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, November 1, 1966, at 9:30 a.m.

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

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

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

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

Mr. Fauver, Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Messrs. Hersey and Reynolds, Advisers, Division of International Finance, Board of Governors
Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Mr. Forrestal, Senior Attorney, Legal Division Board of Governors

Messrs. Willis, Ratchford, Brandt, Baughman, and Jones, Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, and St. Louis, respectively
Messrs. Fousek and MacLaury, Assistant Vice Presidents of the Federal Reserve Bank of New York
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Deming, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Duprey, Economist, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on October 4, 1966, were approved.

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 October 4 through 26, 1966, and a supplemental report for October 27 through 31, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury said that the Treasury gold stock would again remain unchanged this week and there was a good chance of getting through November as well without any drop in the gold stock. That respite from previous sales reflected in part the halt in French reserve gains during recent months, and the widely publicized decision of the French

authorities to forego this month their regular 30-ton purchase in the absence of reserve gains. During October the gold pool came out about even on balance, with prices in the London gold market remaining within a narrow range of $35.15-$35.165. Since July, South Africa had not been adding to its reserves with the result that new production of gold had been coming from that country to London in substantially larger amounts than earlier in the year. On the other hand, it seemed increasingly unlikely that Russia would have to sell gold in the foreseeable future.

There were many cross-currents in the sterling picture in October, Mr. MacLaury commented, but the underlying trend in the market was generally one of strength. As the Committee would recall, in July, at the time of extremely heavy selling of sterling, the Bank of England had extended very substantial support in the forward market as well as in the spot market. A large portion of the forward sterling purchases it had made at that time--i.e., those with three-month maturities--fell due in October. Most of those contracts represented hedging of one sort or another, and since the sellers in most cases did not have sterling receipts coming in, they had to buy sterling to make delivery; and, in effect, they bought it from the Bank of England. Thus, the Bank of England was able to pick up from the market most of the dollars it needed to meet the heavy

maturities, when it was not able to roll the contracts forward. On several occasions during the month, however, the timing of dollar purchases and commitments did not coincide and, on balance, there probably was some net dollar drain in paying off the sizable maturities that were not rolled over.

The Bank of England had borrowed $360 million overnight at the end of September, Mr. MacLaury continued. Also, because of an increase in sterling balances in September, it was required under the terms of the sterling balance credit arrangement to repay $125 million of previously borrowed funds to the Bank for International Settlements. As a result, the Bank of England would have needed nearly $500 million at the end of October just to refinance previous borrowings. Of that amount, the U.S. put up $250 million on an overnight basis--from yesterday to today--with $200 million from the Treasury and $50 million from the System. As it turned out, however, sizable dollar receipts from the market in the last few days of the month would permit the Bank of England to announce tomorrow that it had made a net reduction of foreign indebtedness as well as a satisfactory gain in its official reserves. Thus, the U.S. credits to the Bank of England this month-end represented only a partial refinancing of credits previously extended to the British. Taking into account the net repayments of debt, the increase in reserves,

and the substantial reduction in forward commitments, the overall improvement in the British position in October amounted to about $400 million. That was an encouraging pattern.

The dollar continued to show strength during the month against most continental currencies except the German mark, Mr. MacLaury reported. The Belgian franc and Italian lira held around par, and the French franc was frequently just below par. In each case, it appeared that the central bank concerned supported its currency on occasion through the sales of dollars in its market. In the last few days the System Account had bought about $12 million equivalent of lire in New York, $10 million of which would be used tomorrow (November 2) to reduce the System's $100 million drawing on the Bank of Italy to $90 million. Even greater progress had been made during the month in reducing System drawings of Swiss francs from the Swiss National Bank. Total repayments in Swiss francs since the previous meeting of the Committee amounted to $45 million equivalent, leaving $100 million still outstanding--including the $75 million Swiss franc drawing on the BIS. In contrast to the currencies just mentioned, the German mark strengthened considerably during the month and the German Federal Bank took in about $100 million. That mainly reflected the persistence of very tight money conditions and the improvement in Germany's

trade surplus that began earlier this year. The German cabinet resignations last week did not seem to have had any lasting impact on the exchange market.

Finally, Mr. MacLaury said, his impression was that the weakening tendency of the Canadian dollar during October was attributable to the cumulative effects of the reduction in the rate of new Canadian capital issues in the United States from the first to the second half of the year, combined with short-term capital outflows from Canada.

Mr. Mitchell asked whether his understanding was correct that the Bank of England's position had improved by roughly $400 million in October after all window-dressing operations were discounted. Mr. MacLaury replied that that understanding was correct.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period October 4 through 31, 1966, were approved, ratified, and confirmed.

Mr. MacLaury reported that two drawings by the Bank of England on its swap line with the System, of $50 million each, would mature at the end of November. The Bank of England was highly conscious of the desirability of paying down those drawings, and it was possible that they would do so before the maturity date. He would recommend renewal of the drawings,

however, if that should prove necessary. One would be a first renewal and the other a second renewal.

> Possible renewal of the two drawings by the Bank of England was noted without objection.

Mr. MacLaury then noted that on December 2, 1966, the System's drawing on the Bank of Italy which, as he had indicated earlier, would be reduced tomorrow from $100 million to $90 million, would come up for a first renewal. He hoped that further progress would be made toward repaying the drawing, but recommended renewal if it did not prove possible to liquidate it in full.

> Possible renewal of the drawing on the Bank of Italy was noted without objection.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period October 4 through 26, 1966, and a supplemental report for October 27 through 31, 1966. Copies of both reports have been placed in the files of the Committee.

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

The more buoyant psychology that had emerged in financial markets prior to the last Committee meeting has developed further over the past four weeks. The factors underlying this improved sentiment have been described in some detail in the written reports to the Committee and I will not enumerate them here. Pressure on the markets subsided markedly, interest rates moved lower, and the corporate and municipal calendar showed no signs of an unusual buildup. At the same time, bank credit--as measured by the credit proxy--declined in October in contrast to the 5-6 per cent rise projected at the time of the last meeting. While commercial banks were constrained by a substantial loss in CD's over the month, the recent decline in Treasury bill rates has tended to ease somewhat the pressure in that area as well.

The important question that market participants have been debating is whether the sign of reduced pressure in financial markets represents the beginning of a cyclical downtrend in interest rates and credit demand or whether it has been a temporary lull, in part an unwinding of the tensions and psychoses of late August in the bond markets and of early September in the short-term financial markets. Many banks and market observers feel that loan demand remains very strong and will soon be reasserting itself vigorously. They ascribe the current shortfall in credit expansion to anticipatory borrowing earlier and to some lessened feeling of urgency to borrow now. At the same time, with interest rates declining, borrowers in the capital market, they argue, have tended to postpone needs but may soon be seen again in force. This group also sees less likelihood of a tax increase now than a few weeks ago, and on balance is generally optimistic about the business outlook.

The other major group would read something more fundamental into recent indications of reduced credit demand, and would generally argue that the tight money and fiscal actions taken to date have already taken the edge off business expansion, and that a tax increase is no longer necessary. Vietnam is a complicating factor for both schools of thought, but the latter group would tend to view military spending as the only major support of the domestic economy.

The resolution of views just outlined is, of course, identical with the issue that the Committee faces today. For the time being market participants would agree that the pressures on financial markets have subsided. The question of "how long" remains.

System open market operations over the period have, of course, been strongly affected by the progressive shortfall of the bank credit proxy, required reserves, and other aggregate measures from the expectations of four weeks ago. A somewhat more comfortable tone has been permitted to emerge in the money market, partly reflecting the change in expectations, and net borrowed reserve figures have fluctuated widely without exciting either the press or the market.

Early in the period--in the week ending October 12, for example--there appeared to be some tendency for the larger banks to anticipate reserve needs at the discount window. In that week heavy average borrowings and a net borrowed reserve figure of about $500 million were associated with a generally comfortable Federal funds market. In the week ending October 19 country banks built up their excess reserves substantially in the first week of their settlement period, with the result that a far lower level of net borrowed reserves--around $300 million--was consistent with about the same tone in the Federal funds market. Last week, as excess reserves were put to use by country banks, a somewhat higher level of net borrowed reserves than the $366 million that eventuated would have been consistent with the general money market atmosphere of recent weeks. But, as the written reports spell out, after injecting about $250 million of reserves on Monday, October 24, when the money market was firm and net borrowed reserve estimates for the week were around $600 million, we were faced with unexpectedly large revisions in the figures on Tuesday. While we absorbed reserves on Tuesday we did not think it worthwhile to press too hard, particularly in light of the behavior of the credit proxy.

Looking ahead, the Board staff is projecting a 2 per cent decline in the credit proxy for November, as the blue book[1] indicates; the New York Reserve

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

Bank projection is for a larger decline. I confess that at the Desk we had been anticipating some resurgence in private credit demand in November, and had also expected the Treasury financing program to result in the acquisition of Government securities by banks. Thus I find the projections hard to believe. I believe that in the circumstances, the proviso clause of the directive[1] may be hard to interpret. On the basis of my understanding of the Committee's intentions in the recent past, I would think that the proviso clause should be interpreted as calling for tighter money market conditions only if bank credit appeared to be expanding again at a rapid rate in November. Perhaps a rate in excess of the average expansion so far this year would be required to bring the proviso into play. On the other hand, if the staff expectations appeared to be borne out, some further easing of money market conditions might be called for. Any shading of money market conditions and reserve availability from recent patterns would of course have to take place within the context of even keel considerations. I would find it helpful if the Committee members would comment on their own interpretation of the proviso clause during the course of the go-around.

For the past several months now we have been paying more attention to short-range aggregate measures--the credit proxy and required reserves--in conducting day-to-day open market operations. On the whole I believe this has worked rather well. The credit proxy, however, could be improved if more weight were given to some of the nondeposit liabilities of banks which have a counterpart in bank credit although they do not affect the proxy as it is currently calculated. I would hope that the staff would give early consideration to the improvement of the proxy in order to make it a still better measure of daily average bank credit.

1/ A draft directive submitted by the staff for consideration by the Committee is appended to these minutes as Attachment A. A set of explanatory notes was attached to the draft in an experimental effort to clarify the staff's reasons for proposing certain language at particular points.

Treasury financing will be an important market factor over the remainder of the year. The books are open today on the November refunding, in which the Treasury is offering for cash $2.5 billion of 5-5/8 per cent 15-month notes and $1.6 billion of 5-3/8 per cent 5-year notes in exchange for $4.1 billion of maturing obligations--of which $3.2 billion are held by the public. The offering announcement last Thursday met with an enthusiastic response, and the market anticipates that subscribers to both issues--and especially the longer note--will receive only small allotments on their subscriptions. Both issues are attractively priced (these are the highest coupons on Governments since the early 1920s), and there seems to be a lively interest on the part of dealers, banks, public funds, and small investors. Some speculative demand is apparent, but the Treasury's decision to use a cash rather than a rights exchange minimizes the risk by keeping the size of the longer issue under control. The System holds $829.1 million of the maturing issue and I would plan to exchange the full amount for the 5-5/8 per cent 15-month note.

By using a cash refunding the Treasury will avoid attrition and can raise about $300 million in new money with a normal 10 per cent overallotment. Cash needs for the remainder of the year amount to about $2-1/2 billion, which the Treasury currently plans to raise through a strip of Treasury bills in the one-year cycle and through an additional offering of tax anticipation bills. The first part of this cash financing should be announced before the November 15 payment date on the refunding, with the second part scheduled for some time in December.

It should be noted that the decision to postpone marketing of Federal National Mortgage Association and Export-Import Bank participation certificates has created problems with the debt limit as the Treasury's own financing has been increased. The Treasury will be pressing against the $330 billion temporary ceiling by late this month, and December could bring additional problems. While the Treasury probably will be able to live under the present ceiling through the rest of this year, especially if market conditions permit the issuance of participation certificates, there could be some annoying problems in operating the Treasury's cash position in the next two months and an increase in the debt ceiling may be required early next year.

Mr. Swan asked whether the somewhat shallower net borrowed reserve figures of the last two weeks were likely to recur in the current week or whether Mr. Holmes would expect the figure to deepen at this point. Mr. Holmes responded that last night the Desk was looking at a figure of $469 million for the current week. It was hard to predict the final figure, however, partly because one could not say what revision would be indicated by the country-bank sample; last week the sample had added about $100 million to reserves. On the whole, however, he thought the figure would not be far from last week's, and perhaps a bit deeper. Such a figure probably would be consistent with a relatively constant tone in the money market.

Mr. Mitchell remarked that like Mr. Holmes he had reservations about the proviso clause in the directive, but perhaps for different reasons; he was troubled by the language. He noted that the staff projected a decline in the bank credit proxy at an annual rate of about 2 per cent in November. If in fact the Committee wanted to moderate the disintermediation that was taking place, what could it achieve and what would be the implications for the rate structure? What should be done about attrition in CD's?

