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, December 13, 1966, at 9:30 a.m.

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

Messrs. 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. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Eastburn, Green, Koch, Mann, Partee, Solomon, Tow, and Young, Associate Economists
Mr. Holmes, Manager, System Open Market Account

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

Mr. Lewis, First Vice President, Federal Reserve Bank of St. Louis
Messrs. Eisenmenger, Link, Ratchford, Brandt, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, New York, Richmond, Atlanta, St. Louis, and San Francisco, respectively
Mr. MacLaury, Assistant Vice President, Federal Reserve Bank of New York
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Stiles, Senior Economist, Federal Reserve Bank of Chicago
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 22, 1966, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period November 22 through December 7, 1966, and a supplemental report for December 8 through 12, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury noted that the Treasury gold stock remained unchanged this week following a $100 million drop two weeks ago. The Stabilization Fund had sufficient gold on hand to take care of the second Italian purchase of $30 million expected this month without having to show any further decline in the stock before the end of the year. The London gold market naturally reflected the ups and downs of the Rhodesian crisis, although the fixing price remained in a relatively narrow range ($35.15-1/2 - 17-1/2). Trading was generally heavy whenever headlines concerning the Rhodesian crisis appeared and the possibility of sanctions against South Africa came to the fore, and on balance the gold pool lost about $12 million during the period. That meant that there was still $25 million in the pool, not counting the $50 million supplement that was also available. That could go quickly, of course, if there should be a blow-up in the discussions of the Rhodesian situation.

Events since the last meeting had demonstrated the usefulness of the preparations made to meet year-end pressures, Mr. MacLaury said. Those pressures developed suddenly and with great intensity on November 29 when one-month trading began for over-the-year-end dates. Euro-dollar rates for maturities of one month and over jumped by a full percentage point--from 6-1/2 per cent to 7-1/2 per cent--and the scramble for funds in the Euro-dollar market was hectic. As anticipated, the sudden demand for funds put spot sterling under strain; and the Bank of England had to provide nearly $50 million in spot support of the pound on that day. Under the circumstances, the Account Management decided to put into operation immediately the various techniques that previously had been agreed upon to deal with such a situation. The Swiss National Bank, which up until that time had been buying dollars spot only, announced that it would meet the temporary demand for Swiss francs by taking in dollars on a covered basis without cost to the banks, i.e., through flat swaps. The dollars taken in were to be redeposited in the Euro-dollar market, like the dollars previously bought outright. That same day, November 29, the Bank for International Settlements began placing sizable amounts of new money in the Euro-dollar market, acquiring the dollars through activation of its swap facility with the Federal Reserve in currencies other than Swiss francs. Finally, in New York, the Federal Reserve began purchasing spot sterling against forward sale for delivery after year-end, acquiring that day a total of $28 million for System and Treasury accounts combined.

That three-pronged attack, Mr. MacLaury said, coming as an immediate and coordinated official response to sudden market pressures, did much to relieve the pressures themselves, but it was equally important psychologically as a demonstration that the markets would not be left to fend for themselves over year-end. Including operations prior to November 29, the Swiss National Bank had thus far replaced in the Euro-market a total of about $200 million, partly through the BIS. In addition, the BIS had drawn the full $200 million under its swap arrangement with the System and placed those new funds in the Euro-market, as well as serving, as it had in the past, as a channel for dollar deposits of central banks other than the Swiss National Bank. With Euro-market pressures pretty well under control, and with the strain on sterling from that source considerably alleviated, it was not necessary for the System to extend its swap purchases of sterling beyond November 30, by which time a total of $36 million had been acquired for the System and the Treasury together.

Although sterling had been fairly well insulated from year-end pressures by the operations he had just mentioned, Mr. MacLaury continued, it nevertheless felt the impact of the Rhodesian crisis. All things considered, the markets seemed to have taken the day-to-day swings in headlines from unwarranted optimism to undue pessimism on that issue in better stride than one might have expected. So far, at least, British reserves on balance had not suffered from the shifting prospects for settlement or sanctions; the British had recouped all of the losses they incurred when the Rhodesian rejection of the proposed settlement was announced. Of course, it was impossible to tell how much better their reserves might have looked had it not been for that problem. But that volatile issue remained potentially explosive and made it difficult to predict how the month might turn out for sterling reserves.

As the Committee knew, Mr. MacLaury said, November turned out better for the British than appeared likely at the time of the previous Committee meeting. In addition to announcing a reserve gain of $64 million they were able to liquidate about $90 million in short-term debt, as well as to liquidate a sizable amount of forward commitments. It was to be hoped that December would turn out as well, and that further repayments of short-term debt could be made. There were two hopeful signs. First, at the meeting in Basle this past weekend the package of credits of $400 million made available to the Bank of England last September, at the time the swap network was increased, had been extended for another three months. (Those credits had been due to expire at the end of this month.) Second, the trade figures announced today were the most encouraging for some time. For the first time in at least the last three years, there was a surplus even on a crude basis; when adjusted to a balance of payments basis the surplus was 80 million pounds. Part of the improvement was due to the postponement of imports pending removal of the surcharge on November 30. Nevertheless, exports were up, and that was encouraging.

Mr. MacLaury then referred to two other developments, the first of which was the recent sales of marks by the System. During the period the German Federal Bank took in a total of $152 million as repatriation of bank funds came on top of a strengthening German balance of payments. With marks in demand in New York the Reserve Bank sold a total of $16.7 million equivalent in the New York market, and in addition sold $15 million equivalent to the Federal Bank on one day, December 7, when the latter had picked up $60 million in Frankfurt. All of those sales were financed by drawing down the System's mark balances. Second, the Account had continued to make progress in reducing the swap drawing from the Bank of Italy. Lira purchases of $45 million equivalent in New York during the period had enabled that commitment to be brought down to $25 million from the original $100 million.

Mr. MacLaury added that there had been a discussion of multilateral surveillance, insofar as it impinged on the swap network, at the recent Basle meeting. He did not know the details; however, Mr. Coombs had reported that the discussion went well and that he thought there would be a minimum of interference with the swap network through multilateral surveillance in the future. Specifically, the Netherlands and Belgium agreed to extend their supplementary swap arrangements with the System for another three months.

Mr. Hickman asked whether Mr. Coombs had commented on the German attitude with respect to their tight money policy and on the possibility of their attaining a little more balance in their mix of monetary and fiscal policies. He gathered that the inflow of dollars to Germany reflected both year-end operations and general monetary tightness.

Mr. MacLaury replied that the Germans had been taking in dollars fairly steadily for several months due to the sharp upturn in their trade surplus. Each year in the past the German Federal Bank had taken in sizable amounts of dollars in December, as much as $500 million. The repatriation of dollars by German banks was partly for year-end window-dressing purposes, but also because the largest tax payments came due December 15. This year, because of changes in reserve requirements for German banks, it was less clear that there would be a complete reversal of the inflow after the year-end.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period November 22 through December 12, 1966, were approved, ratified, and confirmed.

Mr. MacLaury noted that the $500 million swap agreement with the Bank of Canada, having a term of twelve months, would mature on December 28, 1966, and he recommended renewal.

Chairman Martin asked whether there had been any use of that swap this year, and Mr. MacLaury replied the Bank of Canada had drawn on it this fall for a small amount for a brief period.

> Renewal of the $500 million swap agreement with the Bank of Canada for 12 months was approved.

Mr. MacLaury then said that the System's swap agreement with the Swiss National Bank, and the two with the BIS, in the amount of $200 million each, would reach the end of their six-month terms on January 20, 1967. He recommended renewal in each instance, adding that there was outstanding a $75 million drawing under the Swiss franc arrangement with the BIS and $15 million under the arrangement with the Swiss National Bank.

Renewal of the three swap agreements for further periods of six months each was approved.

Mr. MacLaury then reported that there were three outstanding drawings by the British under the swap agreement with the Bank of England, all with terms of three months, as follows: one in the amount of $100 million maturing December 29, 1966; one in the amount of $50 million maturing December 30, 1966; and one for $100 million maturing January 20, 1967. If the latter two were renewed, those would be second renewals. It was hoped that the British would be able to make repayments on their short-term debt this month and in January. They had already taken in $50 million today on market anticipations of good trade figures. He recommended that insofar as they were not able to make full repayment, the drawings be renewed.

Mr. Mitchell inquired what the position would be if third renewals should be requested, and Mr. MacLaury recalled that some time ago, after a second renewal, a letter was written to the Bank of England expressing the Committee's philosophy on renewal of swap drawings and emphasizing that they were of short-term character. The Bank of England made it clear that they agreed. He did not mean to imply there should be a second letter, but the British were well aware of the System's philosophy on the matter.

Renewal of the drawings by the Bank of England, if requested, was noted without objection.

Finally, Mr. MacLaury said, a System drawing on the Bank for International Settlements in the amount of $50 million would mature January 13, 1967. At present the Swiss franc was not at its ceiling, as normally might be expected at this time of the year. He hoped it would be even easier after the end of the year and some progress might be made in paying down the drawing. In the event that the Account was unable to do so, he would recommend that the drawing be rolled over a second time.

Renewal of the drawing, if necessary, was noted without objection.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period November 22 through December 7, 1966, and a supplemental report for December 8 through 12, 1966. Copies of both reports have been placed in the files of the Committee.

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

> The comfortable money market conditions that have developed since the Committee last met have generally been interpreted by the market as a sign that the Federal Reserve has moved in the direction of less monetary restraint. This interpretation has been strengthened by continued discussion of a possible tax increase and reports of somewhat less exuberant economic growth. Despite seasonal pressures, the change in market expectations has led to a sharp decline in Treasury bill and other short-term rates, and, equally important, to a ready flow of funds in the capital market in an atmosphere of rising prices. Three weeks ago underwriters were looking with trepidation at the heavy calendar of corporate and municipal issues to be sold. By last Friday the atmosphere had changed to the extent that market soundings by the FNMA with respect to an early sale of participation certificates were received with enthusiasm. Indeed, in the market for Treasury issues prices advanced very sharply, with gains of 1/2 to 1 full point recorded in yesterday's ebullient trading session.
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> In the short-term sector of the market dealers were aggressive bidders for Treasury bills in the regular weekly auctions and also in the special auction of $800 million tax anticipation bills, which completed the Treasury's financing program for calendar 1966. By Friday night the three-month bill was 5.11 bid and the six-month bill 5.22 bid. The market moved decidedly lower in rate again yesterday with the average issuing rate on three- and six-month bills established at about 5.05 per cent and 5.13 per cent, respectively. This represented declines of 20 and 37 basis points from the auction held the day before the last Committee meeting.
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> The decline in short-term rates is, of course, providing a major assist to the banks in limiting the run-off of the $5.5 billion CD's maturing during December. We have heard of some corporations that have changed their

approach to CD's since the beginning of the month. Given the heavy maturity schedule a substantial decline in CD's is inevitable, but it now seems likely that the run-off will be towards the lower end of the $700 million - $1 billion range mentioned in the blue book.1/

Despite the improved atmosphere in the money and capital markets there are a number of hurdles to be crossed before the year-end. Dealer positions in bills are at a high level, and rate stability over the rest of the year depends on the continued availability of financing at reasonable rates, and on continued investor demand for bills. While new corporate and municipal issues have moved out quickly there have undoubtedly been sizable dealer takedowns and some of the buying has been at least semi-speculative in nature. As payments are made for the new issues some pressure may become evident. Tax date pressures are just upon us, and there are still uncertainties about the international flow of funds over the year-end. The fact that the year-end falls on a weekend could also cause a knot in the money market if banks adhere to their traditional reluctance to show substantial borrowings on statement dates. Thus, although the underlying atmosphere is much improved, we can still expect considerable churning in the money market over the rest of the month.

As the blue book notes, the decline in market rates and reduced marginal reserve pressure on banks has not, as yet, been reflected in any notable impact on bank credit expansion. December estimates at the New York Bank show less of a decline in the bank credit proxy than anticipated three weeks ago, and our estimates would now be close to the Board staff estimate of within two percentage points either side of zero. Banks' holdings of Euro-dollar deposits have so far held up better than some had feared, reflecting in part the concerted efforts by European central banks and the System to avoid extensive repercussions of December window-dressing activity. The year-end, however, will

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

probably bring certain special and temporary problems. The relatively high cost of Euro-dollars cannot help but influence some major banks to switch their borrowing to the Federal funds market at rates around 5-1/2 per cent. While bank credit has showed no signs of real strength, banks have been aggressive bidders for new municipal issues, and a better CD outlook could bring about resumed expansion after the regular seasonal pressures have passed.

Open market operations have been described in detail in the written reports to the Committee and I will not dwell on them here. In general, we tried to anticipate reserve needs and to head off any tendency for the money market to tighten, rather than offset tightness after it had emerged. This shift of emphasis in the conduct of operations was fully understood by the market. Repurchase agreements proved a particularly useful operational tool in the light of the reserve supply stemming from the Treasury's cash position and of seasonal uncertainties. Given the improved outlook for Treasury bill rates, dealers felt little pressure to cut back bill inventories, and the substantial supply of repurchase accommodation available from the System at the discount rate helped the performance of the bill market over the period. The use of repurchase agreements during this period also provided the opportunity for the Desk to make use for the first time of the new authority to purchase Government agency issues under such agreements. The System also took advantage, on occasions, of the aggressive bidding in the weekly bill auctions to run off a portion of maturing Treasury bills, thus keeping what at times appeared to be a substantial future need to absorb reserves through outright bill sales at a minimum.

