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 22, 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, and Swan, Alternate Members of the Federal Open Market Committee

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

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

Mr. Cardon, Legislative Counsel, Board of Governors
Mr. Fauver, Assistant to the Board of Governors
Mr. O'Connell, Assistant General Counsel, Legal Division, Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors

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

Messrs. MacDonald and Lewis, First Vice Presidents of the Federal Reserve Banks of Cleveland and St. Louis, respectively
Messrs. Parthemos, Taylor, Baughman, and Jones, Vice Presidents of the Federal Reserve Banks of Richmond, Atlanta, Chicago, and St. Louis, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York
Mr. Arena, Financial Economist, Federal Reserve Bank of Boston
Mr. Kareken, Consultant, 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 November 1, 1966, were approved.

At the invitation of Chairman Martin, Mr. Hackley reviewed some possible implications for Committee procedures of the "Freedom of Information Act" (Public Law 89-487, enacted July 4, 1966, with an effective date of July 4, 1967), noting that the terms of the Act were still under study. Following his remarks, Mr. Hackley responded to questions.

After this discussion, Chairman Martin suggested that the members might continue to give consideration to the subject and that the Committee might plan on pursuing it further at coming meetings.

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 November 1 through 16, 1966, and a supplemental report for November 17 through 21, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that the Treasury gold stock would remain unchanged again this week for the thirteenth consecutive week, but the uncommitted holdings of the Stabilization Fund were now down to about $32 million. No French purchases were expected this month; the Bank of France lost $37 million in October, and their holdings seemed to be down about another $30 million so far this month. Unfortunately, however, there was a new customer in the form of the Bank of Italy, which was beginning to feel domestic political pressure as a result of a decline not only in its gold ratio, but also in the absolute amount of its gold holdings. Governor Carli estimated that the decline in Italian gold reserves this year might come to roughly $60 million. He had approached the U.S. regarding gold purchases of $30 million this month and $30 million in December to rebuild Italian gold reserves to their end-of-1965 level. Unless Governor Carli changed his mind, or unless the Russians made some massive gold sales during

December, the Treasury would have to show another major reduction in the gold stock fairly soon. More generally, the prospective Italian purchase would represent in part a compensation for gold losses resulting from Italian participation in the London gold pool. If other central banks should decide to follow the Italian example, the usefulness of the pool to the United States would, of course, be correspondingly reduced.

On the London gold market, Mr. Coombs continued, conditions had been fairly quiet in recent weeks, with the pool picking up about $20 million during October as a result of Egyptian sales plus a heavier flow of newly-mined gold from South Africa. As of the moment, the pool had available $32 million of the $270 million originally committed, plus a supplementary commitment of $50 million agreed to last September, for a total of $82 million. Yesterday and today there were heavy demands in the gold market with the price moving up to $35.18. As he had indicated at other recent meetings, in his view the gold market was likely to prove to be the single most troublesome source of problems for the dollar in the period ahead.

On the exchange markets, Mr. Coombs said, sterling remained a problem. So far this month, the Bank of England had made further progress in paying off forward contracts, which had been reduced since the middle of September by nearly $1 billion. On the other hand, there had been no sustained inflow into the reserves; in fact,

as of Friday, November 18, the Bank of England was down about $40 million so far this month. The market reception of the excellent trade figures reported for October was disappointing. Yesterday and today the Bank began to execute market swaps of sterling against dollars, and through this technique should be able to show a net surplus at the end of the month, but probably not enough to permit any substantial repayment of debt now outstanding. In fact, he saw very little alternative to Britain's rolling over again most of the overnight credits of $425 million which they received at the end of October. Those overnight credits were supplied in the amount of $200 million by the U.S. Treasury, $175 million by various foreign central banks, and $50 million by the System.

Looking a bit further ahead, Mr. Coombs remarked, some troublesome problems could arise in December as a result of possibly severe pressures on the Euro-dollar market, which might react against sterling. As the Committee knew, U.S. banks had attracted a great deal of money from the Euro-dollar market and, if they tried to maintain those holdings through the year-end, the result might be something of a tug-of-war between the U.S. banks and foreign banks seeking to repatriate funds from the market for year-end window-dressing purposes. Such a tug-of-war could produce a very sharp rise in the Euro-dollar rates, which would in turn exert a strong pull on liquid funds now held in sterling.

At the last meeting of the Bank for International Settlements, Mr. Coombs continued, ways and means had been considered of avoiding such a sudden vacuum in the Euro-dollar market which could pull in money from London, and most of the European central banks seemed agreeable to the U.S. suggestion of a joint effort to cushion the year-end strains. The Swiss National Bank and the Netherlands Bank, for example, would be prepared to funnel back into the Euro-dollar market via the BIS most of the money that they took in as a result of year-end window-dressing by their banks. The Bundesbank had already announced a reduction in reserve requirements during December and the Bank of Italy would try to restrain run-offs of Euro-dollar market placements by the Italian commercial banks.

If those measures did not suffice, Mr. Coombs said, there were two additional steps that might be worth taking. As the Committee knew, the System had a reciprocal line of credit with the BIS of dollars against European currencies other than Swiss francs in the amount of $200 million equivalent. A short-term drawing of dollars by the BIS of perhaps no more than a week's duration for placement in the Euro-dollar market might help considerably to relieve any sudden strains that might develop, at no risk to the System. Secondly, if a sharp rise in the Euro-dollar rates should tend to pull liquid funds out of London, that would probably be reflected in a weakening of spot sterling and a strengthening of the forward rate, with the

result that the New York-London arbitrage differential on Treasury bills might move sharply in favor of London. In such circumstances, it might be worthwhile for the System to execute in the market covered purchases of sterling with the dual objective of preventing any outflows from New York while simultaneously protecting sterling against year-end pressures.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period November 1 through 21, 1966, were approved, ratified, and confirmed.

Mr. Coombs noted that the longer-standing portions of the swap arrangements with the National Bank of Belgium and the Netherlands Bank--setting aside for the moment the increases that had been negotiated in September 1966--would both mature soon. Specifically, the $100 million line with the National Bank of Belgium, with a 12-month term, would mature on December 22; and the $100 million line with the Netherlands Bank, having a three-month term, would mature on December 15. He recommended renewal of the two standby swap lines for another twelve and three months, respectively.

Renewal of the $100 million standby swap arrangements with the National Bank of Belgium and the Netherlands Bank was approved.

Under the twelve-month line of credit with the National Bank of Belgium, Mr. Coombs said, it had been the established

practice for both parties to make a $50 million drawing with a maturity of six months. That $50 million drawing, on which neither party had any disbursements outstanding at the moment, also reached the end of its term on December 22, 1966, and he recommended its renewal for another six months.

> Renewal of the six-month drawing on the standby swap arrangement with the National Bank of Belgium was noted without objection.

As the Committee knew, Mr. Coombs said, the standby credit lines with both the National Bank of Belgium and the Netherlands Bank were increased by $50 million last September, with the proviso by both the Dutch and the Belgians that they regarded the increases as temporary, and that a prolongation should be discussed in advance on a multilateral basis at a meeting of WP-3. That question had in fact been on the agenda at a recent WP-3 meeting, but apparently time did not permit a discussion then; and no further WP-3 meeting was scheduled before the swap line increases reached their maturities around the middle of December. He had been in touch informally with the Netherlands Bank on the matter, and understood that their present thinking was to relate the question of prolongation of the September increase in the swap line to the question of whether the $400 million of short-term facilities placed at the disposal of the Bank of England by European countries in September would be renewed when

they matured after the turn of the year. In effect, the Dutch position, as he understood it, was that if the September credits to the U.K. were renewed they would be prepared to renew the additional $50 million on their swap line with the System. An extension of the September credits to the U.K. would probably be discussed at the December meeting in Basle, and as far as he could see the general attitude in Europe now might be reasonably sympathetic. He was not sure of the reasoning underlying the position of the Netherlands Bank; perhaps their effort to avoid hardening the $50 million enlargement of the line into a permanent arrangement reflected a desire to bring it under multilateral surveillance by representatives of Governments rather than of central banks. He suspected, however, that the continental lines to the U.K. would themselves eventually take on a semi-permanent character, so the Dutch might well end up having made no more than an empty debating point. Second, and more important, he thought they were worried about the objectives of U.S. policy at the moment--specifically, about the goals with respect to reforms in the international monetary system--and were not sure how the U.S. thought the swap network would fit in.

In any case, Mr. Coombs said, it had already been indicated to the Dutch on several occasions that the System would prefer not to have any reluctant partners in the network; and that, if the

Netherlands Bank should find it inconvenient to prolong the increase in the swap line, the point certainly would not be pressed. He suspected that they realized that they would attract to themselves a fair amount of unwanted publicity if it became generally known that they had withdrawn part of their credit lines to the U.S. Accordingly, he felt reasonably sure that the September increase in the credit lines with the Netherlands Bank would ultimately harden into a permanent increase. In his judgment, much the same considerations applied to the increase of $50 million in the swap line with the National Bank of Belgium. Against that background, he would like to recommend Committee approval for renewal for another three months of the $50 million increases in the two swap lines in question, if the other parties were agreeable.

In reply to a question by Mr. Mitchell, Mr. Coombs said it had already been made clear to the two central banks that the System would not concur in a renewal if they wanted to incorporate conditions in the documents exchanged.

Mr. Daane said he thought Mr. Coombs' approach was probably the right one and he would support it. As a sidelight, he would note that despite all the discussion at the previous WP-3 meeting of the desirability of initiating multilateral surveillance of the swap network in that forum, at the most recent meeting--presided over by the Netherlands delegate--no time had been allowed for the planned discussion and that fact did not seem to disturb anyone. Since the

next meeting was scheduled for January, it was obvious then that no discussion could be held before the September 1966 enlargements of the network came up for renewal.

Renewal of the $50 million enlargements of the standby swap arrangements with National Bank of Belgium and the Netherlands Bank was approved.

Mr. Coombs said his next recommendation related to the Committee's authorization of November 1965 to assume commitments for forward sales of lire up to $500 million equivalent. When the Committee authorized such operations there were several suggestions by Committee members that the subject should be re-examined if those commitments were still on the books after a year had passed. During the last few months, he had given a fair amount of thought to the matter and had discussed it with the Treasury, which also had outstanding commitments in forward lire, totaling $1 billion. If the Committee so desired, it could pull out of those operations right now without disturbance to the international financial markets or to the Bank of Italy; the U.S. Treasury would be prepared to take over the System's $500 million. As he had thought about the question, however, it had seemed increasingly desirable to him to make a distinction between the time element involved in such forward operations on the one hand and in the swap operations on the other. In the case of swap operations, it seemed to him absolutely essential to keep such credits short-term, preferably no more than six months.

Very fundamental questions of discipline in the entire international payments mechanism were involved; swap drawings were made by a deficit country in the expectation, or at least the hope, that it was dealing with a short-term situation which might be reversed either through natural forces or by corrective policy moves. Such swap drawings constituted the short end of the credit spectrum, with drawings upon the IMF and inter-governmental loans constituting the medium- and long-term segments of the spectrum. No central bank in the swap network, he was sure, wanted to see the maturities of the swaps lengthened out, regardless of whether the central bank concerned was doing the borrowing or the lending.

However, Mr. Coombs continued, forward operations did not represent debt of one central bank to another; rather, they were contracts with the market which had been executed in order to relieve market tensions. Large-scale forward operations such as the Bank of Italy had undertaken were essentially a means of lubricating the international financial machinery and, in particular, insuring that no serious disruptions occurred in the Euro-dollar market--which, as the Committee knew, had become a major source of financing for a wide variety of international trade and investment. No central bank had any direct responsibility for the Euro-dollar market, but he thought it would be highly dangerous for the central banks to treat that market as something of a free planet whose movements

could be disregarded. By shunting Italian commercial bank money into the Euro-dollar market through those forward lire contracts, the Bank of Italy had acted to relieve a stringency in that market in the same sense that the Federal Reserve or any other central bank would buy Treasury bills to relieve pressures in its domestic market.

If that analogy had any validity, Mr. Coombs said, he was inclined to think that the Committee should not be rigid insofar as the time element in such forward operations were concerned. To him, the essential issue rather seemed to be whether the operation in question was performing a useful function; if so, it should not be abruptly terminated because it reached some arbitrary maturity date. In that connection, he might also note that none of the European central banks which had engaged in such forward operations--and that included the Germans, Swiss, Dutch, and British as well as the Italians--had applied to such forward operations the same time limits they would attach to central bank swap operations. He would, therefore, like to recommend to the Committee that the System's present commitments in forward lire be continued on the books, subject to further review in three or six months. He would hope that the progressive reduction of the Italian balance of payments surplus which had been going on this year would continue and that in the new year opportunities would arise for liquidation of a substantial

portion, if not all, of those commitments. In that connection, he might mention that he had secured the agreement of the U.S. Treasury to allow the System priority over the Treasury in liquidating its commitments insofar as market opportunities permitted. There was, of course, no risk to the System in the forward lire operations.

Mr. Daane expressed the view that the Committee should continue the present authorization for forward lire commitments and plan on reviewing those operations in three months.

Mr. Mitchell noted that Mr. Coombs had suggested the possibility of some reduction in the outstanding commitments, and asked whether the latter would spell out his expectations in that regard.

Mr. Coombs replied that growth in the commitments had slowed almost to zero. The real key to the outlook for them lay in the Italian balance of payments situation. They had a heavy surplus in 1965. This year, however, their surplus had been at hardly more than half last year's rate, and their recent disastrous floods might accentuate the trend toward balance. Secondly, the Italian payments position tended in general to be highly volatile. Accordingly, he would not be surprised to find them in heavy deficit in 1967 or 1968.

In reply to a question by Mr. Hickman, Mr. Coombs said that the swing in the Italian balance of payments could easily be large

enough to permit liquidating all of the forward lire commitments of the Treasury and the System.

Mr. Maisel said he had no specific objections to the course Mr. Coombs recommended. However, he still felt as he had when the subject was originally discussed in November 1965; the Committee was making a major decision on an ad hoc basis. Along with the Treasury, the System was underwriting $1-1/2 billion of the $9 billion Euro-dollar market. Why that particular part of the market? What should the reaction be if it were proposed to underwrite the whole market? It seemed to him that a basic study of the System's role with respect to the Euro-dollar market was needed.