Mr. Holmes commented that many banks thought they might be approaching the end of the road with respect to attrition in their outstanding CD's; they felt that their position with respect to CD's had improved, and that the outlook did not appear as

discouraging as earlier. Of course, the average maturity of CD's was now quite short and the banks' positions remained vulnerable.

Mr. Mitchell observed that bill rates might have to remain close to their present levels to avoid a considerable amount of attrition, and rates might have to drop by 20 or 25 basis points further to stop attrition altogether. If there was some rise in bill rates more CD run-offs would follow and the credit proxy might well decline by more than now projected.

Mr. Holmes agreed that a rise in bill rates would tend to increase CD run-offs, but he thought there was a range within which rates might fluctuate without substantial effects. It was hard to say how much of a decline in bill rates would be required to bring attrition to a halt.

In response to a question, Mr. Holland indicated that the staff's projection of the bank credit proxy in November allowed for a CD run-off of about $1/2 billion, with short-term rates expected to rise a bit.

Mr. Hickman asked whether the one-month bill rate was the most relevant for assessing CD developments, and Mr. Holmes replied that rates on bills with maturities out to three months had to be considered.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances

during the period October 4 through 31, 1966, were approved, ratified, and confirmed.

Chairman Martin observed that at its preceding meeting the Committee had agreed to consider today the subject of possible System operations in agency issues, and he asked Mr. Holland to comment.

Mr. Holland noted that recent legislation gave the System authority to engage in open market operations in direct obligations of U.S. agencies and obligations guaranteed by such agencies, and that a staff memorandum on the subject, dated October 3, 1966, had been distributed. The question before the Committee today was whether it wished to take some action at this juncture in recognition of the new authority. The Account Manager had indicated that he was not prepared to recommend outright transactions in agency issues at this time because of a number of problems, outlined in his memorandum to the Committee of June 23, 1966, that required resolution; but that he would consider repurchase agreements in such issues to be a potentially useful addition to the kit of tools available for reserve management.

Mr. Holland went on to say that in his judgment the immediate market situation was not such as to make the matter a pressing one. It was true, however, that dealer inventories of agency issues had been rising, and now were approaching $1/2 billion. On occasions

when dealers had financing needs in connection with those holdings, the use of RP's against agency issues might be an appropriate means of making some necessary reserve injections; and such RP's might also facilitate flotations of agency issues. In the staff's opinion, the only action required to authorize RP's in agency issues, if the Committee so desired, was an amendment to paragraph 1(c) of the continuing authority directive, and a draft of an amended paragraph was incorporated in the October 3 memorandum.

In response to the Chairman's invitation to comment, Mr. Holmes said he thought Mr. Holland's remarks had covered the matter well. He would add only that some dealers were now complaining about a shortage of agency issues. In the present atmosphere, which was quite different from that of June, outright transactions were likely to distort the market--and that was an additional reason for not engaging in such operations now. Repurchase agreements against agency issues would have been useful in the recent past on occasions when there was a shortage of bills in the market and it was necessary to supply reserves.

Mr. Mitchell observed that the agency market was likely to be under great pressures in the spring. He thought it would be desirable to go beyond authorizing repurchase agreements against agency issues now, and also to authorize outright transactions in them.

Mr. Brimmer said he favored authorizing RP's against agency issues at this time. In the absence of some unexpected development, U.S. agencies probably would be in the market again in the spring, and it would be helpful then to have had some experience with agency RP's and to have accustomed the market to such operations. Moreover, he thought the Committee should take some action in response to the enactment of enabling legislation.

Mr. Daane said he would go along, although somewhat reluctantly, with the proposal to authorize RP's against agency issues, largely for the second of the two reasons Mr. Brimmer had mentioned. He felt that the basic consideration in decisions on use of the authority should be--in words drawn from the Manager's June memorandum--"whether such operations would be of value in implementing System policy objectives." He would not favor authorizing outright transactions in agency issues at present.

Mr. Maisel remarked that the Committee should give a good deal of attention to the matter of outright transactions. He then asked about the rates at which recent RP's against Treasury bills had been made.

Mr. Holmes replied that all RP's recently had been made at the discount rate. For some time he had felt that that rate was undesirably low, considering the levels of short-term market rates in general. On three different occasions he had considered

applying a higher rate; the continuing authority directive, of course, specified only a minimum rate. Unfortunately, on each such occasion, the market situation and psychology had developed in a manner that led him to conclude that a higher RP rate would have an undesirable impact on expectations.

Mr. Holmes added that the subject of agency issues was being given extended consideration in the joint Treasury-Federal Reserve study of the Government securities market now underway, and at some later time the study group might bring forward some expressions of opinion.

Chairman Martin said it seemed to him that it would be desirable for the Committee to authorize RP's against agency issues now. He thought the Committee would want to study the question of outright transactions further, and be prepared to reach a decision regarding them at a later date.

Mr. Mitchell reiterated his view that the Committee should go further now. In his opinion authorizing outright transactions would be consistent with the position the Board had taken at the time the legislation was under consideration in Congress, and it would be appropriate on other grounds also. He did not think the Committee would be trying to influence the prices of agency issues in any manner other than that in which it now influenced Treasury security prices. The Committee put funds into some sector of the

market to achieve monetary objectives--which might be defined in terms of reserves, money supply, total deposits, interest rates, or other variables. He saw operations in agency issues as a further means of achieving monetary objectives.

Mr. Daane commented that he had meant to indicate that monetary objectives should be placed first even in the use of RP's against agency issues, and on that point he felt there was no disagreement between Mr. Mitchell and himself.

Mr. Brimmer asked when Mr. Holmes thought the current study of the Government securities market would be completed.

Mr. Holmes said the study group had made substantial progress recently and hoped to move further ahead in November. He was not able, however, to indicate a specific date for completion of its work at this time.

Mr. Brimmer said he hoped the matter of the availability of the study would not influence the date at which the Committee would reach a decision on outright transactions in agency issues. At the same time, he personally would be reluctant to go ahead without having the study, and therefore he hoped that it could be accelerated.

Mr. Hayes said that on the general issue he found himself in agreement with both Messrs. Daane and Brimmer. Authorizing RP's against agency issues would be useful, and he thought the

Committee should take that step; but he saw no need for the Committee to reach a judgment on the broader question of outright operations at this time. He strongly agreed with Mr. Daane that any operations in agency issues should be for monetary purposes alone.

Mr. Robertson said that if the Committee thought authorizing RP's against agency issues would facilitate their underwriting, it should authorize such RP's, to be utilized just as RP's were utilized elsewhere. He would favor going that far now. At some point the Committee would have to face the question of authorizing outright transactions, and it should do so in advance of the time at which the question of actually undertaking such transactions became pressing.

Thereupon, upon motion duly made and seconded, and by unanimous vote, paragraph 1(c) of the continuing authority directive to the Federal Reserve Bank of New York was amended to read as follows:

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the U.S., and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities or agency

issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

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

Mr. Brill made the following statement on economic conditions:

An economist has to take his economic information where he can find it, and I'm not above using, as the text of my sermon this morning, the caption on a delightful cartoon which appeared in The New Yorker magazine last week. Most of you must have seen it. It's the one showing two attache-case-carrying types stepping out of a building marked "Federal Reserve." On spotting that infamous symbol of the Great Depression (a man selling apples on a street corner), one of the two comments, "I say, don't you think we've cooled the boom off enough?"

Certainly, a number of economic indicators suggest some cooling off. And certainly, we don't want to wait until there are apple-sellers on street corners before reversing the stance of policy. But as usual, many of the indicators now available are ambiguous, and some of the uncertainties about the future, particularly about defense outlays, remain. Under these circumstances, the appropriate stance of policy is far from being crystal clear.

Looking back over the economic performance of the past several months, one can see many signs of a slowing in the rate of rise in activity. But some of this has to be attributed to supply constraints, perhaps as much as to moderation in demands. For example, the industrial production index slowed considerably in the third quarter, rising only half as fast from June to September as it had over the spring quarter. The reduced rate of expansion

did reflect production cutbacks in industries where demands have eased, such as in autos and home goods. But it also represented the reaching of labor and plant capacity limits in other industries, such as business and defense equipment. Over all, our newly revised measure of capacity use in manufacturing indicates that the utilization rate has remained fairly steady this year, at levels as high as that reached at the peak in 1955.

There also have been signs of a slowing in nonfarm employment growth in recent months, over and above that attributable to the exceptionally large withdrawals of teen-agers from employment in September in order to return to school. Here, again, there is a mixture of supply limits and demand weakening, with shortages of skilled workers in some manufacturing industries requiring a lengthening of the workweek, while in other industries--such as textiles and construction--smaller employment growth reflects reduced demands. Over all, the rate of increase in employment is still pushing up against available supply, and the over-all unemployment rate will show little change for October, with unemployment of adult males continuing at low frictional levels.

Many of us have been trying to read back from the financial figures to the performance of the real economy to demonstrate weakening. It may well be that the recent abatement of pressures on banks and in financial markets does reflect some softening in demands for goods and services, not just financial supply limitations as lenders ration credit more severely. While I would caution that the ratio of financing to spending can be a volatile measure in the short run, the recent moderation in business loans undoubtedly has its counterpart in some reduction in business inventory demand. This is not implausible after the very fast inventory run-up in the second quarter and the continued large accumulation in the July-August period; inventory-sales ratios rose in this period and some cutback in forward buying is not unexpected.

Preliminary figures for manufacturing inventories, to be released today, do indicate a decline in the rate of accumulation in September. But a large share of the decline was in the auto industry, which had also accounted for a large share of the July-August inventory build-up. Stockpiling in machinery and defense equipment industries has continued strong and rising throughout, and with the substantial revision in the September figure for new defense orders--it now shows an incredible 50 per cent rise from

August to September, compared with what we thought was a very large 26 per cent increase as originally reported--we are likely to see a surge in materials buying and work-in-process in these industries shortly. This could well show up in the business loan figures shortly, too. At this stage of the game, I'm prone to regard recent financial figures as useful but still somewhat tenuous and definitely reversible indicators of the broader economic scene.

Let me now turn to areas where the economic readings, while far from certain, are somewhat less ambiguous. First, retail sales figures have not been strong recently, with preliminary numbers showing a slight decline in sales in September and early October. As best we can penetrate the murky areas of seasonally adjusting auto sales at this time of year, it doesn't appear that the new models have gotten off to a sensational start. Since the strong rebound in consumption expenditures in the summer months resulted in a sharp drop in the savings rate to well below the rate of recent years, it would not be implausible to expect consumers now to be readjusting their spending down to more normal relationships with income.

Second, the situation in housing, which I need not belabor for this Committee, gives every sign of becoming a bit worse before it becomes any better. Close to $6 billion of housing expenditures will have been cut from GNP between the first and fourth quarter of this year, and while we may be near a bottoming-out, as some analysts suggest, there is no evidence in the building permits figures or in the credit flow figures to warrant expectations of any resurgence soon.

Third, it is becoming increasingly evident that the expansion in business capital outlays is going to slow down next year. The Edie survey of a month ago pointed in this direction, and preliminary--and still very confidential--information from a partial tabulation of McGraw-Hill survey results confirm the likelihood of a slowdown. The final survey results are now expected to show an increase, year over year, of from 5 to 8 per cent, compared with the obviously unsustainable 17 per cent rise this year. And while the McGraw-Hill survey has generally understated the rise in periods of expansion, this year the 5 to 8 per cent forecast might be an overstatement because the survey coverage is weak in commercial construction, an area hard hit by monetary restraint. Interpolating a plausible quarterly pattern for this annual increase, one might conclude that the

pace of spending will continue to rise rapidly through early 1967, begin to level off by midyear, and turn down before year-end.

Fourth, since midyear the prices of a number of sensitive or basic industrial materials have declined sharply and the rate of increase in other industrial commodities has slowed by half. The over-all index of industrial commodities was nearly stable from midyear through September, and only a moderate rise is likely to be recorded for October. Both the over-all wholesale price index and the consumer price index have benefited recently from the decline in food prices.

What this all should mean for policy depends much on one's notion of the lag in the effects of monetary policy, and the efficacy of policy in restraining induced and lagged cost-push. It would seem likely that, for at least a few quarters ahead, business spending for capital equipment will continue to rise rapidly and their needs for external financing to remain strong. An easing in monetary policy at this point, therefore, might not be translated substantially into an improvement in housing activity; in fact, it might serve to rekindle fairly promptly spending plans for shopping centers, office buildings, and other areas of nonresidential construction which have been temporarily deferred because of financing shortages, as well as for additional plant capacity. Or easing in financial conditions might encourage inventory accumulation just when stock-sales ratios are beginning to mount.

As for price trends, wage costs are rising and are likely to maintain and possibly boost pressures on many industrial prices in the months ahead. So long as an exuberant pace of expansion persists, employers will undoubtedly attempt to pass through these higher costs. An easing of monetary policy, without concomitant tax action, might encourage such cost pass-throughs.

