an excessive rate of growth for the third quarter as a whole. Despite misgivings about the August record, he was prepared to live with growth of the credit proxy plus Euro-dollars in the range of 7.5 per cent to 10.5 per cent as projected for September. On the other hand, the Committee should take whatever steps were necessary to make sure that the proxy did not exceed the upper end of that range.

Along that line, Mr. Hickman said he hoped that developments in August did not foreshadow events in September. On July 26, for example, the credit proxy for August was projected at an annual rate of growth of 13 per cent (excluding Euro-dollars), which even then was considered excessive by the majority of this Committee. In four of the next five weeks, the proxy for August was revised upward, so that by the end of the month the rate of growth of the proxy had reached 21.5 per cent. It had already been noted by the Committee's critics that that rate of expansion was inflationary and could not have occurred without System operations to accommodate it. He supported the policy directive calling for no change at this time, provided it was interpreted to mean that the Manager would take the action necessary to hold the credit proxy in the desired range, and preferably in the lower end of that range, even if that meant somewhat higher (or lower) interest rates. If the directive meant that the Committee would tolerate slippage as it did in August and that the Manager would validate it, then he would vote against the directive. He thought vigorous offsetting action should be taken if the growth rate of the credit proxy exceeded 10.5 per cent, and some offsetting action if it exceeded 7.5 per cent, even if that meant that the 91-day bill rate would go substantially above 5.35 per cent. In short, he came out just about where Mr. Hayes did.

Mr. Sherril said he continued to expect a slowdown in the pace of economic expansion and a downtrend in interest rates over the longer run, and he thought the Committee should formulate policy today with a view to avoiding problems later. Specifically, the Committee should be cautious in deciding how much of a short-run increase in the 90-day bill rate it was prepared to accept. The 5.35 per cent upper limit of the range given in the blue book would be acceptable to him for a short period, especially in view of the temporary pressures expected in the next statement week. If the bill rate were to continue at that level for very many days, however, there might be a major change in market expectations and resulting efforts to unload inventories of securities. Such developments could drive rates to high levels, necessitating a sharp reversal later as the slackening of economic expansion became apparent in coming months. Such wide fluctuations in interest rates would not be consistent with the Committee's long-range objectives.

Accordingly, Mr. Sherrill observed, he would favor pressing bank credit growth in September to the upper limit of the 7 - 10 per cent projected range, and perhaps even higher, if that was necessary to prevent excessive increases in the bill rate--say, to levels above 5.50 per cent. For the directive he preferred the staff's draft, including the two-way proviso.

Mr. Brimmer remarked that he concurred in the staff's analysis of the economic outlook. He did not think the recent performance of the Desk merited criticism; in particular, he disagreed with the statement that the Desk had "validated slippage" in bank credit growth. At the time of the August 13 meeting--when the expectation was for lower bill rates than had actually developed--Mr. Holmes had said that in the absence of a discount rate reduction a substantial volume of reserves might have to be provided to deal with upward rate pressures. The Committee might well have asked the Manager to do the impossible when it gave him both bill rate and bank credit targets. The quarter-point cut in the discount rate had eased the Manager's task, but a half-point cut would have eased it more, as would have more rapid discount rate actions by Reserve Banks generally, after the first reductions were made.

Nevertheless, Mr. Brimmer continued, he shared the concern about the rapid growth in reserves and bank credit, and he did not agree with Mr. Sherrill's suggestion that the rate of bank credit growth in September should be pressed to 10 per cent or above. He thought the Committee had to run the risk of somewhat higher bill rates. However, he was inclined to agree that bill rates above 5.40 per cent would be counter-productive; an upper limit of 5.35 or 5-3/8 per cent seemed reasonable. If upward rate pressures

persisted the Desk would have to strike a balance between interest rate and bank credit objectives.

Mr. Brimmer shared Mr. Sherrill's view that the Committee should keep the longer-run outlook in mind in formulating its policy today. He did not accept Mr. Bopp's comment that the System could not simultaneously meet a threat of unemployment and combat inflation; both had consistently been included among its broad goals.

Mr. Brimmer said he thought the Desk should be given the leeway it obviously would need in the coming period. The target ranges for money market variables that Mr. Hayes had suggested were acceptable to him. He preferred the staff's draft of the directive, but would not dissent if a majority favored Mr. Hayes' proposed amendment.

Mr. Maisel observed that he also favored the staff's draft directive, which seemed to him to put the stress in the right place. Like others, he had been somewhat concerned about the rate of bank credit growth in August. But whether or not that rate was judged excessive depended on the period over which average rates were calculated, as well as on the interpretation given to the peculiar set of circumstances prevailing during the month. The high growth rate apparently reflected the fact that CD's, the outstanding volume of which had been declining earlier, had become competitive

with other market instruments in the period. In addition, the rate of increase in total deposits was held down by the fact that for July and August deposits in thrift institutions probably had expanded by less than 6 per cent. The bank credit projections given in the blue book for September and October fell well within the ranges that he had suggested were desirable at recent Committee meetings, and he was quite prepared to accept them as the basis for a two-way proviso.