Mr. Coombs agreed that a staff study of the type Mr. Maisel mentioned was desirable. On the substantive question, he would repeat that no central bank had specific responsibility for coping with the problems that arose in the Euro-dollar market, and one could only hope that central banks would attempt to cooperate informally to minimize the dangers. As he had indicated, he was inclined to think that to a large extent such forward operations should be viewed as the international equivalent to central bank operations in domestic markets. The record seemed to suggest that this was a painless way for the System to join with other central banks in dealing with the problem of restoring liquidity to the Euro-dollar market. In addition, the operations of the Bank of Italy were a

good object lesson to other central banks on desirable international behavior under conditions of payments surpluses.

Mr. Daane said that similar questions had arisen in the meetings in Paris last week. He thought a review of the System's role in the Euro-dollar market was justified.

Chairman Martin noted that no objections had been raised to continuing the System's forward commitments in Italian lire at present. He suggested that the Committee plan on reviewing the matter again in three months, and that the staff proceed with a study along the lines of that Mr. Maisel had suggested.

Mr. Coombs then said he would like to mention that during the past few months there had been suggestions from the National Bank of Denmark and the Bank of Norway that they would welcome an opportunity to join the Federal Reserve swap network. One reason those countries had not been included earlier was the fact that neither had so far qualified for Article VIII status under the IMF regulations. He was informed, however, that it was probable that both countries would meet the Article VIII requirements early next year. In that connection, he thought it was also worth pointing out that in September both central banks joined for the first time in the credits to the Bank of England. It would be useful, in his opinion, to have staff studies of the possible desirability of including both central banks in the network, probably with relatively

small lines of credit in each case--possibly $50 million. It would be desirable, he thought, for the Committee to reach a decision in the matter fairly soon.

Chairman Martin suggested the staff prepare such studies. He added that it would be worthwhile to have corresponding studies with respect to Mexico and Venezuela, since both of those countries also were interested in joining the System swap network.

Mr. Brimmer referred to the two steps that Mr. Coombs had said might be taken if further measures were needed to deal with year-end problems in the Euro-dollar market, and asked which approach Mr. Coombs thought would be most likely. The choice might have important implications for the Committee's domestic operations, since the Euro-dollar market had been an important source of funds to U.S. banks recently.

Mr. Coombs replied that the decision between the two courses--as well as the timing of the operations and their scale--would depend largely on the market situation. If, however, the strains were serious it might be useful to follow both courses; the two types of operations together might well be more effective than either alone.

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 November 1 through 16, 1966,

and a supplemental report for November 17 through 21, 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 money market was subjected to some moderate pressure during the period since the Committee last met. As the written reports have indicated, this was mainly a reflection of increased pressure on money center banks which, for reasons we do not fully understand, appears to have been somewhat greater than has been typical in early November in other recent years. On the day following the last meeting of the Committee the effective Federal funds rate reached 6-1/4 per cent despite the injection of nearly $1/2 billion of reserves on the day and a net borrowed reserve position for the week of about $300 million. With the credit proxy showing no signs of strength, net borrowed reserves were permitted to fall still lower in the subsequent two weeks. Nonetheless, with excess reserves at a high level at country banks, the Federal funds rate remained within a 5-1/2 to 6 per cent range. Three- and six-month Treasury bill rates moved up about 20 basis points from the relatively low 5-1/4 and 5-1/2 per cent rates prevailing at the time of the last meeting, but declined sharply last Friday and yesterday as strong demand for bills developed and the temporary stresses receded from the money market. By the close of business yesterday the key three- and six-month rates were back where they were at the time of the last meeting. In yesterday's regular weekly auction the three-month rate was set at 5.25 per cent and the six-month rate at 5.50 per cent.
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> Dealer financing rates at New York City banks touched a new high of 6-7/8 per cent for new money before receding again prior to last weekend. Dealers were able to find financing out of town at lower rates, however, and were not under pressure to liquidate inventories which had been built up as dealers took on issues involved in the Treasury's November cash refunding and increased their holdings of longer bills. Despite the fact that prices of the new notes offered by the Treasury had fallen below par before the November 15 payment date, dealers tended to view their still substantial holdings as a good investment for the

longer pull. They were not anxious, however, to build up their holdings further and backed away from modest selling by some speculative holders. Both new issues moved above par bid in yesterday's strong bond market. As far as bill holdings are concerned, the dealers are expecting heavy seasonal buying by the System over the next few weeks. While dealers had no major financing problems over the period, the high cost of money remains a serious concern to them and has, of course, made them unwilling to hold short-term bills, thus aggravating market shortages.

Perhaps the most significant development since the Committee last met has been the resurgence of demand in the capital markets. As you will recall, a considerable feeling of confidence had built up in the bond markets at the time of the last Committee meeting. There was no rush of borrowers into the market and corporate and municipal dealers had willingly increased their portfolios. Since then a steady stream of announcements of additions to the new financing calendar--headed by the A.T.&T. issue set for early January--has introduced a new note of caution and long-term interest rates have moved higher. The long markets were also affected by rumors that the Federal National Mortgage Association might come to the market with participation certificates before year-end, and by the continuing uncertainty about the likelihood of fiscal policy action. At the moment the market is rather delicately poised and much will depend on the stream of economic news and on Administration tax and spending decisions that could be forthcoming before the next meeting of the Committee.

The Treasury has about completed its 1966 financing program. The November refunding is now just about out of the way, although final distribution of the new issues is by no means complete, and $1.2 billion of new money was raised in a highly successful bill strip auction last week. All that remains is an auction of $1 billion or so tax anticipation bills set for early December.

Looking ahead to the rest of the year there are a number of problem areas--the buildup of demand in the capital market, the Treasury's tenuous cash position which seems likely to result in direct borrowing from the System, uncertainties regarding the international flow of funds as the year-end window dressing period for European banks approaches, and the continued pressure that CD attrition has been putting on money center banks. The movement of short-term interest rates is of course of crucial importance in

determining the likely CD runoff between now and the end of the year. At the current level of Treasury bill rates the banks might well be able to handle their very large CD maturities without undue problems. Given the large banks' heavy dependence on the Euro-dollar market, and the possibilities they have of switching from that market to the Federal funds market, it could be difficult to bring the Federal funds rate much lower on a consistent basis than it has been lately without a massive injection of reserves. While a loss of Euro-dollar deposits does not necessarily mean a loss of deposits in our banking system as a whole there is apt to be considerable churning if banks with large basic deficits have to make up Euro-dollar deposit losses. Mr. Coombs has already noted the international complications of this situation.

The uncertainties about the Treasury cash position and the international flow of funds make the forecasting of likely interest rate movements in the weeks ahead a highly risky proposition. The blue book1/ notes that current estimates of a need to supply about $1 billion reserves by early December could be substantially reduced--or the position could even be reversed--if direct Treasury borrowing from the System reaches substantial proportions. Open market operations will, of course, have to be adapted to meet the situation as it develops day by day, but it may be difficult to achieve pinpoint control of the reserve situation. In addition, a frustration of dealer expectations of heavy System bill purchases could lead to upward pressure on bill rates. Some offsetting demand may result from sustained private buying and foreign central bank purchases, but such demand might well be concentrated on shorter bill maturities where there are already acute market shortages. If such a situation should develop, it might be useful for the System to engage in Treasury bill swaps--selling short bills that are in demand and taking longer bills from dealer positions. I would be prepared, if the Committee agrees, to undertake such swaps over the coming weeks if unsettled market conditions in the longer bill maturities appear to warrant them and provided that the market wants shorter bills at about current rates.

Returning to the likelihood that the Treasury will borrow from the System, there are some technical problems that require the Committee's attention. As you know, direct borrowing by the Treasury from the System is limited by law to $5 billion. The continuing authority directive

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

> authorizes and directs the Federal Reserve Bank of New York to purchase for its account directly from the Treasury, with discretion to issue participations to other Reserve Banks, special short-term certificates of indebtedness only up to $500 million. We have been working with the Treasury to try to determine what their needs might be; current guestimates--which are far from precise--range from about $100 million to around $600 million--with the maximum need beginning in early December. While these estimates may be too high, I believe--to be on the safe side--that the Committee should increase the maximum amount of short-term certificates that may be held at any one time by the Federal Reserve Banks from $500 million to $1.0 billion.

Mr. Daane said it was his impression that some of the recent pressures in money markets were due to maldistribution of reserves toward country banks. He asked whether that situation was in process of being corrected.

Mr. Holmes replied that the maldistribution already had been largely corrected. A flow of reserves from city to country banks seemed to be a phenomenon characteristic of early November, although it was larger this year than in past years.

Mr. Daane then asked whether the Manager expected Treasury bill rates in coming weeks to reflect the upward pressures that were usually experienced near the end of the year.

Mr. Holmes replied it was particularly difficult now to say what would happen to bill rates because there were forces working in both directions. As he had indicated, there would be upward pressures if reserves were supplied by means other than the System purchases of bills the market expected. On the other hand, rates had declined sharply in the past few days as a result of strong demands.

Mr. Daane asked whether Mr. Holmes would characterize present money market conditions as somewhat easier than they had been recently, and Mr. Holmes replied affirmatively. He would anticipate that the money market would turn very easy today unless pressures developed from some unexpected source. While it was too early to say what the level of net borrowed reserves would be for the current statement week the Desk was now looking at a figure well below $200 million.

Mr. Mitchell asked what level of bill rates would be required to permit banks to expand their outstanding CD's to offset a reflow of funds to the Euro-dollar market in a volume of, say, $400 million.

Mr. Holmes replied that while such judgments were difficult to make he thought the bill rate probably would have to be somewhat lower than it was now.

Mr. Brimmer asked whether the bill rate might have to drop as low as 5 per cent, and Mr. Holmes replied that he could not be sure.

Mr. Ellis asked Mr. Holmes if there would be any rate objectives in the proposed market swaps of short bills for long.

Mr. Holmes said that pressures had begun to build up in longer-term bills recently. The expected demands from foreign central banks, and perhaps other sources, probably would be concentrated in the shorter-term area where supplies were limited. If that occurred he thought it would be useful for the Desk to feed short bills into the

market and take out longer bills. There would be no particular rate objectives to the operation; the purpose would be to relieve pressures.

Chairman Martin asked whether the Manager was proposing a balanced operation.

Mr. Holmes replied in the affirmative. He added that if Treasury actions and perhaps also the System's foreign currency operations supplied reserves over the rest of the year there would be much less to be done through domestic open market operations than the projections implied. That might well affect expectations and produce a turnaround in bill rate movements. That would not be particularly desirable at a time of seasonal churning in the market.

Mr. Hickman remarked that one aspect of the proposal he found puzzling was that dealers did not have many longer-term bills available for sale at present.

Mr. Holmes agreed that that was the case at the moment, but noted that such bills would be coming back to dealers as outstanding long-term repurchase agreements matured. Such RP's would be running off all through December, but particularly around the middle of the month. They had been scheduled in that way precisely because dealers had expected seasonal buying by the System in December.

Mr. Hickman then commented that the one-month bill was closely competitive with negotiable CD's of banks, and he did not think the System would want to operate in a manner that would put rates on those

bills under upward pressure. It would be desirable, he thought, to give the banks ample room to retain their outstanding CD's, and he would be dubious about selling too many bills in the short-term area.

Mr. Holmes agreed, and indicated that he would propose to engage in the operation only if it could be carried out without too much effect on short bill rates.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period November 1 through 21, 1966, were approved, ratified, and confirmed.

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

Mr. Koch made the following statement on economic conditions:

> In my view, domestic nonfinancial developments now confirm more clearly developments discernible earlier in the financial area in suggesting an appreciable slowing down in the rate of expansion in total economic activity. The average annual rate of real growth in the GNP for the past two quarters combined, for example, is now estimated at less than 3 per cent. Moreover, the pattern of GNP revisions seems now to be becoming one of downward adjustments in contrast to the upward revisions typical when the economy is in a vigorously expanding phase. Right now, for example, recent weakening in housing starts and auto output suggest our current fourth-quarter GNP estimate, made before these developments were reported, may prove too high.

Growth in industrial production has also slackened markedly since August, with the 0.3 per cent rise in October being due largely to a sharp spurt in auto production to a level from which it has already been cut back. Employment growth continues to be sizable, but the rise since mid-year has been less than earlier.

Turning to the recent spending proclivities of the major sectors of the economy, consumer outlays have been sluggish for some months now. When one makes allowance for larger tax payments and higher prices, real consumer disposable income and spending have both only increased at around a 2 per cent annual rate thus far this year. Although earnings of factory workers are rising by more than 4 per cent, and recent wage settlements are averaging around 5 per cent a year and have resulted in higher labor costs, from the wage earners' point of view the lion's share of these wage increases has been absorbed by higher consumer prices and has not been available for purchases of additional real goods and services.

One of the sharpest and earliest drops in consumer spending, of course, was that for new housing. As a result, housing starts fell to a 1.1 million annual rate level in the third quarter and then plummeted to around the 850,000 level last month. New permits for future starts declined only slightly further in October, but they were already very low.

Consumer outlays on furniture and major appliances have also weakened, reflecting in part the decline in housing expenditures. Moreover, public reception of the 1967 model autos to date has not been overly enthusiastic. Only consumer spending on nondurable goods and services is continuing apace, and for both categories higher prices have been accounting for a significant part of the increase in dollar purchases.

The course of future consumer spending will depend in large part on the spending decisions of business enterprises and governments which help generate additional consumer income. Turning to business spending first, it, too, now has undoubtedly passed the point of maximum rate of increase. The rate of inventory accumulation dropped substantially in September at manufacturers and outstanding stocks actually declined at wholesalers. Total retail inventories were up in September, but the rise was due entirely to an increase in auto stocks. Auto stocks rose again in October to a point sparking the production cut-back

I noted earlier. Surveys of business firms and purchasing agents suggest over-all inventory accumulation is likely to taper off further in the coming months.

New orders for durable goods declined rather sharply in October following the brisk run-up the month before. New orders have shown no increase on balance since spring. Several private surveys now also suggest a sharp retardation in business spending on new plant and equipment some time in 1967. If one takes into account the level such spending is already reaching in the current quarter, real business spending on plant and equipment may already be near its peak for the current investment boom.