Of course, arguments against premature easing have been made at every cyclical peak, and have often left the System in the position of accepting the blame for the subsequent turndown. There _is_ a lag in policy effects, and we can't be oblivious to the long-run necessity of anticipating cyclical swings, as well as to the short-run dangers of acting too soon. But with the future course of defense spending and the likelihood of additional fiscal restraint still unresolved, and with the ambiguities noted in the production, inventory, employment, and credit figures,

the evidence isn't clear enough to me to warrant recommending an aggressive move toward monetary ease now, even if even-keel considerations weren't present. However, there is enough evidence in the domestic economy, I submit, to justify shading policy in an easing direction.

Mr. Koch made the following statement concerning financial developments:

Monetary policy must always be based mainly on developments in the real economy, including those in our relations with the rest of the world. But there is a lot to learn today for monetary policy from the financial indicators as they have been developing. It is hard for me to reconcile the recent striking weakening in the financial data with an estimated annual rate of rise of GNP in the third quarter of 7.5 per cent in current dollars and 4.5 per cent in real terms, and with our current projection of substantial further expansion in the fourth quarter. More weakness may be developing in the real economy than meets the eye, and the current financial numbers may be leading indicators of such weakness.

Look first at the recent course of bank credit as reflected in the credit proxy. Declines have occurred in each of the past 3 months, and a further drop is projected for November. Earlier, the most dynamic component of bank credit was business loans, but growth in bank lending to business slackened markedly in August and September. Growth in October continued to be slow, especially in view of large cash needs stemming from the accelerated tax payments during the month.

The developing weakness in over-all bank credit is dramatically reflected in the persistent downward revisions in our weekly projections of the change in the credit proxy. These have been marked down in every one of the past 10 weeks. Our first estimate for September was +4.7 per cent, annual rate. It finally turned out to be -0.5 per cent after five successive weekly reductions. Our first estimate of the likely October rate of expansion was +5.6 per cent. Our latest figure is -2.9 per cent after another five successive reductions. Perhaps we will be more accurate in our first estimate of a further annual rate of decline on the order of 2 per cent for November. Inclusion in these bank credit proxy numbers of funds obtained from branches

abroad would raise them, but not materially over the last 2 months.

Disintermediation is part of the explanation for the recent weakness in bank credit. Some of the credit that previously had been obtained from banks has more recently been obtained from the money and capital markets. With bank credit growing less, more borrowers have been forced to go to the market for funds. In the process, pressures have developed from the marked structural changes in credit flows that were involved. Higher interest rates forced some borrowers out of the market. Lack of access to credit pushed out others, such as home buyers and small and medium-size businesses. Moreover, the higher cost and restricted availability of borrowed funds forced more spending to be self-financed and some spending to be curtailed. Preliminary flow-of-funds data for the third quarter suggest a decline of about 20 per cent in the total amount of private credit financing--to $60 billion from $75 billion in the second quarter.

The cessation of growth in bank credit has been accompanied by a similar movement in the narrowly defined money supply. The money supply has been declining on balance since spring. The rate of increase in money defined to include time deposits continued fairly substantial through August, but has dropped off drastically since. A total liquid asset measure shows similar movements, with the tapering off of growth starting in the second quarter.

How can one explain the weakness in the narrowly defined money supply most recently at a time when interest rates have been declining and incomes presumably have still been rising fairly rapidly? Lagged responses are no doubt a partial explanation. But perhaps incomes are not rising as fast as the preliminary figures suggest, and perhaps individuals and businesses, in order to maintain current consumption and investment levels, are having to spend a larger part of their current incomes as well as having to draw down previously accumulated cash balances.

But interest rates have been declining since early September. Isn't this development an indication that monetary restraint is already less severe? Perhaps it is to some extent, but it may also be reflecting some diminution in the demand for credit.

In the business loan area, for example, our September bank lending practices survey provides some slight evidence of a moderation of loan demand. So does the slowing in the

actual rate of business loan expansion in the last 3 months, since it has not been accompanied by a buildup in either actual or prospective security flotations by corporations, although it has been associated with some rise in commercial paper financing.

Even in the municipal field it is somewhat surprising that a 40 basis point decline in yields since August has brought to market few issues that had been postponed earlier. Indeed, more postponements continue to be announced. In a changing economic situation, the course of interest rates, like the level of net borrowed reserves, can be a poor indicator of the degree of monetary restraint or ease.

This review of the recent course of the financial variables suggests to me that the time has come for a further backing off from the restraining posture of monetary policy. Have we really been aiming at a cessation of growth in both bank credit and the money supply? High incomes and the drawing down of previously accumulated liquidity may have adequately sustained spending with reduced credit growth this fall, but it is questionable how long this situation is sustainable. Moreover, we do not want to be caught again maintaining a set of money market variables, including net borrowed reserves, when the combination of the existing degree of tightness and demand factors is leading to declines in more basic indicators of policy such as total reserves, nonborrowed reserves, bank credit, and the money supply.

As the next step in relaxing monetary restraint, a drop in net borrowed reserves to a range of, say, $200 to $300 million as a short-run operating guide for open market operations might be in order. As for timing, such easing might proceed as soon as Treasury financing requirements permit, and assuming market sentiment itself does not in the meantime precipitate too abrupt and speculative an easing in financial conditions. It is also probably not too soon to consider a more overt move toward less monetary restraint than can be achieved through the open market operations instrument.

Mr. Hickman referred to Mr. Koch's statement that total private credit financing appeared to have declined substantially in the third quarter and asked how much of the decline occurred in the

flow of bank credit relative to flows through other channels. In particular, was there evidence of slackening in the flows of savings through nonbank financial intermediaries?

Mr. Koch replied that the slackening was sharper in bank credit than in other flows taken together; in the third quarter banks accounted for less than 15 per cent of total private credit flows, as compared with almost 40 per cent in the second quarter. Flows through other intermediaries had slackened earlier, and remained small in the third quarter.

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

> Recent newspaper stories about the U.S. balance of payments have been rather cheerful. The news that the liquidity deficit was surprisingly small in the third quarter, and that the official settlements balance was in substantial surplus, has leaked out piecemeal. Hence, it has been written up repeatedly, and will, of course, be written up again when the figures are officially announced in mid-November.
>
> Other news has also tended to allay anxiety. Observers have been pleasantly surprised by the recent weakness of the French franc, and they have been grimly reassured by rising unemployment in Britain, although most of them recognize that the real test of the sterling parity still lies ahead.
>
> It is always useful to be reminded that payments positions can change. But on the question whether the U.S. payments position has recently changed for the better in any fundamental sense, the answer still seems pretty clearly to be "no." Most of the recent sense of relief stems from official window-dressing transactions, from liquid inflows that are bound to prove temporary, and from the fact that the situation has not worsened in other respects as much as was earlier feared.

The deficit on the liquidity basis was at an annual rate of less than $1 billion in the third quarter and about $1-1/4 billion in the first 9 months; the latter figure is unchanged from last year's level. If it had not been for debt prepayments and shifts of foreign official funds from liquid to nominally nonliquid assets--shifts which I am inclined to regard as window-dressing--the liquidity deficit would have been at a rate close to $2 billion in the third quarter and a little more than that for the 9 months. Partial data for October indicate that the liquidity deficit has continued in roughly the $2 billion range.

The official settlements balance was in very substantial surplus in the third quarter, and for the first 9 months there was also a surplus, at an annual rate of roughly $3/4 billion. However, a main source of this surplus was the massive inflow of foreign liquid funds through the foreign branches of U.S. banks. Discussion at the last meeting of this Committee made clear that these funds are fairly hot money, likely to flow out again when interest differentials and confidence factors change. Even if the funds do not flow out again soon, they seem certain to stop flowing in at anything like the recent rate, and that change alone will suffice to throw the official settlements balance back into deficit.

If the inflow of funds from banks and branches abroad had been of more normal proportions--say at the average rate of the past few years--there would have been an official settlements deficit at about a $1 billion annual rate during the first 9 months of this year, little changed from last year, instead of the actual surplus. In October, liquid inflows from foreign branches continued on a reduced but still fairly large scale ($200 million in the latest 4 weeks), and the official settlements balance appears to have been very roughly zero; so again, without abnormally large liquid inflows there would probably have been a deficit at a rate of $1 billion or more.

As the liquid inflows slacken or reverse in the months ahead, the outlook is for a sizable deficit on official reserve transactions, and hence for renewed reserve losses, probably including gold drains, unless something else gets better.

The something else that could get better might be either capital flows (other than those special flows I have already mentioned) or merchandise trade. It would

probably be a mistake to count on any improvement in ordinary capital transactions over the months ahead. It seems more likely that having brought the outflow of U.S. private capital down to its lowest level since 1959, we should now brace ourselves for the possibility of some renewed rise in outflows.

The expansion plans of major U.S. corporations for next year seem likely to require an increased outflow of direct investment capital, as well as continued borrowing abroad. Government programs will seek to limit that increase, but they probably cannot entirely prevent it.

U.S. commercial banks are not likely to go on reducing their foreign loans indefinitely. Even during the recent period of extremely tight credit, the reductions have not been very large. Of the unadjusted reduction of $550 million in bank-reported claims on foreigners during the first 9 months of this year, more than half was seasonal, leaving the adjusted reflow at about $250 million.

If I am correct in believing that the outlook for ordinary capital flows is for no further improvement, and perhaps for some deterioration, even if domestic monetary conditions stay pretty tight, then improvement in the over-all payments situation will require improvement in the merchandise trade account. So far, the trade account has continued to deteriorate. There was an encouraging 4 per cent increase in exports from the second quarter to the third. But merchandise imports jumped even more sharply, by nearly 7 per cent. Hence the trade surplus shrank further, to an annual rate of less than $3 billion. For the first 9 months, the rate of trade surplus now stands at $3.6 billion, compared with last year's $4.8 billion.

Even if exports go on rising briskly over the next year, as Government analysts expect, a very marked slowing down in imports will be needed to achieve significant improvement in the trade balance. It seems reasonable to expect a slowdown whenever domestic demand pressures abate. But it is very difficult to judge what the precise relationship between domestic demand and imports will be at that time. The last time there was an import boom at all comparable to the present one was in 1950-51, and world conditions have changed so much since then that the parallel is not a close one.

It seems to me that the still unsatisfactory state of the balance of payments, and the present lack of evidence of any durable improvement, point towards a cautious approach to any easing of monetary restraint at this time. I think it would be unfortunate if we should experience a significant increase in net capital outflows before we can point to any improvement on the trade side.

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 expansion of total demand in the economy is now less hectic than it was in the spring of 1966, but it still appears to be proceeding at a rate in excess of the economy's capacity. Defense expenditures are now the main force behind the economic upswing, and the uncertainties inherent in the Vietnam situation quite naturally becloud the economic outlook. However, it looks as if defense expenditures would continue to increase substantially over the next year, though perhaps at a less feverish pace than in the third quarter. Along with the speedup of defense outlays, the soft spots in the civilian economy have undoubtedly become more pronounced and new signs of a possible easing of demand pressures have appeared, including some evidence that inventory accumulation has reached a point where some inventories are beginning to look excessive. In my judgment, however, it would be a mistake to equate the prospect of a modest slowing in the business expansion with a likelihood of actual business recession in the foreseeable future.

The stability of wholesale prices since July is a reflection of the moderation of the growth of demand, together with the rapid expansion of industrial capacity. On the other hand, this year's advance in consumer prices is quite disturbing, especially because of the effects on future wage negotiations. With a rate of 5 per cent apparently having been established as a pattern for wage increases in coming negotiations, and with cost-of-living escalator clauses becoming more common, we face a major threat of a cost-price spiral, with all that that implies both domestically and internationally.

The basic balance of payments position remains precarious. While the liquidity deficit this year may be close to the $1.3 billion of 1965, special transactions of various sorts are again of great importance in holding down the total. The official settlements deficit will doubtless be much smaller, but only because extremely tight credit conditions in this country since mid-year have caused such a rapid increase in foreign private dollar holdings, especially balances acquired by American banks from their foreign branches. Whatever recovery in the current account might be expected from a slackening in the hectic pace of imports may be nullified if our competitive position is sufficiently damaged by the expected cost-price pressures; and we are clearly vulnerable on capital account. Easier domestic credit conditions could well bring a reversal of holdings of private dollar balances; and in any event we probably cannot continue to look to this area as a major means of financing our deficit. Under the circumstances, I believe that a concerted effort should be under way to attack the balance of payments deficit next year from a number of angles. The emphasis should probably be on direct investments and Government expenditures, but the banks should be expected to continue to play their part, and some modest reduction in their ceilings might be incorporated, if an effective over-all payments program can be worked out.