Mr. Maisel noted that the Desk's operating problems were expected to be particularly severe during the week ending September 18. It seemed to him that the Manager should have complete leeway to deal with the problems of market psychology in that period without being unduly concerned about the level of marginal reserves or even total reserves. As Mr. Sternlight had noted earlier, short-run fluctuations in the growth rates of the aggregates were not highly visible to the market. Moreover, high growth rates for a week would not make the longer-period averages unduly high. Accordingly, supplying additional reserves in that week would not have much effect on market expectations, whereas expectations were likely to be significantly affected if bill rates were permitted to rise rapidly or if the Federal funds rate moved back above 6 per cent.

In sum, Mr. Maisel said, he favored maintaing prevailing money market conditions subject to a two-way proviso, and giving the Manager more than the usual latitude for operations over the next ten days.

Mr. Daane remarked that the Committee had not often had the opportunity of hearing Mr. Sternlight report for the Desk, and he wanted to commend him on the excellence of his presentation. He (Mr. Daane) was persuaded that both Mr. Sternlight's analysis and his assessments of the outlook were correct. The Committee, as well as the market, had to be prepared to accept some gyrations in interest rates, and in his judgment the Committee should not attempt to specify narrow target ranges for the bill rate. He was sympathetic with some of the views Mr. Francis had expressed today, but thought it would be difficult to conduct open market operations on the basis of aggregative targets.

Mr. Daane said he favored the staff's draft for the directive, and thought the Manager should be given leeway to deal with whatever developments occurred in the coming period. In his judgment both the timing and the size of the recent discount rate reduction were appropriate.

Mr. Mitchell remarked that he had no objection to the staff's draft directive. Evidently much of the recent rapid growth of bank credit--like that in the early 1960's--reflected a surge

of intermediation by banks. He did not think there were grounds for apprehension in the replacement by banks of the large volume of CD's that had run off earlier and their use of the inflows to buy Treasury and municipal securities. However, to the extent that recent bank credit growth reflected monetary creation, he would share the concern that others had expressed.

Mr. Heflin reported that the latest information for the Fifth District suggested that the pace of activity might have accelerated in August. Respondents in the Richmond Reserve Bank's most recent survey reported a substantial pickup in new car sales and moderate gains in other retail lines as well. Similarly, construction activity in both the residential and the business areas appeared to be quickening again, after a slowdown earlier in the summer. Except in the textile industry, most District manufacturers reported further increases in new orders, backlogs, and shipments, and reduced inventories. A reduced pace of Government orders, however, was apparently beginning to exert a dampening effect in some textile markets. Business loans at District weekly reporting banks remained moderately strong, while consumer loans continued to record sizable gains.

On the national scene, Mr. Heflin said, it was now reasonably clear that the impact of the tax surcharge on third-quarter consumer spending would be considerably less than expected two months ago.

Moreover, third-quarter construction spending now appeared likely to be significantly higher than earlier projections. But he thought it was a mistake to assume therefore that the economy remained overly robust. The sharp cutback in steel output was a fact and it was clear that the August industrial production figure would be down. Similarly, the slowdown in inventory accumulation had not yet been reflected in any published figures. Over-all, despite the rather bullish recent data, he believed the staff's second-half projections, while perhaps still shaded on the low side, were nonetheless in the right ball park.

As of the present, it appeared to Mr. Heflin that the System's latest discount rate action had only temporarily arrested the upward drift in rates that had been in process at the time of the Committee's August 13 meeting. So far as he could see the new discount rate had not eliminated the market's technical problem. While dealer carrying costs had been reduced somewhat, they remained burdensome and dealer inventories were still uncomfortably bloated. Moreover, the market itself appeared to be in no better mood than four weeks ago to accommodate any move on the part of dealers to pare down inventories. The fact that the Desk might have to press a sizable volume of securities on the market to offset a seasonal buildup of reserves could prove an aggravating factor.

From the policy standpoint, Mr. Heflin continued, both the technical situation in the market and the near-term prospects for

the domestic economy would seem to require that the Committee resist any sharp updrift in market rates. As he saw it, the basic problem the Committee confronted today was much the same as the one it faced at its August 13 meeting, although there were important background differences that might bear on the question of how it should approach a solution. At the time of that meeting, discount rate action appeared to provide the best solution and, in retrospect, he believed that action was correct. Today, the international risks of an overt easing move were considerably greater than they had been four weeks ago and argued against any further discount rate action at this time. That was especially the case in view of the tone of the IMF's annual report released over the weekend. Moreover, in mid-August it had not been possible to relieve upward rate pressures through open market operations without serious risk that the Desk would have to make unacceptably large injections of new reserves. He believed that the post-holiday buildup of reserves presented a different situation today, and might provide the Desk with an opportunity to resist upward rate pressures without risking an overly rapid credit expansion. That might be achieved if the Desk were something less than aggressive in mopping up reserves. Given the seasonal swings in reserve needs over the next few weeks, that might amount to little more than an early provision of reserve needs for the autumn upswing. In any

event, it seemed to him that reserve management over the next period should resolve doubts on the side of ease. That was all the more the case in view of the changeover to lagged reserve accounting this week.