Unfortunately, I can add little today to your knowledge about the likely course of defense spending. All I can say is that it seems to me unlikely that the increase in such spending in coming quarters will exceed on average the large $4.2 billion rise of the third quarter, partly because $0.5 billion of the third-quarter rise was due to the one-time effect of the military pay increase. Our staff guess of the increase in defense spending in the current quarter is $3.5 billion. When one assesses the likely effects of future defense spending on total economic activity, he should note that effects start when orders are placed and that the large third-quarter rise in defense spending was at a time when the increase in total activity in the economy was moderate and when inflationary pressures were becoming less obvious. It is likely to take a goodly increase in aggregate Government spending next year just to offset the smaller likely rise in spending by the private sectors of the economy.

As for the significance of these demand developments for resource use and prices, the rate of utilization of manufacturing capacity no doubt dropped off a little in September and October as new capacity continued to be put in place at the earlier pace and as growth in output slowed markedly. You will have noted from the green book[1/] that revised data on capacity utilization have been developed. These data show that a high rate of utilization has prevailed in recent quarters but the level of utilization has been revised down a little for many years back.

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

The unemployment rate has remained just under 4 per cent in recent months due to the fact that a reduced labor force growth has approximately matched the reduced rise in employment. Average weekly hours of work have dropped off a little, too, but remain high.

Over-all industrial prices have been little changed now for several months. A drop in sensitive prices has concealed a rise in prices of other industrial goods in the total index since May whereas earlier a sharp rise in sensitive prices had hidden the relative stability of prices of other commodities in the total. In any case, over the past year as a whole, industrial prices have risen about 2 per cent, an accomplishment that most other industrial countries would no doubt have been happy to have emulated.

There will be some further upward pressure on over-all industrial prices in the months to come if wage increases continue in the 5 per cent annual-rate area, and if the decline in sensitive material prices ceases. Incidentally, the Census Bureau has recently revised its data on labor costs in manufacturing to show a sharper recent increase than had been indicated by the earlier data. But some further wage, labor cost, and price inflation may be an unavoidable result of past excesses. They probably cannot be averted without a degree of over-all restraint on the economy that would produce a recession.

Three weeks ago I said that domestic financial developments suggested to me that the time had come for a further relaxation of monetary restraint. Today, I feel that nonfinancial developments suggest the same course of action. Monetary policy has achieved the moderation in the upward thrust of aggregate demand it has been seeking. Policy should now be adjusted in a timely manner lest we be saddled with the blame for overstaying the boom.

Mr. Hickman commented that he thought Mr. Koch's presentation was an excellent one. He then asked about the specific statistical calculation Mr. Koch had used in arriving at the conclusion that both real disposable income and spending of consumers had risen at an annual rate of 2 per cent thus far this year.

Mr. Koch replied that his statement was based on the calculated percentage increases in the variables in question from the fourth quarter of 1965 to the third quarter of 1966, expressed at annual rates.

Mr. Brill made the following statement concerning financial developments:

> In assessing the economic situation for the Committee three weeks ago, I expressed some skepticism about the validity of the softening signals financial statistics had been giving us in October. While some of the preliminary nonfinancial figures available on November 1 suggested a change occurring in the underlying economic situation, I was reluctant then to accept all of the figures at full value, or to recommend more than a shading of policy in an easing direction.
>
> But as better and later figures have come in, I've had to swallow some of my skepticism and, to use a phrase hallowed in FOMC deliberation, "resolve doubts on the side of ease." The financial figures were right in signaling a major shift in activity this fall, albeit they seem to have overstated the extent of the change. While neither industrial output nor total GNP has actually contracted, as have financial flows, the production, price, and spending developments reviewed by Mr. Koch this morning all confirm that expansion of economic activity has slowed markedly.
>
> Under the circumstances, one might have expected financial indicators in November to continue to signal slackening trends in activity. Some of the financial measures have. Bank credit has continued to contract (at least on the proxy basis), and business loan growth has proceeded at only a sluggish pace. But other financial indicators have hinted at renewed pressures. After declining in late October, member bank borrowing increased through mid-November; the Federal funds rate also bounced back, reaching, at one point, a new high; and there was a surge in bank borrowing from abroad through foreign branches. These indicators of intensified pressure on the banking system were reflected throughout most money and capital markets, with both short- and long-term rates advancing by up to a quarter of a per cent. Could this be taken as a signal of resurgence in economic activity in

November? Was the late summer-early fall lull in economic activity over?

I doubt it. Nothing in the fragments we have on a current weekly basis suggests a revival in business or consumer spending such as to lead to a sharp expansion in private credit demands. Indeed, the fragments suggest further economic dampening, at best, and the behavior of financial markets in the past few days suggests that investors are coming around to this view.

Frankly, I'm not satisfied with any of the explanations as to why there was a turnaround from an easing to a tightening trend in financial figures and expectations between late October and mid-November. Analysts have attributed it variously to the build-up in the corporate calendar, the aftermath of the Treasury's November refunding, rumors of a revival of participation certificate issues, and the Administration's backing and filling on tax policy. Undoubtedly, all of these factors have contributed to uncertainty in financial markets; market participants have reacted in a predictable manner, with investors holding back a bit and borrowers pressing harder.

But let's not put all of the blame--and I use the word "blame" deliberately--on recent and prospective Treasury financings, or Administration indecision, or the usual vagaries of investor sentiment. Let's recognize that the Fed has contributed importantly to market uncertainties, in failing to give the banking system and financial markets a clearer signal of the current objectives of monetary policy. Not that we're free of uncertainty ourselves; we know precious little more than any banker or bond buyer as to what defense spending or tax policies will be. But we have observed that expansion in economic activity was slowing, and even earlier that bank credit was not expanding at a rate appropriate to the needs of the economy. We've wanted to correct this, as the continued inclusion of the proviso clause in the directive would indicate. Why haven't we succeeded?

I would argue that the failure stems in part from misplaced devotion by this Committee to the marginal reserve measure, under conditions that were bound to make it an inadequate indicator of tightness or ease in either money market conditions or bank reserve availability. Today, more than ever, the key to banking developments is the spread in interest rates between those on CD's and those on alternative investments. With rate pressures this fall forcing a shortening in CD maturities such that about

half the volume of large CD's outstanding at the end of October mature before year-end, with the rollback in ceiling rates on consumer CD's forcing a slowing in these inflows to banks, with use of the discount window made uncomfortable, and with bank liquidity already reduced, how could we expect bank management to loosen the leash on lending officers, or even refrain from security sales to finance loan commitments? Why should we be surprised at a build-up in the capital market calendar, when monetary restraint has already forced a wring-out of corporate liquidity, and tax payments are expected to accelerate significantly in the first half of 1967, and bank loans are difficult to obtain or renew? At least one large borrower is tapping the capital market soon to repay bank loans, and some of the other issues scheduled for coming months undoubtedly are to rebuild liquidity drawn down as a result of the unavailability of bank loans, rather than as precursors to a burst of capital spending.

Results such as these were legitimate objectives of policy earlier. But there's no need to carry a good thing as far or as long as we seem to be doing. By permitting a variety of forces to press bill rates back closer to CD ceilings, by limiting the possibility of banks tapping the consumer saving stream, by keeping the borrowing of reserves unattractive through retention of the September 1 letter philosophy, and--at least until recently--by providing nonborrowed reserves niggardly, we have closed off almost all of the domestic sources of bank credit expansion. There is not much logic, then, in bemoaning the failure of credit to expand. So long as there's a price at which the public will demand credit, we can achieve bank credit expansion by moderating one or more of the constraints we ourselves have imposed.

Undoubtedly, it would be advisable to wait for clarification of the fiscal situation before undertaking a major loosening of constraints. And there are balance-of-payments consequences to consider, as Mr. Solomon will be discussing in a moment. But if it is the appraisal of this Committee that the current domestic situation affords the possibility of some moderate easing in bank credit availability, I would suggest that policy and its implementation be directed toward sufficient provision of reserves so as to permit market rates to sink well below CD ceilings, overriding even the seasonal rate pressures customary in the weeks ahead. The objective

would be a pattern of rate relationships such as to eliminate the drain of funds from financial intermediaries--savings and loan associations as well as banks--without permitting the whole rate structure to fall so far as to induce massive resurgence in credit extensions.

Our knowledge of money market and bank credit interrelationships is not as well developed as yet to permit much confidence in quantifying the level of marginal reserves that would be associated with desired developments in interest rates and in the reserve and credit aggregates. The estimates advanced in the blue book--with justifiable diffidence--suggest that one consistent complex of variables might be: net reserves fluctuating around zero, 5 per cent rates on 3-month bills, and bank credit expansion in the 2-4 per cent annual rate range. This is probably as good a guess as any, although with the very recent change in financial market sentiment, these rate and aggregate objectives might possibly be reached with a milder change in net borrowed reserves than going all the way to zero. Nevertheless, there are seasonal and other pressure points ahead, as Mr. Holmes has indicated, and it would seem to me important to insure that the six-month bill rate moved down along with shorter-bill rates. Given our recent frustrations in using marginal reserve targets to achieve bank credit expansion and interest rate moderation, I would suggest putting greater emphasis on the latter variables directly as guides to the System's intervention in money markets in coming weeks.

Mr. Ellis remarked that in times past suggestions had been made at Committee meetings regarding appropriate fiscal policy in relation to monetary policy. He asked what prescription for fiscal policy Mr. Brill would have in view of his projection of a slower economic growth rate.

Mr. Brill said he could not be certain that economic growth would continue to slow until he knew more than at present about the probable course of defense spending next year. If defense spending

continued to rise at the rate the staff had guessed for the fourth quarter--and he would not be surprised if the fourth-quarter guess turned out to be on the high side--he would still favor an increase in taxes given what was known about other trends. He would add, however, that he now was less certain than he had been three weeks ago about the desirability of a tax increase.

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

> I propose to concentrate this morning on the links between monetary policy and the balance of payments, focusing on the possible repercussions on capital flows of an easing of monetary conditions in the United States. The impact of an easing here would depend importantly on what happens to monetary conditions in Europe, a subject that was discussed intensively at last week's meetings of Working Party 3 and the Economic Policy Committee of the OECD.
>
> The Committee is well aware that over the past year the deterioration of the trade balance has been more than offset by inflows of capital in response to tight credit conditions in the United States. Both the increase in imports and the inflows of capital are extraordinary and temporary--reflecting the surge of domestic spending and policy responses to it. The major forms of capital inflow have been the net repayment of U.S. bank loans by foreigners--amounting to $500 million in the first nine months of this year (partly seasonal)--and Euro-dollar borrowings by U.S. banks through their foreign branches--amounting to more than $2-1/2 billion thus far this year (part of which is also seasonal).
>
> Although these Euro-dollar borrowings are often disparaged as being "hot money" and as not affecting the balance of payments on the liquidity basis, there is no question that in a real sense these flows have relieved the U.S. balance of payments this year. Surely our balance of payments problem is mainly a problem involving official acquisition of additional dollars by Europe.

What the Euro-dollar borrowings have done is to sweep up dollars that would otherwise have gone to European central banks; to some extent these borrowings may also have diverted dollars from the U.K. Without these Euro-dollar borrowings, larger reserve gains by continental Europe would have required the United States either to draw on the IMF or sell gold, after possibly first using the swaps more actively.

If indeed the reduction in the trade balance is temporary--reflecting an income surge at home rather than a deterioration in our competitive position in world markets--it is difficult to find fault with a temporary capital inflow offsetting it.

The question to be faced now is: what will happen to these capital inflows if monetary policy eases in the United States? In this connection, one can visualize either a move toward monetary ease by itself or such a move as part of a shift in the policy mix, in which tax rates are increased. A shift in the mix that led to more housing expenditures and less business and consumer spending would provide a modest benefit to imports, in view of the smaller import content of housing. But, whether the mix is shifted or not, the major questions have to do with the response of capital flows to a change in monetary policy. What can be said on this matter?

(1) It should be noted that if banks merely stop adding to their debt to the foreign branches--without any repayments--the balance on official settlements next year will tend to worsen--from this factor taken by itself--by over $2 billion. Ideally, this cessation of capital inflow would be offset by a slackening of imports, while exports continue to increase at the recent rate. The green book suggests that we should be seeing some slowdown in import growth beginning this quarter. A reduction in import growth from close to 20 per cent annual rate to 10 per cent would help the trade balance by more than $2 billion per year, other things including export expansion remaining the same. Even this ideal outcome might involve lags such that the capital account deteriorated before the trade

balance improved. Much more serious would be a failure of exports to increase at a healthy rate. But that is a problem about which monetary policy can do little aside from its efforts to maintain domestic price stability.

(2) It is also reasonable to assume that U.S. banks, having developed this source of funds in Europe and being anxious to rebuild their liquidity, will not rush to reduce their Euro-dollar indebtedness. What goes up does not automatically come down. We may find that this source of funds to banks remains more important than in the past.

(3) The level of interest rates in the Euro-dollar market will have an important bearing on the attitude of U.S. banks toward Euro-dollar indebtedness. It is the differential between rates here and in the Euro-dollar market that counts rather than the absolute level of rates here. From the viewpoint of our balance of payments, it is desirable that Euro-dollar rates come down with short-term rates in the United States. But it matters greatly how the Euro-dollar rates are pushed down. If they fall only because U.S. banks are pouring dollars back into the Euro-dollar market, our balance of payments will suffer. On the other hand, if Euro-dollar rates decline because Europeans are demanding fewer, or supplying more, dollars to that market, U.S. banks will feel less of an incentive to reduce their Euro-dollar indebtedness.

(4) There is now some reason to think that European interest rates may decline, as the green book indicates. Two major countries, Germany and the U.K., are experiencing a distinct slowdown in economic activity. The U.K. is ready to relax its monetary policy as soon as it can do so without losing funds through interest-induced capital outflows. Much of the WP-3 and EPC meetings last week were devoted to

persuading the German authorities that, on the basis of their own reports regarding the outlook for the German economy--slowdown and possibly recession ahead--and the German balance of payments--rapidly increasing surplus--German monetary policy should be eased significantly. Such an easing of monetary policy in Germany, combined with declining credit demands there, should put downward pressure on Euro-dollar rates.