The Treasury has done a bit better in maintaining its cash position than seemed likely three weeks ago. As you know, there was borrowing of $169 million over last weekend against a special certificate issued at 1/4 per cent below the discount rate. It now looks as if no further direct borrowing will be necessary, although the balance at Reserve Banks will be at a low ebb through the 15th and 16th. By the 19th the Treasury balance should begin to work its way back towards more normal levels. All in all, the supply of reserves through the forced decline in the Treasury balance at Reserve Banks did not prove overly disturbing to open market operations, and, from a broader point of view, it was desirable for the Treasury to make use of the special arrangement which had remained dormant since 1958.

The debt ceiling remains a continuing though not insurmountable problem to the Treasury, with the latest daily Treasury statement showing debt subject to the ceiling at $329.7 billion compared with the ceiling of $330 billion. It seems clear that an increase in the ceiling will have to be an early item on the new Congressional agenda.

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 22 through December 12, 1966, were approved, ratified, and confirmed.

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

Mr. Brill made the following statement on economic conditions:

For several meetings now, the Committee's staff has been stalled in coming to grips with the economic outlook, since so much of the future course of the economy rested on the still unknown spending plans of business and Government. We have been alert to unfolding developments that have indicated, since early fall, a marked slowing in economic expansion, but we've hesitated to project these trends into the future as long as the possibility existed that capital expenditures and defense outlays--the two most expansive forces driving GNP this past year--might continue to provide significant upward thrust to the economy in 1967.

Now the veil has been partially lifted, and the staff can no longer dodge the critical policy issues involved. First, let's review the major new items of information in terms of their impact on the course of the economy. Business capital spending plans, as revealed in the latest Commerce-SEC survey, indicate a distinct tapering off of the investment boom. It is not only that anticipated expenditures rise so much more slowly through mid-1967 than the pace of these outlays this past year. Perhaps more significant are the indications that actual spending is beginning to fall short of earlier anticipations, a development which in only small degree can be attributed to supply difficulties. In the present situation, such shortfalls must represent a distinct and significant change in the outlook among many business planners. The intent of monetary restraint and of the fiscal actions taken this fall was to cool off the investment boom; these policies seem to have succeeded, perhaps too well.

The less ebullient outlook of businessmen seems matched by consumers. The latest Census survey of consumer buying intentions, and recent evidence of sluggish retail sales, suggest little thrust from consumer expenditures over the near- and intermediate-term future, especially for durable goods but also for housing.

Finally, as to Government spending plans, hard numbers are not yet available, but one can deduce from the range of numbers leaked to the press, and from the size of the supplemental appropriation for fiscal year 1967 the President has announced he will request, that the rate of expansion in Government spending may also decelerate. The green book[1/] number on Federal spending in the first quarter of 1967 is but a guess, and we tried to flag it as such. But it is a guess from which not too much dissent is likely to be found among Washington crystal-ball readers.

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

Of course, we all recognize that military spending requirements can depart suddenly and widely from budget projections. Even though valiant efforts are being made to pin down this major element in Government spending with more precision this year, one can still legitimately harbor reservations. But one must also credit budget planners with enough intelligence to learn from mistakes.

If, for the moment, one is willing to accept current private and Government spending plans at face value, one comes up with a relatively soggy economic outlook, one in which GNP rises at a slower rate, over the winter and spring, than even the current moderate pace, with capacity use drifting off, hours of work cut back and, possibly, the unemployment rate beginning to creep up. While all GNP projections must be regarded only as point estimates within a probability range, it seems to me that, barring an upward revision in defense spending, deviations around this point are more likely to be on the down side than on the up side. Under the circumstances postulated earlier, for example, we may be relatively optimistic in assuming only a moderate decline in business inventory accumulation in the months ahead, particularly since the October figures on inventories, sales, and business attitudes towards inventories suggest that the recent high rate of accumulation was in part involuntary. One can easily visualize a much sharper reduction in inventories than was projected in the green book, with repercussions on output and employment that could cumulate.

If such an over-all expenditure outlook were the only determinant of economic policy making, the prescription would be fairly simple--forget about tax increases and gear up for the possible need to stimulate the economy some time next year. At the last FOMC meeting, President Ellis asked me whether I thought a tax increase was still needed. After hedging and qualifying in the time-honored fashion of staff economists, I recall admitting that I did think a rise in taxes would be needed. I'm not sure I can give the same answer today; if I did, it certainly would be for different reasons.

But it's not crystal clear as to what the <u>right</u> answers should be, since anticipated domestic spending plans cannot, in themselves, provide all of the bases for policy making. There are balance of payments, wage, and price implications to consider. Short of an actual recession, for example, it is likely that wage rates and wage costs would continue to rise over the next half year, despite further slowing in economic activity. The levelling off in industrial output--which started in early summer and has extended into November, according to preliminary estimates of the production index--has been accompanied by continued strong advances in employment. This implies a marked drop in the rate of productivity gain, which in turn has been reflected in a significant rise in unit labor costs.

While producers may be willing to suffer some further narrowing of profit margins, I suspect that the reaction to continued rise in labor costs will be a tendency to try to pass them on, thus keeping upward pressure on industrial prices. Once the offset from declining food prices ends--a development which some analysts think is about on us already--the broad price measures, at both wholesale and retail, will begin to reflect more of the industrial price creep.

Many current and prospective economic symptoms, then, are the classic ones of a cyclical peak--inventory-sales ratios rising, business investment tapering off, consumer demand sluggish, capacity use beginning to drift down, and wages and prices continuing to push up. Unfortunately, the Government's freedom of maneuver in dealing with these developing symptoms is limited by two major constraints: a continued serious balance of payments problem, and the heritage of last year's fiscal failure, i.e., a large budgetary deficit that is hobbling the choice of appropriate fiscal and debt management policies.

Having done their share of the job this year, monetary policy makers have somewhat more room for maneuver, assuming that more rigorous capital control programs will limit our balance of payments losses to tolerable levels. It seems to me, in light of domestic economic developments and prospects, that at least the direction in which monetary policy has to move is clear; fiscal decisions, or the lack of them, will merely condition the extent and pace of the monetary move. In a more tranquil economy that appears to be heading toward less intensive resource use, monetary policy can appropriately continue to ease, and not be diverted by "last gasp" wage and price increases that reflect earlier sins and don't portend an acceleration. If the size of the prospective budget deficit forces the

Administration to ask for higher taxes, then the monetary easing could be prompt and substantial. If the fiscal decision is not to ask for higher taxes, or if the decision is postponed, then monetary easing could be more gradual and moderate.

For it's not as though we're starting from a position of only mild monetary restraint. Interest rates are still historically high, and bank credit has been contracting, on balance, for five months now. These are far too restrictive a set of policy results to be appropriate to the current moderate pace of economic expansion, let alone the prospect of even more moderation in output and incomes. I would recommend, therefore, continuing to press ahead with the policy initiated at the last meeting, with sufficient vigor to achieve easier credit conditions and, through this, some expansion in bank credit.

Mr. Daane asked, with reference to Mr. Brill's suggestion that the rate of increase in defense spending might decelerate, whether there was any firm basis for that expectation. Mr. Brill replied that it reflected the best information he could obtain from those associated with the formulation of the budget. The numbers might change; they had been changing over time in recent months, but the changes were in the direction he had indicated.

Mr. Daane then asked whether informed judgments were involved or simply guesses, and Chairman Martin observed that what Mr. Brill had reported reflected the most informed judgments available, which he felt might be regarded as fairly accurate at this stage. Mr. Brill commented that it should be borne in mind that a military operation was involved, rather than a civilian-type program. Various developments, such as a new anti-ballistic missile program, of course could cause the figures to be adjusted upward, but the responsible parties had been pressing to get as good a set of figures as possible for the budget, and what he had reported reflected the best current judgments.

Mr. Brimmer noted that it should be remembered that certain basic questions of military strategy were still open. On the other hand, it appeared from the press and other sources of information that some basic decisions had been made recently on strategic questions that offered a better basis for making judgments about military spending over at least the next six months. He understood that the people in the Department of Commerce who worked on national income statistics had reached the same judgment as Mr. Brill.

Mr. Brill then commented on the apparent pace of defense spending thus far in the fourth quarter as it could be read from the Treasury's daily statement, following which Mr. Daane inquired about the possibility of a repetition of last year's experience--an unanticipated upsurge in defense spending. Chairman Martin indicated that he felt that would be likely only if major new decisions were made that would change the whole picture.

Mr. Hickman commented that he assumed there was likely to be enough feed-back of information in the event of such decisions to enable the Committee to alter policy. In his judgment the situation probably would be unlike that of last year when the

Committee simply did not know the facts and continued a relatively easy monetary policy too long. If the Committee became aware that the pace of military spending was about to accelerate sharply, it could shift policy.

Mr. Daane said that he doubted whether anyone in Washington today could say what size the anti-ballistic missile program might assume.

Mr. Partee made the following statement concerning financial developments:

> Despite the moderate easing in money market conditions achieved on average over the last three weeks, the banking aggregates have not yet shown strengthening tendencies. In fact, the November figures on total member bank deposits are somewhat weaker than was projected just prior to the Committee's last meeting. All of the shortfall is accounted for by a significantly weaker private demand deposit performance than had been expected, and this, along with an indicated decline in demand deposits in the current week, has led us to lower our sights for December. Little or no increase in the credit proxy this month now seems likely.
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> November marked the fourth consecutive month in which actual deposit expansion fell appreciably below the projections made around the beginning of the month. Even allowing for some staff bias, which may result from a tendency to project past trends into the future, this is an impressive string of shortfalls. In August, member bank deposits were projected to rise at about a 4 per cent annual rate, but they actually fell 3-1/2 per cent; in September the expectation was for a 3-1/2 per cent rise, but the final result was a fractional decline; in October a 5-1/2 per cent increase was initially projected, but the outcome was a 3-1/2 per cent decrease; and in November the staff started off projecting a 2 per cent decline and then at mid-month lowered the figure to 3 per cent, but the actual drop turned out to be 5-1/2 per cent.

Earlier in this period, these shortfalls were spread among both demand and time deposits, but in both October and November the misses were entirely in the private demand deposit category. As a result, the money stock has moved further downward, on a monthly average basis, and in November was lower than at any time since last February and down nearly 3 per cent, annual rate, from the June peak. The last several weeks have shown some net increase in money stock, and we would expect a sizable rise in the December average--in both cases reflecting mainly outpayments from the Treasury balance--but not by very much more than enough to offset the November decline. Meanwhile, total bank credit, though not quite so weak as the deposit figures in view of increased Euro-dollar liabilities, has also declined on balance over recent months.

I have gone into this background in some detail in order to emphasize as strongly as possible my feeling that something important has been going on to affect financial relationships. We have consistently overestimated the amount of deposit and bank credit expansion that would be associated with a given set of money market conditions in recent months. Moreover, the banking system has failed to respond to the modest easing in conditions that has proceeded irregularly going all the way back to mid-October. Thus, net borrowed reserves were nearly $200 million smaller in November than October, on average, and the whole family of shorter-term bill rates moved somewhat lower. Nevertheless, the decline in member bank deposits was sharper in November than in the earlier months. Obviously, the relationship between money market variables and the banking aggregates has been shifting even faster than allowed for in the increasingly pessimistic staff projections.

Three possible explanations for this unexpectedly strong shift suggest themselves. First is the possibility that credit demands in the private sectors of the economy are diminishing markedly. Certainly the bank lending figures of recent months do not refute this possibility. Not only has business loan expansion declined sharply, with virtually every industrial sector showing slower growth than earlier in the year, but other types of bank lending also have tended to level off. Most of this undoubtedly reflects supply constraints rather than reduced demands for funds, which are now being reflected in heavy current and prospective private flotations in the money and capital markets. In the business sector, particularly, further increases in capital outlays and high rates of inventory accumulation, combined with a leveling off--and possibly a decline--in internal funds, should be producing record external financing needs. Nevertheless, it is only reasonable to assume that the slowing of economic expansion generally over recent months is having its financial counterpart in a less intense demand for borrowed funds.

A second possibility is that bank credit is being curbed as a result of the attitudes of bankers themselves. By this I mean something more than just that terms, lending standards, and other methods of rationing credit have been tightened, which obviously has occurred. It may be that the developments of recent months--deposit losses, sharply declining liquidity, the September 1 letter, and other Federal Reserve restraining actions--have created so many uncertainties that banks are not pushing so hard to use the credit available to them. Many banks may now be inclined to use any modest easing in their positions to repay short-term indebtedness to the Fed and others, rather than to make investments or ease up on lending policy. And if the banks do not push to expand loans and investments, deposits are not created and new reserves are not required. In this situation, even a gradually easing net reserve target could fail to produce an expansive policy effect, since reserves might have to be absorbed through open market operations in order to keep borrowings from declining as rapidly as bankers desired.

The third possibility is that the demand for deposits may have declined. This is clearly the case in the time deposit field, where the 4 per cent savings rate, the 5 per cent consumer CD rate, and the 5-1/2 per cent negotiable CD rate remain out of touch with the best yields on competitive instruments. And it also is probably a factor in the sluggishness of demand balances, in view of the high yields available on cash substitutes. But the behavior of deposits is also probably influenced by the very limited availability of bank credit, one effect of which is to force holders to live with cash balances below desired levels. Many businesses may be working their available funds harder than they otherwise would, for example, simply because they are inadequately financed. Support for this view is provided by the exceptionally large decline in liquidity reported by the SEC-FTC survey of corporate manufacturers for the third quarter.