Mr. Clay observed that the national economy continued to show substantial strength, notably in the consumer sector. A slower rate of expansion in the months ahead appeared likely, but the shape of those events could not be known at this time. In view of the current strength of the economy and the large expansion in member bank reserves and credit in the last two months, further easing of monetary policy should await added evidence on the future course of economic activity. That view was underscored by the continuing price inflation problem and the risk that too much credit expansion might nullify prospective gains on the wage-price spiral. The international balance of payments record and prospects, particularly the balance of trade component, also argued for making as much headway as possible on the cost-price pressures.

Mr. Clay suggested that policy aim generally at the maintenance of prevailing money market conditions, as described on pages 4 and 5 of the blue book.[1/] Even though policy was not

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1/ The blue book passages referred to read in part as follows: "Assuming no change from around levels prevailing since the discount rate cut in the cost of one day money, the 3-month (continued on next page)

eased, staff projections indicated bank credit proxy growth of 7 to 10 per cent in September and on the high side of that range in October. That was in excess of what appeared to be desirable, especially in view of the excessive credit growth of recent periods. Accordingly, should it become possible to have credit expansion in the lower part of that range without putting upward pressure on money market conditions beyond those contemplated by projected defensive open market operations, that should be done.

The draft directive appeared to Mr. Clay to be satisfactory.

Mr. Scanlon reported that surging retail sales continued in the Seventh District, with strength found in both durables and

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1/ (continued from preceding page) Treasury bill rate may fluctuate in a 5.05--5.35 per cent range between now and the next meeting of the Committee. Bill rates may rise into about the third week in September, and then decline, for reasons explained. . . below. These wide swings in bill rates, should they develop, may also be accompanied by fairly broad movements in other money market rates and conditions.

"Prevailing levels of 1-day money rates center around 5-7/8 per cent for the Federal funds rate, and 6-1/2 per cent for dealer new loan rates. These rates may be consistent with member bank borrowings in a $400-$600 million range. Excess reserves of banks in this period may vary from their usual pattern as banks begin to adapt themselves to the new lagged reserve requirements, weekly country bank settlements, and permission to carry over reserve excesses into the next statement week--which become effective in the week beginning September 12. Over the long run, one might expect excess reserves to be reduced further as a result of these innovations, but in the transition period excess reserves could rise as banks cautiously appraise the effects of the new provisions. As a result, there is considerable uncertainty about the level of net borrowed reserves that is likely to be consistent with other money market conditions."

nondurables. An extremely high rate of auto sales had been accompanied by vigorous demand for furniture, color televisions, and certain appliances. The expected improvement in home building would probably augment demand for household durables.

Employment was expected to be well maintained in the District, Mr. Scanlon said. Unemployment remained very low, except for the automotive centers, but those centers would benefit if the projected high levels of output of cars and trucks materialized. Aside from steel, business inventories at both manufacturing and trade firms appeared low relative to shipments or sales. Increasingly, he had encountered the view that maintenance of the recent high level of retail sales might result in a general desire to increase inventories that would largely offset the liquidation of excess holdings of steel. Reports from makers of producers' equipment continued to be mixed. Construction contracts continued strong.

Mr. Scanlon thought that the prospective decline in farm prices associated with excellent crops, together with weakness in prices of most nonferrous metals, some types of steel, and certain raw materials, might cause the wholesale price index to level off or even decline. But there had not been any abatement in the rise in prices of most classes of finished manufactured products or of services.

Information on bank lending suggested that demand for business loans was slowing, Mr. Scanlon observed. Weaker than expected loan demand was reported in the August lending practices survey, and was verified by recent declines in outstanding commercial and industrial loans. While a portion of the recent paydowns might reflect inventory reductions by steel-using firms, loans to most other major industries had also declined. The strong expansion in term loans at the large banks in the District that began last fall and continued through most of the first half of 1968 appeared to have ceased. Mortgage and consumer loans, on the other hand, had strengthened in recent weeks. Several lending practice respondents commented on rising demand for mortgages. Others indicated a strong interest in increasing their instalment credit business.

Basic deficit positions of money market banks in the District showed little change last month, Mr. Scanlon continued. Acquisitions of longer-term Governments and municipals in August were offset by sales of bills and loan paydowns. Inflows through the CD market had tapered off recently, while funds obtained through foreign branches had risen. Inventories of securities remained high and additions to bill portfolios last week had resulted in very heavy buying of Federal funds, but use of the window had been minimal.