There is no doubt that significant monetary restraint is now being felt in all financial markets, despite the great improvement in atmosphere since the nearly panicky conditions of late August. It is gratifying to note that total bank credit increased over the first nine months of 1966 at a rate of only 6.5 per cent, thanks to a sharp slowdown to about 3 per cent in the third quarter. Also, the growth rate of business loans has declined recently and the New York banks have noted a definite easing off in business loan requests. They are uncertain, however, to what extent loan demand is really declining and to what extent the banks' negative attitude is discouraging business borrowers from making as frequent loan requests as in the recent past. I think it is too early to say that the banks have definitely brought business loans under close control; but it is unequivocally clear that business loans have shared importantly in the last few months' reduction in the rate of loan extensions. After many weeks of severe run-offs in CD's at the New York banks (over half of the total national run-off), the pace

slowed materially last week. The CD has recently been a competitive market instrument only in relatively short maturities, but there are signs that this competitive maturity range is widening. It is encouraging to note that savings institutions generally reported a rather substantial inflow of funds in August and September, and October indications are encouraging.

No doubt some of the slackening in bank credit growth is being replaced by other credit flows. However, very rough estimates indicate that the growth rate of total credit outstanding may also have declined in the third quarter, although by less than the bank credit growth rate. A slower rate of expansion is also being registered by all the major indicators of liquidity of the nonbank public.

Since we are in the midst of a Treasury financing, even-keel considerations preclude a change of credit policy at this time. In any case, I agree with the Chairman's comment at the last meeting that monetary policy has done about all it can be expected to do for the present. In view of the much slower expansion recently of most monetary variables, I would hope that the less strained tone in the money market might be preserved and that doubts might be resolved on the side of ease rather than tightness. At the same time it would seem premature to ease sharply, in view of the continuing possibility of a resurgence of credit demands. In trying to maintain money market conditions about where they are, the Manager will need ample leeway to exercise his judgment, but he may find the Federal funds rate and CD developments the most useful guides to market tone. If I had to pick a range for net borrowed reserves, I would like to see it centered around $400 million. I might add that, in my judgment, there is still a very real need for a tax increase to offset the continuing inflationary stimulus provided by rising defense outlays.

Obviously it would be inappropriate to change the discount rate under present conditions. Moreover, in view of the cumulative evidence of a substantially slower growth of both total bank credit and business loans, I should think the System would do well to soft-pedal our earlier emphasis on the need for curtailing the expansion of business lending.

As for the directive, I would agree with the staff that it should be revised materially. While I recognize all the problems involved in rewriting the directive around the table,

> I feel a slightly different version would be more satisfactory.[1] First, the first sentence of the first paragraph ought to recognize the importance of rising defense expenditures in over-all economic activity. The sentence might then read ". . .over-all domestic economic activity is continuing to expand, with rising defense expenditures offsetting moderating tendencies in some sectors of the private economy." Second, I think we ought to have a simple and general sentence on the balance of payments, such as "The balance of payments remains a serious problem." Third, in order to have some reference to the possibility of furthur fiscal policy changes I would prefer the phrase on fiscal policy to say "in the light of recent and possible future fiscal policy measures." Finally, it seems to me that the proviso clause should not be related to current expectations in view of the staff estimates of further declines of bank credit in November. In my view, System policy has been aiming on balance for a moderate growth of bank credit and should continue to do so. I myself would think a bank credit growth rate of 4 to 6 per cent might be appropriate, and I would not be particularly disturbed if the growth rate was temporarily a bit higher, especially in view of the declines over the last three months.
>
> With this in mind, I would suggest that the proviso clause read "provided, however, that operations shall be modified--in so far as the Treasury financing permits--in the light of bank credit developments during the month." The intent of this rather general statement would be amply spelled out in the record of this meeting.

Mr. Ellis commented that because expectations affect attitudes, which in turn affect events, perhaps it was as important to report shifting expectations as it was to report changes in performance. For example, the 90 manufacturers covered in the Boston Reserve Bank's quarterly sales survey reported that

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1/ The complete text of the directive proposed by Mr. Hayes is appended to these minutes as Attachment B.

third-quarter sales exceeded previous-quarter levels by 3.7 per cent when the rise expected had been only 0.9 per cent. They currently anticipated a 5.6 per cent decline for the fourth quarter, a type of projection he had learned to discount substantially. It had to be reckoned with, however, in appraising their capital expenditure forecasts for 1967 which now--in final tabulation--called for a year-to-year expansion of only 3.5 per cent. The year-ago survey called for an 18 per cent expansion, which had now been converted into a 33 per cent actual gain.

Expectations were in flux also with respect to interest rates on savings in Massachusetts, Mr. Ellis said. During September, only three of the 80 regularly reporting mutual savings banks were paying as high as 5 per cent on special notice accounts. During October, three Boston commercial banks lowered to $1,000 the minimum account balance on which they would pay 5 per cent, and they were heavily advertising the change in the Boston press. October data on savings flows through the mutuals were too fragmentary to be conclusive, but there had been some official note taken of the fact that only eight of the 179 Massachusetts mutual savings banks were members of Federal Deposit Insurance Corporation and subject to its rate ceilings. The other 171, with almost 80 per cent of the deposits, looked to the Massachusetts Banking Commissioner for rate guidance. There was some concern that he

(the Commissioner) might grant a ceiling of 5-1/4 per cent to allow the State-controlled mutuals to be competitive with the savings and loan associations' ceiling, set by the Federal Home Loan Bank Board, of 5-1/4 per cent on special certificates. Of course, the FDIC member mutuals hoped such action could be forestalled.

Meanwhile, Mr. Ellis continued, the housewives' protests against high food costs had a possible parallel in complaints about high mortgage rates. The Massachusetts Consumers Council, an official government board appointed by the Governor, had been importuned to investigate high interest rates.

Mr. Ellis noted that one District bank had received front page news attention last Wednesday when it announced a proposed CD rate of 5.25 per cent on 3-9 month deposits. As nearly as he could establish, their easy position evaporated quickly. It was necessary for them to borrow from the Reserve Bank on the same day and again over the last weekend. Apparently the market was not ready to back off from its 5-1/2 per cent rate on 90-day deposits.

Mr. Ellis remarked that short-run, even-keel considerations set the framework of monetary policy for the next three weeks. The decline in rates and easier market conditions of the past two weeks

had about optimised circumstances for the Treasury in its current financing.

Some sense of relief accompanied his recognition of the need for a period of even keel, Mr. Ellis observed. Three months of no growth in total bank credit and the money supply required some appraisal as to cause. As usual, causes seemed to be multiple--tightened monetary policy and lessened bank liquidity had to be named. But increasingly he had come to sense that some lessened intensity of demand for credit was a cause also. Were it not for the pervasive effect of accelerating defense spending, the economic outlook would be substantially altered. But Vietnam was a fact that had to be reckoned with--and that reckoning might become more widely comprehended after the elections on November 8. Mr. Holmes had described the interpretations placed on recent financial developments by two groups of observers, which might be labeled the "pause" and the "turn down" groups, and he (Mr. Ellis) would place himself in the pause group. He expected bank credit to be stronger in November than the staff projection indicated. If no fiscal action on taxes was forthcoming until some time in 1967, the evidence of impending recession should be quite overwhelming before the Committee retreated from the restraint it had been able to achieve via monetary policy.

Meanwhile, Mr. Ellis continued, the Committee again faced the responsibility of defining a policy of "no change" meaningfully for the Manager. Not the least of the difficulties was the burden the Committee placed on the staff by not specifying its goals so that their projections might at least be premised on stated goals of policy. He reminded the Committee that four weeks ago the staff projections were based on a "no change" policy involving net borrowed reserves of $450 million. Today the staff had presented the Committee with projections based on net borrowed reserves of $416 million, the average of the past four weeks. If pressures continued to lessen, four months hence the Committee might find itself with net borrowed reserve levels of $100 million, which it continued to ratify as a "no change" policy. The thrust of his criticism, he emphasized, was toward procedure, and not toward the objective of adopting a no-change position.

Mr. Ellis thought the staff had done the Committee a real service in attaching notes to the suggested directive to explain its proposed changes in language. The first paragraph of the draft directive represented a substantial achievement. With regard to the second paragraph, however, the exclusion of the word "firm" from the description of the money market conditions to be sought, and the introduction of the term "generally steady," was likely to appear in retrospect as a definite turning point in

the direction of monetary policy. He was inclined to fault the staff for not providing alternative wordings of the second paragraph that reflected the kind of clear-cut choice of policies reflected in the remarks of Messrs. Brill and Koch this morning; and for simply suggesting, instead, that as an easing alternative the Committee might interpret the "generally steady conditions" mentioned in the draft as being the somewhat easier conditions of the last two weeks. The proviso clause, of course, had been devised as an escape hatch against an undesired degree of firming, and if the Committee gave up the concept of firm money market conditions he did not see any further need for the clause. He would be reluctant to see the proviso clause dropped--that might be a step on the road carrying the Committee back to the kind of "clause b" instruction used before December 1961--but nevertheless he would suggest its deletion at this time in the hope that the staff would bring forward more meaningful language at the next meeting. Basically, he was inclined to agree with Mr. Brill's conclusions. He favored no change in policy and opposed the deletion of the concept of firm money market conditions from the language of the directive.

Mr. Irons reported that most of the recent economic changes in the Eleventh District had been consistent with what might have been expected on seasonal grounds. That was the case for employment

and industrial production, although the latter was down slightly more than seasonally at the moment. Construction contract awards continued their previous pattern of easing, and there were signs of dampening in retail sales. Agricultural conditions could be described as generally good, although there were some spotty situations. In particular, there was considerable uncertainty regarding probable developments for cotton, largely because of sharp cut-backs in the Government support program. But in terms of general farm prices and farm cash receipts the picture was favorable.

There were no highly significant changes in the District financial situation, Mr. Irons said. Bank loans were off during the latest period. Investments were up, largely as a result of operations in Treasury bills, and deposits were down. Borrowings from the Reserve Bank did not appear to be following a normal pattern; fewer of the smaller country banks were borrowing, and in smaller amounts, relative to the customary situation at the discount window. Net purchases of Federal funds had been rather substantial during the period and a sizable number of banks were in and out of the funds market on a regular basis.

Mr. Irons' interpretation of the national situation was much like the analyses that had been presented this morning. The economy was on a very high plateau with some evidence of stability

in sight, and with strength showing in some sectors and dampening tendencies in others. The large underlying questions related to the probable course of defense expenditures for Vietnam and the possibility of further fiscal policy action. Money market conditions had been easier in the past several weeks, with most of the major variables actually showing declines. In part that probably reflected past monetary policy, but it also reflected market reactions to a number of other factors, including the possibility of further fiscal action, guesses as to future monetary policy, the possibility of a real slowdown in economic activity, and a dampening in underlying credit demands. In his opinion, the Committee had been meeting with some success in achieving the restraint it had sought on expansive pressures in the economy, but it remained to be seen how lasting that might be.

As to policy, Mr. Irons started with the presumption that whatever decisions the Committee reached today they would be in the framework of even keel, and that the Manager would be given considerable leeway to be guided by the feel of the market. Current economic trends and money market conditions seemed to call for continuing the degree of restraint that had characterized policy for the last few weeks. He would not be in favor of any action that could be termed aggressive, either toward tightening or toward easing. He would try to maintain generally steady

conditions and a reasonably balanced set of market relationships. While he did not particularly like to use numbers, he agreed with Mr. Hayes that net borrowed reserves should be in the $400 million area. The bill rate might be somewhere in the 5.20 - 5.40 per cent range, and the Federal funds rate around 5-1/2 per cent. He mentioned those numbers only to indicate the broad range of conditions he favored; the Committee could specify its objectives simply as maintaining the degree of restraint existing in the last three or four weeks and trying to encourage a general tone of steadiness in money market conditions. He preferred the way the market had performed in recent weeks relative to the preceding weeks, and would like to maintain about the same set of market relationships. He would not favor a change in the discount rate at this time.

Mr. Irons thought the notes attached to the draft directive submitted for this meeting were useful; the explanations of the staff's thinking in preparing the draft were of value to the Committee in its own deliberations. As to the directive itself, he had questioned the value of the proviso clause all along--and he continued to have doubts about it, although he did not feel strongly on the matter. If the proviso was to be retained, however, he would prefer Mr. Hayes' wording to that of the staff draft, which referred to "current expectations" for bank credit.

He was not certain what expectations were intended, but if they were the staff projections for the bank credit proxy reported in the blue book, he did not think the reference should be in the directive.

Mr. Swan observed that the employment situation in the Pacific Coast States improved somewhat in September. Nonagricultural employment rose in all major groups except mining, and the net advance more than offset a decline in agriculture. The unemployment rate dropped 0.2 per cent after rising in each of the five preceding months; in September the rate was 4.8 per cent, compared with the April low of 4.4 per cent. Lumber and plywood prices edged down in September and October, with the sharpest reductions occurring in materials for residential construction. In the four weeks ending October 19, total credit outstanding at weekly reporting banks declined, with a reduction in business loans of about the same magnitude as in the comparable period of 1965. There continued to be very little pressure at the discount window of the San Francisco Reserve Bank.