Whatever the relative weights assigned to these three possible explanations of weakness in the banking aggregates, the general policy prescription seems clear. If the Committee wishes to foster a resumption of moderate growth in bank credit, some further easing in restraints on the banks is needed. An overt and highly visible move would be most certain to alter the attitudes of "reluctant" bankers. But barring this, a continued easing in money market conditions--including some further reduction in short-term rates--may accomplish the objective of bank credit expansion more gradually. A renewed inflow of CD funds, especially one of size, should serve to stimulate credit growth both directly, through increased intermediation, and indirectly, through improvement in banker expectations.

Given the range of rates available on broadly competitive money market instruments, as well as the reduced pool of liquidity to be shared, I believe that it would take a 3-month bill rate at or slightly below 5 per cent--with enough follow-through to bring commensurately lower rates on other money market instruments--to re-establish a reasonable competitiveness for 5-1/2 per cent CDs. Even so, not much CD expansion could be expected before January, in view of the heavy December pressures on liquidity positions. A gradual easing in money market rates over coming weeks would also tend to help bank and other savings institutions hold on to their consumer-type time and savings deposits in the important January interest-crediting period. And an improving money market should help to maintain a receptive tone in the long-term bond markets, which continue to face a prospectively heavy financing calendar from corporate borrowers and also probably from the Treasury.

Mr. Daane asked the Manager when he would expect the seasonal peak in short-term rates. Normally it had been thought that the peak occurred around the 16th or 18th of December, and he wondered whether that was still applicable.

Mr. Holmes agreed that that had been the normal pattern. Whether it would prevail this year, he did not know.

Mr. Daane then requested clarification of Mr. Partee's views about the role of supply constraints on bank credit expansion.

Mr. Partee replied that he thought one would have to say that supply constraints--that is, constraints on the supply of reserves available to the banking system--had been the major factor in limiting growth in bank credit and deposits. But there also had been some demand effects on both the bank credit and deposit sides of the balance sheet. The various influences had all been mixed together.

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

> This morning I would like to comment on some developments abroad that have a look of recession about them, and then try to see what implications these developments have for Federal Reserve policy or--on a different level--for appraising the economic situation in the United States.

Unemployment in Britain and Germany has been rising this autumn at a pace, in each country, that seems to have surprised the governments as well as other observers. True, the levels of seasonally adjusted unemployment are still very low: in November still below 2 per cent in Britain and below 1 per cent in Germany, but these lines will be broken through very soon if the rises continue. The industrial production indexes are not available for October and November; in September, industrial activity was clearly falling in both countries. In both countries domestic plans and orders for business capital expenditures began to decline gradually in real terms early in 1965, and the declines have become faster lately. The picture for inventory investment is similar. Residential construction has also been falling off gradually for some time. Monetary policy has made credit and capital market conditions extraordinarily tight, and this is an important key to what is happening.

At the moment the world economic situation bears no resemblance to the 1957-58 downturn, which involved a transition from world-wide shortages of materials to ease of supply, on top of the unwinding of the 1955 investment and automobile boom. Japan and Italy now play much larger roles than in earlier years, and both of them, as well as France, are in the early stages of strong new domestic upswings. On the other hand, several other European countries and also Canada have been experiencing a leveling off in industrial production this year.

For Britain and Germany, the present situation somewhat resembles the pause during 1961 and 1962, in the second half of a previous four-year cycle, but there are more elements of outright recession now than then. It has taken the British longer this time to get some slack in their economy; but now that the turn has been made some kinds of demand appear to be shrinking with some speed. In Germany, the previous pause involved hardly more than a slowing of rise in industrial production; this time, after slowing for a year and a half, German industrial production, as seasonally adjusted by the OECD, fell 5 per cent in three months from the high reached last spring.

These developments abroad may require some rappraisal of U.S. balance of payments prospects for coming months. The slide-off in German demand is a bearish factor for our exports; if continental European countries as a group now let their economies cool off, or in some cases keep them from heating up, more successfully than it had previously seemed they could, that would tend to dampen our export growth for a time. On the other hand, recession, or a pause, in European economic expansion now might conceivably be just the catalyst needed to cause American manufacturers to review and reject some of their projects for enlargement of operations in Europe.

Another whole series of questions relates to the timing of changes in monetary policies in Britain or continental Europe, as compared with the timing of any movement toward lower interest rates in the United States.

In thinking about the relevance for Federal Reserve policy of all such questions about the U.S. balance of payments next year, we may well come to the conclusion that the objective of working toward long-run equilibrium in international payments will be served best by policies aimed wholeheartedly at the two-fold domestic objective of sustaining growth and minimizing inflation of prices and costs, without much concern about short-run variations in our balance-of-payments prospects or results, so long as the rise of domestic prices slackens. Two main lines of argument can be advanced to support such a conclusion at the present time.

First, even on balance-of-payments grounds, a recession in the United States could have harmful long-run effects if it were to tilt the whole demand-and-supply situation in the world at large toward recession. Under present conditions, we can look for some slackening of import expansion as excess demand diminishes. But the further benefits our balance of payments might get from depression of our imports in a U.S. recession might well be cancelled off in the longer run by subsequent unfavorable repercussions on our exports through a related recession abroad. In short, the United States stands the best chance of enlarging its exports in an expanding world economy, and the size of our country gives us a special responsibility for helping to maintain noninflationary growth in the world economy.

Second, the prestige of the dollar stands well enough for the moment, and the Administration's voluntary programs, plus the I.E.T. and the related arrangements with Canada, will give us some protection again next year. Under these conditions, the United States will be doing all we can properly be asked to do towards restoring order in international payments if we follow policies that can be seen by everyone to be the right ones for maintaining noninflationary growth. _If_ one consequence of what we do and of what others do is a sharp rise next year in the reserves of Germany or other Common Market countries, so be it. It should then become clearer to the whole world than ever that the chronic and semichronic surplus countries must play a more positive role than they have yet done to restore international equilibrium.

With regard to the specific, narrow, question of U.S. banks' borrowings from the Euro-dollar market, it would be far better to let this money flow back to Europe as soon as that tendency develops, rather than try to hang on to it at a cost of keeping interest rates higher than domestic conditions might call for.

These few thoughts about the balance of payments and monetary policy under current and prospective conditions do not help judge how to stay on the tight-rope: to minimize price and cost inflation on the one hand and to maintain growth on the other.

The first essential--easier said than done--is to appraise current domestic developments accurately. As we make our appraisals, perhaps the recent developments abroad have some usable lessons for us. One lesson is the reminder that a slide-off in activity _can_ begin quite suddenly and almost unexpectedly, when investment decisions and inventory policies are being revised under the pressures of very tight money and capital markets.

In conclusion, let me come back to the policy issue. We are fortunate that our gold reserves are larger than Britain's, and our basic payments position stronger. We are fortunate also that our wage inflation, up to now at least, has been less rapid than Germany's. Thus we have some freedom of maneuver to deal, in a cautious way, with the danger that the economy may be moving toward recession--while keeping on the look-out to avoid the opposite danger of a new build-up of inflationary pressures.

Mr. Daane asked, if the Committee followed the policy prescription advocated by Messrs. Brill and Partee, what sort of capital outflow might be expected, taking into account the extent of recent borrowing by American banks from the Euro-dollar market and the leeway available for foreign lending by U.S. banks under the new guidelines of the voluntary foreign credit restraint program.

Mr. Hersey said he supposed, if there was an easing of rates here, that there would be a tendency for U.S. banks to turn more to the Federal funds market and to repay borrowings in the Euro-dollar market. However, he did not feel he could make a very good judgment on how and when that might happen. He thought the tightness in the Euro-dollar market was due, to a large extent, to the American banks' demands and that if those demands lessened Euro-dollar rates might decline. If at the same time there was an easing of rates in the national money markets in Europe, the Euro-dollar might come to seem less expensive, and the shift might be neither rapid nor far-reaching. It was difficult to predict what might happen; the gist of what he had said in his statement was that, given current economic conditions here and abroad, the Committee probably should not place great emphasis on short-run movements in the balance of payments. As to foreign lending by U.S. banks, a moderate and gradual easing of domestic monetary policy was not likely to lead to a sudden rapid rise.

Mr. Brimmer commented that this might be a good point at which to discuss the new 1967 program of voluntary restraints to improve the balance of payments position, which he understood was being announced today.

In answer to a question from the Chairman, Mr. Robertson said that the Board's new guidelines for financial institutions had been announced this morning. He suggested that Mr. Brimmer might want to discuss the Commerce Department program.

Mr. Brimmer said that the Commerce program would be of essentially the same type as in 1966. For direct investments, which was the critical area, the 1962-1964 period would still be used as a base, and the two years 1966 and 1967 would be combined for the purpose of providing a quota for the companies participating in the program. However, the rate of investment permitted within this quota--which for 1965-1966 was 135 per cent of the average during the base period--would be reduced to an average of 120 per cent for 1966-1967. That was a substantially more restrictive program, as far as percentages were concerned, than was anticipated a few weeks ago. The quantitative result expected under the program should be in the neighborhood of a $2.4 billion direct investment outflow. Earlier it had been thought the figure would be $2.8 billion, the same as 1966, so the program had been tightened substantially in the last week or so after discussion within the Administration. There seemed to be some $400 or $500 million of direct outflow covered by neither the Commerce Department program nor the nonbank financial institution part of the Federal Reserve program, and the question of how to deal with those flows was still open. Nevertheless, the further tightening of the Commerce Department program would provide an additional barrier to capital outflow, and thus was a favorable development.

Chairman Martin then suggested that Mr. Daane give the Committee a summary report on the meeting on international monetary reform held recently in Washington.

Mr. Daane said that the meeting, held November 28 and 29, was interesting and significant. It was the first of a series of four joint meetings of the Executive Directors of the International Monetary Fund and the Deputies of the Group of Ten. He thought a fair sum-up of the meeting was that given by the Chairman of the Group of Ten Deputies, who said that the results exceeded the most optimistic expectations. The Chairman of the meeting, Mr. Schweitzer of the Fund, made a similar comment. Despite some earlierfears that the meeting would simply elicit a Group of Ten view and a Fund view, that was not the case. Instead of bloc positions, the participants presented their individual views in a frank and effective exchange.

As he had indicated at the last Committee meeting, Mr. Daane continued, an agenda had been agreed on earlier, and it served as a guide to the discussions. The first item related to the aims of reserve creation, including the need for reserves and its relationship to adjustment policies and the supply of conditional liquidity. That discussion was sparked by Under Secretary of the Treasury Deming. On the basis of the work that the Group of Ten had previously done, he made the case for the need for reserves to provide adequate growth in liquidity. Mr. Deming stressed secular considerations, emphasizing the global need for reserves to be provided over a period of time. He cited past experience in terms of annual increments in reserves required and noted that gold and reserve currencies could not in the future be expected to satisfy fully needs of the magnitudes foreseen. It was implied by Mr. Deming's comments--and clearly recognized by the non-U.S. participants--that the U.S. was moving away from its earlier stand in favor of a dual approach involving a combination of drawing rights and reserve units.

Mr. Daane added that the French position, stated by Mr. Perouse of the Finance Ministry early in the sessions and maintained throughout, was essentially that there was no imminent shortage of reserves and, therefore, that it was more important to focus on "more fundamental problems" than on reserve asset creation. Mr. Perouse listed five such problems, which were: The adjustment process--in discussing which he focused on the deficits in the U.S. balance of payments; the holding of reserve currencies, and whether some restrictions should be placed on the holding of national currencies as international reserves; the relationship between conditional and unconditional liquidity; the role of gold, including the price of gold; and the question of stability of international commodity prices and the organization of international commodity markets. Throughout the sessions the French urged that the group should focus on those issues rather than on the matter of reserve asset creation. But no other country, either in or outside the meeting, accepted that diversionary tactic. It was the consensus that a clear need existed to proceed with contingency planning to provide for adequate secular growth of international liquidity.

The second agenda item, Mr. Daane said, had to do with the nature and form of deliberately created reserves. The Chairman of the Group of Ten Deputies, Dr. Emminger, tried to make a case for an asset specifically designed for a limited group of countries, on the basis that only a limited group held gold in their reserves and were interested in having a gold-like reserve asset. Therefore, he (Dr. Emminger) proposed having a gold-like asset for that group and a different type of asset for other countries. The representatives of non-Ten countries convincingly presented their views on the need for universality in all aspects of reserve creation. They clearly were not interested in accepting "separate but equal" treatment. They received support around the table for universality, and there was clear adherence to the view that it was desirable, particularly with respect to the distribution of new assets. A major question left open here, however, was the desirability of universality in decision-making.

Distribution of deliberately created reserves was the third topic on the agenda, Mr. Daane continued. There was very little disagreement with the view that there should be some form of across-the-board distribution, according to an objective formula such as Fund quotas.

The fourth item on the agenda concerned the utilization of new reserve assets, including such questions as insuring acceptability and preventing misuse, and the kinds of safeguards needed, Mr. Daane said. There was a fairly clear consensus that what the group was striving for was an unconditional asset. With respect to safeguards, the Emminger position in favor of having a gold transfer ratio attached to the asset was clearly rejected, not only by the U.S. but by the non-Ten. On the last day of the meeting Chairman Emminger indicated that while a gold transfer ratio might be the more elegant way of providing a safeguard, one could not always have elegance. Thus, there was evidence of some re-thinking on the part of the Group of Ten--particularly by such people as Messrs. Emminger and Ossola--on how to provide safeguards without a gold link.