In view of continued evidence of upward price pressures, the need to improve the U.S. balance of payments, and the scarcity of tangible signs of economic slowdown, Mr. Scanlon believed the Committee should use caution in relaxing monetary policy. The slower growth in credit expected this month seemed appropriate; and it should be remembered that with September figures included, the rate of growth for the third quarter apparently would be larger than for the first half for all the aggregate monetary measures and larger than desirable.

Mr. Scanlon commented that the recent updrift in interest rates could be attributed to a number of factors, including a technical reaction to the June-July rally, the overhang of a large supply of securities, and the market's reassessment of the prospects for lower rates. In light of current credit projections, he would not be worried about that updrift so long as rates remained within the range suggested by Mr. Hayes and others. The staff's draft directive was acceptable to him.

Mr. Galusha said he would not summarize Ninth District economic developments this morning, but he did want to relay some rather interesting information about the District mortgage market which had been given him last Friday by an important District mortgage banker. The latter had reported quite a sharp decline--one quarter of one percentage point--in the residential mortgage

rate over the past few weeks. By way of explanation, he said that savings and loans were "full up" with non-residential mortgages, and that with funds coming in, they were in a position of having to make residential mortgage loans--or, in other words, of having to shade their residential mortgage rates. That mortgage banker was moderately optimistic about the near-term future of the construction industry, although the banker did say that speculative builders, most of whom were expecting lower interest rates, were still reluctant to start building again on a grand scale.

Mr. Galusha found his conversation with that mortgage banker--and the green book comments about mortgage rates and construction activity as well--somewhat encouraging, for there seemed to him to be a distinct possibility that unless there was a sustained increase in housing starts the unemployment rate could be expected to rise this winter. He would grant, of course, that some increase in the unemployment rate might be unavoidable. It might even be that if inflationary pressures were to moderate appreciably, that rate might have to remain above 4 per cent for quite a period. The point, however, was that without continuing recovery in the housing industry, there could be more unemployment than he, for one, would like to see.

To ensure a continuing recovery, Mr. Galusha continued, the Committee could find it necessary to shift to a modestly easier

monetary policy. Having said all that, he believed the Committee could afford to wait a while before acting. He was this morning for "no change" in Committee policy. Market rates should not be forced lower over the coming few weeks, and certainly they should not be forced higher.

If policy were for him alone to decide, Mr. Galusha said, he would have the Account Manager stabilize the bill rate within a narrower range than proposed and allow expected seasonal changes in the demand for bills to show up in offsetting quantity changes. He saw some risk of a sharp increase in long-term rates if the bill rate increased, even seasonally. But he could accept the staff's draft directive, which seemed primarily directed toward maintenance of orderly markets--a conclusion he believed was implicit in the very broad ranges of the monetary targets given in the blue book. The present was a period of long-range adjustment in the economy, complicated in the short run by seasonal patterns and market positions, and still further complicated by uncertainty about the numbers to which the change to lagged reserves had contributed. Given that environment, the draft directive appeared appropriate.

Mr. Galusha concluded by noting that while he thought it would be inadvisable to ease policy in the present environment, he did not think the Committee could discard the staff's GNP projections

and other projections suggesting that economic growth would slacken in the second half of the year. He was persuaded that as the year progressed those projections would be found to be justified.

Mr. Swan reported that large banks in the Twelfth District still seemed to be substantial net buyers of inter-bank Federal funds, substantial borrowers under corporate repurchase agreements, and substantial lenders to securities dealers. In August, both passbook savings deposits and time deposits rose at District weekly reporting banks. Also, data for a small sample of California savings and loan associations--five associations accounting for about 18 per cent of the total S&L shareholdings in the State--suggested that there might have been a net inflow to California S&L's in the neighborhood of $100 million in August.

Mr. Swan said he could subscribe in general to the description of the present state of the national economy that had been given today. There were signs of moderating growth, but they did not seem to him to indicate that the degree of slowing was disturbing or excessive. He was prepared to accept the staff's draft directive, recognizing that--as had been indicated by several speakers--it was necessary to accept relatively wide target ranges for the money market variables and to give a great deal of leeway to the Manager. However, he shared the concern that several members had expressed about the recent high growth rates in bank credit.

He agreed with Mr. Hayes that a 6 to 8 per cent annual rate of growth in September would be better than a 10 per cent rate, and accordingly he would prefer the type of proviso clause Mr. Hayes had proposed. In light of the circumstances that were likely to prevail in the next two weeks, he would not be disturbed if the three-month bill rate rose to 5.40 per cent, or even higher, particularly if present relationships were maintained between the rates on three-month bills and on those of longer maturity. At the moment, the one-year bill rate was below the three-month rate, suggesting that the market did not expect rates to be rising on balance.