(5) As for bank credits to foreigners, it seems likely that these would respond to an easing of credit conditions in the United States with a lag and by small amounts. The desire of banks to rebuild liquidity and to meet the needs of domestic borrowers should make for a gradual resumption of new loan extensions and therefore for a gradual reversal of the present tendency toward net repayments.

(6) Thus there are reasons to expect that an easing of monetary policy here will not lead to a symmetrical reversal of this year's capital inflows. But suppose this turns out to be wrong and that next year U.S. banks do not increase their Euro-dollar indebtedness at all. This is an extreme assumption--even in 1964 and 1965, U.S. banks borrowed net from their branches, though in much smaller amounts than this year. Such a cessation of Euro-dollar borrowing would by itself bring a deterioration of some $2-1/2 billion in the official settlements balance. Following this year's surplus of about $500 million, we would have an official settlements deficit next year of $2 billion. While this year's balance of payments has looked better than we had any reason to expect, next year's balance would look worse than we have reason to expect. But taking the two years together, the average deficit on official settlements would be $750 million--better than in 1965 or any previous year of this decade. We would still have a balance of payments

> problem, but that is not surprising. We had no reason to think that the long-run balance of payments problem would solve itself. It must still be faced as a long-run problem. But meanwhile, it need not freeze the present posture of monetary policy if it appears appropriate to change that policy for domestic reasons.

Mr. Maisel asked whether the Euro-dollar transactions of U.S. banks were really of great significance to the U.S. balance of payments if a large part of the flows was to and from Britain.

Mr. Solomon replied that the impact on the British balance of payments of the Euro-dollar funds drawn in by U.S. banks this year was a point of contention between some officials of the U.S. and the U.K. There was no question but that a large volume of funds left the U.K. this summer. He suspected, however, that that outflow reflected factors of confidence, and that the funds would have gone elsewhere if they had not come to the U.S. Thus, the dollars were absorbed by U.S. banks rather than flowing to foreign central banks. More recently British reserves had been rising--although, as Mr. Coombs had indicated, not at a rapid rate--and U.S. banks might have been attracting some dollars that might otherwise have gone to Britain. But some dollars also were being drawn from the continent, and there was no way of assessing the relative importance of the two sources. Accordingly, he did not think it was safe to say that most of the funds were coming from Britain.

Chairman Martin then asked Mr. Solomon to report to the Committee on the recent meetings of the Economic Policy Committee and Working Party 3 which he had attended.

Mr. Solomon said that in general, the attitude toward the U.S. at those meetings was gentle. There was a strong awareness of both domestic and balance of payments effects of tight monetary policy. The most conspicuous cases were Germany and the United States. Mr. Ackley reported to EPC that monetary policy had restrained demand expansion by $8-$10 billion, before multiplier effects, in 1966. A general desire was expressed to end and reverse the escalation of interest rates in major countries, but in a manner that contributed to better balance in international payments. Hence the stress on monetary policy in Germany, where both domestic and balance of payments considerations pointed to the desirability of a relaxation of credit restraint. The German central bank representative resisted the suggestion that one country could swing world interest rates, but did indicate that a relaxation of policy was likely.

As for the prospects for economic activity and payments balances in 1967, Mr. Solomon continued, it was expected that both Germany and the U.K. would experience slower expansion. For both countries recession was possible next year. On the other hand, Italy, France, and Japan were likely to experience faster expansion. The French representative stated that the recent fall-off in the

French balance of payments surplus was more than a transitory development. What seemed to be happening was that French imports were accelerating with domestic expansion, while exports had fallen off as a result of the slowdown in Germany and the U.K. Thus, part of the French surplus had been absorbed by domestic expansion and part was being shifted to other countries. Also, there had apparently been some capital outflow in response to short-term rates abroad.

Mr. Solomon said that WP-3 had held a frank discussion in a restricted session in which the Europeans let their hair down regarding the future of the international payments system. They reiterated a well-known continental view that European official dollar holdings should not increase in total, although the dollar holdings of individual countries could swing up and down with shifting payments balances. In fact, European dollar holdings had declined by $1-1/2 billion in the past two years. Thus, the Europeans recognized that the U.S. had been financing its deficit not as a reserve currency country but no differently from non-reserve currency countries--by using its reserve assets.

The second major point in that discussion, Mr. Solomon observed, was a recognition of what was called the "collective responsibility" of the gold-holding countries to avoid destabilizing the system by converting existing dollar holdings into gold. Although the means of implementing that responsibility were not

clearly at hand, it was recognized in a constructive way. The entire discussion was clearly a condemnation of French policy and of "Rueffism."

Finally, Mr. Solomon said, the discussion of swap arrangements that had been initiated at the September meeting of WP-3 was put off until January of 1967, as Mr. Coombs had indicated.

Chairman Martin then invited Mr. Daane to comment on the developments at the recent meeting of the Group of Ten Deputies.

Mr. Daane said he would first add one or two observations to Mr. Solomon's report. Some of those around the table at the EPC meeting--including Mr. Ackley of the U.S. delegation--urged that the Germans consider fiscal as well as monetary policy actions in moving to relax economic constraints. Secondly, the Italians thought their balance of payments surplus this year might be on the order of $450 million, but that estimate did not allow for the impact of the recent floods.

Turning to the Group of Ten Deputies' meeting, held in Paris on November 16, 1966, Mr. Daane said that it was concerned largely, if not entirely, with procedural questions, including the physical and other arrangements for the first joint meeting with the Directors of the IMF. That meeting would be held at the Fund in Washington on November 28 and 29, 1966. Formally, the meetings would be chaired jointly by the Managing Director of the Fund and the Chairman of the

Deputies, but in practice it was expected that Mr. Schweitzer would preside over the meetings held in the U.S. and Mr. Emminger would preside over the alternate meetings held elsewhere. Those attending would be the Executive Directors of the Fund and their alternates; the Deputies of the Ministers and Governors of countries participating in the General Arrangements to Borrow (two persons per country) and their alternates; the Managing Director and Deputy Managing Director of the Fund and members of the IMF staff designated by the Managing Director; and, finally, observers from Switzerland, the BIS, and the OECD.

As to the agenda for the first joint meeting, Mr. Daane continued, the Deputies developed a draft which was later amended in discussions between Messrs. Schweitzer and Emminger. It was now generally agreed that the agenda should include five items, as follows: the aims and objectives of reserve creation, including the need for reserves and its relationship to adjustment policies and the supply of conditional liquidity; the nature and form of deliberately created reserves, including their financing; distribution of deliberately created reserves; utilization of new reserve assets, including conditions for the transfer of new reserve assets and for assuring the acceptance of these assets; and conditions and circumstances of activation of a contingency plan. With respect to each topic, one or more Deputies would take the lead in setting forth the views of the Deputies within the framework of the report they issued in August 1966.

Mr. Perouse of France offered to take the lead on the first item, but it was agreed that he would be joined by Mr. Deming of the U.S.

Mr. Daane went on to say that the Deputies agreed to hold a meeting of their own immediately following the joint meeting in Washington to consider their work program. One possibility discussed was that of appointing small task forces from among the Deputies, alternates, and members of the secretariat to do advance work on those problems the Deputies regarded as being within their orbit, including the problems of lessening possible strains on the international monetary system and the question of the future role of gold.

Mr. Daane concluded by noting that the second joint meeting with the IMF probably would be held in London in the latter part of January 1967.

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:

> There is no doubt that in recent weeks the state of the economy has become more complex and subject to more uncertainties than was true a few months ago. After many months of almost uninterrupted exuberance, we now find clear signs that the pace of the expansion has become less rapid. Perhaps it is only natural that this change should give rise to doubts whether the uptrend can be sustained at all, or whether we are close to an actual business recession; but on careful analysis, I find no basis at all for such a pessimistic conclusion, at least short of a major turn-around in Vietnam developments,

of which we have no convincing evidence whatever. And, after all, a basic objective of our policy in the past year or more has been precisely to slow an excessively rapid growth in aggregate demand.

Economic activity continues to expand. Given the probability that defense spending will be moving up strongly through next year, inflation--both demand-pull and cost-push--remains a serious threat. It is interesting to observe that even the more pessimistic forecasters of 1967 GNP seem to assume without question a continuing price rise on the order of 3 to 3-1/2 per cent per annum. Certainly there is no reason to accept such a rise with complacence.

A good deal of stress is being placed by the pessimists on the likelihood that plant and equipment spending will rise only very moderately in 1967, after a 17 per cent increase in 1966. In our Bank we believe that, as in many recent years, the McGraw-Hill figure of 5 per cent will probably turn out to be too low. We would expect an actual increase closer to 10 per cent, even after taking full account of the dampening effects of the suspension of the tax credit and accelerated depreciation, and of the significant impact of tight money on capital spending plans. As for consumer spending, this does seem to be losing some of the extra buoyancy it had shown earlier in the year. For one thing, the rate of private saving has been lower than the long-term average in the first three quarters of this year, and it appears that a rise may now be taking place. Nevertheless, as long as personal income is increasing at a substantial pace, as it is, I believe that reasonably well-sustained consumer spending will no doubt provide a strong underpinning for the economy.

According to our estimates of fiscal impact of the Federal budget, the latter is providing a sizable stimulus to the economy in the current half-year, and the stimulus will still be large in the first half of calendar 1967. With the prospect of a Federal budget deficit in the current fiscal year of about $8 billion or more, whether figured on a cash or on an administrative basis, I find it hard to understand, on any economic grounds, the Administration's reluctance to request a general tax increase in the very near future. Such an increase could easily be rescinded if economic developments should take a serious turn for the worse some time in the coming year.

While the wholesale price indices have been behaving quite well in the last few months, the outlook for labor costs is anything but encouraging. The 5 per cent pattern set in several recent major settlements now seems to be regarded as a probable minimum for next year's important negotiations, and much more ambitious demands seem to be in the making in many industries. I was shocked, in a recent talk with Governor Rasminsky, to learn of the extreme magnitude of recent labor demands beyond our northern border.

Turning to the balance of payments, we find a disturbingly large underlying deficit temporarily obscured by special transactions, including large placements of foreign short-term funds in longer-term time deposits and U.S. agency obligations--many of these being in the nature of "window-dressing" transactions. And the reduced liquidity deficit that remains has been more than adequately financed by the massive inflow of Euro-dollars through the foreign branches of American banks--a flow which is bound to slacken and may well be reversed in the coming months. Meanwhile the trade surplus, which is the major hope for ultimate payments equilibrium, has been deteriorating substantially. Under such conditions, even though the rate of import expansion may decline with the slowdown in domestic business growth, the prospect of considerable cost inflation is ominous indeed.

In the credit area, we do see further evidence that the System's restrictive policies have significantly slowed the expansion of bank credit. Indeed, the actual decline in bank credit, as measured by the credit proxy, in the past 3-1/2 months might even suggest that we have gone too far in this direction. But in view of the fallibility of all of our seasonal adjustments, especially in the light of the altered tax payment schedules in effect this year, I think it would be unwise to lay too much stress on the statistical showing of three or four months. In somewhat longer perspective, the reduction in the annual rate of bank credit growth to 5.6 per cent in the first ten months of 1966 from somewhere around 10 per cent in 1965 seems to me a gratifying achievement. And it is well to bear in mind that total credit flows through the economy have not been reduced nearly as sharply as the bank figures might suggest. Furthermore, the heavy calendar of corporate

bond offerings suggests that credit demands remain very high.

Under all these circumstances, both domestic and international, I can see no basis for making an explicit change at this time in our basic policy of credit restraint. While there is always a risk of overstaying a policy of tightness, I believe we would face an even greater risk if we were to relax policy too much too soon. There is still no assurance that fiscal policy will be moving soon to support our efforts to contain inflationary pressures, and it would seem to me unwise to consider easing monetary policy significantly before vital fiscal decisions have been made by the Administration. Since none of us has wanted to achieve an absolute cessation of bank credit expansion, I would be willing to see doubts continue to be resolved on the side of ease, if staff expectations of further declines in bank credit and related aggregate measures over the rest of the year actually materialize.

Given the stresses and strains that can come to bear on financial markets between now and the year-end I believe that a great deal of flexibility will be needed in the conduct of System open market operations. The Manager will have to work in terms of the feel of the market, with due attention to the Federal funds rate, the bill rate, and dealer lending rates. Our experience of the last two weeks demonstrates pretty clearly that net borrowed reserves are a rather unreliable indicator of credit conditions, especially under present circumstances. Nevertheless, the net borrowed reserve statistics receive so much public attention that we run some danger of a misinterpretation of our policy, i.e., an impression that we have moved to a significantly easier policy. Thus, I would hope that net borrowed reserves would tend to be closer to $300 or $400 million than to $200 million, provided that those net borrowed reserve figures turned out to be consistent with a comfortable money market. I think the Manager should continue to pay close attention to the various measures of bank credit and liquidity. And I would be quite happy to see some weakening of interest rates attributable to further cooling of demand pressures. But I am fearful that we are not likely to see a sufficient slackening of demand pressures if a tax increase is not forthcoming. Hopefully we will know more about this by the time we next meet.

As far as the directive is concerned I would prefer alternative A as presented by the staff.[1] If aggregate measures prove to be as weak as the staff now projects, this would, as I interpret it, mean some modification of operations to permit somewhat more confortable conditions in the money market. The net results would probably not be far different from the thrust of alternative B, but I think it unwise to commit ourselves to an overt policy of less restraint until some decisions have been made on fiscal policy.

Mr. Lewis reported that the boom had apparently lost some of its strength in the Eighth District. Spending might be slowing; the volume of check payments changed little from July to October after going up 12 per cent in the previous year; business loans at large banks had also been about unchanged since July. Real output might be expanding less rapidly in the District as many sectors had reached capacity. Payroll employment had risen at a 2 per cent rate since June after growing 4 per cent in the previous twelve months. There had been little change in nonmanufacturing employment since mid-year.

Nationally, Mr. Lewis said, it could now be seen from the recent revisions of the national accounts figures that total spending on goods and services rose about 7 per cent from the first to the third quarter. By comparison, outlays had gone up at a 9.5 per cent rate from late 1964 to early 1966. He thought that that

1/ Alternative draft directives proposed by the staff for consideration by the Committee are appended to these minutes as Attachment A.

apparent slowing in the growth rate of total spending had been desirable, with the economy operating at capacity and inflationary pressures building up. The abrupt change from rapid expansion in bank reserves and money to contraction beginning last spring had probably contributed to the slower growth in total demand in recent months in spite of a stimulative budget situation.