As to the national picture, Mr. Swan said, he would agree with the descriptions given today of recent developments. Of course, the tapering off of growth rates in many areas was neither surprising nor unwelcome, but the Committee had to recognize that there was less pressure now not only in financial markets but

throughout the economy. He, too, would not favor overt action to ease at this point. He would relate the even keel to be maintained during the Treasury financing to the conditions of the last two or three weeks, rather than to the average conditions in the four weeks since the preceding meeting. It seemed to him that the easing, if one wanted to use that term, that had occurred in money markets was quite consistent with the proviso clause regarding bank credit developments contained in the last directive. He saw no reason to be concerned about that easing, and none for starting off from some position different from the more recent one in defining even keel.

Mr. Swan said he had found the explanatory notes attached to the directive to be extremely helpful. The preparation of such notes undoubtedly would lead to more extended comments about the directive at meetings, but on the whole that probably would be to the good.

With respect to the draft directive itself, it seemed to Mr. Swan that the statement in the first sentence that "economic activity is still expanding despite evidences of slackening in some sectors of the private economy" would be read as implying not a slower over-all growth rate but actual deterioration, and he did not think that was what the Committee would intend. Mr. Hayes' proposed reference to "moderating tendencies in some

sectors of the private economy" would help meet the problem, but it might be best to say that ". . . domestic economic activity is still expanding, although growth rates are slackening in some sectors of the private economy and there has been substantial weakening in residential construction activity." Secondly, while he agreed that there should be some reference to the recent fiscal policy measures, he did not believe that it should be included in the sentence describing the Committee's general policy; the statement of the latter was appropriate apart from fiscal policy actions. He would include the reference with other statements of fact in the third sentence, which would then read, "Bank credit expansion has slackened, earlier strains in financial markets have abated, and certain fiscal policy measures have recently been enacted by the Congress."

With respect to the second paragraph, Mr. Swan said, he also had a question about the use of the term "generally steady" in describing the desired money market conditions, although he was not as concerned as Mr. Ellis was about the proposed deletion of the word "firm." He would prefer calling for operations to be conducted with a view to "maintaining about the same conditions in the money market as have developed in the past two weeks." That would make clear that the Committee did not intend to relate even keel to the four-week averages; to him it would imply net

borrowed reserve figures in the $350-$400 million range, or perhaps $300-$400 million, and a level of borrowings and Federal funds rate as in the more recent weeks. As to the proviso clause, he agreed with those who objected to the phrase, "any apparently significant deviations of bank credit from current expectations," because--as Mr. Hayes had pointed out--current expectations were for a decline, and the Committee certainly would not want to encourage a decline at this point. Mr. Hayes' suggestion, to call for modification of operations "in the light of bank credit developments during the month" would be satisfactory if the Committee's specific intentions were clearly understood; but it might be best to state those intentions directly. Accordingly, he would suggest saying that "operations shall be modified, insofar as Treasury financing permits, if it appears necessary to encourage no more than a moderate increase in bank credit."

Mr. Galusha observed that the economic situation in the Ninth District appeared to be approximately what it was at the beginning of October and so required no extensive summarizing. For what it was worth, however, he would point out that District reserve city bankers had cautioned against interpreting their recent contra-seasonal decline in loans as indicating a marked change in loan demand. Not surprisingly, perhaps, they saw that decline as having been produced by an increasing shortage

of reserves and, even more, by an essentially fortuitous bunching of loan repayments by borrowers with nation-wide banking connections.

Mr. Galusha reported that the Minneapolis Reserve Bank's discount lending had lately been almost exclusively to country banks, and for the traditional reasons. A few weeks ago one reserve city bank had borrowed for several days to finance an unexpectedly large corporate CD run-off, but even that bank made it quite clear that it would do everything possible to get along without continuing Reserve Bank help. In that connection, recent experience indicated that both keeping the ceiling on CD rates unchanged and the Reserve Banks' September 1 letter to member banks had had very decided effects on bank lending; and, happily, the Reserve Bank had not had to get involved in member bank decision-making. But when he thought about what had been happening, he had to confess that his feet got a little chilly, if not actually cold. While the members of the business establishment of the Ninth District with whom he had visited in the last three weeks had expressed views as diverse as those expressed by the staff today, there were significantly more on the pessimistic side than was the case 60 days ago, although still a distinct minority.

Mr. Galusha noted that the forthcoming Treasury refinancing precluded a change in open market policy now. But he thought the

Committee perhaps would be well-advised, in defining "even keel," to look only at the numbers of the past week or two and not bother about the slightly tighter money market conditions prevailing earlier in October, and to maintain from now until the Committee's next meeting the money market conditions of the very recent past. That was what he would favor.

Mr. Galusha said he did not propose to be drawn into the controversy regarding the language of the directive but, given a choice between the wording of the staff draft and that proposed by Mr. Hayes, he would prefer the latter. He assumed that the phrase "generally steady conditions in the money market" would be interpreted to refer to the conditions of the last week, or possibly the last two weeks, and not to the average conditions since the preceding meeting.

Mr. Scanlon reported that there was scattered evidence that pressures upon productive resources of the Seventh Federal Reserve District had relaxed somewhat. Fewer complaints were heard concerning shortages of materials and components. The rate of steel output had declined since mid-September, and probably would be reduced further. Residential permits had fallen sharply. New orders for some types of machinery and equipment had leveled off at a high rate in the past several months, and orders for construction equipment had declined. Orders for

furniture and household appliances had eased. Some general merchandisers had been disappointed by the rate of consumer purchases, and forecasters expected auto sales to continue below year-ago levels. Most economic forecasts now being prepared for managements of businesses and banks in the District visualized a slower rate of growth in both real and dollar terms in the period ahead.

Despite those developments, Mr. Scanlon commented, no easing in tight labor markets had yet been noted in District centers. Shortages of skilled workers and "trainable" unskilled workers persisted. Some firms complained of reduced profit margins resulting from poorer quality labor, higher turnover, and increased absenteeism. A larger share of motor vehicles and business equipment reached the finish line requiring additional work to correct imperfections--so-called "cripples."

Most manufacturers of machinery and equipment, including railroad equipment and heavy trucks, continued to operate at practical capacity, Mr. Scanlon said. Producers of farm machinery were particularly optimistic, and had maintained production in months of normal seasonal let-down to assure adequate supplies to meet anticipated heavy demand. Farm machinery was expected to remain strong because of increased acreage allotments, higher price supports, larger farm income, and Government plans to

encourage food exports. Many firms continued to report capital expenditure programs behind schedule because of shortages of manpower and delays in construction or in delivery of equipment. Reserve Bank inquiries revealed no instances of major firms reducing programs already in the planning stage for 1967.

Mr. Scanlon believed that construction of single-family homes and smaller apartments would respond fairly promptly to increased availability of credit and labor. Vacancy rates were low in most Seventh District centers.

Bank reports still indicated a basically strong demand for credit by business firms, Mr. Scanlon continued. Some bankers had suggested recently that business borrowing was likely to increase more than seasonally before the end of the year. While the timing of the expansion in business loans since mid-year had deviated somewhat from the expected pattern, the relative increase was only slightly less than the very strong rise in the same period a year ago. A relatively large proportion of the expansion in recent months was attributable to borrowing by manufacturers of durables; increases in loans to trade concerns had been well below the usual seasonal amount. Other types of bank lending had slowed and, after adjustment for Treasury financing, bank investments had dropped sharply--apparently reflecting reduced availability of funds, not reduced demand for credit.

After reporting a very large basic deficit in mid-October, Mr. Scanlon said, the major Chicago banks ended the month in a somewhat improved position, having eliminated their borrowing at the discount window. They had continued to lose funds through CD run-offs, and gains through issuance of smaller certificates appeared to have ceased. The number of country banks accommodated at the discount window had declined since August, but some borrowers had appeared for the first time in many years.

Mr. Scanlon commented that it now appeared that bank reserves, member bank credit, and money supply all declined in October, continuing a downward drift. That reflected, in part, at least, the reduced ability of banks to compete effectively for time deposits. It was likely that the growth of total credit had slowed also. While the easing of interest rates probably was, in large part, a reaction to the sharp run-up of rates in August, it could be reflecting also the fragmentary evidence of some easing of pressures on capacity in some sectors of the private economy. However, consumer prices probably would continue to rise at their recent rapid rate, at least through the year-end.

Mr. Scanlon observed that the Treasury financing dictated an even keel posture in the period immediately ahead. He found the directive language suggested by Mr. Hayes acceptable, but he shared Mr. Swan's views on the clause concerning fiscal policy

measures. With regard to the second paragraph, he believed the Committee should undertake to achieve moderate growth of total reserves.

Mr. Clay remarked that the most striking changes that had taken place in the economy in recent weeks had been in the financial variables. While there had been declines in interest rates in most credit markets, perhaps the most notable changes had been in the commercial banking system, including bank credit, bank loans, and the money supply. Understandably, that raised questions as to the meaning of those developments for the course of the economy and as to the appropriate monetary policy.

The over-all level of economic activity continued to advance at a rapid pace, Mr. Clay noted, although there were important cross-currents in the economy. While pressure on resources and capacity continued in the defense and business equipment sectors and their related industries, personal consumption was somewhat more relaxed and residential construction was declining. Aggregate labor requirements were strong enough to place pressure generally on labor markets and, despite variability, over-all price advances remained a matter of appropriate concern.

The future pattern of economic activity was by no means clear, Mr. Clay remarked. In addition to the need to observe closely all future economic developments, particular attention

centered on future defense expenditures and business capital outlays. Both the McGraw-Hill report in early November and the Commerce-SEC report in early December should help clarify the business capital outlays picture, and it was hoped that further indications of future defense expenditures would become available during that period.

In view of the current economic and financial situation, Mr. Clay continued, it was obvious that further monetary restraint should be avoided. Whether to reduce monetary restraint, and if so, to what degree, was a more difficult question. The general state of the economy and the resource-price situation probably did not call for an overt move toward easing of monetary policy, although such developments warranted careful watching. At the same time, bank credit developments of recent weeks did not appear to be in keeping with an appropriate prescription for the economy. It would seem desirable for bank credit to experience some expansion. Perhaps the preferable course for monetary policy, under the circumstances, would be an extension of the program carried out since the last meeting of the Committee, whereby net reserve availability would be adjusted in accordance with bank credit developments. Thus, if bank credit showed further weakness, net reserve availability would be increased. The forthcoming Treasury financing operations and the need to maintain "even keel" conditions

also would seem to argue for the avoidance of an overt change in monetary policy.

The draft economic policy directive was satisfactory to Mr. Clay if it was understood that the proviso clause referred to a somewhat stronger bank credit performance in November than that projected in the blue book. That interpretation was in accordance with the last paragraph of the staff notes accompanying the policy directive draft.

Mr. Wayne said that the mixed air of pessimism evident in recent Fifth District surveys appeared to have eased slightly, although textile and durable goods manufacturers continued to report weakness. One textileman indicated a substantial cutback in machine use and work force while a number of others reported reductions from a six- to a five-day week in the face of declining orders and backlogs. Other nondurable goods manufacturers, however, noted increased orders, employment, and prices. Insured unemployment rates had declined further and were now at record lows in all but one Fifth District State. Retailers had expressed some concern about the availability of help for the Christmas rush.

The latest data on the national economy seemed to Mr. Wayne to accentuate what he took to be a growing feeling of uncertainty in the business community. The leading indicators had been growing more bearish for some time and the new business intelligence of the

past six weeks lent some support to that trend. To date, the large surge in private credit demands generally expected some weeks ago had not materialized. Defense spending now seemed to have assumed added importance as a mainstay of the business advance. The private sector appeared to be either experiencing or about to experience some kind of readjustment to a change in the composition of aggregate demand in favor of Government spending. That might account for the rather sluggish behavior of the business measures in the latest period. In any event, with defense outlays continuing to rise, and with higher labor costs a possibility because of larger wage increases, it was premature to interpret the latest data as suggesting the imminence of a turnaround, even though inflationary pressures had moderated somewhat for the present.

Mr. Wayne commented that in the policy area the Committee seemed to be getting the kinds of results it had been saying were necessary. It might be that the squeeze on CD's had reduced the aggressive bidding for short-term funds, or that the demand for loans had not been as strong as expected. Perhaps, also, as Mr. Galusha had suggested, the banks were putting real effort into the rationing of credit. But, judged by results produced, the present mix of tools and techniques appeared to be effective. In any event, it seemed to him that the Committee's present posture was about right for existing circumstances and in view of the present

operations of the Treasury. Mr. Brill's caution lest the Committee over-stay its posture of restraint was appropriate and timely. However, until sufficient reason for a change was evident, the Committee should be especially careful not to give any false signals which might occasion a disturbing turnaround of expectation patterns.