Mr. Coldwell reported that Eleventh District economic conditions were holding at a very advanced level. There were a few indicators of additional strength, mainly in construction and retail trade, but virtually no indicators showing noticeable weakness. Thus, the majority of the District economic measurements reflected little change at record or near-record levels. Industrial production and employment had leveled off or shown only slight increases for almost three months. To some extent, those trends could be explained by the offsetting forces in industrial production, where crude oil output had slipped but other production, especially machinery, had advanced. Employment levels similarly concealed some offsets although the general trend had been slightly upward.

Agricultural activity had increased as harvesting of fall crops accelerated, Mr. Coldwell said. Increased resort to Government loan programs for wheat was especially noticeable, but the large gain in cotton output might be absorbed by the market even at present price levels because of above-average disappearance and the small crop of last year, which might require inventory rebuilding. Nationally, carry-over stocks of cotton were cut almost in half from mid-1967 to mid-1968.

District banking trends virtually paralleled those in the nation during August, Mr. Coldwell continued, as investments and time deposits rose while loans and demand deposits declined. Loan demand still reflected a stronger-than-seasonal tone, but bank liquidity was improving, especially in agricultural areas as larger-than-expected Government support payments were received. That feeling of greater ease was also reflected in a sharply reduced net-purchase position in Federal funds and somewhat lower borrowings from the Reserve Bank. Nevertheless, the outlook for continued strength in loan demand and some slackening in the rate of CD purchase might slow an over-all easing of positions.

Nationally, Mr. Coldwell observed, it seemed to him that statistical evidence of a slowdown was still lacking. Inventory adjustments in steel and automobiles certainly were expected, but such adjustments did not call for a change in monetary policy,

especially when there was evidence of some improvement in construction and continued strength in consumer spending. Moreover, it appeared that wage-cost pressures and advances in consumer prices would continue; and the Czechoslovakian crisis had apparently diminished the chances of realizing the full cutback contemplated in Federal spending.

With respect to policy, Mr. Coldwell thought the Committee had to take cognizance of the recent excessive growth rates in bank credit and the money supply. No matter what their cause, those high growth rates had already persisted too long. It was important to remember that even if prevailing levels of net borrowed reserves were maintained the System would be steadily reconstituting the reserve position of banks.

Mr. Coldwell said he would recommend a policy posture which permitted seasonal pressures to be exerted on bank reserves and which sacrificed some of the Committee's interest rate objectives to the objective of slowing bank credit growth. He would not attempt to specify targets for individual money market variables because existing conditions made it necessary to give a great deal of latitude to the Manager. In any case, some of the combinations of target ranges that had been suggested today struck him as too precise; as had been demonstrated recently, it could prove impossible to achieve such targets simultaneously.

Mr. Coldwell concluded with the observation that he shared the concern of the directors of his Bank, as expressed in a letter to the Board at the time of the recent discount rate action, about the persistence of inflationary pressures in the economy.

Mr. Morris remarked that he could report on recent attitudes in financial markets from first-hand experience, having been a participant himself until joining the System in mid-August. There was a high degree of confidence in the market that the recently enacted fiscal package would be effective in slowing down the rate of economic expansion; market participants generally were looking at projections to mid-1969 that showed a pattern of slower growth and a gradual easing of financial pressures. He thought that confidence in the effectiveness of the fiscal program had not been shaken by the recent surge in the consumer spending. One piece of evidence suggesting that the market did not expect the consumer spending surge to be of long duration was that prices of stocks of corporations engaged in retail trade had, by and large, remained below the peaks reached in the spring.

At the same time, Mr. Morris continued, the fear of "over-kill" had clearly diminished. A few weeks earlier there had been a great deal of concern that the fiscal package, together with the existing degree of monetary restraint, might produce a greater reaction in the economy than anyone desired. He thought the

abatement of that fear over the past few weeks could be attributed primarily to the actions taken by the Federal Reserve to relieve financial pressures somewhat, even before there was definite evidence in hand of the effects of the fiscal package. The recent behavior of both stock and bond markets reflected the belief that the combination of fiscal and monetary restraint would be well managed and that overkill would be avoided.

The continued willingness of Government securities dealers to hold very large inventories despite a sizable negative carry was one indication of expectations that financial pressures would ease, Mr. Morris said. He thought those expectations were not highly fragile--that participants were not likely to react strongly to a moderate rise in the bill rate. In his judgment the three-month bill rate could rise to 5-3/8 per cent without precipitating a major change in expectations. Obviously, however, there was some level of the bill rate--perhaps in the 5.40 per cent area--at which the market would begin to have doubts about its present expectations.

Mr. Morris said that the staff's draft directive was acceptable to him. In light of the very large increase in bank reserves during July and August, however, he would not be disturbed if growth in the bank credit proxy fell below a 7 per cent annual rate in September.