The fifth topic on the agenda, Mr. Daane said, concerned conditions and circumstances of activation of a contingency plan, but that topic was not discussed. The second joint meeting would be held in London on January 24-25, 1967, and among the items on the agenda probably would be the questions of decision-making and of the holding and use of the reserve asset.

Mr. Daane added that the Group of Ten Deputies had a separate session on November 30, largely procedural in nature, at which two working sub-groups were set up looking forward to the agenda in January. One of those, on which he was included as a U.S. representative, was to consider the question of reserve policies. The other sub-group would deal primarily with the holding and use of the reserve asset, but also with the entire range of questions having to do with the construction of the asset. It was not entirely clear to him whether the sub-groups were simply to look back at the record and pull together the relevant considerations or whether they were to do some thinking of their own, looking forward.

Mr. Solomon, whose comments were invited by Mr. Daane at this point, noted that after the meeting there were quite a few releases from Paris, not all official, commenting on some of the same issues that were raised at the meeting by the French representative. Two questions were included that had not been discussed specifically at the meeting. One had to do with the price of gold, which the French representative had passed over lightly at the meeting. The French seemed now to be saying through the Paris press that, if and when there were a need for additional liquidity, thought should be given to raising the price of gold, which had not been changed in more than 30 years. The second factor brought in was that there was one major country with an interest in these matters--the Soviet Union--that was not a member of the IMF. He did not know whether the introduction of those two new considerations would lead anywhere or not. On the gold price question, the French were trying to be responsible by saying that any need for a price increase lay at some point in the future, and therefore the gold market need not become disturbed now. At the same time, however, they were trying to keep the issue alive. It was clear to everyone who had been at the meeting that the price of gold had not been on the agenda at joint or separate meetings of the Group of Ten or the Fund, nor would it be.

Mr. Daane added that both Dr. Emminger and Mr. Schweitzer had stated categorically at their press conference that the price of gold was not on the agenda for the London meeting or any other meetings of their respective groups. The French then asserted that Messrs. Emminger and Schweitzer had no authority to make such a statement, but the fact that they did have full authority was subsequently confirmed.

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:

> An accurate reading on the economic outlook seems even more difficult at this time than usual because of the abundance of uncertainties and conflicting cross-currents. For the moment, demand pressures in the economy continue to moderate at the same time that cost pressures appear to be mounting. Despite the further evidence of a slower rate of expansion in the private sectors of the economy provided in the latest surveys of plant and equipment spending plans and of consumer buying intentions, I am not at all convinced that anything resembling a recession is in prospect for next year. In fact, several elements in the current picture suggest that the pace of the advance may accelerate again early next year. The precipitous housing decline should level off, the drag on production of the currently much slower rate of inventory accumulation should diminish, and most of the adjustment to a higher and more normal savings rate should be completed. With every prospect for a further large rise in defense spending in 1967--in the absence of any definite word to the contrary from the Administration--a strong and even excessive expansion seems to be in the cards. Our economists see a good likelihood that GNP growth may be of roughly the same order of magnitude next year as in 1966. I might add, parenthetically, that it is amazing to me how different economists can look at the same figures and come out with varying conclusions.
>
> Even during the current quarter of slower GNP growth the price situation is distinctly unsatisfactory. Consumer prices continue to increase and overall

industrial wholesale prices are likely to resume their rise. Declines in crude material prices seem to be leveling off as prices of finished products remain on the uptrend. I have been struck by the number of individual wholesale price increases announced in the last week or so. Labor costs per unit of output have advanced sharply since July, and with growing wage pressures and a slowdown in productivity growth, the outlook for such costs is disturbing. As we have all recognized, today's general business situation is very different from the nicely balanced growth of the early 1960's. There is no assurance that such a well-balanced growth can be re-established within the near future. Rather, we may have to face the fact that somewhat slower than ideal real growth may be required if we are to avoid grossly excessive inflationary pressures.

The balance of payments statistics for October, showing a liquidity deficit of $770 million, underlined the continued imbalance in our international accounts. Following the November deficit of perhaps $300 to $400 million, a substantial surplus may be achieved in December, but only as a result of prepayments on military orders and other special transactions. If so, the full year liquidity deficit may be only moderately greater than the $1.3 billion of 1965. However, as we look ahead the chances for avoiding a considerable worsening of the deficit in 1967 do not seem favorable. Some deterioration on capital account seems inevitable. I was glad to hear Mr. Brimmer's report on the direct investment program, but I still feel that some deterioration on total capital account is ahead. And military outlays abroad will probably rise substantially. I see no assurance that our trade surplus will improve enough to offset these adverse factors, more particularly if the business expansion accelerates again and if appreciably higher labor costs become built into the economy during the year. Finally, it goes without saying that we are likely to incur a sizable official settlements deficit in contrast with near-balance for 1966.

I confess that I am still puzzled by the general weakness of the credit and monetary statistics over the past few months. In my judgment, the extent of their weakness is not matched by any visible development of the real economy. It still seems quite likely that our seasonal adjustments have given an exaggerated picture of the slowdown by failing to take adequate account of tax-related and anticipatory borrowing in the first seven months of the year. There is no doubt that there has been a significant slowing of bank credit growth, but if we look at the year as a whole the rate of slowdown is reasonable and more or less in line with what we have been trying to achieve right along. One question of particular interest is whether the current slowdown in loan growth is still related primarily to the supply restraints imposed by the banks, or whether there is a slackening of underlying loan demand. Both elements are doubtless present, but most New York bank lending officers believe that their own restraint policies are the major cause. The banks generally view Federal Reserve policy as still restrictive, and they are acutely aware of their liquidity problems. Thus their conservatism in dealing with loan requests is quite understandable. There has not yet been sufficient time for them to react to the easing of their marginal reserve positions in November nor to the decline in short-term rates in recent weeks. Clearly, some modest resumption of bank credit growth, as compared with the apparent cessation of growth in the last few months, now seems very much in order; and I hope that the somewhat easier money market conditions that now prevail will lead to that result.

It was suggested that it would be helpful for the Reserve Bank Presidents to comment briefly at this time on the construction and mortgage loan situation in their Districts.1/ It was the general feeling of most of the senior loan officers surveyed that new commitments for

1/ In a wire dated November 29, 1966, to the Presidents of all Federal Reserve Banks, the Secretary of the Committee stated that some members had indicated it would be helpful to have comments at this meeting concerning the degree to which the construction and mortgage loan situation in the respective Districts was showing signs of change. It was suggested that a small sample of representative bank and nonbank lenders be asked several questions relating to current flows of new commitments for construction and mortgage loans.

such loans are at or near the low point for the year. At best, only a moderate recovery can be expected in the immediate future. Savings and loan associations were the most pessimistic of the four groups of lenders contacted, and mutual savings banks were probably the most optimistic. Life insurance companies are presently willing to commit themselves for permanent mortgage loans, but at a reduced pace and only in the quite distant future--no earlier than late 1967. Commercial banks report that they have not tightened up on construction lending to any greater degree than on other types of business lending; nevertheless, the cutbacks have in fact been substantial, possibly reflecting the fact that the construction industry has many nonprime borrowers. The commercial banks continue to grant a fair amount of homeowner mortgage loans, but the relatively few large banks that had actively sought to expand their role in this field during the past few years have cut back on their efforts in this direction.

Under all the circumstances, I think it is reasonably clear that credit policy should remain unchanged over the next four weeks. The underlying strength of the economy and the unsatisfactory balance of payments position argue effectively against any further easing of policy. On the other hand, while I felt that we were moving a little too overtly toward a policy of greater ease at the last meeting, I would not advocate at this time a return to a posture of greater firmness in view of some further evidence of a slowdown in the rate of economic expansion, the weakness of the credit and liquidity indicators, and the prospect of the usual year-end churning in the money market. As for specific instructions to the Manager, I think we should stress maintenance of current money market conditions, with Treasury bill rates in a 5 to 5-1/4 per cent range and a Federal funds rate of around 5-1/2 per cent or less. I would hope that net borrowed reserves of around $200 million would be consistent with these money market conditions. In any event, conditions in the money market should take precedence over net borrowed reserves, and the Manager should again be given considerable leeway to use his judgment as to how best to maintain stable market conditions.

With respect to the directive, I think that the staff's draft alternative A is entirely satisfactory.1/

I would just like to make one further comment with respect to our longer-term policy considerations and the so-called policy mix. I believe a general tax increase is still highly desirable as a sort of insurance against finding ourselves again facing problems similar to those of last summer if the economy should gain speed next year. On the other hand, I believe we should not encourage any tendency to think that a very major easing of monetary policy might be considered as a sort of "trade off" against a tax rise. I say this because I am convinced that our continuing balance of payments difficulties place a rather strong limitation on how far we can go in easing monetary conditions for domestic purposes. Unfortunately, we find the flexibility of monetary policy curtailed in both directions, insofar as major swings of policy are concerned. This is not to deny, of course, that there is still considerable room within which to exercise an important influence on business and credit developments.

Mr. Ellis commented that quite clearly the major propellent driving the New England economy had been and continued to be the stimulus to manufacturing that derived from Federal spending, especially the defense and space programs. A tally of published defense contracts--which showed sharp expansion last spring--plus application of an established lag period of six months or more, suggested that New England manufacturers would continue under delivery pressure for some time. Such pressure was showing up in employment, which registered its twelfth seasonally adjusted

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

increase in October; in manhours of production workers, which increased in October to a new record of plus 7.2 per cent from October last year; and finally in personal income payments, which showed New England exceeding the nation in year-to-year percentage gains. In the construction field, declines in the residential category were just barely offset in the totals by gains in other categories for a 3 per cent year-to-year gain in October. The ten-month total now measured a 20 per cent gain over a year ago--for the U.S. it was 4 per cent.

Mr. Ellis remarked that in response to the Reserve Bank's queries concerning present and prospective mortgage flows, both the banks and insurance companies reported that their new commitments remained very low. After a period of rebuilding their liquidity and gaining assurance about the probable flow of deposits and policy loans, they hoped to resume mortgage lending. A very few banks reported that they did have money and were still granting mortgages, but most reported only extending commitments to long-established customers that they felt they must serve.

Mr. Ellis stressed (1) the desire of the insurance companies to see a halt in policy loans before they resumed new commitments; (2) the desire of the mutual savings banks to see their loan-deposit ratios recede from the 85 per cent legal limit before they resumed new committing; and (3) the desire of the commercial banks to rebuild liquidity before turning their loan officers loose. A year ago liquid asset ratios of New England banks matched or exceeded the national average; today they ran 2 percentage points below. While such ratios had declined perhaps 2 percentage points for the national average, they had declined 5 or 6 percentage points for the Boston banks.

Looking ahead, Mr. Ellis said, his economic perspective agreed more nearly with that of Mr. Hayes than what he judged the staff to be presenting. In deliberating the proper course of monetary policy for the next four weeks, the Committee had two major kinds of confirmation that it was looking for at its last meeting. On the one hand, it had a further confirmation of slow-down in the rate of expansion of the economy to what used to be called "a more sustainable rate of expansion." That was now called "soggy," which he judged meant a qualitative evaluation of a strong possibility of an actual turndown in the economy some time in 1967 unless emerging trends in the private economy were reversed. On the other hand, the Committee had confirmation of a large, and probably still growing, volume of Federal outlays. As expected, the delay in availability of information about Federal outlays traced not to possible shortfalls but rather to how large they should be allowed to appear to be. He appreciated Mr. Brill's measurement of the maneuvering room left for monetary policy.

Failure to accompany the deficiency appropriation request with any request for a tax increase suggested that the maneuvering room for the Committee to lessen monetary pressures in favor of fiscal restraint was narrower than it would be otherwise. The Committee's choice of policy now seemed confined to the question how much monetary restraint remained appropriate given the conditions of private and Government demand emerging in the present fiscal and debt management context.

The principal effect of the Committee's policy change to date, Mr. Ellis judged, had been to demonstrate that the Committee was flexibly sensitive to the desirability of less monetary restraint if the economy could accept it without resurgence of the earlier excesses. With the Committee's having demonstrated that awareness, he would be prepared to see it rest on its oars and initiate no further change in policy until the course of fiscal policy became more clear.

Mr. Ellis suggested that the two draft directives were not really different alternatives. The blue book projected a failure to expand or little change (plus or minus 2 per cent) in the bank credit proxy for December. Alternative A provided that "somewhat easier conditions shall be sought if bank credit appears to be failing to expand." So, if the staff projections were correct, the Manager was directed to ease further. Alternative B without equivocation directed the Manager toward "attaining somewhat easier conditions." In effect, therefore, both alternatives called for easing. To provide language that would afford more choice, he suggested that alternative B be left as it was but that alternative A be converted to a "no change" directive by substituting the word "declining" for the words "failing to expand," with the understanding that "declining" would mean something more than the plus or minus 2 per cent projected by the staff. With that change his choice would be alternative A.

Mr. Irons commented, with regard to the construction and mortgage loan situation in the Eleventh District, that 41 banks, insurance companies, savings and loan associations, and other lenders had been contacted. Of the 41, 25 indicated that the flow of commitments was at its lowest level for the year. Seven of the 25 expected it to go still lower; 18 of the 25 felt that there might be some signs of recovery within the next two or three months. The remaining group was about evenly divided, with 8 taking the position that they were at the low point of the year but anticipating recovery and the other 8 already experiencing recovery from the low point. He would caution with respect to the over-all figures, however, that the views reflected the situation of the particular lender interviewed. For example, the answers of the two largest banks in the District did not jibe. The same thing was true of the two largest locally-based insurance companies; and one of the two largest mortgage bankers was optimistic while the other was pessimistic.