Mr. Wayne said that Mr. Holmes' review this morning was especially lucid and helpful. His comments concerning the growing usefulness of the credit proxy and required reserves as guides to the Manager were encouraging and should stimulate the Committee's continuing search for more satisfactory measures of policy action. Mr. Wayne would concur in Mr. Holmes' suggested interpretation of the proviso clause of the draft directive. With that understanding, he (Mr. Wayne) would approve the first paragraph of the draft directive submitted by the staff. The changes Mr. Hayes had proposed in the second paragraph had merit, and Mr. Hayes' version of that paragraph appeared preferable.

Mr. Wayne concluded by saying that he preferred to give the Manager a high degree of discretion, and that was reflected in the proviso clause. The discussion this morning emphasized the difficulty of writing a directive by the Committee as a whole. The staff had done a good job in its work on the directive, and their explanatory comments were helpful and should be continued.

Mr. Shepardson said that the description of the economic situation in the staff comments certainly put the problem before the Committee into focus. Evidence had been presented of apparent easing in some sectors and of downturns in some economic indicators. The rise in defense expenditures and the uncertainties about the course of developments in Vietnam also had been stressed. One point, however, that he thought had been given insufficient attention was that some clarification of the Vietnam situation might reasonably be expected following the President's return from his Asian trip and the elections next week. Accordingly, the Committee might have a much better idea at its next meeting of likely developments in the uncertain, but highly significant, area of defense spending. Both for that reason and because of the need for an even keel in the face of the Treasury financing, it seemed unwise to him to consider any policy change at this time. The Committee should not give any potentially misleading signals of easing now, particularly because of the uncertainties regarding Vietnam and the expectation of some further clarification soon. On the other hand, this certainly was not a time for tightening. He would maintain the recent situation in the money market--and by that he meant the average conditions over the whole period since the preceding meeting, not those that had developed in the last week or so.

Mr. Shepardson said he could accept the staff's draft directive, but he thought the changes suggested by Mr. Hayes in the first paragraph were desirable. In the second paragraph he definitely would call for "firm but orderly" rather than "generally steady" market conditions. He also would eliminate the proviso clause, which had been introduced some months ago at a time when there was a great deal more uncertainty in the market than existed now.

Mr. Mitchell commented that as he listened to the discussion today he became more troubled than he usually was about the role of monetary policy. It seemed to him that three different issues had been run together in the discussion thus far: what monetary policy could do; what monetary policy had already done, including the effects to come that were now in the pipeline; and what it could not do.

The most basic single thing that had been accomplished, Mr. Mitchell continued, was to immobilize holders of existing assets and outstanding debt. That was most evident in the case of home-owners, but it also was evident in the case of holders of other types of assets--particularly municipal securities, which now could be liquidated only at large losses. In his judgment that had been the great contribution of monetary policy over the past few months, and it had done much to bring about the improved climate existing today.

The Committee's second major accomplishment, Mr. Mitchell said, was to postpone a fair amount of actual spending, again most conspicuously in the area of construction. In addition, the Committee had chilled all efforts to secure commitments of funds for the future; the position of all financial intermediaries had changed drastically. And the stock market decline this year, which reflected the classical Keynesian reaction to tighter monetary policy, had had a salutory effect on expectations even with the recent recovery. As everyone knew, monetary policy had lagged effects, and there were more consequences to come from earlier actions.

As to what monetary policy could or should not do, Mr. Mitchell continued, he did not think it could roll back wages. It could produce a climate in which business resistance to wage increases would reduce the pace of the advance, but the rise in wages that had already taken place was water over the dam and he did not think the Committee should attempt to do anything about it.

Also, Mr. Mitchell said, the Committee should not overstay its policy of tightness. As he had mentioned earlier, asset holders had been immobilized by the rapid change in interest rates; but the new position was not one which the Committee should permit to become hardened. He did not think the new level of rates was compatible with continued expansion of the economy, and in his judgment the Committee should start pulling away from that rate level as soon as it felt it

had accomplished its objectives. It was important to remember that monetary policy was a flexible tool, and that if a policy of restraint was maintained too long it would do more harm than good.

On the whole, Mr. Mitchell observed, he did not think he differed substantially from those who had already spoken with respect to the appropriate policy course now. He did disagree, however, with much of the reasoning that had been advanced in support of that course.

Turning to the directive, Mr. Mitchell said he would contribute only two points to the discussion of the first paragraph. Mr. Swan had criticized the opening sentence of the staff's draft as mistakenly implying declines elsewhere than in construction. But such an implication would be consistent with the facts. Secondly, he would not refer to "possible future fiscal policy measures" as Mr. Hayes proposed, on the grounds that it was not appropriate to try to predict what Congress and the Administration would do. Otherwise, he had no objection to Mr. Hayes' version of the first paragraph.

As to the second paragraph, Mr. Mitchell said, along with others he did not like the proviso clause in the staff's draft. Mr. Ellis had suggested the easy solution of deleting the clause entirely, and he (Mr. Mitchell) would rather do that than accept Mr. Hayes' version. The latter, he thought, involved the not unusual problem of inconsistent instructions, since net borrowed reserves around $350 or $400 million were not likely to be consistent with an increase in bank

credit in November. As he read the staff reports, to achieve an increase in bank credit it would be necessary to have much shallower net borrowed reserves. What was needed was a little more ease, insofar as that was consistent with the Treasury financing, and he would suggest a clause calling for operations to be modified "to resist any falling off in the projected rate of money supply growth." He proposed referring to the money supply because the credit proxy did not strike him as a good measure to use as a standard, although possibly it could be improved. Using the money supply would suggest about the same objectives and would be understood better by the public.

Mr. Daane said he found himself very much in agreement today with Mr. Hayes. He thought monetary policy had been doing what it could and should be doing, and that the Committee was achieving just about the results it had intended--notwithstanding the protestations to the contrary that he had heard last week at the meeting of the American Bankers Association. In response to Mr. Mitchell's useful caveat about the need for flexibility in policy and for not holding rigidly to any level of interest rates, he would submit that the decline in yields since the end of August indicated that the Committee's posture was not overly rigid. Although no one at the table was privy to any special information on the future course of defense spending, it had been rising rapidly; his own intuition was

that it was rising much faster than publicly recognized or admitted and perhaps even faster than Mr. Brill had intimated.

Mr. Daane went on to say that like Mr. Hayes and Mr. Reynolds he was concerned about the U.S. balance of payments situation. He did not think the Committee could take much comfort from the recent figures on the official settlements basis of calculation. However, since the Administration was continuing to work on the problem with a view to continuing and perhaps strengthening its over-all program in the area, he thought it would be inappropriate for the Committee to make an overt shift in policy now. He agreed with Mr. Hayes that the time had come to reappraise the problem in a more fundamental way, and he hoped that a System effort to do just that could be mounted. Despite erroneous press reports of his position, he also agreed with what Mr. Hayes had said today and what Chairman Martin was reported in the press to have said in Boston yesterday, that there continued to be a need for the tax increase that would have been most appropriately made earlier this year. He was still enough of a Keynesian to believe that the U.S. should finance the Vietnam war on a pay-as-you-go basis, so that it could be carried on to the extent possible without inflation.

The Committee's policy decision today, Mr. Daane continued, could only be to call for an even keel. Within that framework, however, and in an attempt to respond to the Manager's request for

guidance, he would refer Mr. Holmes to the opening statement of his own written report, which read, "System open market operations in the period since the last meeting of the Committee sought to maintain generally firm and steady conditions in the money market, though with some leaning on the side of less firmness as bank credit continued to show signs of weakness." He hoped that, within the framework of even keel, the Manager would continue to interpret the directive in exactly the manner implied by that statement.

Mr. Daane said he would not simply accept but would strongly endorse Mr. Hayes' suggestions for the directive, except that he would retain the word "vigorously" in the statement of the first sentence regarding the expansion in domestic economic activity. Certainly there was nothing in the GNP projections contained in the green book[1/] to indicate that the economy was going into a decline. Also, he disliked the language proposed by Mr. Hayes in which rising defense expenditures were said to be "offsetting" moderating tendencies elsewhere. Accordingly, he would prefer language in the first sentence reading ". . . over-all domestic economic activity is continuing to expand vigorously, with sharply rising defense expenditures and some evidence of moderating tendencies in some sectors of the private economy." For the

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

second paragraph, he would prefer Mr. Hayes' version, to be interpreted in line with the statement he had cited from Mr. Holmes' report.

Mr. Maisel remarked that, as had been made clear, the present was a period of great uncertainty with respect to the actual economic outlook. That was all the more reason for the Committee to pay particular attention to the specific monetary variables for which it was responsible.

When one looked at reserves--the item which the Committee primarily influenced--one noted a lack of normal growth, Mr. Maisel continued. Depending upon which monetary variables were examined, current levels were as low or lower than the levels reached in the first quarter of the year. It was proper to have restrained growth in reserves during the second and part of the third quarter in order to correct for their great acceleration in the first quarter. However, the period of stagnation for those variables should not continue. He particularly felt that the Committee should not at this point attempt to hold up interest rates if demand fell. The attempt to hold up rates seemed to him the thrust of several suggestions which indicated that the Committee had to restrict growth in reserves or even continue to have them decline rather than have interest rates fall back to their early summer levels. Given its lagged effects, policy should attempt to bring about a normal growth in total reserves and

non-borrowed reserves. That meant that a further fall in required reserves and the bank credit proxy for this month would not be useful.

Mr. Maisel hoped that the Manager would interpret "generally steady conditions" to refer to somewhat easier conditions than had developed. He was disappointed that the proviso clause had not had more influence on action during the last period. He felt that a fall at an annual rate of nearly 3 per cent, compared to an expected increase of 5 per cent, in the bank credit proxy was a significant deviation from expectations. He did not feel that the action taken was sufficient in the light of that deviation. He recognized that there were two weeks with somewhat lower net borrowed reserves. Still, if one looked at most of the monetary variables, the action of the latest three weeks for which there were data could be considered about as restrictive as that in the corresponding three-week period before the last meeting. Net borrowed reserves were about the same, and total reserves and the credit proxy declined.

The major exception to that generalization was that interest rates receded part way from their abnormal height, Mr. Maisel said. That correction from the height reached as a result of the extreme crisis in expectations which occurred at the end of August was to be expected. As he had indicated before, the Committee should guard against allowing any changes which occurred simply from a sharp runup based on expectations to get built into the system. It

must take a larger view and consider the total monetary picture, not simply the retreat of interest rates from their temporary levels. It should not be satisfied with a further decline in reserves and the credit proxy. The Desk should take the necessary action under the proviso of today's directive to try to start those variables back along a normal growth path. That meant that total reserves should expand. He would guess that it probably meant lower net borrowed reserves and a continuation of the return of interest rates toward the early August levels.

Mr. Maisel said he did not favor retaining the word "vigorously" in the first sentence of the directive, as Mr. Daane had suggested. He preferred the directive proposed by Mr. Hayes to the staff draft, but he would replace the final phrase of the proviso clause, reading "in the light of bank credit developments during the month," with the phrase, "in order to aid in a moderate expansion in bank credit and reserves."

Mr. Brimmer said that he had proposed to include in his comments today a review of some implications of the recently reduced liquidity of life insurance companies. In the interest of time, however, he would make only summary remarks on the subject and ask that the comments he had prepared be included in the record. He then summarized the following statement:

The tendency for gross cash flows at life insurance companies to fall short of company projections has created a serious liquidity squeeze on some individual companies because of the very large share of projected cash flows (well in excess of 90 per cent) which had already been allocated through advance loan commitments. The short-fall in basic cash flows has reflected a combination of (1) lower than estimated pre-payments on mortgages, (2) higher than estimated policy loans, and (3) larger than expected withdrawals of policy proceeds left on deposit with the company. Some insurance companies have been hit much harder by the policy loan increase than others--with the increase in several extreme cases pre-empting all or virtually all of the basic cash flow.

To meet loan commitments in the face of this unexpected squeeze on their basic cash flows, some companies have had to reduce their cash balances, and/or liquidate security holdings and draw on bank credit lines. Initially, as evidence of the liquidity squeeze developed, life companies stretched out the ultimate payment dates on a large part of their loan commitments. But more recently, with the policy loan problem continuing, some companies have ceased making any new loan commitments altogether. Moreover, in the absence of a basic general easing of credit conditions, there is no obvious reason to expect these pressures on insurance companies to abate for some time.

The persistence of this liquidity squeeze on life companies poses several logical questions for the Federal Reserve:

1) Is it likely that life insurance companies (generally assumed to be good business customers at banks) will pre-empt a significantly larger share of bank credit, either by drawing on their own credit lines, or by deferring the allocation of long-term funds to mortgage companies, thereby necessitating an extension of construction lending by banks or leading to an increase of mortgage warehousing?