Mr. Robertson made the following statement:

> It seems to me the position we find ourselves in this morning can be summed up fairly briefly.
>
> The figures on business developments and money and credit flows that have come out since we last met are too strong to warrant any easing policy step at this meeting. On the other hand, the restraining measures already introduced into the economy are too great, and the time period since their enactment is too short, for us to infer from the strong current figures that a turn back toward monetary tightening is in order.
>
> I, for one, would not like to see us so quickly reverse policy direction after having taken an overt easing step a little over three weeks ago. We need to look at future prospects as well as current events in deciding upon the proper monetary policy. From that perspective, a lot of the developments taking place currently seem to be transitional. I think the wisest counsel right now is for a little more patience on the part of the Committee to let things begin to work themselves out. We will meet again in four weeks, and there should still be enough time between that meeting and any ensuing Treasury coupon financing to permit any policy adaptations that seem desirable at that time.
>
> Between now and then, I favor a policy of essentially "no change". For that purpose, I would vote for the draft directive as prepared by the staff, with a two-way proviso clause included to insure a little resistance by the Trading Desk to any unexpectedly large bank credit movements in either direction.

Chairman Martin commented that in his judgment the existing momentum of inflationary pressures was largely a consequence of the fact that both fiscal and monetary restraint had come much too late. He thought it would be asking too much of the available tools of monetary policy to expect them to deal with the inflationary psychology that had resulted from that delay.

The Chairman noted that he was still of the view that the general trend of interest rates should be downward, but there were

questions of timing. At the moment, he thought the stance of monetary policy was about right, and he would not change it in either direction. He would expect conditions in financial markets to settle down and market forces to take care of some present problems.

Personally, Chairman Martin said, he favored the directive as drafted by the staff. Since that also seemed to be the position of the majority today, he proposed that the Committee vote on the staff's draft. If any of the members who had expressed a preference for the type of proviso clause suggested by Mr. Hayes felt strongly about the matter, they could cast a dissenting vote.

Mr. Hayes said that while he planned to vote affirmatively, he would emphasize that he remained highly concerned about the danger of excessive credit expansion. It appeared from the go-around that that danger bulked large in the minds of some of the Reserve Bank Presidents, who were in a position to observe closely the strength of inflationary pressures from developments in their respective Districts.

Mr. Hickman associated himself with Mr. Hayes' observation, and Mr. Daane said he also shared that view to some extent.

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

The information reviewed at this meeting suggests that, although consumer demands have been strong this summer, reduced rates of inventory accumulation and tapering growth of Government expenditures are being reflected in a slowing of expansion in over-all activity. Industrial prices have been increasing less rapidly in recent months, but consumer prices have continued to rise substantially and wage pressures remain strong. Most market interest rates have changed little on balance following reductions in Federal Reserve Bank discount rates. Growth in bank credit and time and savings deposits has been rapid this summer; growth in the money supply slowed in August as U.S. Government deposits were built up following an extended decline. The earlier improvement in the U.S. balance of payments was not maintained in August, according to preliminary indications, and the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Chairman Martin then suggested that the Committee continue the discussion it had begun on August 13 of the proposal for lending U.S. Government securities held in the System Open Market Account. He noted that the earlier memoranda on the subject had been supplemented by a new memorandum from the Manager distributed on September 4, and entitled "System Lending of U.S. Government

Securities."[1] The Chairman asked Mr. Sternlight to open the discussion.

Mr. Sternlight observed that in his latest memorandum the Manager continued to recommend that the Committee amend its continuing authority directive to authorize lending of securities from the System Account, on terms and conditions to be established by the Committee, to Government securities dealers and to banks participating in a securities clearing arrangement conducted through a Federal Reserve Bank. The main purpose of the new memorandum was to recommend a reformulated version of the proposed terms and conditions. The new formulation had evolved from staff discussions following the Committee's preliminary consideration of the matter on August 13.

Most of the modifications from the terms and conditions proposed earlier were of a clarifying nature, Mr. Sternlight said. However, one involved a substantive change in the accounting procedures. It was now proposed that all loans of securities be treated as loans solely from the unpledged portion of the participation of the Federal Reserve Bank of New York in the System Account. On that basis, the accounting procedures--which were summarized in an attachment to the memorandum--would be much simpler than if the

1/ A copy of this memorandum has been placed in the files of the Committee.

participations of all twelve Reserve Banks were affected. That treatment also would minimize the potential problem of insufficient securities in the participations of some Reserve Banks beyond those pledged as collateral for Federal Reserve notes. He was informed that the Committee's General Counsel and Counsel at the Federal Reserve Bank of New York were satisfied that the proposal to lend unpledged securities from the New York Bank's participation was consistent with the System's plan for securing Federal Reserve notes, as set forth in paragraph 2025.20 of the Federal Reserve Loose-Leaf Service.

Mr. Sternlight observed that the Account Management planned to discuss details of the proposed lending arrangements with interested market participants if the Committee approved the Manager's recommendations. If such discussions were to result in suggestions for significant modifications of the terms of the arrangements, the Manager would, of course, bring the matter back to the Committee for consideration.