Despite that apparent slackening in the rate of growth of total demand, Mr. Lewis remarked, price increases this year had accelerated. The general price index went up at a 3.8 per cent rate from the first to the third quarter as against a 2.1 per cent rate from late 1964 to early 1966. He was fearful that the basic price trends were still strongly upward.

Real output, which had risen at a clearly unsustainable 7 per cent rate from late 1964 to early 1966, had since increased at a 3 per cent rate, Mr. Lewis continued. The 3 per cent rate of gain in real output was probably less than the long-run potential of the economy; yet, during the period of acceleration of production for defense at the expense of civilian goods that might be the necessary growth rate. Furthermore, acceptance of a 3 per cent growth rate might be desirable in the short-run in order to bring under control the strong inflationary pressures.

As to policy, Mr. Lewis believed the marked change from rapid monetary expansion to some monetary contraction beginning

last spring had been desirable and had probably been a significant factor in moderating total demand. Total member bank reserves and the money supply had both declined at a 2 per cent rate since last April. He thought it would be a mistake to permit such declines in bank reserves and money to continue at this time. In the past two or three months it appeared that the monetary contraction had not been the Committee's intent. Initial projections had repeatedly been that the stock of reserves and money would rise; yet, after the fact, declines had occurred. As a result of some recent weakness in loan demand, net sales of Governments were required to prevent greater declines in interest rates. Monetary contraction acted as a drag on both spending and credit demand, and lessening of credit demand in turn tended to cause further unplanned monetary contraction.

For the near future, Mr. Lewis suggested that the System take the action needed to avoid a further decline in bank reserves and money. On the other hand, since inflationary pressures were present, he thought that any rapid expansion of those magnitudes should also be avoided. Interest rates and net borrowed reserves might properly be allowed a relatively wide range of movement in response to changing credit demand. As to the directive, Mr. Lewis preferred alternative B.

Mr. Patterson reported that the economic data that had become available for the Sixth District since the last meeting of the Committee confirmed the previous appraisal that the economy of the area was proceeding at a slower pace than earlier in the year. In some sectors of the District the behavior was better than nationally, but even in such cases the performance exhibited no great exuberance. Contrary to national developments, total construction contract volume continued to run slightly ahead of last year, but the volume of residential construction was now feeling the pinch of the money shortage and rates to a much greater extent, and construction employment continued to trend downward. Early November reports on automobile sales suggested that sales continued below last year's, and the behavior of consumer credit statistics reflected that development.

Continuing, Mr. Patterson commented that the latest loan statistics for the Sixth District gave additional evidence of a changing pattern of lending. Loans at large weekly reporting banks declined sharply during the final week of October and had shown only slight increases during the first two weeks of November. In most years the loan increase was fairly large in November. No major type of loan showed any expansionary strength at those banks. At all Sixth District member banks seasonally adjusted loans in October changed little from September, and total loans and investments declined slightly. He found no clear-cut answer from bankers

as to whether or not current loan trends resulted from a deliberate tightening of lending by the banks or changes in the demand for loans stemming from changed economic conditions. Apparently some of both were occurring, from what bankers told him. Bankers reported not only more restrictive practices but also a less frantic demand for bank loans. Certainly, he concluded that, so far as his own District was concerned, the demand for bank loans was no longer accelerating, as it had been earlier this year, even though credit demands might still be high.

Turning to the national scene, it seemed clear to Mr. Patterson that total credit demands were still high. It also seemed clear that there was considerable difference between conditions now and those prevailing only a short time ago. Then credit demands were accelerating, and the nonbanking economic data helped explain the cause of that acceleration. Now credit demands were apparently not accelerating, and the economic data such as statistics on industrial production, retail sales, employment, and prices did not provide evidence that credit demands were growing faster than productive capacity. On the other hand, the behavior of the aggregate reserve and the money supply figures suggested that System policy had had a major influence on maintaining the high level of rates, for rates were still extremely high although they might be lower than two months ago.

Under those conditions, Mr. Patterson said, a policy posture that was appropriate during the period of accelerating demands for bank credit was no longer appropriate. On the contrary, a less restrictive policy seemed to be in order. If policy were to be measured solely by net borrowed reserve figures of the past two weeks, it could be concluded that policy had indeed eased. Nevertheless, banks continued under extremely strong pressures, as evidenced by the continued high level of borrowing and the constraints imposed by recent trends in time deposits. He believed that the Committee should try to prevent a further drift downward in the seasonally adjusted reserve figures and the money supply. He would also like to have the Committee place itself in a position that might be quickly reversed if the same sort of conditions that prevailed a few months ago reappeared. A move toward greater ease at the present time should be in the nature of a probing operation and might be accomplished by aiming toward a net borrowed reserve figure below $200 million.

Mr. Bopp said evidence was growing that inflationary pressures might be subsiding somewhat. One could not fail to be impressed by these facts: the decline in total construction expenditures, in physical volume to the extent of about 5 per cent below a year ago; the slowdown in accumulation of inventories and a rise in the inventory-sales ratio; the slower increase in industrial production; the small increase in capital expenditures

now planned for 1967; and the stability of wholesale prices in October. It appeared that the upward pull of demand on prices was weakening.

But even though business expansion might be losing some of its steam, Mr. Bopp continued, upward pressures remained. The backlog of manufacturers' new orders for durables continued to grow. Both defense spending and capital expenditures were expected to rise at about current rates for the remainder of this year. Growth in personal after-tax income should provide strong support for consumer demand. Wage settlements continued to show increases well above the guideline. Thus, the cost-push effect on prices could offset any weakening in demand-pull.

Financial markets also reflected mixed trends, Mr. Bopp said. One that should be watched carefully was the slow downward movement of total bank credit and the money supply. Liquidation of investments had exceeded loan expansion; however, total loans and business loans had been rising at a slower rate. He had been unable to determine to what extent slower loan expansion reflected more restrictive bank lending policies or weaker demand resulting from earlier anticipatory borrowing and a slower rate of inventory accumulation.

Looking ahead, however, the demand for funds in the capital market seemed to Mr. Bopp likely to be strong during the remainder of the year. Perhaps some of the larger volume of offerings for December reflected a spill-over from restrictive bank lending

policies; but regardless of the reasons, the likelihood was good that private demand, possibly augmented by some agency offerings and participations, would tend to force yields higher.

As he summarized those various developments, Mr. Bopp observed, the situation appeared more encouraging than alarming. The economy seemed to be moving toward a more sustainable rate of growth instead of either runaway inflation or recession. As for policy, he would favor supplying sufficient funds to meet the large anticipated demands in the capital market and CD runoffs and would put more emphasis on preventing a rise in rates and arresting the decline in nonborrowed reserves and bank credit than he would on net reserve positions. Alternative B of the draft directives, as interpreted in the notes attached, would be appropriate.[1/]

1/ The note to which Mr. Bopp referred read as follows: "The reference to 'somewhat easier conditions in the money market' might be interpreted to call for the money market conditions described in the second full paragraph on page 5 of the blue book. As indicated in the following paragraph on that page, these money market conditions cannot be counted on to result in an appreciable expansion of bank credit before year-end. The proviso clause is worded, however, to guard against unforeseen expansion at a 'rapid' rate. Recent Committee commentary might suggest about a 10 per cent growth rate as an upper limit."

The blue book paragraph (second full paragraph on page 5) mentioned in the note read as follows: "It might well be necessary, however, to move net borrowed reserves to a shallower level than has prevailed in the past two weeks in order to keep bill rates from rising much above current levels. Under such conditions, the Federal funds rate would be likely to drop to a level averaging closer to 5 per cent, dealer financing costs should decline further, and dealers would find it more comfortable to finance their inventories--not only of bills but also of coupon issues. These developments would also tend to moderate rate pressures in long-term markets, as expectations of monetary easing took hold."

Mr. Hickman commented that there was now little doubt that the pace of economic expansion moderated in the third quarter and through October. Confirming evidence included the downward revision in GNP, the slight decline in corporate profits, the further drop in construction outlays, the reduced rate of increase of business inventories and employment, some leveling tendencies in retail sales, and four months of stability in the index of wholesale industrial prices. The theme of moderation had permeated the discussion at the November meeting of the Cleveland Reserve Bank's Board of Directors. It was then pointed out that machine tool buying seemed to have passed its peak, and that delivery schedules in that key industry were shortening. Less optimism in the auto industry was reported, and steel companies were lowering their estimates of fourth-quarter shipments.

The evidence did not suggest to Mr. Hickman that a recession was approaching but, coinciding with the widely-discussed surveys of plans for new plant and equipment spending in 1967, signs of moderation could not be ignored. Moreover, the Committee should recognize that a large part of the gain in real product that had taken place in recent months had been due to defense spending, and that the behavior of the private sector had been weak. Analysis of the industrial production index, for example, suggested that the weights of those components that had been posting successive new

highs during recent months accounted for only about one-third of the total. Most of the steady risers were defense-connected.

Financial developments bore out the change in the business climate, Mr. Hickman said. An informal survey last week of important Fourth District banks revealed a recent general softening in the demand for business loans. Applications for new loans were fewer, and some earlier commitments were not being taken down. Opinion was divided as to whether those commitments would be activated later this year.

Before turning to policy, Mr. Hickman said, he would like to remind the Committee once again of the lack of adequate information for the design of appropriate policy. Inventories were an obvious gap in the Committee's knowledge, as indicated by the fact that two-thirds of the revision in third-quarter GNP was in the inventory component. Such information as was available on defense spending was almost useless until well after the fact; a significant part of the $1.7 billion difference between the estimated and actual national income budget for the third quarter was due to larger-than-anticipated defense expenditures.

Against the background of past moderation and future uncertainty, Mr. Hickman remarked, the Committee should continue to shade monetary policy on the side of ease. He was increasingly disturbed by the recent behavior of the bank credit proxy, which

was expected to decline in November and December, with the latter being the fifth month in a row. A stiff price could be paid in the real sector next year if the reduced flow of funds through the financial intermediaries continued much longer. In the period immediately ahead he would again let the behavior of the credit proxy and the money supply determine policy, but would seek to obtain an annual rate of growth in the credit proxy on the order of 3 or 4 per cent, even if that meant substantially shallower net borrowed reserves. The mounting calendar of corporate and tax-free bonds reduced the risk that such a tactic would touch off a speculative wave in the bond market. Hopefully, by the time of the Committee's next meeting, fiscal policy for 1967 would be revealed, and the Committee would be able to determine the future course of monetary policy more easily. Mr. Hickman favored alternative B of the staff's current economic policy directive drafts.

Mr. Brimmer said there was no need for him to review again the evidence on domestic economic conditions presented by the staff and also discussed in the preceding comments of members. He shared the doubts and uncertainties about the underlying strength of the private economy. He would even go further to say that in the absence of defense and related expenditures the Committee probably would be on the verge of describing the outlook for the U.S. economy

in the manner Mr. Solomon reported the German economic outlook had been described at the recent Paris meetings: slowdown and possibly recession ahead. The Committee had gone quite far in restraining domestic activity in recent months and it should be concerned about the desirability of continuing that restraint in the months ahead.

Mr. Brimmer noted that some of the discussion today related to the question of the appropriate means for formulating national economic policy. He had not been a member of the Board last fall when the discount rate was raised, but after reviewing the record he felt that that step toward restraint was a proper one. Although the problem of the appropriate mix of monetary and fiscal policy had not been resolved at that time, the System had not failed to move ahead. Now, as then, it was highly desirable to have a proper fiscal-monetary policy mix. Specifically, if it was necessary to maintain the existing degree of over-all restraint, it would be dangerous to rely on monetary policy to provide it; a tax increase would be required. But he did not think the Committee should wait for assurance of fiscal action before easing monetary policy at present, just as the System had not waited for fiscal action last December before moving toward restraint. It was necessary, of course, to remain sensitive to the issue and to continue to urge a tax increase--hopefully one large enough to do the job but not so large as to damage the economy.

Secondly, Mr. Brimmer said, he thought the Committee should remain alert to the possibility that capital market flotations were now substituting for bank credit. He was impressed by the recent cessation of growth--and decline--in bank credit. The Committee obviously had wanted to provide sufficient reserves in recent months to permit some expansion in bank credit; and, on the assumption that much of the impending increase in capital market flotations reflected substitutions for bank credit, he thought the reserve supply should be increased. Also, the attrition in CD's had gone far enough, and the Committee should be especially careful to prevent further run-offs. It was not easy to say how far the Desk should go in that connection--it would be undesirable to overdo the action--but hopefully a proper course could be found.

Mr. Brimmer then referred to the Manager's comment that the volume of his operations in the coming period would depend on the actions of the Treasury and the operations of the Special Manager, and that domestic open market operations might not have to supply as much in reserves as was usual at this time of the year. While he (Mr. Brimmer) was not sure of the precise mechanism that should be employed, he hoped that care would be taken to insure that the System's operations in foreign currencies did not interfere with the goals of its domestic operations.

As far as the balance of payments was concerned, Mr. Brimmer was particularly pleased to hear Mr. Solomon's conclusion that there was no necessary incompatibility in the short run between the policy requirements in that area and in the domestic economy. He hoped that it would continue to be possible to take that position, and to rely primarily on the voluntary restraint program to deal with the problem of capital outflows.

In concluding, Mr. Brimmer said he would lay stress on his view that it would be inappropriate for the Committee to postpone the kind of policy change indicated as necessary by the evidence on the domestic economy until there was assurance that fiscal action would be taken. Of the two draft directives, he favored alternative B; indeed, he leaned toward a "B minus" directive--one that called for going somewhat further toward easing than did alternative B.

Mr. Maisel said that in preparing for today's meeting he had reviewed his statements at previous meetings of this year, and had to admit that he was beginning to feel like a broken record. At most meetings he had called attention to the fact that the Committee seemed to be following an erratic path. The failure to move directly to where it wanted to be was not due to uncertainty as to its goals. Rather, it was because the Committee had not been

willing to specify its true goals, and the method by which it hoped to achieve them, in its directive.

The Committee had failed to develop clear-cut policies and procedures to alter the factors actually under its control--total reserves or bank credit, Mr. Maisel continued. It had paid too much attention to changes in money market conditions and net borrowed reserves. As a result it had introduced a major lag in policy. All during the winter and spring the Committee was moving in the wrong direction, in one opposite to that necessary to reach its agreed-upon goals of restraint. That had again been true since August but in the opposite direction.