Moving to District economic conditions, Mr. Irons said that the various elements of the economy seemed to be basically strong but not advancing with the same strength as some time ago. Employment continued to rise, inching up to record levels each month. It was estimated that in Dallas the unemployment ratio was slightly over 2 per cent and would go to 1.9, while Houston was already at 1.9, so there was a very tight labor market. The index of production continued to move up. Construction was stronger last month and department store sales were regarded as generally favorable, although it was again a matter of obtaining the expressions of particular department stores. Agricultural conditions were quite good, but there was a general need for rain in the area. Cotton production was going to be about 25 per cent below a year ago, largely because of the new cotton program. Livestock conditions were good, but the lack of rain was having its effect on winter wheat in the District. A couple of months ago, two West Texas banks asked if they could obtain six-month discount accommodation for grazing on winter wheat, but they had not been heard from since. Credit demands in the District might be affected somewhat depending on whether winter wheat was sufficient to meet grazing requirements.

On the financial side, Mr. Irons reported that bank loans in the District had been drifting down a bit. Total deposits were down, but time and savings deposits were up slightly. Borrowings from the Reserve Bank had not been large; over the past four weeks they had declined by some $10 million. Throughout the fall period there had rather surprisingly not been a demand for credit through the discount window from the usual seasonal country bank borrowers. Some small country banks had come in that had never been in before, having been referred by their city correspondents, but generally there had not been the usual demand from country banks.

The cautious conclusion of businessmen and bankers in the major District cities was that there had been an easing of monetary policy, Mr. Irons said. They thought the worst of the tight money period was over. But they were still cautious and were worried about the outcome in Vietnam and about the tax situation. On balance, the majority probably would favor an increase in taxes if they were told why it was necessary. In his opinion, the public probably was more ready to move in that direction, if they knew what was needed, particularly in terms of the cost of the Vietnam involvement, than the politicians seemed to suppose.

On the national side, Mr. Irons noted that there had been some further slackening in the growth of the economy, although high levels of employment, output, and income were being maintained.

The recent slackening in the pace of business plant and equipment expenditures was of some significance. The strength in that area had been compensating for several weaker sectors such as housing, automobiles, and heavy durables. On the other hand, income and employment continued to rise, there continued to be almost full utilization of plant capacity, and a high volume of trade was expected over the holiday period. In summary, there was some indication of lag in the private economy, but an offsetting trend in the public sector, and the private sector did not appear to be fundamentally weak. One should not rule out the possibility of a re-appearance of general strength. Also, he had some doubt that inflationary pressures had been calmed to the point of being more or less canceled out as a problem. There were still price pressures in the economy, and wage pressures could be expected over the coming months. While bank credit had not increased in line with the availability of reserves, it did not always follow that bank credit would expand just from putting reserves into the market. There are a number of factors that cause businessmen and bankers to decide whether to borrow or lend, and they must be taken into consideration.

Mr. Irons suggested that credit policy until the next meeting of the Committee be directed toward maintaining about the same money market conditions as had prevailed over the recent period. He would avoid further easing, especially any overt move in that direction. He considered alternative A of the draft directives as the more desirable of the two, although he was somewhat concerned about the proviso clause, which specified that if bank credit appeared to be failing to expand, somewhat easier conditions should be sought. He did not think the problem was as direct and simple as that language implied, especially when a short-term period was involved. This was a period of great uncertainty in a number of ways, and one would hardly expect the direct relationship to prevail that seemed implied by the proviso clause. Nevertheless, he would accept alternative A. He would expect that within a reasonable margin of error the three-month Treasury bill rate would be around 5.10 per cent, the six-month bill rate around 5.20 - 5.25 per cent, the Federal funds rate around 5-1/2 per cent, and net borrowed reserves around $200 million, possibly less.

Mr. Swan reported that October saw a rather broadly based increase in nonagricultural employment in the Twelfth District, despite the possibility of a fractional increase in the unemployment rate, and it appeared that that trend may have continued in November on the basis of the total employment figure for California. However, the projected employment gains in December and January in the aerospace industry were quite modest, in part because of expected shortages and delivery delays for various components, including engines. There had been a further considerable decline in construction contract awards in October in all categories, and in the first ten months of 1966 there had been a decline of 8 per cent in total awards from the similar period in 1965, compared with a gain of 7 per cent for the U.S. as a whole. Residential contract awards were down 26 per cent compared with a 4 per cent increase in nonresidential awards and a 5 per cent increase in heavy construction awards.

Twelfth District weekly reporting banks showed an increase in total credit in the three weeks through the end of November, Mr. Swan said, primarily because of acquisitions of Government securities. Business loans were up a little more than in the U.S. as a whole, reversing the trend during the earlier part of the year, but the increase was substantially less than for those same weeks a year earlier. He gained the impression from some of the major banks that they still felt loan demand was strong. In the business loan area they were not supplying all the potential borrowers, but at the same time there was some willingness to admit that demands were somewhat less intense than a few months ago.

In the three weeks through the end of November, Mr. Swan continued, the principal weekly reporting banks showed a large gain in time deposits of States and political subdivisions and a better picture in the behavior of large CD's than banks in the rest of the country, although that was perhaps related to the State and municipal deposits. Large denomination CD's in total showed a gain of some $66 million, although there was a loss of $2 million in such certificates issued to individuals, partnerships, and corporations. In October the savings and loan institutions in California apparently accounted for more than the total loss of funds for all savings and loan institutions in the country as a whole. That was somewhat surprising, and he had no specific explanation.

As to the survey relating to construction and mortgage loans, Mr. Swan reported encountering much the same experience as reported by Mr. Irons in terms of differences between the same types of institutions in the same areas. Over all, respondents indicated that mortgage commitment activity was now at about its lowest point, with some slight improvement expected over the next several months but not necessarily the next two or three months. Activity would still be at a rather low level even with the improvement anticipated. As to the various types of institutions, with few exceptions commercial banks and insurance companies seemed to be still headed downward in their commitment volume. The banks had not reduced their lending in the same proportion as the others, so they accounted for a smaller part of the decline thus far. The savings and loans had cut back sharply in the spring and now expected some improvement, with a few expecting to increase their lending substantially, from the present low level, in the next few months. There seemed to be more differences between areas within the District than among types of institutions. The Los Angeles and Salt Lake City areas saw little expectation of early recovery; those were areas where overbuilding had been pronounced in the past. In the northern California area there was some indication of improvement over the next several months. In the Northwest the optimism seemed to be greatest. The decline in Oregon had been more modest than in California. In Seattle it was doubtful whether there was any real decline due to the substantial increase in demand for housing during most of 1966.

It was pointed out by some lenders, Mr. Swan said, that second mortgages taken by sellers had filled part of the gap. Data on loan records that the Reserve Bank had been able to obtain for certain areas tended to bear that out. Recorded loans made by lenders other than financial institutions were up about one-third, in terms of the share of the total, from August 1965 to August 1966.

Mr. Swan said he had nothing specific to add to what had been said about the national picture. There were still uncertainties in the situation, although some aspects of the over-all picture were not as weak as the financial picture seemed to be. He would translate that into a view that any further monetary easing should be quite modest; he would not favor any substantial move in that direction. It seemed to him that the Committee would have a much better perspective when the budget figures were available and when it could see whether the seasonal decline in the early part of next year was orderly.

In terms of the directive, Mr. Swan felt somewhat like Mr. Ellis: given the proviso clause, there was not a great choice between the two draft directives. That led him to favor, although not strongly, alternative A as originally written. If alternative A were modified as Mr. Ellis has suggested, however, he (Mr. Swan) would prefer alternative B.

Mr. Galusha reported that last week's survey of Ninth District mortgage lenders yielded a rather confused outlook. Mortgage commitments, well below the 1965 total in May, had continued to decline, and many of the lenders were inclined to believe that commitments would not increase again soon. But the situation of the savings and loan associations appeared, when seasonally adjusted, to have improved somewhat; and on that count one could reasonably look for an increase in the level of mortgage commitments fairly soon. Also, mortgage terms appeared to have stabilized, at least in the Twin Cities area.

Mr. Galusha added that he had, surprisingly enough, received a few reports of country banks being on the look again for business loans. The situation of District city banks, as measured by their combined basic reserve position and combined loan-deposit ratio, had eased of late, but not enough to send those banks looking for loans. According to reports, city banks still felt themselves strapped.

From what the authors of the green book had to say, particularly about banking developments nationally, it appeared to Mr. Galusha that the Committee should continue the recently initiated trend to easier monetary conditions. With the plant and equipment survey results in, it was possible to be more confident today than a couple of weeks ago about the economic outlook. And that outlook, being bearish, called for an easing of the position of commercial banks--an easing which, even allowing for lags, had apparently not yet been effected. There were still some important fiscal decisions to be made, but that fact seemed to provide no reason for the Committee to pause now. The point, of course, was that if tax rates were increased, the need would be for a sharply easier monetary environment.

The September 1 letter was a constraint in the Ninth District on the operation of the discount window, Mr. Galusha said. An obvious written withdrawal would be difficult enough to write in the best of circumstances, and in the context of these perilous times might well be impossible. But interment of the letter in other less structured ways could be encouraged.

Mr. Galusha added that with the U.S. balance of payments position being what it was, a reinstatement of the investment tax credit would seem to make more sense than a sharply easier monetary environment. But that was looking rather far down the road. The balance of payments problem, however serious it might be, would not seem to preclude some modest easing of monetary restraint now. To be a bit more precise, he personally would have no misgivings--assuming the blue book authors were right--about a level of free reserves close to zero or better.

Mr. Galusha commented that he shared Mr. Hayes' perplexities but not Mr. Hayes' conclusions. He favored draft alternative B. He liked the way it was written and the fact that it had no proviso clause.

Mr. Galusha suggested a need to begin looking closely at prospects for the second and third quarters of next year. He had a feeling that there was in process a substantial slowing up of domestic Federal programs, at least in the Ninth District, that would begin to show up clearly next spring and summer. Cutbacks in Federal spending were particularly important in areas like the Ninth District where so much of the economy was dependent on Federal programs and their absorption of labor displaced from other lines of work such as construction. Highway construction, for example, had done a remarkable job of absorbing carpenters no longer engaged in building houses.

Mr. Scanlon reported that the past several weeks had witnessed growing uncertainty among Seventh District businessmen and lenders with regard to economic prospects for the coming year. Forecasts by prominent economists had emphasized that the restrictive monetary policy of the past several months made a slowdown in 1967 almost inevitable. The business community was in a mood to make downward adjustments in inventories, capital expenditures, and new hirings. Output cutbacks had occurred in building materials, steel, autos, and household appliances.

Forecasts of auto output for next year had been reduced to about 8 million units, Mr. Scanlon noted, compared to 8.6 million in 1966. Steel orders had been very slow in December and output was expected to be off 5 to 10 per cent from the fourth quarter to the first quarter. District orders for machinery and equipment were at the lowest level in several months in October, with construction machinery orders down sharply. The outlook for construction had not improved. Despite all of that, little easing had been noted in District labor markets except for those heavily involved in output of autos. New claims for unemployment compensation in October and November were well above last year in the State of Michigan and in some Wisconsin centers, but otherwise labor shortages persisted.

Credit developments at Seventh District banks closely paralleled the national picture, Mr. Scanlon said. Although the evidence suggested that some weakening in demand for credit probably had taken place, much of it was undoubtedly attributable to monetary restraint and to continued restrictive loan policies of the major banks. Moreover, low bank liquidity might keep banks reluctant to reverse those loan policies for some time ahead. The large Chicago banks continued to show quite large basic deficit positions although they had managed to cover them with relatively little resort to the discount window. Some gradual attrition in CD's had continued despite the current interest differential over 3-month bills, and there had been no net inflow of funds from consumer-type certificates in recent weeks.

With respect to Mr. Holland's wire of November 29, Mr. Scanlon said that inquiries had been made of 21 lenders (12 savings and loan associations, 4 commercial banks, and 5 mortgage and life insurance companies). Three savings and loan respondents indicated that the year's low in new commitment volume had passed and one bank indicated that volume had been on the rise throughout the year. All of the other lenders (9 savings and loan associations, 3 banks, and the 5 life and mortgage companies), reported commitments now at their low points for the year, with respondents about evenly divided between the wire's categories A and B combined (volume projected as falling further or remaining at the present level) and C (some recovery anticipated in next two or three months).

Several of the savings and loans reporting some improvement in savings inflow since October 1 indicated that they had been holding back on new commitments and expected to continue to do so until the reaction to the year-end dividend payout had been felt, Mr. Scanlon added. Signs of weakness in the demand for mortgage loans were reported by a sizable proportion of the respondents, who cited the sharp decline in used home sales associated with the construction slowdown as responsible factors, along with the persistence of a rate level (with contract rates commonly in the 6-1/2 to 7 per cent range), fees and charges, and credit worthiness/security requirements related more appropriately to the exuberance of early 1966 than to currently prevailing conditions. No marked differences turned up among classes of lenders or kinds of property financed (or areas) in the survey responses, although the smallness of the sample might conceal such differences.