In response to the Chairman's request for his views, Mr. Hackley said he continued to believe that the authority of the Reserve Banks to lend securities in the manner proposed was subject to legal question. His opinion was based mainly on the consideration that the proposed activity had not been demonstrated to be reasonably necessary to accomplish the objectives of open market

operations. Admittedly, the issue was open to debate and different legal opinions had been expressed. Moreover, it was unlikely that the matter would be tested in litigation; and even if it were, it was possible--although not certain--that the courts would sustain the System's authority. He had reviewed the proposed terms and conditions and accounting procedures accompanying the Manager's latest memorandum and had concluded that they would be reasonably satisfactory from a legal standpoint if the Committee approved the Manager's recommendations.

Mr. Brimmer remarked that the legal question Mr. Hackley had raised seemed to turn on the importance, from the point of view of System open market operations, that was attached to reducing the frequency of delivery failures by banks and dealers. He asked Mr. Sternlight to comment on that subject.

Mr. Sternlight replied that he would not want to overstate the case; obviously, it had been possible for the System to conduct operations up to this point without benefit of the proposed lending arrangements. Nevertheless, open market operations were facilitated by a smoothly functioning market, and it seemed clear that the market's performance would be improved if the ability of participants to deliver on their contracts was enhanced.

Chairman Martin observed that after considering the matter at some length the Steering Committee had concluded that implementing

the proposal would contribute importantly toward improving the functioning of the market.

Mr. Robertson said he would oppose the proposal. Since no specific power to lend securities had been granted to the Federal Reserve Banks by statute, such loans had to be justified under their incidental powers. In turn, that meant that the proposed activity had to be shown to be necessary to the implementation of the System's statutory responsibilities and not just highly desirable. Such a demonstration had not been made, and open market operations had been conducted for years without the proposed type of activity. Moreover, the practical problem at which the proposal was directed arose from the scarcity of certain Treasury issues. Questions of whether and how the market supply of scarce issues should be temporarily supplemented seemed to him to be more a matter of debt management than of monetary policy. Accordingly, it appeared more appropriate for the Treasury than for the System to deal with the problem. If the Treasury did not view the problem as sufficiently serious to call for action on its part, it would clearly not be desirable, he thought, for the System to undertake a legally questionable activity.

Mr. Heflin said he agreed with Mr. Robertson, In his judgment, the change in the Manager's proposal--to treat loans of securities as coming from the New York Banks participation rather

than from that of all Reserve Banks--did not affect the basic legal issue.

Mr. Mitchell commented that the staff's original proposals had included one, for lending securities to dealers in order to facilitate short sales, that he thought would have involved the System in debt management. However, that specific proposal had been omitted from the Steering Committee's recommendations. He personally had no objections to the proposal under consideration, which was quite limited in scope.

Chairman Martin said he thought the issue Mr. Robertson had raised was debatable. It was difficult, in his judgment, to draw a line in this area between Treasury and Federal Reserve responsibilities; if, as he thought was the case, the Government securities market did not function as well as it should, that was a matter of concern to both the Treasury and the System.

Mr. Daane agreed that the System had a deep concern with the functioning of the Government securities market. He thought the proposed lending of securities would provide a useful and proper adjunct to the System's open market operations. As Mr. Hackley had noted, the question of legal authority was open to debate, and the Committee had before it conflicting legal opinions.

Mr. Hayes commented that like Mr. Daane he thought the proposed activity would be a useful adjunct to open market operations.

He was not in a position to judge the validity of the conflicting legal arguments, but since the legal questions were viewed as debatable he thought the Committee should resolve the doubt in favor of the proposal. He noted that the Secretary of the Treasury and other senior Treasury officials were members of the Steering Committee that had endorsed the proposed lending activity.

Mr. Morris observed that the proposal would mitigate one debt management problem that was of interest to the Committee. When a specific Treasury issue was in scarce market supply, it typically was quoted at an artificial price rather than at a realistic price at which significant amounts of the issue could be bought and sold. Such artificial prices created problems for the Treasury when it had to price new issues and often resulted in a tendency toward underpricing. That result was undesirable from the standpoint of the Federal Reserve as well as the Treasury.

Mr. Scanlon asked if it was contemplated that securities would be lent to any dealer bank or just to those located in New York City.

Mr. Sternlight replied that the proposal was intended to apply to all dealers doing business with the Desk, including dealer banks outside of New York City.

Mr. Scanlon then observed that technical problems, including those arising from time differentials, would seem to limit loans

of securities to cases in which deliveries were to be made in New York. Problems stemming from time differentials would be reduced if the closing time for New York transactions was extended to later in the day, but even then it would not seem feasible to include transactions in which deliveries were to be made on the West Coast.