Mr. Maisel commented that the proviso clause in the directive was a major step forward in attempting to reduce that lag and to get the Committee on its desired path more rapidly. Unfortunately, the Committee had not really been willing to live with the proviso. Those general comments were illustrated particularly by the actions of the past six weeks. In that period there seemed to be agreement that bank credit ought to stop declining and probably should expand. Action, however, had not been consistent with that goal. Other constraints to policy had been followed in the Desk's operations. Initially they were those of the Federal funds rate and more recently that of net borrowed reserves. As a result, policy had followed paths set by the market

instead of letting the market react against a policy the Committee adopted in order to reach its goals. Mr. Brill's discussion this morning was very pertinent.

It was true, Mr. Maisel remarked, that for the past three months there had been great uncertainties in the production and output situation. A rapid resolution of those uncertainties was not likely. On the other hand, it had also been clear that it was not necessary to arrive at a basic decision as to the future course of the real economy in order to stake out a logical path for monetary policy. No matter what happened to output and production, the economy would be harmed if the Committee continued a policy creating great distortions in the field of money and credit.

In the present situation it seemed quite clear to Mr. Maisel that further harm to the productive sphere, through a failure to allow credit to expand at a normal rate, could only defeat the Committee's basic goals. Depending upon which index was used, the monetary variables had failed to expand for from three to six months. The distortions in the economy and related supply imbalances grew greater day by day. That meant inflationary pushes on the cost side. Those supply imbalances might well be at a point where they were exceeding any unfavorable price effects threatened through increasing demand. In any case, an actual weighing of possible relative courses was not necessary because in the current situation putting the monetary

house in balance was unlikely to raise aggregate demand above supply. As a result of the past three months' experience, when bank credit declined instead of increasing, the total was probably $6 billion or so below a desirable level. There had been a shortfall in the furnishing of total reserves of somewhere between $300 and $500 million.

What the Committee had to do now was avoid further delay, Mr. Maisel said. It should recognize that its lags in implementing its goals were extremely dangerous. It had to be concerned with the future costs of failing now to expand the reserve base at a normal rate. The Committee also had heard that it could get into a major Euro-dollar market problem.

The Committee's directives should pick a desirable level of expansion in required reserves and then instruct the Desk to attempt to insure that such a level of reserves was furnished the market, Mr. Maisel continued. The Committee should be concerned with the amount of credit being furnished and allow the market to determine the interest rate that went along with it. It seemed clear to him that for the past three months the Committee had been far too concerned with attempting to control interest rates rather than the amount of money and credit. The estimates of reserves had been good in terms of rates of expansion or decline.

However, even though the Committee's goal was an expansion of reserves it absorbed reserves on a day-by-day basis in order to meet the market constraints.

Mr. Maisel said he would support alternative B of the draft directives, but he would like to see it changed to make clear that the amount of ease called for was simply that required to achieve a normal reserve expansion of approximately 1 per cent a quarter on a seasonally adjusted basis. Sufficient reserves should be furnished for the credit proxy to grow at a rate of approximately 6 per cent. Actually, the rate could be slightly higher if deposits in other institutions continued to expand at a slower rate than the credit proxy. It should be clear that any given concept of a net borrowed figure was rejected. Although he did not feel strongly, if the Committee agreed, he would like to attempt again a more direct statement of the goal. Specifically, he would revise the second paragraph of alternative B to call for operations "with a view to attaining moderate expansion in bank reserves, money, and credit," and would delete the final clause of the staff's draft.

Mr. Daane remarked that in talking about the question of a possible tax increase last week Walter Heller had described himself as a "cautious hawk." As far as monetary policy was concerned today, Mr. Daane said, he personally was no hawk at all; but he

would describe himself as a "reluctant dove," at least with respect to an overt move. The balance of payments continued to pose a major problem, and the trade balance was a crucial element in that situation. Thus, while Mr. Solomon had said today that monetary policy could do little to encourage exports except for its efforts to maintain price stability, he (Mr. Daane) regarded such efforts as an extremely important contribution which the Committee should continue to make. Nor was he confident that one could look for other than adverse effects on capital flows of an overt move toward ease. For those reasons, and with the additional uncertainty in the fiscal policy area, he concluded that the position of a reluctant dove was the better position.

Mr. Daane felt that there was a significant difference between a policy action taken by the Committee as part of a change in the mix of over-all national economic policies and a Committee action taken independently. He agreed with Mr. Brimmer that timing was of the essence, but he reached a somewhat different conclusion on what timing was appropriate. He would much prefer a monetary policy posture of initial non-resistance to an easing in interest rates, and subsequent validation as desired, if and when fiscal policy action came into view. He was impressed by Mr. Koch's review of the indications of weakness in the economy, but he was also impressed by Mr. Brill's unwillingness to predict slower

economic growth until he knew more about the Federal budget. While the projections of defense spending seemed reasonable, the Committee did not in fact know what was likely to happen in that area. He thought too much emphasis was being placed on developments in the private sector in the discussion today and too little on public sector developments.

Unlike Mr. Brimmer, Mr. Daane thought there was not a close analogy between the present situation with respect to the economic policy mix and that of last December. A year ago the question was whether monetary and fiscal policies should be coordinated in a general move toward restraint. The question now was whether monetary policy should be eased in advance of a fiscal policy move toward restraint--and against a background of existing fiscal stimulus.

Operationally, Mr. Daane said, for a long time he had lectured against the use of free reserves as a guide to monetary policy, and he had been unhappy with both the Committee's and the market's emphasis on that variable. Nevertheless, he felt that there would be risks in deciding simply to ignore it and to try to break away from that emphasis in the current uncertain market. Despite this, he would give the Manager full flexibility and would suggest that there be a much greater emphasis in operations on interest rates. From this viewpoint the Manager should be directed

to maintain the current comfortable tone in the market, resolving doubts on the side of ease.

As to the directive, Mr. Daane said the wording of the first-paragraph statement of the Committee's general policy contained in alternative B was more felicitous than that in alternative A; it appropriately reflected the realities of the situation in the private economy. For the second paragraph he would also favor alternative B, but with a significant amendment. He would say "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the somewhat easier conditions presently prevailing in the money market, unless bank credit appears to be resuming a rapid rate of expansion." As the Manager had indicated, market conditions at the moment were easier than they had been earlier in the recent period. If those conditions were maintained in the face of the expected seasonal pressures, the Committee would have achieved the desired shading of policy without making an overt move toward easing, which in his judgment would be undesirable.

Mr. Mitchell said he agreed with Mr. Brill's analysis today. As far as the general posture of policy was concerned, he did not think the kind of signal reflected in a change in the discount rate would be appropriate at this time--even if the discount rate was at a level at which it could be used for such a purpose--but he would

be willing to take a step just short of that. He felt that the Committee should be pushing hard now, up to a certain point. That view presumably aligned him with Mr. Brimmer's "B minus" and perhaps with Mr. Maisel's position.

One thing that appeared to be disturbing to the Committee, Mr. Mitchell remarked, was that the banking system was not responding to the System's moderate blandishments toward easing. Perhaps the System had not blandished banks enough. In his judgment the banks were so concerned about their liquidity positions that a successful effort to attain renewed growth in bank credit probably would require much more drastic open market operations than most of the speakers around the table had implied. He was convinced that net borrowed reserves in the $300-$400 million range suggested by Mr. Hayes would not do the job, and he was not sure that a zero level would do it; net reserves might well have to be positive. Having gotten banks to do what it wanted them to do, the System might find it hard to get them to change, but it was important that they should do so.

With respect to the question of the relation between monetary and fiscal policy, Mr. Mitchell said he was inclined to agree with Mr. Daane rather than with Mr. Brimmer. But he would not like to see the System led struggling and resisting toward ease. He would prefer making a policy change that would be recognized as

such--not necessarily widely, but by market technicians--and that would be the probable result if net reserves became positive. The Committee itself had something to gain from recognizing the recent developments in the economy; developments which, he would remind the members, were occurring despite escalating defense expenditures. He also would remind the Committee of another fact that should not be overlooked--that net funds raised in the nonfinancial sectors dropped in the third quarter to an annual rate of $63 billion, from $84 billion in the second quarter.

It was quite important, Mr. Mitchell thought, for the Committee to make a change in policy significant enough for the banks to recognize. Hopefully, they would then start rebuilding their liquidity positions even though they were experiencing an outflow of funds resulting from European window-dressing operations; and at least some small growth in bank credit and the money supply would be achieved.

Mr. Shepardson said he would not undertake to present another review of economic conditions, since they had already been extensively discussed. On the matter of timing, he would note that his view was similar to those of Messrs. Daane and Mitchell, rather than to that of Mr. Brimmer.

It was clear, Mr. Shepardson continued, that bank credit had not been expanding recently. Whether or not that was inadvertent,

he did not think it was the Committee's intention now to press further in the direction of restraint. But he would not consider an overt change toward ease to be appropriate at this time, in view of the large existing uncertainties--and also of the near-certainty of cost-push pressures on prices, which would have both domestic and balance of payments consequences. In his view it would be better to adopt alternative A, which provided for maintaining money market conditions in their recent ranges, for the directive. By adopting A, the Committee would be accepting the slight easing that had occurred in money markets and the shallower level of net borrowed reserves that had come about. He was not disturbed by the fact that the net borrowed reserve figure had not been as deep recently as some members had suggested at previous meetings. Finally, he thought that the situation that might develop around the year-end in connection with international flows of funds should be dealt with, and in his judgment it would be possible to do so under the proviso clause of alternative A.

Mr. Wayne reported that over-all activity in the Fifth District continued at a high level, although it now seemed rather definite that the pace of advance had slowed considerably in the past month or two. Reports of manufacturers in the latest survey indicated some further slowdown in new orders, backlogs, and shipments, with most of the easing in durable goods lines. Respondents

also reported further weakness in residential construction, a reduced pace of automobile sales, and smaller gains in retail trade. Confidence among both bankers and businessmen continued considerably less buoyant than earlier in the year, although perhaps a little stronger than three weeks ago. While textilemen remained concerned over growing imports and rising labor costs, they now seemed to view the future with cautious optimism. He continued to receive reports of large cutbacks in construction spending, but the building permits series showed only a relatively small over-all decline from last year.

Mr. Wayne commented that no purpose would be served in repeating analyses of the national economy that had already been heard. In the country as a whole, signs of easing continued to appear. On balance, it would seem that for the present the growth of aggregate demand had been reduced to a rate which was not contributing significantly to inflation.

In the matter of policy, Mr. Wayne concurred in both the analysis and conclusion expressed by Mr. Koch. The developments in the capital markets noted by Mr. Brill were not surprising; they were more or less following an anticipated course. They did serve to reinforce his support of the policy posture indicated by Mr. Koch. Mr. Solomon's concluding comment encouraged the Committee to give priority to the domestic situation.

There was considerable lag between cause and effect, Mr. Wayne continued. The Committee's restraint continued to be quite firm and its effects would be felt for several weeks or months into the future; and the Committee should consider whether it wanted to see the current easing trends in economic activity intensified over such a period. The reduction in bank credit had brought a substantial reduction in required reserves which, in turn, had brought into play the proviso clause of the directive. Measured by marginal reserve levels, the Committee had moved into a somewhat easier policy by that back door. Historically, October and November 1966 might mark that point in time when restrictive monetary policy once again proved its painful but salutory effectiveness. To overstay that posture would be regrettable. Certainly the proviso clause should be retained, but he believed the time had come when the Committee should recognize positively the desirability of some easing. He would favor a policy of increasing slowly the availability of reserves, the amount of easing to depend on the behavior of required reserves. Alternative B, along with the explanatory notes, represented what he believed to be a proper course of action for the Committee to adopt today.

Mr. Clay observed that recent measures of economic activity gave further evidence of slackening in the pace of activity in some sectors of the national economy. It was becoming increasingly a

mixed picture, with a widening disparity from one sector to another. The situation was further complicated by the fact that the most important source of expanding activity was military spending and that the magnitude and course of that spending remained very unclear. Some of the most striking behavior continued to be found in the financial variables, notably the decreases in bank reserves, bank credit, and the money supply.

The recent record of economic activity indicated to Mr. Clay that some relaxation of monetary policy would be appropriate. The monetary data particularly underscored the need for some shift in monetary policy. Decreases such as had been taking place in bank reserves, bank credit, and the money supply were not suitable for the current economic situation and, despite the increase in net reserve availability, were not in keeping with what the Committee presumably had desired to accomplish in recent weeks. Some positive growth in bank reserves that would provide the basis for moderate growth in bank credit was rather what was desired. In consideration of recent developments in interest rates in the money and capital markets, some relaxation in monetary policy probably would have a salutary effect on the money and capital markets too.

In view of the prevailing military program and the accompanying tight resource utilization situation in many sectors of

the economy, Mr. Clay continued, any shift in monetary policy should be less aggressive than it might be under other circumstances. That view was further underscored by the uncertainty as to the volume of military spending and as to the Government's fiscal program.

As he had already indicated, Mr. Clay said, the objective was to provide reserves so that both bank reserves and bank credit could show moderate growth. What targets might be consistent with that goal was difficult to know, but tentative targets might include a Treasury bill rate ranging down toward 5 per cent, and net borrowed reserves ranging substantially below recent levels, if necessary. It should be indicated, however, that a dramatic move on the part of the Federal Reserve, with accompanying sharp movements in credit markets, was not the goal sought; rather, a more gradual approach was desired. Allowance would need to be made in conducting operations for any direct Treasury borrowing from the Federal Reserve. Moreover, the program would need to adjust for any tendency toward money market tightness as the December tax date approached.

Alternative B of the economic policy directive drafts was satisfactory to Mr. Clay.

Mr. Scanlon said that in the interest of time he would summarize the remarks he had prepared and ask that his complete statement be included in the record. He then briefly summarized the following statement:

Although there is widespread agreement in the Seventh District that the economy has entered a period of slower growth, there is an equally widespread view that general price inflation will continue into 1967.