As to policy, Mr. Scanlon said that while he would prefer to see the figures reflect some moderate growth in aggregate monetary and credit measures, he believed that in view of the uncertainty over tax policy and the course of military expenditures and the year-end churning in the markets, a policy of maintaining currently prevailing money market conditions was appropriate for the next four weeks. He favored alternative A of the draft policy directives.

Mr. Clay said that information obtained from a survey of 23 financial institutions located in the six largest cities of the Tenth District indicated that mortgage market conditions had eased slightly since mid-summer. In some cities, interest rates on conventional mortgages and discounts on Government-underwritten loans had declined slightly from the high levels prevailing last summer. A moderate improvement in net savings flows was reported by a majority of the savings and loan associations queried, but the availability of mortgage funds at commercial banks appeared to be unchanged or moderately lower and the availability from life insurance companies remained at previous low levels.

Mr. Clay also said that the recent improvement on the supply side did not appear to be fully reflected in new commitment extensions. In part, that reflected a deficiency in demand resulting from unsold new houses, houses on the market from defaults on FHA and VA loans, and various special supply situations. The demand deficiency further reflected reported unwillingness or inability of many buyers to borrow at present rates and terms.

Another reason why the increased availability of funds was not fully reflected in new commitments was a cautious approach adopted by the lenders, Mr. Clay continued. Although savings and loan institutions might have funds available, they were concerned about their liquidity positions and were taking steps to reduce their Federal Home Loan Bank borrowings. In some cases they had increased their extensions of loans to purchase existing homes but were not yet willing to make commitments for new construction.

In summary, Mr. Clay said, the present flow of new commitments extended by savings and loan associations appeared to exceed the low established in the preceding months, but, due in part to deficiency in demand and to lender caution, new permanent financing and construction had not kept pace with improved fund availability. If the improvement in net savings flows continued, an increase in commitments was anticipated as the market adjusted to new conditions.

At commercial banks, Mr. Clay said, the availability of funds was unchanged or down moderately from levels in preceding months. That development on the supply side together with conditions of demand already mentioned had reduced the level of new commitments extended by banks to the low point of the year. Most banks were expecting little change in their commitment extensions during the next few months. The flow of new commitments extended by life insurance companies remained at its low level of the year. Some market participants expressed a weak expectation that life insurance companies would increase their commitments in coming months.

In view of recent economic developments, Mr. Clay continued, the decision made at the last Committee meeting to reduce the degree of monetary restraint appeared justified. The shift in policy brought significant response in the money markets. While the resulting developments in bank reserves and bank credit might have been less than hoped for, note must be taken of the advance in nonborrowed reserves as member banks reduced their borrowing from the Federal Reserve Banks.

With the prevailing uncertainties concerning Government spending and fiscal policy, Mr. Clay thought any further action toward credit easing at the present time should be of moderate proportions. It would appear appropriate, however, to proceed somewhat further in the process of relaxing the degree of monetary restraint. In the period ahead, targets might include a Treasury bill rate of 5 to 5.15 per cent, an effective Federal funds rate of 5 to 5-1/4 per cent, and net borrowed reserves ranging downward from recent levels toward zero.

Open market operations conducted in accordance with those goals should contribute to member bank reserve expansion, as desired under present circumstances. The most recent weekly data suggested to Mr. Clay that that development might now be in process. Such money market conditions also should substantially reduce or possibly remove the incentive to liquidate CD's for interest rate differentials, although there could be no assurance that substantial CD liquidation would not take place to obtain funds apart from interest rate considerations.

Alternative B of the draft economic policy directives appeared to Mr. Clay to be in line with the foregoing policy approach. Such a policy prescription for the period until the next meeting, including the directive choice and the rough targets for implementing policy, should be thought of in comparison with the interval since the last meeting.

Mr. Wayne commented that on the basis of results obtained from a small sample (18 lenders), it appeared that most mortgage lenders in the Fifth District felt that the flow of new loan commitments had reached its lowest point. Half of the lenders saw no recovery in sight, slightly less than half (7) felt that some improvement might be expected in the next two or three months, and two respondents felt that the recovery had already begun.

In a personal contact apart from the survey, Mr. Wayne continued, one large mortgage company reported that within the past two weeks it had received several unsolicited calls from financial institutions that had bought mortgages in the past. The callers indicated clearly that they were not buying at present, but wanted to know what offerings were available and intimated that they might be buying before long.

The slower rate of advance that had characterized over-all economic activity in the Fifth District for the past two or three months had continued and perhaps deepened slightly, Mr. Wayne said. Over half of the textile and durable goods manufacturers included in the Reserve Bank's latest survey reported declines in new orders and backlogs; on balance, the same trend was noted among manufacturers of other nondurables but the proportion was somewhat less. A larger number of respondents reported shorter work weeks and slight reductions in prices received. Paradoxically, in the face of those reported declines, businessmen's expectations for improvement had increased. Gains in nonagricultural employment had been reported and the insured unemployment rate continued to be very low.

In terms of the national economy, Mr. Wayne agreed with the analysis presented by the staff: the trend toward less vigorous growth seemed to be continuing slowly but steadily. Except for the slightly higher growth of payroll employment and the drop in the rate of unemployment, the latest data suggested a progressive easing in the private sector. The cutback in automobile sales and output now appeared to have spread to other consumer durable lines and the recent survey of consumer buying intentions provided no basis for expecting any early improvement in automobiles or home appliances. A significant new development was the reporting by several large companies of the laying off of sizable numbers of workers and a considerable reduction of overtime. Steel and lumber producers, other suppliers of building materials, and the furniture industry were feeling the effects of the long decline in residential building. Retail sales continued to move at a rather subdued pace and the irregular but persistent downward trend in the growth rate of instalment credit for the past 16 months suggested a more than temporary decline in the demand for durable goods. The construction industry might be depressed further by proposed reductions in Federal spending recently announced by the President, especially the large cut in the highway program. Nor could the builders derive much encouragement from the latest surveys of planned capital outlays by business and consumer plans to build homes. While the economy would certainly receive a significant stimulus from defense spending over the next six months, it was by no means clear that strength in the Government sector would offset entirely the developing weakness in the private sector.

In any event, it seemed to Mr. Wayne that the recent behavior of aggregate reserves, bank credit, and the money supply was not appropriate to the current business environment. The Committee had moved gradually toward slightly less restraint in its policy, but the money supply and bank credit had shown no significant response. He felt the Committee should seek to encourage moderate rates of growth in both; to attain that goal, he would favor continuing the policy of slightly less restraint.

Mr. Wayne also suggested that serious consideration be given to an orderly withdrawal of the restrictive implications in the September 1 letter. There was never an ideal time for making such a move, but the longer the wait the more difficult it would be to abandon that position. He was aware that such action at this time might suggest to the market more ease than was wanted, but he believed that the danger of an undue increase in business loans had been reduced by the banks' recent experience with CD's, by the easing in economic activity, and by the much slower growth of capital outlays planned for next year. Further, he saw a moral obligation to the member banks. In response to conversations last spring and the September 1 letter, some Fifth District banks had, in good faith, carried out an effective policy of curbing business loans. In return, they had asked to be advised when the restriction ended so that they would not be at a competitive disadvantage. If their cooperation was to be expected in the future, the System should keep faith with them on that matter. Finally, he would be happy to get back to what he considered more appropriate methods of implementing monetary policy.

Mr. Wayne said, in conclusion, that alternative B of the draft directives was appropriate to his view of a proper policy for the next few weeks.

Mr. Shepardson said it seemed to him that the action taken at the last meeting of the Committee had resulted in some easing as indicated by some of the rate movements that had occurred and by the prospect of an upturn in the money supply, which he thought was appropriate. Admittedly, credit expansion still lagged in light of the liquidity situation of the banks, but it might be expected that the banks would try to improve their liquidity before undertaking any significant credit expansion. Recognizing the somewhat lesser degree of pressure in the private economy, it nevertheless seemed to him that there was still a great deal of uncertainty in what the Government's fiscal program might be. Therefore, in the weeks prior to the next meeting there was still reason for proceeding cautiously. He thought that in view of the rate levels achieved, the report of the staff that some growth in the money supply was indicated, and the probability of a lower net borrowed reserve figure this week, it would be appropriate to continue for the coming period in about the status quo.

On the directive, Mr. Shepardson agreed with Mr. Ellis that with the proviso clause included there was not much difference between the two draft directives. His preference was for alternative A, either without the proviso clause or with Mr. Ellis' suggested change.

Mr. Mitchell said he regarded today's staff analysis as a strong warning against showing too little concern about the danger of slipping into recession. Several people had commented that the performance of the economy was still good. However, the acceleration of the economy had lost its momentum several months ago. The question now was whether the economy was decelerating, a state not far from that of slipping into a downturn. There was evidence in the GNP figures, in the industrial production index, and in the specifics given by Mr. Scanlon, for example. It was necessary to keep in mind the lags in policy. Members of the Committee were now apprehensive about the recent lag in achieving growth in the money supply and bank credit. He did not think the Committee could afford any longer to take a relaxed position on that score; it must do something sufficiently drastic to achieve the desired growth. Maybe, as some people suspected, growth had already begun, but from the information the staff had supplied he doubted that the liquidity barrier had yet been pierced. Until that barrier was pierced the desired results would not be obtained.

Mr. Mitchell also expressed the view that the housing situation was more serious than some seemed to assume. Recovery in that area was necessary, but the question was how to achieve it. One way would be to put the financial intermediaries back in business and give them confidence that they could compete with rates in the market. Another way would be to make it possible for the larger banks to warehouse some mortgages so that the insurance companies would come back into the market.

Mr. Mitchell said he believed that everyone at this meeting shared a common objective, although that fact tended to be obscured by semantics. He was interested in what Mr. Ellis had said about the directive, and agreed that the staff's two alternatives did not give the Committee much choice. However, he (Mr. Mitchell) doubted that the staff could conscientiously offer the Committee any real alternative to easing, considering the nature of their economic analysis. He recalled that at the last meeting Mr. Robertson had suggested a directive calling for operations "with a view to encouraging moderate expansion in aggregate reserves and bank credit, provided that money market conditions do not ease sharply." He (Mr. Mitchell) now wished he had supported that proposal more strongly then. He would favor a modified version of alternative B today, calling for operations "with a view to attaining a moderate expansion in the money supply and bank credit."

Mr. Daane commented that he wished he could share the staff's seeming sense of certainty as to the economic outlook and its implications for monetary policy, but he could not. As an economist and long-time member of the System's forecasting committee on business developments, he recalled well an occasion at the end of May 1950 when a former member of the staff assured that committee that the one certainty that could be depended upon was that there would be no intensification of the "cold war." Only a few weeks later the Korean conflict began.

On the substantive side, Mr. Daane said he remained skeptical about a deceleration of defense spending. He did not doubt the credibility of the figures that would shortly appear in the budget, nor would he impugn the motives of anyone involved in the presentation of those figures. He simply doubted that a war was waged that way, and he would be surprised to see an actual deceleration. As to the tapering off of capital spending, he thought that reflected the situation on the financial supply side and also the physical supply side, and that it was in the interest of sustainable expansion. As to the domestic outlook, he agreed with Mr. Irons that the private sector was not fundamentally weak. While he conceded the weight of evidence on the staff side, he would not rule out a resurgence of pressures.

Similarly, Mr. Daane said, he was impressed by the thoughtful views presented by Mr. Polak of the International Monetary Fund at the conclusion of this year's Article VIII consultation with the U.S. Mr. Polak had said in part that: ". . . if monetary conditions should ease in 1967, whether because of a tax increase and a shift in the policy mix or because of subsiding domestic credit demands, there would be a great need to avoid redundancy of bank reserves, bank credit, and general domestic liquidity thoughout the system. In contrast to the 1961-62 policy, for example, the banks would have to be kept 'snug' enough, as domestic loan demands subsided, to minimize the external leakage. Even so, we find it hard to envisage an easing of credit conditions sufficient to promote a revival of home building that would not at the same time encourage banks to give up the expensive accommodation they have obtained from the Euro-dollar market. Also to be borne in mind is a problem of timing, in that a deterioration in the capital account could happen with some rapidity whereas any improvement in the current account during the course of 1967 is likely to proceed gradually." One further comment from the observations of Mr. Polak, relating to the voluntary foreign credit restraint program, was as follows: "The bank program has, of course, been only on a stand-by basis during the past year, while the banks have accumulated a large leeway under their credit ceilings; it would seem to us important that the program be formulated in such a way that the amount of net credit that the banks could extend during 1967 would be kept small."

Carrying his divergence from the staff view to a logical conclusion, Mr. Daane said, he found himself questioning the view he understood to have been stated by Mr. Hersey that the Committee could ignore the consequences on the capital account side of the balance of payments in continuing to push for monetary ease. He questioned such a conclusion, particularly in the light of the formulation of the bank portion of the voluntary restraint program for the coming year. He thought the Fund representative was more nearly correct in appraising the immediacy of the outflow on the Euro-dollar side.

On balance, Mr. Daane thought the action taken by the Committee last time had resulted in some significant easing in the money market, as gauged by the financial variables looked at most, including bill rates and net borrowed reserves. Therefore, he would once again conclude that the better course of wisdom was to stand steady. To carry that out in the framework of a directive, he would choose alternative A, but he would couch it in a "no change" version as suggested by Mr. Ellis with slightly different phraseology. He would say that operations ". . . shall be conducted with a view to maintaining the currently somewhat easier money market conditions, unless bank credit appears to be declining." That would carry the flavor of validating what the Committee had done, yet leave the Committee in a position of not pushing further toward ease at this juncture.