Mr. Sternlight commented that the market for U.S. Government securities was centered in New York and even the dealers located outside New York often made their deliveries in New York. Thus, the dealer banks in Chicago or on the West Coast could participate in connection with deliveries to be made in New York. Also, the proposal related in part to loans of securities to banks participating in a securities clearing arrangement conducted through a Federal Reserve Bank. While only the New York Bank conducted such a clearing arrangement at present, the proposal might be applied to any such facilities that other Reserve Banks might establish in the future.

In response to a question by Chairman Martin, Mr. Scanlon said that he did not feel that he needed additional time to study the proposal. He wanted to emphasize that the proposed activity would be basically a New York City operation.

Mr. Hickman indicated that the General Counsel of the Cleveland Reserve Bank had reached essentially the same conclusion

as Messrs. Robertson and Hackley. Also, there seemed to be some question as to whether the matter lay within the jurisdiction of the Federal Open Market Committee, since it involved loans of securities rather than purchases or sales. Perhaps it was a matter for the Board of Governors or the Directors of the Federal Reserve Bank of New York to resolve.

Mr. Hackley said he had given some thought to the question of jurisdiction. While at one point section 12a of the Federal Reserve Act spoke only in terms of purchases and sales of Government securities, another provision of that section specifically vested authority over "open market operations" under section 14 of the Act in the Federal Open Market Committee. Accordingly, he believed that jurisdiction over any activity clearly incidental to open market operations rested with the Committee, even if direct purchases or sales of securities were not involved. As he had indicated, however, it was still arguable whether the Committee had the legal authority to sanction the activity in question.

Mr. Robertson reiterated his view that for the Committee to sanction the proposed activity under its incidental powers would be stretching the law. He thought that if the matter was deemed important enough to pursue, the Committee should seek appropriate legislation from Congress.

Chairman Martin observed that the Steering Committee had considered that possibility and had decided unanimously that it was not necessary to go to Congress on the matter.

Mr. Maisel commented that if the legality of the lending proposal was dependent upon a finding as to its degree of importance, the conclusion that the activity was important enough to warrant seeking new legislation might in itself be taken as evidence that it was important enough to justify under the incidental powers of the Reserve Banks.

Mr. Robertson remarked that the question at issue was not whether the proposed activity was important in some sense but whether it was necessary to the conduct of open market operations.

Mr. Galusha suggested that when the Committee came to a vote on the question it might take two separate votes, the first of which would be on the merits of the proposal, ignoring legal questions. Such a procedure would clarify the members' views on the substantive issue, apart from any doubts regarding its legality, and would be a useful preliminary to the vote on the proposal itself.

Mr. Robertson commented that the Committee's General Counsel had stated quite specifically that in his opinion the proposed activity was not legal. He (Mr. Robertson) agreed that it was not likely that the matter would be litigated, but that fact did not seem to him to justify approving the proposal.

Chairman Martin remarked that his earlier understanding of Mr. Hackley's position was that the proposal was subject to some legal questions, not that it was illegal.

Mr. Hackley observed that it was always difficult to predict what the courts might decide. However, it was his opinion that the Reserve Banks did not have authority to lend Government securities in the manner proposed, in the absence of a demonstration that the activity was required or reasonably necessary to enable the Reserve Banks to carry out effectively their express authority to buy and sell securities in the open market. On the basis of his understanding that, under present conditions, the lending of securities would be regarded as something convenient but not reasonably necessary in the effectuation of open market operations, he concluded that the Reserve Banks did not now have incidental power to engage in the proposed practice.

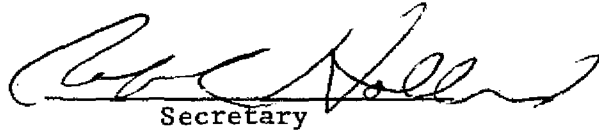
Chairman Martin commented that he had formed a somewhat different impression of Mr. Hackley's position at meetings of the Steering Committee.

The Chairman then suggested that the matter be held over to allow time for further study. He recalled that Mr. Bopp also had expressed reservations about the proposal on legal grounds and he (Chairman Martin) wanted to discuss the matter further with Treasury officials.

No objection was expressed to the Chairman's suggestion.

It was agreed the next meeting of the Committee would be held on Tuesday, October 8, 1968, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

September 9, 1968

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 10, 1968

The information reviewed at this meeting suggests that, although consumer demands have been strong this summer, reduced rates of inventory accumulation and tapering growth of Government expenditures are being reflected in a slowing of expansion in over-all activity. Industrial prices have been increasing less rapidly in recent months, but consumer prices have continued to rise substantially and wage pressures remain strong. Most market interest rates have changed little on balance following reductions in Federal Reserve Bank discount rates. Growth in bank credit and time and savings deposits has been rapid this summer; growth in the money supply slowed in August as U.S. Government deposits were built up following an extended decline. The earlier improvement in the U.S. balance of payments was not maintained in August, according to preliminary indications, and the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.