Opinion varies as to the impact of the suspension of the investment tax credit. Some marginal expenditures are being sliced from 1967 capital expenditure budgets now being formulated. But it does not appear that the effect of the suspension of the credit, in itself, will be a major factor depressing capital outlays. The chief executive of a large petroleum firm finds profitable investment opportunities outrunning availability of funds, in contrast to experience of earlier years. A steel firm's management recently reviewed all capital expenditure programs to pinpoint possible deferments. Although little was accomplished, it was noted that clear signs of the development of a business recession in 1967 would slow capital projects through the abolition of overtime, extra crews, and other costly methods dictated by urgent need.

A sharp decline in orders for construction equipment has occurred in recent weeks. This is not simply a reflection of the drop in home building because heavy excavating equipment has been affected. Demand for other types of machinery and equipment remains strong and backlogs continue to rise.

Steel orders have slowed as steel users have been cutting inventories as delivery times have been reduced. Shipments of finished steel have not kept pace with ingot production, indicating a further reduction in the ingot production rate. Ingot production for all of 1966 is expected to be 135 million tons, compared with last year's record 131 million tons. Shipments, however, are expected to total slightly less this year than last. Production and shipments in 1967 are expected to equal this year's, despite an estimated drop in auto assemblies of about 300,000 units.

There are continued complaints of the poorer quality of available labor, high turnover, and wildcat strikes. Profit margins are likely to shrink.

Some manufacturers who have announced price increases recently have waited anxiously for the reaction from Washington. A farm machinery producer has encountered strong pressures from Governments in other countries, _e.g._, Canada, against increasing prices on its products.

In the past three weeks, our major banks have shown a contra-seasonal reduction in business loans although some bankers have indicated that they are expecting demands for business credit to increase substantially in the weeks ahead.

Meanwhile, bank acquisition of mortgages has slowed markedly, outstanding loans to finance companies have been reduced, and sizable holdings of municipal and U.S. agency securities have been liquidated.

Despite over-all credit contraction, the large Chicago banks continued to show a substantial basic deficit position as both demand and time deposits declined somewhat further. However, pressures appear to be less than a month ago, and a much smaller portion of funds to cover the position was acquired at the discount window. Country bank borrowings are also significantly below the August experience both in amount and number of banks.

Current financial data do not indicate a substantial reversal in the slow downward drift of aggregate monetary and credit measures, although slight increases in total reserves, money supply, and time deposits may still occur for November as a whole. It is not clear whether the recent firming of interest rates reflects monetary restraint or stronger credit demands. The same amount of non-bank credit growth may entail higher interest rates. On the other hand, the recent tendency toward stabilization of CD's may indicate a slowing or halting in the process of disintermediation.

Given the increasing signs of hesitancy in the private sector, some portion of which I trust we can attribute to our own actions, I think it unwise to continue to permit reserves, money supply and bank credit to decline. I would favor a policy posture designed to achieve moderate growth in total bank credit and related aggregate measures.

I support alternative B for the directive, although the 10 per cent growth rate suggested as the upper limit for the proviso clause in the staff notes seems too high to me. I do not foresee a problem in this regard but I would hope that if bank credit resumes a rapid rate of expansion we don't wait until we reach a 10 per cent rate to reverse our position.

Mr. Galusha said that, by all appearances, the rate of economic growth had declined so the Committee had, in a way, succeeded in its

stabilization objective. The Committee might find, come mid-1967, that the rate of growth had declined still more--too much, in fact. His impression--based admittedly on a relatively brief experience as a member of the Committee--was that monetary policy actions had an effect not immediately but after a rather appreciable length of time.

No immediate vanishing of inflation was in prospect, Mr. Galusha continued. The outlook was, however, for less inflation than there had been. If history was any guide, price increases would continue for some time, possibly through much of 1967. But historians would have to trace the price increases of 1967 to already past changes in the unemployment rate and the level of corporate profits, not to a present and continuing excess demand. There was, then, little chance at the moment that price increases were going to accelerate, or that an inflationary psychology of major dimensions was going to be created. Even if the present unemployment rate held, price increases from here on in would get smaller and smaller.

Undeniably, Mr. Galusha remarked, the more pressure the Committee put on the economy, the smaller future price increases would be. Even cost-push inflation, so-called, could be checked by monetary policy--but, as compared with demand-pull inflation, only at the cost of a relatively great amount of unemployment. Thus, to persist in trying to check further price increases--which in prospect

seemed quite modest--would be to recreate the very economic situation that was barely escaped a few years ago. And in getting back again to something like full employment, the Committee would almost inevitably produce the kind of changes, particularly in corporate profits, that were conducive of relatively large increases in money wages.

What the Committee had to avoid, therefore, was a stop-go type of monetary policy, Mr. Galusha said. It was necessary to avoid moving away again from near-full employment. And in the interest, he would stress, of the country's long-run international competitive position. It was better to hold steadily to a satisfactory unemployment rate than to attain the same rate only on average.

What all that suggested to Mr. Galusha was that the Committee even now should be giving its attention to increasing the supply of bank loans. Perhaps it was not too soon to begin thinking about ironing out the wrinkle that had been put in discount policy a few months ago, which would probably require some form of concerted action to avoid inter-District unevenness. Or about money market conditions which would facilitate, not hinder, the rolling-over of maturing CD's. Even an increase in the average maturity of CD's might be desirable. The Committee perhaps would be well-advised to go to some lengths to convince banks, particularly the large ones, that they were not badly over-extended, and that they could get back

to where they wanted to be without having to persist in the stringent rationing of loans.

Having said all of that, Mr. Galusha continued, he would be uneasy with any obvious move of major dimensions. Rather, he would prefer to encourage the Desk to continue a cautious groping along the cliff to easier footing--plus joint efforts to correct the aberrations in discount window administration.

Mr. Swan remarked that he could summarize economic developments in the Twelfth District with the statement that there had been no major changes in the last few weeks. He also would favor some moderate move toward easing. In light of the general economic situation he thought the Committee certainly should be looking toward some expansion in bank credit and the money supply. In the immediate short-run, the Manager was confronted with a need to try to smooth out the special stresses in the money market that were anticipated between now and mid-December, and to prevent the current pressures in capital markets from having some backlash effects in the money markets. To him that implied a comfortable money market. While he again hesitated to quantify objectives, it did seem that the bill rate should be 5-1/4 per cent or somewhat less, and the Federal funds rate certainly should be below 6 per cent. He did not think that that could be accomplished with net borrowed reserves of $300 million, but he hoped it would not be necessary to go to

zero. In any case, he thought the net reserve figure was somewhat less important at this juncture.

The policy change should be moderate, Mr. Swan continued. At the same time, he would strongly urge the adoption of alternative B; the action, even though modest, should be a positive one, and it should be explicit in the directive. As to the interpretation of the proviso clause in that alternative, he shared Mr. Scanlon's question about the appropriateness of a 10 per cent upper limit on bank credit expansion. And he questioned, as he had three weeks ago, the use of the word "sharply" in the first paragraph to describe rising defense expenditures. The description probably was correct, but definitive evidence was not available to the Committee.

Mr. Swan's concluding observation related to Mr. Mitchell's comments about the difficulty of getting banks to develop a more positive attitude toward credit expansion. That difficulty might be due, in part, to strong feelings at banks about their liquidity positions. In his judgment, however, the attitudes of banks were still conditioned by the System's September 1 letter to member banks. While the letter had been appropriate at the time it was issued, he thought the System should now give serious consideration to the possibility of taking steps soon to dispel its effects, at least if the present attitudes of banks persisted.

Mr. Irons said there had been no significant new developments in economic conditions in the Eleventh District over the past three weeks. The District economy had been following the national pattern, with evidences of moderation in some sectors and of strength or expansion in others. On balance, the District economy was expanding a bit, in a manner not greatly different from the national economy.

About the same statement would hold in the financial area, Mr. Irons observed. Total bank loans and investments had declined in the recent period, although loans changed relatively little. Deposits were down, and the CD situation was posing difficulties for some banks. Borrowings from the Reserve Bank had not been large except for borrowings under the special program.

With regard to credit policy, Mr. Irons remarked that it might be well for the Committee to avoid any overt action at this time, or any action that might appear to represent a change in policy. He did not question the signs of a slower growth rate or of lessened inflationary pressures in the economy, but he was skeptical about the desirability of moving in an abrupt or overt manner on the basis of the evidence available at this time. It had been suggested that the Committee should avoid overstaying a posture of restraint; but the Committee should also avoid over-eagerness to change its position on the basis of the information it now had.

For the directive, Mr. Irons favored either alternative A or the version of alternative B Mr. Daane had suggested, which was fairly close to A. He was not overly concerned about the specific level of net borrowed reserves, but he did not think the Committee could completely ignore net borrowed reserves at this time; market participants still gave them attention, and there was little the Committee could do about that. He favored a Treasury bill rate in the 5 - 5-1/4 per cent range, and a Federal funds rate in the area of 5-1/2 per cent. He would not be disturbed if net borrowed reserves were at $200 million or less. He thought the Manager had to be given a great deal of leeway to be guided by market developments, but that he should not operate in a manner that would make the market conclude the Committee had moved to a different policy posture.

Mr. Irons agreed with Mr. Swan's comments about the September 1 letter, and thought the System was running the risk of inconsistency in policy by leaving the letter outstanding. Regardless of the System's intentions, many banks--in the Eleventh District at least--were interpreting the letter to mean that they should not come to the discount window except under conditions of a degree of restraint which they associated with the September 1 letter. A number of the larger District banks now had large built-in deficits and found it necessary to borrow from some source every

day. That situation probably was not limited to the Eleventh District. The System probably would not make the same statements today that were considered appropriate on September 1; there appeared to be no desire now, for example, to call for a slower rate of growth in business loans. The problem now was not one of strong demands for credit and a strong desire by banks to make loans, but rather one of illiquid positions and built-in deficits at banks. But the letter remained outstanding and continued to affect the attitudes of banks. The conflict was not one that could be brushed aside, and a re-examination of the September 1 letter was clearly needed.

Mr. Ellis said that in the interest of time he would omit the remarks he had prepared on recent developments in the New England economy. The Boston Reserve Bank had now had visits by officers from four of the District's largest insurance companies and from the farm credit banks of the District, each wishing to review any special avenues of borrowing should their liquidity needs worsen further. The Reserve Bank had initiated an informal tally of New England insurance company policy loan trends on a monthly basis. So far it revealed that (1) prepayments of outstanding loans had virtually ceased, lessening their cash inflows; (2) policy lending spurted abruptly in the summer and early fall to rates 10 times or more above year-ago rates; (3) 1967 cash

flows were virtually committed so that in general they were not making new commitments for 1967 funds; and (4) October and early November had seen some slackening in the squeeze and the better condition in municipal markets had allowed them to sell off enough assets to rebuild liquidity somewhat. They now felt they might get through this year without calling on their bank lines.

Of course, Mr. Ellis said, the System's most direct concern was with commercial banks. In appraising their activities since September 1--a date he thought was meaningful for the purpose--he found no substantial evidence of change in pattern in New England. As of November 9, their total loans were 10.5 per cent above a year earlier. The comparable figure on August 31 was 10.3 per cent. Business loans on November 9 showed a 17.5 per cent year-to-year gain, compared with 17.2 per cent on August 31.

Of the four Boston reserve city banks, only one had a business loan volume below its August 31 level. The other three had expanded their business loans as much as--and in one case, substantially more than--in the same periods of the past two years. Just about the same observation might be applied to the patterns of their total loans. Each of those four banks had been relying heavily on borrowed funds in the forms of negotiable CD's, Federal funds, or discounts at the Reserve Bank. But each had also been able to reduce quite substantially the ratio of borrowed funds to

required reserves. It seemed that the strengthening in the municipal securities market had enabled them to use their secondary reserves as originally intended.

Turning to monetary policy, Mr. Ellis agreed with the staff's analysis but disagreed with their prescription, and he suspected that a question of timing was involved. He would focus briefly on two points. First, there was an important difference between an inflection point--the point of maximum rate of increase in a growth trend--and a recession downturn in such series as GNP, employment, and so forth. He emphasized the difference because he thought there might well be a tendency to over-react to an inflection point. Last spring and winter the Committee was seeking to slow down an unsustainable rate of economic upsurge. The first paragraph of the green book stated that that had transpired. An inflection point in the rate of growth, not a recession downturn in real terms, had been achieved. Current projections of acceptable growth rates were being made in the context of existing policy, not of an eased policy; the latter would require upward revisions in the projections. The evidences of pause in the financial area, such as the recent pattern of change in business loans at banks, might be interpreted in the same manner as price developments were being interpreted--namely, as reactions to earlier excesses. In that connection he would

endorse the comments that had been made today regarding the continuing impact of the System's September 1 letter. It would be desirable to seek some graceful way of withdrawing that letter.

Secondly, Mr. Ellis said, the proper policy mix to maintain growth at the desired slowed rate probably should be a somewhat tighter fiscal policy and a somewhat easier monetary policy. But his own judgment was that the political process was such that the proper policy mix could not be achieved if the Committee moved first to ease monetary policy. The Committee had been alerted via the press to the possibility, perhaps by early December, of a decision and an announcement by the President concerning the outlook for the budget, including tax considerations. Certainly the prospects for Presidential support and legislative approval of any tax increase could be severely worsened if monetary policy were to be substantially eased in advance. That act would be taken as evidence that the economy had weakened to a point that obviously ruled out tighter fiscal policy. Thus, an overt move toward ease in the next three weeks would substantially reduce the chances of a tax increase.

That suggested to Mr. Ellis the essentiality for the next three weeks of avoiding an overt move and the appearance of numbers that would allow the interpretation that such a move had been made. To be quite specific, while the Committee might decry as antedeluvian continuing analyst attention to net borrowed reserves as an indicator of policy, there seemed little chance that re-education could be

accomplished this year. To him, that meant the Committee should continue as a target of operations a net borrowed reserve figure within the $300-$400 million range and not move overtly lower to a zero-$200 million range. He would agree with Mr. Hayes' description of desirable operations under that objective.