2) Is it likely that security liquidations by life companies seeking to obtain funds will be large enough to create instability in bond markets?
3) Is it possible that any particular companies, under pressure from policy loan increases, will run through all of their own sources of liquidity and have to renege on their advance loan commitments, or be bailed out by special loan arrangements?

The Life Insurance Association has not indicated whether any particular companies are about to run through all of their liquidity reserves. But it seems unlikely that the industry in general is facing any such problem. Moreover, with long-term interest rates declining recently, the capacity of bond markets to absorb some portfolio liquidation has been improved.

In these circumstances, it seems to me that it is up to the life insurance industry to demonstrate more fully a need for special liquidity assistance, if there is one. Without better evidence on the state of individual companies, it is difficult to decide whether any special use of Federal Reserve Bank credit (either directly or indirectly) would be justified for this purpose.

At the same time, however, it should be recognized that life insurance commitment activity has been substantially curtailed, so that credit from this source is much less readily available. Here, too, if the problem were presently acute, corporate bond yields would probably not be declining. But any build-up in the corporate calendar would clearly be more difficult to accommodate in the absence of active life company participation. Also, it seems likely that the volume of life insurance credit available for commercial and multifamily residential construction will be substantially reduced in 1967, relative to the supply available at the start of 1966. Finally, it seems very possible that life insurance company demands for accommodation at banks will increase. All of these elements in the total credit picture, therefore, need to be kept in mind while setting reserve policy for banks--although at this point it is difficult to quantify their precise significance.

Mr. Brimmer then said that he would report briefly on the progress being made by the Cabinet committee on the balance of payments in formulating a program for 1967. The discussions were still underway and it was not possible as yet to say what recommendations were likely to be made to the President. It might be helpful to the Committee to have some of the flavor of the discussions, however, because they bore on the relation between monetary policy and the payments balance in the coming year.

Hopefully, Mr. Brimmer continued, the program for 1967 would be announced within the next few weeks, perhaps around the date of the Committee's next meeting. The program would remain a voluntary one, and it now seemed likely that most if not all of the elements of the 1966 program would be retained. Specifically, there would be elements relating to direct investment abroad and to export promotion, under the guidance of the Secretary of Commerce. There was some hope that the Federal Reserve's part of the program would be continued, but that question was still under discussion.

One point he would like to note particularly, Mr. Brimmer remarked, was that there was a definite hope within the Cabinet committee that a balance of payments program could be developed that would permit greater freedom for monetary policy decisions to be made in light of domestic considerations. It was almost a precondition for the current discussions that something be done with respect to capital

flows, so that monetary policy would not have to carry so much of the burden of restraining such flows. He personally doubted that the President would approve any recommended program that did not allow greater flexibility for monetary policy to be based on the needs of the domestic economy.

Since balance of payments considerations had been mentioned in connection with monetary policy this morning, Mr. Brimmer observed, he thought that point was worth keeping in mind. It also had some bearing on the directive to be issued today. Thus, in the first paragraph he would prefer to specify the international payments objective of the Committee's policy in terms of "progress toward" reasonable equilibrium in the balance of payments rather than "restoration of" such equilibrium, as both the staff draft and Mr. Hayes' version specified. The Cabinet committee was actively discussing the question of the payments target for 1967. It was generally agreed that no quantitative goal should be announced, as had been done for the 1966 program, but the question remained of what goal would be reasonable. One issue was whether the goal should be defined apart from the impact of the Vietnam war, which was estimated to have increased the annual deficit by roughly $1 billion. Because the matter was still under discussion, he hoped the Open Market Committee would not imply in the directive that it had set equilibrium as the target.

On a related point, Mr. Brimmer observed that Mr. Hayes' comment to the effect that the recent inflow of foreign private liquid funds was a means of financing the deficit implied that the liquidity basis of calculation was the appropriate one. He did not believe the Committee should accept either that basis or the official settlements basis as the one proper method for calculating the balance. The Administration's decision had been to calculate the balance on both bases and to reach a decision between them only after more experience had been accumulated. The matter had been discussed by the Cabinet committee as recently as yesterday, and it had been left open for the time being. But, however the balance was calculated, he shared Mr. Reynolds' sense of urgency about the country's international payments problem and he hoped that efforts to deal with it would continue.

With respect to other parts of the directive, Mr. Brimmer agreed with Mr. Maisel that economic activity should not be described as expanding "vigorously" now. In the second paragraph he would prefer to call for "generally steady" rather than "firm" money market conditions. He shared Mr. Hayes' view that expansion in the bank credit proxy in November at an annual rate of about 6 per cent would not be disappointing. The series of shortfalls in bank credit growth that had been experienced recently might well result in the Committee's feeling rather uncomfortable; the

fact that the growth expected had not materialized was grounds for pause. Mr. Hayes had implied that a 4-6 per cent growth rate in November would be acceptable, but he (Mr. Brimmer) would prefer to have the Committee set such a rate as an explicit goal.

Mr. Hickman remarked that developments since the Committee's last meeting provided further evidence of moderation in the private sector of the economy and of a continued climb in defense spending. Major economic series showing signs of slackened growth included production of consumer goods and materials, unfilled orders for durables, plant and equipment spending, steel output, and nonfarm employment. For many months, residential construction had been the only major economic series showing an outright decline. In the third quarter, however, several important series joined residential construction on the downside: new orders for durable goods, auto output, and sensitive industrial materials prices. As the Chairman had pointed out at the last meeting, "If it were not for defense spending, the economy might well be experiencing a little downturn right now, and . . . defense spending is (not) a very strong prop for an economy."

Unfortunately, Mr. Hickman said, the evidence cumulated that wage-cost inflation had been built into the economy, due almost entirely, in his opinion, to the failure of the Administration to take appropriate fiscal action earlier this year. Evidence also

cumulated that monetary policy alone had done about all that it could to restrain the economy, and that a further tightening could aggravate imbalances now present in the economy.

As he mentioned at the last meeting, Mr. Hickman continued, in an economy in which defense spending was the prime mover it was extremely difficult to design appropriate monetary or fiscal policy when even the roughest estimates of defense spending were withheld from the U.S. Treasury and this Committee. To the extent that the System could bring influence to bear in appropriate places, it should press to have the Defense Department release data to it on new orders and estimated cash flows for the next two or three quarters. Without such information, monetary and fiscal policy could easily be misdirected, to the great detriment of the economy. He might add that his board of directors at last month's meeting underscored the importance of the Committee's having information on the flow of defense spending for a reasonable period ahead, and urged the System to do what it could to fill the gap in its knowledge.

Lacking reliable information on defense spending and the economic outlook, Mr. Hickman continued, the Committee should allow the behavior of the credit proxy and the money supply to determine policy; that is, it should follow rather than lead. If the credit proxy and the money supply failed to come up to the weak November

projections of the staff, then the Committee should allow net borrowed reserves to ease further, perhaps to $200 million. An important question, it seemed to him, was whether the Committee should attempt to redress recent shortfalls in the money supply and bank credit. He was afraid that that would produce a very easy tone in the money market, and that it might lead to a sharp shift in expectations and perhaps to bond market speculation. He would, therefore, not attempt to redress recent shortfalls but would let deviations of money and the credit proxy from the staff projections lead policy over the next three weeks. That policy of "no change with qualifications" also seemed appropriate in view of the forthcoming Treasury refinancing. For the directive he would favor the staff draft as submitted, with the understanding that it would be interpreted as the Manager had suggested.

Mr. Bopp observed that the course of the war in Vietnam seemed even more unpredictable now than just a few weeks ago--if, indeed, that was possible--and military uncertainties were superimposed upon question marks in inventories, capital spending, and housing. The future of durable goods spending also had been coming under closer scrutiny, with the drop in housing starts raising doubts about furniture and appliance sales in the coming year.

Financial developments during the past few weeks certainly underlined the need for caution in determining monetary policy,

Mr. Bopp said. With reserves, the money supply, and credit flows all falling significantly short of earlier projections, the Committee might do well to aim for somewhat easier money market conditions in the next few weeks. Certainly that would be the appropriate course for policy if those trends persisted.

Of course, Mr. Bopp continued, it was difficult to determine just what proportion of the weakness in credit flows stemmed from slackening demand, reflecting a softening in business. No doubt some of the downturn in money and credit flows resulted from anticipatory borrowing earlier in the year. Some also came from the supply side. Indeed, it appeared that the squeeze in CD's--while not so severe as some had expected--had had an important bearing on lending policies. In the Third District, loss of large negotiable CD's since the August peak ran only about half the 10 per cent rate experienced in the nation as a whole. Yet the loss--or more precisely, the threat of loss--helped to condition thinking on loan policy. Earlier he had reported that several of the large Philadelphia banks had set themselves the goal of holding loans virtually stable. They had accomplished that in large measure. Business loans in particular had remained virtually unchanged from early August to the present.

In view of the present uncertainties on the business front and projected decline in bank credit, Mr. Bopp felt that the recent

modest easing in money market conditions should be continued. That was tolerable within an over-all policy of even keel. However, if flows of money and credit proved to be substantially greater than projected, he would recommend that the Manager restore conditions to where they were two weeks ago.

With respect to the directive, Mr. Bopp said, he could accept any of several alternative proposals that had been made. He thought Mr. Swan's suggestion to move the reference to recent fiscal policy measures to an earlier point in the first paragraph was a particularly good one.

Mr. Patterson reported that over-all gains in the Sixth District in recent months had slowed down. Employment had leveled off in August and in September. Sales of 1967 automobiles were running well behind last year's introductory pace. And residential building contracts would be down between 6 and 8 per cent for the full year on the basis of present trends.

However, Mr. Patterson said, while noting those signs of weakness he would not want to exaggerate their importance. Unemployment remained low. Overtime work was still increasing, and personal income--according to the latest available data--continued to expand. On the whole, though, the District economy was showing less steam, and nowhere was that more apparent than in financial data. Business loans in the first three weeks of October expanded less than a year

ago. Such moderation in pace followed vigorous business loan expansion in September and weakness in August, so there could be little doubt that the trend in business lending had slackened. Other categories of lending also showed signs of easing.

In looking back, Mr. Patterson continued, it was now quite clear that borrowing demands of late last year and much of this year were clearly unsustainable. The loan expansion could not continue indefinitely in the face of progressive System tightening. In fact, his conversations with bankers, as well as the high level of member bank borrowing at the discount window and in the Federal funds market, indicated that even now many banks still felt in a tight position. On the other hand, the recent movement in loans could not be attributed entirely to deposit trends and monetary policy. The demand for loans seemed to be weaker than banks had anticipated several months ago.

Since many of the same observations noted for the Sixth District could be made about the national scene, Mr. Patterson said, it was appropriate to ask whether the time had come for edging away from the Committee's policy of restraint. Considering the delayed impact that monetary policy had, some easing was, indeed, a tempting policy description. The Committee should also keep in mind criticisms leveled against the System in the past for being overly concerned with price developments when economic activity was slowing down.

Thus, a good case could be made for a policy shift, especially since industrial commodity prices had shown little change in the third quarter.

Having almost convinced himself of the wisdom of such a policy change, Mr. Patterson concluded that the time was not quite ripe for it, aside from "even keel" considerations. With defense spending strongly headed upward the economy was unlikely to turn down quickly. Wages were rising rapidly. Fiscal restraint was still in the offing. Monetary restraint was making a contribution to the balance of payments. And he would judge that some recent developments, especially those in financial markets, were in part a reaction to overly dramatic changes in the immediate past and, therefore, only in part for "real." Hence, in the final analysis he believed that the Committee should wait for additional evidence of an easing in private demands before undertaking a major policy shift.

But if the growth in business loans over the next few weeks was as moderate as assumed in the green book, in Mr. Patterson's opinion the Manager could afford to be fairly liberal in providing reserves. And if credit demands were less intense than now anticipated, he might even accommodate banks to the point of permitting some rebuilding of their investments. By and large, though, Mr. Patterson suspected that the Manager would need to be guided in his day-to-day transactions mainly by money market rates.

Mr. Patterson said he favored adopting Mr. Hayes' suggestion with respect to the second paragraph of the directive.

Mr. Francis commented that total spending on goods and services had continued to rise faster than the ability of the economy to produce, and upward pressures on prices were strong. The Government's fiscal situation continued to add to the excessive demands.

Monetary developments since last spring had been restrictive, Mr. Francis noted. Member bank reserves had declined moderately, growth of bank credit had slowed markedly, and the money supply had changed little on balance. In view of both the excessive total demand for goods and services and the fiscal developments, the monetary restraint had been desirable, but care now had to be taken to avoid becoming too restrictive. Monetary actions frequently had their greatest impact after some time lag.

Recently, Mr. Francis said, interest rates had declined and ease had developed in the money market. Those developments might indicate some decline in the private demand for loan funds or might be only a technical reaction to earlier anticipatory borrowing and speculative selling because of an over-estimate of how high rates were going to rise. In either case the net rise in rates since last spring had probably been a good thing, helping to bring planned private investment in line with planned saving less net Government demand for loan funds.

