MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, October 24, 1967, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Brimmer
Mr. Francis
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Sherrill
Mr. Swan
Mr. Wayne
Mr. Treiber, Alternate for Mr. Hayes

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

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

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

Mr. Cardon, Legislative Counsel, Board of Governors
Mr. Fauver, Assistant to the Board of Governors

Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Adviser, Division of International Finance, Board of Governors
Messrs. Axilrod and Gramley, Associate Advisers, Division of Research and Statistics, Board of Governors
Mr. Wernick, Assistant Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss McWhirter, Analyst, Office of the Secretary, Board of Governors

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

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on October 3, 1967, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on October 3, 1967, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period October 3 through 18, 1967, and a supplemental report for October 19 through 23, 1967. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the Treasury gold stock would remain unchanged again this week. However, it probably would be necessary to show a reduction within the next two weeks, not because of central bank buying but because of the continuing pressures on the London gold market. Thus far in October the gold pool had run a deficit of $81 million, of which the U.S. share was $48 million. Additional contributions to the pool totaling $50 million had been negotiated during the Bank-Fund meetings in Rio de Janeiro and subsequently another $50 million had been negotiated, raising total contributions to the pool to $570 million. About $24 million was left as of the close of business yesterday (October 23).

So far this year, Mr. Coombs continued, the loss to the pool had been $286 million and South Africa had reduced its stocks by $160 million, making a total deficit in that period of nearly $450 million. The market was becoming increasingly aware of the situation. In addition to the usual factors that lately had been increasing market demands for gold--such as the Vietnam hostilities, recognition of the underlying supply and demand trends for gold, and the position of sterling, it was possible that some developing concern about the dollar also was reflected in the recent burst of buying. The debate in Congress over the President's tax proposals was being fully reported abroad, and he thought those reports were having some adverse effect. On the favorable side, he had received a report this morning that one of the Iron Curtain countries was about to sell 10 or 15 million tons of gold.

Sterling continued to be the second trouble spot, Mr. Coombs said. As he had reported at the preceding meeting of the Committee, Britain's reserve loss in September had been $345 million, of which $320 million had been financed through additional short-term credits. That had increased Britain's official short-term debt to $1.7 billion, compared with their official reserves of $2.7 billion. Their experience in October was likely to be worse, partly because during the month they announced poor trade figures--for September--for the second successive month. Thus far in October they had incurred a further reserve loss of $450 million, and it was possible that for the month as a whole the loss might approximate $600 million. The British had already financed $150 million by a further drawing on their swap line with the Federal Reserve, leaving perhaps $450 million to be supplied.

Against that probable need, Mr. Coombs observed, there remained only $550 million available to the British under the System swap line, $125 million available under the sterling balance credit package, and the $100 million credit negotiated with Swiss commercial banks a week or two ago, for a total of $775 million. That might be supplemented by further overnight credits from the

U.S. Treasury, although the Treasury had already supplied $245 million in overnight credits at the end of September, which would have to be renewed unless there was a turn in the British situation. Thus, there was some likelihood that the British would be moving into November with only a few hundred million dollars of short-term credits remaining available to them and with two months to go before seasonal forces could be expected to turn favorable. There also was a strong possibility that the trade figures for October, to be reported in November, would be poor and that that would result in another drain on sterling.

Mr. Coombs recalled that at the previous meeting of the Committee he had mentioned that there was some hope for bringing about a turn in the market situation if the British took decisive action on Bank rate. That hope had been frustrated by the fact that the Bank rate increase announced on October 19 was only 1/2 per cent. That action was decidedly disappointing to the market, since it was inadequate to restore short-term rates in London to a fully competitive position with rates in the Euro-dollar market. The situation had been further undermined by the wave of wildcat strikes in Britain last week.

Under those circumstances, Mr. Coombs said, the Bank of England had felt--and he thought rightly--that it would be futile for them to go beyond purely defensive tactics in the exchange

markets. Accordingly, the Bank of England had declined to push down the forward discount on sterling; and the New York Reserve Bank had limited its operations to mopping up sterling offered in New York City by using roughly $50 million of a Treasury authorization to buy guaranteed sterling. Similarly, the Bank of England, the New York Reserve Bank, and the Bank for Interna-tional Settlements had agreed that no more than token intervention in the Euro-dollar market by the BIS would be justified, and such operations had been limited to slightly more than $10 million.
In effect, ammunition was being conserved in the hope that there would be some encouraging development. At the moment, however, to speak quite candidly, he could not visualize just what form such a development might take.

Mr. Coombs remarked that if the British ran out of short-term credit facilities in the first half of November--and that was a distinct possibility if the trade figures for October were as poor as was feared--they would have available two additional sources of funds before using their official reserves. One was their remaining portfolio of U.S. securities, which now amounted to roughly $500 million held largely in the form of U.S. agency issues. The other would be a new drawing on the International Monetary Fund; they could draw as much as $1.4 billion if they managed--with the assistance of some of the Europeans--to make the final payment of $250 million on an earlier drawing when it fell due in December.

Any use the British made of their U.S. securities portfolio would have a corresponding adverse effect on the U.S. balance of payments, Mr. Coombs noted. Such use also was likely to be interpreted by the market as an official acknowledgment that Britain's short-term central bank credit facilities had been completely exhausted. A Fund drawing might be interpreted as a vote of confidence by the Fund in the present sterling parity. At the same time, however, it unavoidably would be accompanied by a great deal of publicity. Furthermore, of the $1.4 billion available to the British in the Fund, $750 million was earmarked for repayment of credits under the sterling balance package. A major risk in either course was that the market might guess that the British were approaching the end of their resources. In general, sterling's difficulties were deepening, and the next few weeks clearly were going to be weeks of critical decisions.