Concerning the directive, Mr. Ellis said that alternative B was seriously defective in providing no directions for operations if bank credit were to resume a rapid rate of expansion. As a minimum an additional clause was necessary; following the words, "unless bank credit appears to be resuming a rapid rate of expansion," should be added--to borrow language from alternative A--a clause reading, "in which case, operations shall be conducted with a view to maintaining about the same range of money market conditions as have prevailed since the previous meeting of the Committee." To be consistent, he should observe that the alternative A proviso clause was silent as to what modification might be undertaken in the light of bank credit developments. His own view was that the clause should provide for modification toward both tightening and easing, as expressed in the relevant staff note of those attached to the draft directives.[1/] He would prefer a proviso clause that

1/ The staff note to which Mr. Ellis referred read as follows: "One possible interpretation (of the proviso clause in alternative A) is that operations shall be modified toward ease if the bank credit proxy appears to be weaker than the fractional declines projected by the staff for November and December...; and modified toward firmness if the proxy resumes expansion at an annual rate in excess of that for the year to date (4.6 per cent)."

read, "provided, however, that operations shall be modified to counter sharp and sustained movements in total bank credit." Obviously, of the two draft directives he favored alternative A.

Mr. Robertson asked that the statement he had prepared for today's meeting, reading as follows, be included in the record:

> I think it is quite clear that both the facts and the analysis before us this morning argue for some easing of monetary policy, with the chief question for debate being how much.
>
> Without doubt, a number of key measures of business activity are softening. Much of this slackening is probably the direct or indirect consequence of restrictive public policies, rather than the independent sprouting of the seeds of recession; but nontheless we need to be very careful not to let money become any tighter than necessary to do its job.
>
> Insofar as the financial side is concerned, all available indicators are consistent with a real and pervasive slowdown in credit expansion. Thus, as has already been indicated, we have had no net growth in bank credit or money supply for three and six months, respectively. Interest rates, particularly in the long-term area, have moved back up near their historic peaks. This, I submit, is too tight a financial restraint to hold for very long on a growing economy, once inflationary pressures seem to have passed their peak.
>
> Yet, while some monetary easing may be called for, my preference continues to be, as I said last time, for a "tentative but gradual and progressive kind of let-up of monetary pressures." In particular, with a new Administration position on taxes promised to be close at hand--perhaps even before our next meeting--I think we should make our move gradually at this time so that it will not importantly reduce our options, depending upon the outcome of the supposed December tax decision.
>
> To accomplish this, I would favor gradually working net borrowed reserves lower, perhaps down into a range around $100 million, over the next three weeks, thereby countering some of the build-up of seasonal pressures that ordinarily takes place during this interval. I refer

primarily to net borrowed reserves for the reasons that I gave at some length at our last meeting. I would expect the most closely associated money market interest rates to show no increase, and perhaps even some decline in this new reserve climate; and also I would expect CD attrition to slow down--outcomes that I would regard as desirable.

I know some observers feel that the degree of restraint exercised by net borrowed reserves is quite variable, and hence is a poor policy guide. But such a view mistakes the best policy role for net borrowed reserves, in my judgment. Certainly the influence of a given net borrowed reserve figure does not stay the same over time, with differences stemming from differences in loan demands, banker attitudes, liquidity positions, et cetera. Proper policy prescription calls for taking all such considerations into account in judging what level or range of net borrowed reserves might best tide us over the days ahead. It is with such an arrangement of thoughts in mind that I advocate dropping net borrowed reserves back to a range around $100 million. Some consideration for such a target might, I suppose, be squeezed in as part of attention to a general "money market conditions" target in the directive. I, myself, however, would prefer to recognize our concern with reserves more directly by calling for open market operations that would, in directive language, "attain somewhat easier net reserve availability and related money market conditions."

For the proviso clause, this time I have no objection to the kind of one-way proviso drafted by the staff in its alternative B, although as a general matter I prefer the two-way kind that we have recently used. Having called for a moderate easing in the first part of the second paragraph, I would not want a proviso that might lead the Manager to ease still further, because I think too marked an easing could be bad policy at this time. On the other hand, I would be willing to see any easing action stopped in the unlikely event that bank credit started to expand rapidly once again.

With these exceptions and interpretive remarks, I favor alternative B of the draft directives supplied by the staff.

Mr. Robertson then said that, as indicated in his statement, he also was in favor of some easing. The only question was how much;

no one would want to ease so far as to damage the chances of fiscal policy action. After hearing the discussion today, he would now propose a new version of the second paragraph of alternative B, reading as follows: "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to encouraging moderate expansion in aggregate reserves and bank credit, provided that money market conditions do not ease sharply." Such language, in his judgment, would avoid the risks of an overt move toward ease that had been noted by some members.

Mr. Hayes commented that the phrase Mr. Robertson had suggested embodied aggregate variables similar to the language the Committee had recently dropped from the first paragraph of the directive. He felt that such language was not feasible as an operating instruction.

Mr. Daane said he felt that the instruction Mr. Robertson proposed would be difficult to implement, since it placed main emphasis on variables that the Manager could not control precisely.

Mr. Hayes noted that Mr. Daane's suggested revision to alternative B had received some support, and indicated that he also would be prepared to vote for it.

Chairman Martin said that before turning to policy he wanted to note that he thought the System had performed well during 1966, all things considered. The performance had not been perfect--the

timing of actions had not necessarily been right in all respects--but the record as a whole held up quite well.

It was important to keep in mind, the Chairman continued, that monetary policy could not achieve results as precise as some people apparently desired. In retrospect, he thought that by May or June of this year monetary policy probably had done about all that could have been expected of it toward slowing down excessive expansion of demand in the economy, short of risking disastrous developments in the money market of a kind that no member of the Committee would want to see. In his judgment the thrift industry was not set up well. Since the beginning of the year the savings of individuals and businesses had been totally inadequate to meet demands for credit but, with full employment and high plant utilization rates, any further monetary expansion earlier in the year would only have added to inflationary pressures. Later, cost-push pressures on prices began to be added to the demand-pull variety, and he doubted whether monetary policy could cope effectively with cost-push pressures. He was hopeful that the Administration would come forward with a fiscal policy program that would supplement monetary policy, but it was necessary to recognize that such fiscal action would be at least six to nine months late, just as the step toward monetary restraint taken a year ago appeared, by hindsight, to have been late.

Many recent developments in the economy were encouraging, the Chairman said. Automobile manufacturers had been prudent in reducing output rather than relying on credit and other forces to propel their industry forward. The shift of borrowers from banks to capital markets noted in the discussion today should have occurred some time ago. That such developments were occurring now was highly encouraging for the longer-run outlook.

The Committee faced a fine judgment now on whether to make an overt change in policy, Chairman Martin observed. Before the meeting he had considered the draft directives suggested by the staff and had concluded that the difference between the policies called for by alternatives A and B was not great. After the go-around today he was inclined toward alternative B--not because a majority seemed to favor it but because it indicated that the Committee was abreast of economic developments. Whether or not any fiscal policy action was likely to be taken should be known in the next three or six weeks, and in the meantime the Committee would be indicating that it was aware of a change in basic elements of the economy. He would consider the policy change as a probing movement, to be reversed if events went the other way. Monetary policy had to be flexible.

The Chairman repeated his view that by early summer the Committee probably had done about all that it could do. Developments had gotten ahead of the Committee, and some adjustments

in the economy were inevitable; if expansion were not slowing now the situation would be serious. He thought the Committee should try to make a moderate change in its policy in line with the statistical analyses that had been presented although, he would add, he had grave reservations about the scientific aspects of analyses in this area. He intended no criticism of the staff; his point was that he doubted whether the Committee could reach firm conclusions solely on the basis of statistical analyses of periods as short as two or three months. Monetary policy remained as much an art as a science.

The Chairman then said he did not think the Committee should attempt to attain the kind of precision implied by some comments today, including the references to a "B minus" directive. The staff's alternative B roughly reflected the policy course a majority appeared to favor. He would suggest adopting that alternative for the directive and leaving to the Manager the task of operating within its framework. He did not believe the appropriate level of net borrowed reserves could be spelled out precisely, but to him that was not of great importance. Several suggestions for amending the staff's draft had been offered but, while they might be workable, in his opinion the staff's alternative B implied everything necessary at this juncture. He would interpret it to call for a modest overt change. Mr. Hayes had made a good case against any overt change at

this time, but an equally good case could be made for a modest change. The Committee should not be overly reluctant to change policy in either direction. The objective now, he thought, should be to move in a gradual way without trying to be too precise about it.

Mr. Brimmer observed that in light of the Chairman's remarks he would withdraw his suggestion that the Committee adopt a "B minus" alternative for the directive. He had used that expression to indicate the strength of his preference for the general type of policy called for in alternative B, and was prepared to vote for the staff's draft without amendment.

Chairman Martin remarked that there obviously were some differences of degree in the views of members. He then suggested that the Committee vote on the staff's alternative B.

Mr. Shepardson said that he would like to hear the language Mr. Daane had proposed again before the vote was taken. Mr. Daane then repeated the version of the second paragraph he had suggested earlier, calling for the maintenance "of the somewhat easier conditions presently prevailing in the money market, unless bank credit appears to be resuming a rapid rate of expansion."

Chairman Martin remarked that one objection to Mr. Daane's proposal was that it implied that the Manager had brought about conditions that the Committee was forced to accept. Such an

implication would be wrong, he thought; the Manager had been trying to carry out the Committee's instructions all along.

Mr. Daane replied the market often moved independently to some degree, and it did not necessarily respond precisely to the Committee's actions. Market conditions had eased recently as a result of the ebb and flow of funds and that change was not inconsistent with the Committee's previous directive. In his judgment the language he had proposed spelled out the objective a majority of the Committee sought. He would be willing to accept alternative B if it was interpreted in a manner consistent with his own proposal. But he would have to vote against it if it was interpreted to call for a degree of ease he considered excessive, such as zero net borrowed reserves and a bill rate down to 5 per cent.

Chairman Martin observed that Mr. Daane's comment reflected the divergence of views he had mentioned. In his opinion a majority favored moving further toward ease rather than accepting existing market conditions.

Mr. Hayes agreed with Mr. Daane that natural factors were capable of influencing money market conditions apart from the Committee's operations, and that that, in fact, had happened recently. Moreover, it was quite conceivable that there would be some deliberate moderate easing of conditions under directives

of the type the Committee had issued recently, given the proviso clause they contained; otherwise there would have been no point in including the proviso. In the recent period there had been a tendency for the Desk to lean toward ease, in view of the behavior of the bank credit proxy. Under those circumstances he saw no reason against Committee acceptance of prevailing market conditions.

Chairman Martin commented that there also was another view on the appropriate policy course at present--that the Committee should move a little further toward ease.

A number of members concurred in the Chairman's statement.

Mr. Mitchell said he would be prepared to vote for either Mr. Robertson's proposed language or the staff's alternative B, although with respect to the latter he shared the view that the 10 per cent rate mentioned in the staff notes as an upper limit on bank credit expansion was too high.

Mr. Maisel remarked that a 10 per cent limit would not strike him as excessive because it applied to a short period and followed several months of decline in the bank credit proxy.

Chairman Martin said he had no objection to Mr. Robertson's proposed language if a majority preferred it, but he still leaned toward alternative B as drafted by the staff.

Mr. Wayne said he favored alternative B because he thought it was important for the record to indicate that the Committee had recognized at this meeting that the time had arrived for some change in policy.

Mr. Daane asked whether the Committee would consider adoption of alternative B to be an overt change in System policy.

Chairman Martin replied that the answer, in his judgment, was yes, although the change would be a modest one--about as modest as an overt move could be.

Mr. Shepardson said it was his understanding that adoption of alternative B would not imply that the Committee found a 10 per cent growth in bank credit acceptable, and the Chairman agreed.

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

> The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand, with sharply rising defense expenditures but with evidences of moderating tendencies in various sectors of the private economy. While there has been some slowing in the pace of advance of broad price measures, upward price pressures persist for many finished goods and services. Bank credit and money have shown no expansion in recent months. Long-term interest rates have again risen somewhat after declining from their late summer peaks. 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 noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be resuming a rapid rate of expansion.

Mr. Hayes said that he had cast a negative vote with reluctance; he found it necessary to dissent because of the interpretation of the action as an overt change in policy. Mr. Daane concurred in Mr. Hayes' statement. Mr. Shepardson indicated that his affirmative vote was cast with reluctance.

Chairman Martin then noted that the Manager had recommended an amendment to the Committee's continuing authority directive to increase from $500 million to $1 billion the limit on holdings of short-term certificates of indebtedness purchased directly from the Treasury. In his judgment such action would be appropriate.

There was general agreement with the Chairman's statement.

Thereupon, upon motion duly made and seconded, and by unanimous vote, paragraph 2 of the continuing authority directive was amended to read as follows:

The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where

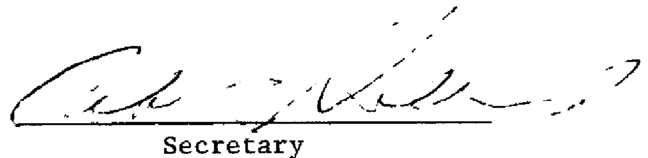
it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate 1/4 of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

In reply to a question by Mr. Daane, Mr. Holmes said that no formal action by the Committee to amend its directives was required to authorize the offsetting purchases of longer-term bills and sales of short-term bills that he had indicated earlier might be desirable under certain circumstances. He had brought the matter to the Committee's attention because the Desk had not customarily engaged in operations of that type.

Mr. Daane then observed that he would favor such operations if the circumstances Mr. Holmes had described eventuated. Other members concurred.

It was agreed the next meeting of the Committee would be held on Tuesday, December 13, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

CONFIDENTIAL (FR) ATTACHMENT A

November 21, 1966.

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on November 22, 1966

Alternative A

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 with evidences of moderating tendencies in various sectors of the private economy. While there has been some slowing in the pace of advance of broad price measures, upward price pressures persist for many finished goods and services. Bank credit and money have shown no expansion in recent months. Long-term interest rates have again risen somewhat after declining from their late summer peaks. 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, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same range of money market conditions as have prevailed since the previous meeting of the Committee; provided, however, that operations shall be modified in the light of bank credit developments.

Alternative B

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 with evidences of moderating tendencies in various sectors of the private economy. While there has been some slowing in the pace of advance of broad price measures, upward price pressures persist for many finished goods and services. Bank credit and money have shown no expansion in recent months. Long-term interest rates have again risen somewhat after declining from their late summer peaks. 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 noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat easier conditions in the money market, unless bank credit appears to be resuming a rapid rate of expansion.