Mr. Maisel said that he agreed fully with the staff analysis today. With reference to Mr. Galusha's comments about cutbacks in domestic nondefense programs, he would add that apparently the Secretary of Defense was cutting back a number of the normal ongoing defense programs to make room for Vietnam requirements.

It was not surprising to him, Mr. Maisel continued, that the money and credit figures had not risen as the result of a modest easing of monetary policy. It was necessary to take into account that the Committee was operating against record high interest rate levels. Bill and other interest rates were a good half point above what might have been expected a year or even six months ago. The actual level of rates was clearly a more important influence on demand than was a relative fall from extremely high levels. The Committee should not fool itself by what had occurred over the last two or three months. It had to move against conditions as they now prevailed with unusually high rates rather than against the situation as it stood several months ago when rates were more modest.

Mr. Maisel suggested that the Committee should be more concerned about the future than about this immediate point in time. It should endeavor to remove the present distortions in the economy and achieve a normal expansion of money and credit. Even if the Committee were not concerned about a downturn in the private sector of the economy, it should make sure that it moved to obtain expansion in money and credit simply to get rid of the existing distortions, which would otherwise become worse.

Mr. Maisel thought that housing was heading into the definite danger of an inflationary situation, given the working of supply and demand factors in that particular industry. If housing starts remained at the prevailing low levels, one could expect run-ups in rents, prices, and therefore in the cost of living, along with a wage push resulting from the increase in the cost of living.

In summary, Mr. Maisel felt that the Committee would have to move more vigorously. At the last meeting he had handed the Secretary of the Committee a note proposing language for the directive along the same lines as Mr. Robertson's subsequent suggestion. As he understood it, Mr. Mitchell was now recommending that alternative B of the draft directives be changed to call for operations with a view to attaining a moderate expansion in bank reserves, money, and bank credit. He would support that point of view. In other words, he would support alternative B with a change to that effect in the last line.

Mr. Brimmer said he would like to make an additional comment on the balance of payments. He had worked along with Mr. Daane on the formulation of the Government's program and had also tried to keep in touch with balance of payments developments generally. From time to time he had expressed his concern about the slow progress that was being made toward attaining a somewhat more viable equilibrium. As he had mentioned at the last Committee meeting, those working on the Government program were exerting every effort to make certain that the voluntary program was put together in a way that would give the central bank as much flexibility as possible in the management of domestic affairs. They had tried to forestall the possibility that a weak balance of payments program would make it necessary for the central bank to carry an additional burden in domestic policy making. While he did not have any indication of the extent to which the voluntary program would be workable next year, especially the Commerce Department program, he was convinced that it would be quite helpful. The pressure that had been brought to keep the direct investment outflow to less than $2.5 billion should prove helpful.

With respect to the Federal Reserve program, Mr. Brimmer shared Mr. Daane's concern that the leeway permitted to accumulate 20 per cent of the quota each quarter was a point of danger. At the same time he saw no reason why the situation could not be corrected by tightening the program further if necessary. So he shared Mr. Hersey's conclusion that it was not necessary to panic at the prospect of a short-run outflow and a return of the funds that had come in through overseas branches of U.S. banks. The Committee ought to shape its policy to the needs of the domestic economy and rely on the voluntary foreign credit restraint program to the fullest extent possible.

In view of the announcement today of the voluntary programs for 1967, Mr. Brimmer suggested a modification in the first paragraph of the draft directive to say that "The balance of payments remains a serious problem and the voluntary programs have been strengthened and extended through 1967." He thought it appropriate for the Committee to take note that the program decisions had been made and that one element of uncertainty in policy making had thereby been removed.

With respect to the domestic situation, Mr. Brimmer shared the views advanced by the staff and many others around the table. He, like Mr. Hayes, was impressed by the fact that different economists sometimes reached different conclusions from the same figures. At the same time he was also impressed at this time by the overwhelming proportion of economists who had come to the same conclusion as the staff had.

With respect to policy making, Mr. Brimmer said he would like to focus both on the period immediately ahead and on the longer run. It was his understanding that there might well be some additional debt management operations, perhaps before the end of the year, involving participation certificates. There were rumors to that effect in the market, with some feeling for the possible configuration. Those operations might exert some upward pressure on interest rates. If the amount to be offered to the public was of the magnitude that had been suggested, the Committee ought to be concerned about the possible need for some further easing in the short run to maintain the same policy stance. For the longer run he thought that further easing was absolutely necessary. It was not surprising that the banks had been sluggish in responding to the easing of monetary policy thus far; over the years economists had learned something about liquidity preferences. The Committee should not overlook the need to make the banks feel a little more liquid. It also was necessary to provide some head-room for banks to achieve an increase in their CD's.

Mr. Brimmer went on to say that another look should be taken at the September 1 letter, not only in terms of agreeing that there was no longer a need for it but in terms of taking an overt step to rescind it. The letter was made necessary by conditions prevailing in the late summer and early fall, but those conditions had passed. It was sent out as a signal that the System wanted some restraint on the expansion of business loans, and he thought it desirable now to have an explicit statement that the letter was no longer in effect. Mr. Wayne had made the point that the banks felt they needed some indication of System attitude, and he (Mr. Brimmer) hoped an appropriate letter could be gotten out.

Mr. Hayes had mentioned the policy mix for the longer run, Mr. Brimmer noted. He (Mr. Brimmer) hoped that monetary policy would play an active part in that mix. If conditions required it, and he thought they did, there should be a shift toward greater ease. Monetary policy had the advantage of being flexible. It should also be timely, and he thought now was the time to get on with further easing. Accordingly, he favored the approach of alternative B of the draft directives, and would subscribe to Mr. Mitchell's proposed change in its wording.

In concluding, Mr. Brimmer observed that the Manager had executed a rather difficult maneuver under a directive that was not abundantly clear.

Mr. Hickman commented that the flow of business and financial news in recent weeks showed clearly that the policy shift at the Committee's last meeting was appropriate. Nevertheless, the latest data indicated to him that the Committee should push further in the direction of ease. Whether one looked backward or forward, monthly data on the monetary variables showed a nearly uniform series of minus signs. The bank credit proxy, total reserves, required reserves, and the money supply had been moving downward, indicating that the supply of credit was declining relative to the less intensive demands of recent months. In that environment, it seemed to him an inescapable conclusion that net borrowed reserves had been too deep, and the money market too tight, to support continued economic expansion. He therefore recommended that the Committee aim for a zero, or even a positive, level of net free reserves, as needed to get back on the high road of balanced money and credit growth.

Since economic activity in the Fourth District had a wider amplitude of cyclical variation than that of the U.S. as a whole, Mr. Hickman thought it might be timely to review briefly business and financial conditions in that region. Evidence had accumulated that heavy industry in the Cleveland-Cincinnati-Pittsburgh triangle was beginning to feel the impact of economic slackening. That was revealed clearly at the joint directors' meeting last week, where important cases were cited of a slowing in new orders, resulting in reduced backlogs and less pressure on resources and capacity.

The Cleveland Bank's monthly survey of manufacturers in the Fourth District, plus a number of regional series collected by the research staff, also reflected the more moderate tempo of local business activity, Mr. Hickman said. Manufacturing activity in major areas, as measured by industrial consumption of electric power, had either turned downward or had slackened its growth. Production and new orders in steel declined in November to the lowest levels since August. Insured unemployment in November increased slightly in 9 out of 14 major District labor markets, and declined in only 3 markets (in one market the decline was caused by a strike settlement). Department store sales seemed to have leveled off, after an almost uninterrupted period of steady growth since late 1962. The decline in construction contracts thus far this year had been more severe than in the nation. The seasonal expansion in bank credit at the weekly reporting banks in November was only about one-fourth as large as in the comparable period a year ago.

Mr. Hickman went on to say that early returns from a confidential survey of recent and anticipated borrowing by a sample of large midwestern business corporations showed that about three-fourths of the respondents had unused commitments at banks, which most planned to draw upon next year. Respondents indicated that credit needs would be large in the second quarter of 1967, but that the purpose of the borrowing would be largely to meet taxes, rather than for asset expansion.

With reference to the recent mortgage survey, Mr. Hickman said that the responses from 23 financial institutions were not reassuring. Only one-third of the lenders reported a recovery in commitments or anticipated a pickup in the near future. Although a general increase in availability of funds had occurred recently, demand for real estate and construction loans had fallen off, partly because of the cool reception given borrowers by lenders earlier this year. Respondents indicated that new commitments would be allocated largely to the residential mortgage market.

Mr. Hickman favored whatever net credit availability was needed to produce pluses in the major monetary variables. The staff's alternative directive B was satisfactory to him, as it stood or as amended by Messrs. Mitchell and Maisel. He thought the September 1 letter should be rescinded.

Mr. Patterson reported that while business activity in the Sixth District was still at a high level, data that had become available since the last Committee meeting indicated additional signs of a slowing down. With November auto sales in the District off sharply from a year ago, the District was sharing in the recently announced auto layoffs. Even the agricultural sector was beginning to lose some of its glow, now that cotton had been reduced in output and prices for livestock and other products were lower. In Florida, the price of oranges had dropped from $2.86 to 83 cents a box. Residential construction volume was also turning in a progressively deteriorating performance, although total construction volume was still slightly ahead of last year and was outpacing the national average. That the softness in autos, construction, and agriculture was becoming one of swelling proportions was further suggested by the most recent reports from head office and branch directors, who seemed to be less optimistic than in several years.

On the other hand, Mr. Patterson continued, the nine commercial banks, five mortgage bankers, and handful of savings and loan associations contacted on the question of mortgage lending seemed to be slightly more cheerful than they had been over the past several months. Savings flows for October and November were better than many had expected earlier, although not good enough to improve commitments in most local lending markets. The majority of lenders indicated that flows of new commitments were at their low for the year. Most of them thought the bottom had been reached and fairly early recovery might be in sight. While commercial bankers were the least optimistic, the savings and loan people did not expect an early turn in the market without clarification of the new Home Loan Bank program. A minority of mortgage bankers, on the other hand, said that their flows of new money had already shown some recovery; and about one-third of all respondents anticipated some recovery in the next two or three months. Many indicated that, with the exception of large commercial properties, money had become more readily available, but that cost remained high. In single family residential housing, most new originations by mortgage bankers were being sold to FNMA. A number of mortgage bankers were retaining one-year options to repurchase them, and some permanent investors had indicated their willingness to absorb or share that cost in order to insure the availability of mortgages. Commitments for large commercial projects were being restricted in some District markets because the permanent investors wanted to defer takeouts for as long as two years. Commercial banks were unable or unwilling to carry them for that length of time.

It seemed quite clear to Mr. Patterson that the picture of insignificant growth in bank lending had not changed in the past several months after allowing for seasonal changes. Loans at the largest banks increased less this November than in comparable past periods. Many bankers with whom he had talked recently said that their loan demand was still very high, but an increasing number of them were also beginning to say that it was not as strong as it had been, possibly because inventory growth had slowed. The bankers were, however, of one mind in complaining that their deposit growth had ceased--a fact borne out by statistics. They still worried about whether they would be able to satisfy the loan demand of their good customers and in many cases were trying to find ways to repay their indebtedness to the Reserve Bank and to reduce their dependence on the Federal funds market. Under those conditions, it would probably be difficult for them to buy municipals on a large scale, even if the Committee were to let up further in its policy of restraint. Sixth District banks also would be slow to benefit from the effects of lower bill rates vis-a-vis CD rates, since even the largest ones were not too active in the CD market and were less sensitive to changes in short-term rates than banks in many other sections of the country.

Turning to the national scene, it seemed clear to Mr. Patterson that with the further slowing down that had occurred, his own position at the last meeting, and that of the Committee, had been eminently correct. He believed the thrust of that new policy should be continued, the Treasury financing calendar permitting, although the uncertainty of fiscal policy and balance of payments considerations demanded that the Committee not let up on monetary restraint to an extreme degree. On the other hand, it must be remembered that the delayed effects of the restrictive policy were still leaving their imprint. Therefore, the Committee should not be under any illusion that slightly lower rates and a reversal in money supply statistics would be likely to have a significant impact on future financial flows unless it continued to lift its policy targets. He would like to see a return to the moderate expansion rate in money and credit experienced in the first half of 1966. He was neutral as to whether the Committee tried to accomplish that by couching its instructions in terms of money market conditions or aggregate reserves, but he preferred alternative B of the draft directives.

Mr. Lewis reported that most lenders surveyed in the Eighth District indicated that new commitments for construction and mortgage loans were at low points for the year. They foresaw no early recovery. A few expected further reductions in the near future. Savings and loan associations in St. Louis reported a net inflow of funds approximating that of a year ago. However, they were making few new commitments because the Federal Home Loan Bank was requiring payoff of borrowings of last summer. There were indications that some insurance companies would like to pick up more mortgages at higher interest rates but were prevented from doing so because of lower cash inflows resulting from a marked reduction in prepayments of old loans.

Most of the commitments made were for commercial, industrial, and multi-dwelling units, Mr. Lewis continued. Few funds were flowing into the single-unit residential market. Several lenders indicated a marked reduction in the number of loan applications, but they felt that if they made known that they had funds available for mortgages, applicants would readily come forth. That was particularly true for insurance companies and savings and loan associations.