At this time, Mr. Francis remarked, the Committee could not be sure what rate of monetary growth was appropriate, but he believed that steps should be taken to avoid any sustained monetary contraction, as well as to avoid a renewal of the rapid monetary expansion that occurred last winter and spring. If demands for credit weakened further, interest rates should be permitted to adjust lower, to the extent permissible during a Treasury refunding. Otherwise, bank reserves, bank credit, and money were apt to decline and the restraining force of monetary actions might cause a more than desired contraction in total spending on goods and services. On the other hand, if demands for credit showed renewed strength, some upward adjustment of interest rates might be necessary to avoid an undue rise in credit and spending, causing further inflationary pressures.

In general, Mr. Francis thought that the Manager might be instructed during the next few weeks to take care of normal seasonal forces, but he should be permitted substantial latitude with regard to fluctuations in measures of money market pressures. If sharp changes occurred in interest rates or other money market pressures, attempts to offset them should be kept to a minimum consistent with the needs of the Treasury. Large demands for funds, especially when translated into increases in required reserves, should be permitted to tighten the money market. Contractions in the demands for funds and declines in required reserves should be allowed to ease the

market rather than be used as a signal for the System to contract reserves, credit, and money further.

Mr. Francis said he would favor Mr. Hayes' version of the directive.

Mr. Robertson made the following statement:

> As everybody around the table has acknowledged, we are in the midst of an "even keel" period that constrains our ability to make any overt change in monetary policy. Sometimes this kind of constraint can be a positive operational advantage to the Committee, because it provides us with a freer opportunity to look ahead and plan possible courses of action to be agreed upon when the even keel period is over. This, it seems to me, is one of those fortunate times.
>
> In the great mass of evidence coming before us, we see more than the usual signs of softening or easing of pressures. Yet none of this evidence is so persuasive as to make us want to ease policy aggressively at this moment. I believe in flexibility in monetary policy, but I am not much attracted to a "stop-and-go" kind of system, operating as if we had only two gears: full speed ahead, and full speed reverse. In circumstances like we face currently, I believe that kind of approach could generate substantially more harm than good.
>
> My preference, if easing signals continue to flash in increasing numbers, is for a tentative but gradual and progressive kind of let-up of monetary pressures, related closely to the kind of market and economic effects that seem to be resulting. This would be my prescription, unless and until a sharp change in the picture is introduced by way of Vietnam spending, additional fiscal action, or a marked further alteration in private spending intentions.
>
> Having spoken in these general terms about our overall policy focus, let me say a few words about our operating instructions to the Manager, both retrospectively and prospectively. It seems to me that the proviso clause has thus far worked out well. I was glad that the Manager permitted a slight easing of money market conditions in the last half of October when it became evident that required reserves were showing substantially less strength

than anticipated. He apparently felt that there was a limit to the ease he could permit in money market interest rates, and this was quite proper given the sense of the Committee's previous discussion and given the stress on money market conditions in the directive.

There are times when it is desirable for the Committee to lay greater stress on money market conditions than on net borrowed or free reserves as an immediate operating target. The recent period, when liquidity crises were threatening, was clearly such a time; perhaps the present even keel period is another. However, I would like to suggest that the time is approaching when we can and should move away from primary reliance on money market conditions as an operating guide. The trouble with too-slavish attention to money market conditions as a target is that our operations then tend to circumscribe short-term interest rate movements into too narrow a band, thereby stultifying market performance and depriving us of an immediate indicator of market pressures. We do not want to see large and erratic rate movements in the financial system, but we should want to see enough rate movements to provide us with a barometer of changing market demand pressures. For rates to reflect underlying pressures, we obviously cannot have them as a principal target.

What we can better use as an immediate target, I think, is our old friend, net borrowed or free reserves--or in directive language, "net reserve availability." For, with all its imperfections, it has the key advantage of cushioning market pressures while leaving market interest rates reasonably free to index changing private demand pressures. With CD run-offs slowing and bank reaction to the September 1 letter settling into a pattern, some of the influencesthat muddied the free reserve waters for a time this fall are calming down and this reserve target is once again becoming more dependable as a week-to-week guide. We have learned, I think, not to rely on net borrowed reserves alone, but to use that measure in conjunction with aggregate reserve and bank credit movements in the interest of fostering orderly and noninflationary monetary expansion.

Our recent experience with the proviso clause has been very instructive in this respect. Given the

> succession of weeks in which aggregates have fallen short of our expectations, I should think the time has arrived to give somewhat more weight to monetary aggregates in our operating instructions than we have in the past. One way to do so at this time is to state clearly that we would like to see bank credit show at least a little more strength than indicated in the blue book projections. This could be done in the directive by adopting the position outlined in the last paragraph of the staff note attached to the draft directive.
>
> This would mean that with money market conditions roughly in the range of the past two weeks, bank credit might show somewhat more strength than projected in November. If it did not, money market conditions could be permitted to gradually ease somewhat more; on the other hand, if bank credit showed considerably more strength, money market conditions could tighten some--all within the constraint of even keel. And next time--when we are beyond even keel--I hope our instructions to the Manager will lay less stress on money market conditions and more on reserve factors as guides to operation.
>
> With these interpretations, I would be prepared to vote in favor of either the draft directive distributed by the staff or that suggested by Mr. Hayes.

Mr. Robertson added that whichever version of the directive was adopted he would favor moving up the reference to fiscal policy measures, as Mr. Swan had suggested, or deleting it completely. He would also agree with Mr. Brimmer that the words "progress toward" should be substituted for "restoration of" before the phrase "reasonable equilibrium in the country's balance of payments."

Chairman Martin observed that he could add little to the discussion today; the comments he had made at the previous meeting still seemed valid. He would simply emphasize that the next meeting of the Committee might well be an important one. As had been pointed

out, the elections would then be over and more information might be available with respect to possible developments in Vietnam and the future course of defense spending. Thus, the Committee should be in a better position at that time to decide whether any overt change in policy was appropriate.

The main problem today appeared to be that of reaching agreement on a directive, the Chairman continued. He noted that the Secretary had prepared a new draft that attempted to take account of various suggestions advanced in the go-around.

The Chairman then read the following draft that had been developed by Mr. Holland:

> The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand with sharply rising defense expenditures but some evidences of moderating tendencies in sectors of the private economy. While prices of some materials have declined recently, upward demand and cost pressures persist for many finished goods and services. Bank credit expansion has slackened. Earlier strains in financial markets have abated and certain fiscal policy measures have recently been enacted by the Congress. The balance of payments remains a serious problem. In this situation, it is the Federal Open Market Committee's policy to maintain money and credit conditions conducive to the restraint of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, and taking account of the current Treasury financing, System Open Market operations until the next meeting of the Committee shall be conducted with a view to maintaining generally steady conditions in the money market.

Mr. Hayes noted that the proviso clause was deleted in the text Mr. Holland proposed. He would regret dropping the clause, because that would imply more emphasis on money market conditions as a guide to operations than he thought was intended. Certainly, money market conditions were not the Committee's sole concern; a high degree of interest had been expressed around the table today with regard to developments in other variables, and some recognition in the directive of that interest would be useful.

Messrs. Robertson and Wayne concurred in Mr. Hayes' observation.

The Chairman then suggested that if the proviso clause was to be retained the version Mr. Maisel had proposed might be acceptable.

Mr. Robertson commented that, while Mr. Maisel's proposed clause was a possibility, the wording suggested by Mr. Hayes might be preferable on the understanding that its intended interpretation would be explained in the record.

Mr. Hickman asked whether inclusion of Mr. Hayes' proposed proviso clause would imply that the Committee wanted not only to offset the expected 2 per cent annual rate of decline in the bank credit proxy in November but also to attempt to attain a growth rate in the neighborhood of 4-6 per cent. In his opinion, if the staff projections were valid such a course would result in a sharp runup in bond prices.

Mr. Holmes said that in his judgment such an implication was not necessarily warranted. Moreover, as he had indicated earlier he doubted the validity of the staff projections. He thought they probably would prove to involve an understatement of bank credit strength in November, perhaps as large as the overstatements of recent months.

Mr. Mitchell noted that there also could be a sharper decline in bank credit than projected, if disintermediation continued at a substantial rate. He was inclined to agree with Mr. Hickman.

Mr. Daane commented that he thought the version of the proviso clause proposed by Mr. Hayes would give the Manager the kind of discretion needed.

Mr. Robertson remarked that he thought the members had agreed that even keel considerations were dominant at this time and, accordingly, that the Committee had to focus on money market conditions; but that action should be taken, insofar as feasible given the Treasury financing, to prevent a further decline in bank credit or an undesirably large increase. That was what he understood both the staff's draft and Mr. Hayes' version of the proviso clause to imply, and that was the course he would consider proper.

A number of expressions of agreement were voiced.

Chairman Martin observed that the discussion reflected a fact he had often noted: particular words meant different things

to different people. Personally, he found Mr. Hayes' version of the proviso clause acceptable. He inquired of Mr. Maisel whether the latter also would find that version acceptable, given the interpretation that had been made, and the response was in the affirmative.

Mr. Swan asked whether it was appropriate to state as a fact that defense expenditures were rising sharply in view of the uncertainty with respect to developments in that area.

In response to the Chairman's request for comment, Mr. Brill said he thought enough was known to justify the statement in question. While monthly figures on defense expenditures were not available, preliminary GNP estimates for the third quarter indicated that defense spending was rising then at a $4 billion annual rate, and the 50 per cent increase in new defense orders from August to September indicated that the rapid advance was continuing.

Mr. Hayes remarked that he was prepared to vote in favor of the directive on which the Committee appeared to be agreeing, but he wanted to note that he would have preferred to retain the original language of the Committee's policy statement relating to the balance of payments, rather than revising it to read "progress toward" reasonable equilibrium.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York

was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand with sharply rising defense expenditures but some evidences of moderating tendencies in sectors of the private economy. While prices of some materials have declined recently, upward demand and cost pressures persist for many finished goods and services. Bank credit expansion has slackened. Earlier strains in financial markets have abated and certain fiscal policy measures have recently been enacted by the Congress. The balance of payments remains a serious problem. In this situation, it is the Federal Open Market Committee's policy to maintain money and credit conditions conducive to the restraint of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, and taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining generally steady conditions in the money market; provided, however, that operations shall be modified, insofar as the Treasury financing permits, in the light of bank credit developments during the month.

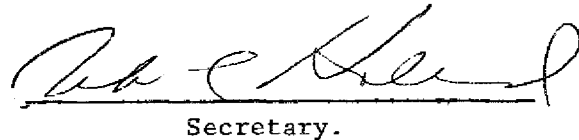
It was agreed that the next meeting of the Committee would be held on Tuesday, November 22, 1966, at 9:30 a.m.

Chairman Martin noted that a tentative schedule for meetings of the Committee in 1967 had been distributed with the agenda for today's meeting. He asked whether anyone had any comments on or changes to suggest in the schedule.

Mr. Daane said that while the tentative schedule was acceptable to him, he would reiterate the view he had expressed on other occasions that the Committee might ideally meet monthly, at dates related to the availability of monthly economic statistics, with interim meetings called when necessary.

Chairman Martin commented that the tentative schedule called for 14 meetings in 1967, only two more than would be held if the Committee met monthly.

Thereupon the meeting adjourned.



Secretary.

CONFIDENTIAL (FR) ATTACHMENT A

October 31, 1966.

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on November 1, 1966

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is still expanding, despite evidences of slackening in some sectors of the private economy. While prices of some materials have declined recently, upward demand and cost pressures persist for many finished goods and services. Bank credit expansion has slackened and earlier strains in financial markets have abated. The balance of payments remains in deficit; although capital inflows increased in the third quarter the trade surplus declined further. In this situation, and in light of the fiscal policy measures recently enacted by Congress, it is the Federal Open Market Committee's policy to maintain money and credit conditions conducive to the restraint of inflationary pressures and to the restoration of reasonable equilibrium in the country's balance of payments.

To implement this policy, and taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining generally steady conditions in the money market; provided, however, that operations shall be modified, insofar as the Treasury financing permits, to moderate any apparently significant deviations of bank credit from current expectations.

ATTACHMENTS B

Current Economic Policy Directive Proposed by Mr. Hayes

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand, with rising defense expenditures offsetting moderating tendencies in some sectors of the private economy. While prices of some materials have declined recently, upward demand and cost pressures persist for many finished goods and services. Bank credit expansion has slackened and earlier strains in financial markets have abated. The balance of payments remains a serious problem. In this situation, and in light of recent and possible future fiscal policy measures, it is the Federal Open Market Committee's policy to maintain money and credit conditions conducive to the restraint of inflationary pressures and to the restoration of reasonable equilibrium in the country's balance of payments.

To implement this policy, and taking account of the current Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining generally steady conditions in the money market; provided, however, that operations shall be modified, insofar as the Treasury financing permits, in the light of bank credit developments during the month.