Total demand for goods and services was continuing to rise, Mr. Lewis observed, but less vigorously than in late 1965 and early 1966. The contraction in bank reserves and money beginning last spring probably had contributed to the slowing in private demand, despite the stimulative budget situation. The mix of fiscal and monetary policy, although leading to a desirable slowing in the growth of expenditures, had fostered high interest rates. While probably beneficial for balance of payments purposes, such rates appeared to be causing hardship on the housing market and private investment, and as a result might be hampering economic growth.

As to the future, it appeared to Mr. Lewis that total public policy--fiscal and monetary--might not need to be so restrictive in coming months as it had been since spring. If the policy mix should include a less stimulative budget in the future than since mid-1965, monetary actions could be relaxed, and interest rates would become less of a drag on economic growth. Even if the fiscal stance remained stimulative, a case might be made, although with less confidence, that some relaxation of monetary restraint was in order. Total demand had slowed and the Committee would not want to overkill the inflationary pressures.

For the next month, Mr. Lewis said, he would like to see still easier conditions in the money market with a view to obtaining a moderate growth in bank reserves, bank credit, and money. He preferred alternative B for the directive.

Mr. Robertson made the following statement:

> Developments that have emerged since the last meeting of this Committee seem to me to have confirmed the wisdom of the judgment we reached at that time to begin a modest but overt easing of monetary policy. Almost every statistic that has since become available is indicative of a little more slackening in final demand pressures. On the financial side, our slight easing to date has brought down a few interest rates, and improved bank liquidity positions a bit, but it has not yet been able to halt the persisting decline in bank credit. Meanwhile, we still await a clear declaration of the future fiscal intentions of the Administration. The budget figures revealed to date support a further but slower rise in expenditures, but no official position is yet definite regarding a tax increase.
>
> In these circumstances, I think our best policy is to continue what I have been calling in previous meetings a "tentative but gradual and progressive kind of let-up of monetary pressures". What I would like us to achieve, in the weeks ahead, is at least a full offset of any tendencies for the money market to firm under the expected seasonal pressures between now and year-end; and thereafter enough further easing of bank liquidity positions to encourage the gradual resumption of orderly, moderate growth in bank credit and money.
>
> I read the "blue book" and the staff directive notes as saying, in effect, that there is a good chance

> of achieving these objectives by continuing virtually unchanged our current directive to the Manager; that is, by adopting the draft alternative B. This, I take it, might involve net borrowed reserves around zero and a three-month bill rate and Federal funds rate around 5 per cent before the Committee meets again.
>
> I am prepared to accept that kind of prescription for now, recognizing that the many end-of-year uncertainties make any elaborate specification of targets a matter of guesswork. However, recent developments do suggest to me that it was not amiss at the last meeting to explore ways of giving more weight to the performance of the monetary aggregates. This could be accomplished in the directive by using the traditional form of the proviso clause, if we continue to direct the Manager to vary the degree of ease or tightness in the money market according to the degree of weakness or strength in bank credit and aggregate reserves. Thus, in that light, it would not bother me if the three-month bill rate or the Federal funds rate fell somewhat below 5 per cent in the month ahead if bank credit were showing no tendency to expand in, at least, the 2-to-4 per cent range.

Mr. Robertson added that he still felt that the suggestion for the language of the directive that he had made at the last meeting was a good one. However, he thought there was probably more sentiment today for alternative B as drafted by the staff. Consequently, he would opt for alternative B, with the understanding that the objective was substantially the same as the objective contemplated by the language he had suggested.

Chairman Martin remarked that he read alternatives A and B in about the same way as Mr. Ellis: there did not seem to be too much difference between them. However, he continued to feel, as he had before today's discussion, that alternative B was preferable. Like Mr. Galusha, he found the way it was written appealing.

The Chairman went on to say that while he did not pretend to know exactly what the leads and lags were, he did not think that the Committee, in moving either toward restraint or ease, could force the statistics in a brief period. It seemed to him the Committee had made the right decision at the last meeting. He questioned, however, whether it would be desirable now to move to net free reserves; it seemed preferable to move more gradually. In his opinion the Desk had performed well over the past few weeks. There had been a general understanding, without news releases, of what the Committee was trying to do, and that was salutary. With the year end approaching, and with all the cross currents involved, he thought the Committee would be running a real risk if any substantial amount of net free reserves appeared. That might be taken to indicate that the Committee had become panic-stricken, and the move would become self-defeating in terms of what the Committee was trying to do. There was always that risk when policy was being changed. As things stood, the Committee had started a gradual move three weeks ago and the statistics so indicated.

The Chairman went on to say that he did not happen to be bearish. He thought the economy was still strong, and he was glad that monetary policy had gotten out of the posture it was in until recently. The pace of the expansion in the private sector of the economy clearly was tending to turn down as long ago as September and October, and it was not good for the System to be in a position of forcing restraint in those circumstances.

Chairman Martin noted that there were probably going to be some tests of public psychology and business sentiment when the Government's general budgetary posture became fully understood. The figures might be rather startling to a lot of people who had not yet achieved the degree of sophistication necessary to accept deficit financing with complacency.

The Government, Chairman Martin continued, had made a lot of progress in the use of its tools of policy and its methods of operation, but it should not force the issues unnecessarily. Personally, he hoped the President would recommend a tax increase, partly because he thought the budgetary situation would call for one and partly because he saw a psychological advantage and, in a sense, a moral advantage in having people share in the cost of the Vietnam effort in one way or another. He thought the country ought to follow a "pay as you go" principle for a lot of things.

Chairman Martin expressed the view that the Committee should keep steady in the boat and not appear unduly concerned. The dampening that had occurred in the excessive pace of economic growth was much to be desired, but he did not think monetary policy should claim the full credit. As he saw it, inflationary tendencies had gotten a foothold at a certain stage, and they in turn produced counter tendencies. The Chairman also referred to the gold situation, saying it was of more concern to him than the balance of payments statistics per se.

Chairman Martin repeated that he liked alternative B of the draft directives as written. While he would not object strongly to the changes that had been suggested, he did not think one could expect to achieve precise results, particularly in a four-week period. It was perfectly normal, as had been pointed out, that when banks became worried about their liquidity positions they would not go out looking for loans at the first opportunity. In fact, he did not believe that that would be desirable under present conditions.

The September 1 letter concerned him a little, the Chairman continued. His personal preference, however, would be to take no overt action and simply let the Presidents talk to people in their respective Districts on an individual basis. Issuance of a statement would attract more attention than seemed warranted and might lead a lot of people to believe that the System was calling upon banks to send their men out to seek business loans. He would just let the matter rest for the moment, although the Presidents could talk with people who came to them with questions.

Mr. Wayne said that in the Fifth District certain banks had in good faith exercised self-restraint. They would like to know when the September 1 letter was no longer in effect. He would not have to say much for the word to get around.

Chairman Martin repeated that his preference would be to talk with such parties individually rather than to issue a statement saying the September 1 letter was no longer in effect. There was no reason a Reserve Bank President could not talk to people about general credit conditions, but the issuance of a statement might be read by the press and others as a blanket invitation to the banks to go out and seek business loans.

Mr. Brimmer expressed reservations about such a procedure. The September 1 letter was a policy statement reflecting a System-wide credit control program. It announced to the public an explicit objective of System policy. Therefore, it would not seem sufficient for the President of a Reserve Bank to talk quietly to each banker who called upon him about the matter. In his judgment, that was not the way System policy should be made or changed. He appreciated the difficulties of letter-drafting and the problem of timing, but when a public policy matter was involved an announcement ought to be made.

Chairman Martin said that he had some question about the wisdom of such a move. The letter of September 1 had been widely misconstrued, and its public withdrawal might likewise be widely misconstrued.

Mr. Swan remarked that he saw no difficulty in discussing the credit situation with bankers. However, the moment a President began to talk with one or two bankers in terms of the September 1 letter, that was going to become known and other banks were going to be critical of the System for not having advised them directly. While there were not very many banks deeply involved, some smaller banks who perhaps had taken the matter seriously might not get the word promptly. He would not hesitate to discuss the general change in credit conditions, but he would hesitate to talk about the September 1 letter without being sure that all interested banks would have the same message at approximately the same time.

Mr. Daane said he subscribed to the view that a formal rescinding of the letter at this time might lead to more repercussions than desirable.

Mr. Hayes also agreed on the inadvisability of sending out another letter at this time. A considerable amount of confusion had resulted from the issuance of the original letter, and in retrospect he was not sure that it was an entirely wise move. While he recognized that the need for the letter no longer existed, rescinding it formally might lead to the same confusion and uncertainty that accompanied the issuance of the original letter. More broadly speaking, he would be reluctant to see the System get into a position of feeling that it must issue letters to the member banks advertising its policy decisions. He thought the System had been on sounder ground in the past in letting its actions speak for themselves.

Mr. Hayes also said that by a formal withdrawal of the September 1 letter the System could hardly fail to highlight whatever policy change had been made. He felt that that would make the change more overt than a majority of the Committee members desired. He could appreciate that it would be useful to get across the idea that the System was taking the attitude that the need for the letter had faded away. But he hoped a formal withdrawal of the letter could be deferred until the idea gradually got across that the letter was no longer operative. It might be useful for the Chairman, in answering questions from the press or in making a speech, to include a comment that the program described in the September 1 letter was designed to meet conditions as of that date, that those conditions had changed in many respects, and that the letter had outlived its usefulness. Gradually that would sink in, and the letter could then be rescinded formally at some later date.

Mr. Galusha subscribed to that view. He noted that there were many ways in which a Reserve Bank President could communicate ideas without having a public gathering or making a general announcement. The only question he had was whether the way was now clear to indicate, in whatever manner seemed appropriate, that a reduction of business loans was no longer considered essential. If that point of view was expressed in conversation with individual bankers, the word would soon get around. If the question came up, as it had the other day from the head of one of the larger District banks, and if the Presidents were free to handle the situation in whatever way appeared necessary, the September letter would gradually die. It could be disposed of formally at a later date. But the issuance of a withdrawal letter at this time could cause many problems.

Mr. Wayne said that although he shared Mr. Brimmer's views about the advantages of a public statement, he also recognized the danger of creating an erroneous impression at this time. The question was one of responsibility to the banks that had cooperated. The September 1 letter was essentially a System statement indicating that under the circumstances as they prevailed at that time the Federal Reserve thought the banks ought to display a high degree of statesmanship. All he would have to say in conversation was that the banks had done a good job, and the word would get around.

Mr. Robertson commented that the System, in issuing the September 1 letter, had deviated from the normal use of monetary policy instruments in a manner that was unique, and the operation had succeeded. If the System was going to terminate the operation--and he thought it should--the only question was how to go about it. If it was true that another letter could be misconstrued, he would not favor that procedure, but the approach should be uniform for all banks. If the operation was to be terminated, he would let each President do what he thought necessary, either through conversation or written communication as he believed best, so long as equal treatment was assured for all banks.

Mr. Maisel also spoke in favor of a uniform approach. He agreed that the timing could be delayed and was not concerned with the form of statement. He did feel, however, that the policy should be terminated by an official and public action of the System.

Mr. Wayne then suggested that everyone think about the problem, with a view to further discussion at the next Committee meeting, and there was general agreement with that suggestion.

Returning to the question of the directive, Chairman Martin suggested that the Secretary poll the Committee on alternative B in the form drafted by the staff. Question was raised whether the vote should be taken instead on alternative B as it would read with the change suggested by Messrs. Mitchell and Maisel, and upon request the Secretary read the language reflecting that suggestion. Mr. Clay commented that he would prefer to have the vote taken on alternative B as written by the staff because in his opinion there was a virtue in continuing along the line of the policy instituted at the preceding meeting.

Chairman Martin observed that the problem seemed to get into semantics to a certain degree. As he had said many times, words meant different things to different people. He happened to prefer alternative B as written by the staff because he found it easier to understand. It specified operations with a view to attaining somewhat easier conditions in the money market. He doubted whether bank credit would resume a rapid rate of expansion at this stage, but if it should the directive also made provision for that contingency. He again proposed voting on alternative B as prepared by the staff. That procedure, he felt, should afford a fair opportunity for expression of opinion because those members who opposed the staff draft no doubt would also oppose the suggested revision of it.

Thereupon, upon motion duly made and seconded, and with Messrs. Hayes, Daane, Irons, and Shepardson 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 rising defense expenditures but with additional evidences of moderating tendencies in the private economy. While there has been some slowing in the pace of advance of most broad price measures, upward price pressures persist for many finished goods and services. Bank credit and money have shown no net expansion in recent months. Although demands on bond markets have increased, upward pressures on long-term interest rates have moderated. The balance of payments remains a serious problem. In this situation, it is the

Federal Open Market Committee's policy to foster 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.

It was agreed the next meeting of the Committee would be held on Tuesday, January 10, 1967, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

December 12, 1966

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

FIRST PARAGRAPH

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing to expand, with rising defense expenditures but with additional evidences of moderating tendencies in the private economy. While there has been some slowing in the pace of advance of most broad price measures, upward price pressures persist for many finished goods and services. Bank credit and money have shown no net expansion in recent months. Although demands on bond markets have increased, upward pressures on long-term interest rates have moderated. The balance of payments remains a serious problem. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions conducive to noninflationary economic expansion and progress toward reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, and taking into account the widely fluctuating seasonal pressures at this time of year, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the currently prevailing money market conditions; provided, however, that somewhat easier conditions shall be sought if bank credit appears to be failing to expand.

Alternative B

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.