Mr. Hickman asked if Mr. Coombs would comment on the observations concerning sterling in the recent report of the Common Market Executive Commission.

Mr. Coombs replied that the section of that report dealing with sterling probably was largely of French authorship, but it formalized certain questions that had been of concern not only to the French but to the other Common Market countries also. One was the question of whether sterling was over-valued at its present parity. Another and perhaps more fundamental question was how Britain, with approximately $11 billion of overseas sterling liabilities, could be brought into a regional grouping of countries with purely national currencies. Of course, it was easy to ask how Britain could function in the Common Market with the enormous overhang of sterling balances; the difficulty was that so far no one had come up with a practical suggestion for dealing with those balances.

By unanimous vote, the System open market transactions in foreign currencies during the period October 3 through 23, 1967, were approved, ratified, and confirmed.

Mr. Coombs then referred to the program for shifting the System's swap lines to year-end maturities, and wherever possible to full-year terms. Noting that the three-month, $100 million arrangement with the Bank of France would mature on November 10, he said it was highly doubtful that the French would agree to a renewal for a period of more than three months. To bring the maturity date of that arrangement in line with the others it would be necessary to renew it for a short period--about fifty days--to the end of the year, in the expectation that subsequent renewals would be for three-month periods. He regretted having to recommend such a procedure but thought it was the only practical course unless the System was prepared to drop the swap line with the Bank of France.

In response to questions by Messrs. Wayne and Robertson, Mr. Coombs commented that the swap line with the Bank of France was of no utility to the System. Indeed, it might be said to have negative utility, since its existence gave the French access to information they would not otherwise have and which they may have used on occasion to the disadvantage of other members of the network. However, if the Federal Reserve did not propose renewal at this time--which in effect would be to suggest that the arrangement be allowed to lapse, since the System customarily had taken the initiative in connection with swap line renewals--the program for moving all of the arrangements to full-year terms maturing at year end might be jeopardized. That was because such an action probably would be regarded by the other Common Market countries as a breach of faith on the part of the Federal Reserve; the System had agreed in the earlier negotiations to seek year-end maturities for all of its lines, including that with the Bank of France. There would, of course, be no breach of faith by the System if the French declined to renew the line, and in his judgment that would be a fortunate outcome.

Mr. Wayne then noted that if the French swap line was renewed now until year end and then for another three months, the next maturity date would occur around the end of March 1968. He asked whether Mr. Coombs thought the constraints that affected the System's actions now would also apply with equal force to the decision regarding further renewal that would be taken then.

Mr. Coombs replied in the negative.

> By unanimous vote, renewal of the $100 million standby swap arrangement with the Bank of France from November 11 to December 29, 1967, was approved.

Mr. Coombs then recommended renewal, if necessary, of three System drawings on the National Bank of Belgium, in the amounts of $10 million, $11.5 million, and $10 million, maturing respectively on November 8, November 8, and November 24. He also recommended renewal, if requested by the Bank of England, of a $50 million drawing by that Bank on its swap line with the System that would mature on November 22. All of these would be first renewals.

> Renewal of the four drawings, as recommended by Mr. Coombs, 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 domestic open market operations for the period October 3 through 18, 1967, and a supplemental report for October 19 through 23, 1967. Copies of both reports have been placed in the files of the Committee.

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

> Interest rates rose to new highs in virtually all sectors of the securities market since the Committee last met. Fears of inflation strengthened as uncertainty grew about the likelihood of Congressional action on taxes, and there certainly was no reassuring news coming out of Vietnam. There was growing concern about the inevitability of some tightening of monetary policy. Strong demand pressures persisted in the capital markets, and the decision of a major oil company to go ahead with a large bond issue despite the level of interest rates led some corporate underwriters to fear that it might set off a wave of anticipatory borrowing by corporations that will need funds next year. As the written reports indicate, investors moved to the sidelines during most of the period; new issues--until late in the period--were generally accorded poor receptions despite steadily higher offering yields. All in all, confidence in the financial markets was at low ebb during the period. A somewhat better atmosphere has emerged in the past few days but whether it is anything more than a technical reaction to the steady erosion of prices of long-term securities is far from clear at the moment.
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> While the capital markets experienced the greatest pressure, short-term interest rates also edged higher on balance, although the low Federal funds rate and the ready availability of bank reserves continued to be a restraining influence. The level of market rates has apparently not yet cut significantly into the flow of funds into savings institutions, but there is some evidence that the competition has recently become keener. While rates on shorter-term CD's are still under the ceiling and providing banks with a margin of safety, 5-1/2 per cent is now available on 6-month deposits, and the New York banks have been increasing their takings in the Euro-dollar market. In the Treasury bill market, the Treasury raised $4.5 billion in cash by the sale of April and June tax bills on the day the Committee last met.

A sobering note was struck by the very small margin of cover that the Treasury received on its offering of $3 billion of June tax bills. The subsequent market performance of the new bills was generally satisfactory and the market took in stride the rise in the British Bank rate. In yesterday's regular auction average rates of 4.60 and 5.12 per cent were established for 3 and 6-month Treasury bills, up 9 and 3 basis points from the levels established just before the last Committee meeting.

Open market operations, directed at maintaining a steady tone in the money market, mainly took the form of repurchase agreements in view of the temporary nature of reserve needs. Nearly $1.5 billion of repurchase agreements were made against Government and agency issues and bankers' acceptances, and all were terminated by the end of the period. In addition, near the end of the period reserves were absorbed as the System bid to redeem $200 million of Treasury bills maturing October 19 and as small sales of Treasury bills were made to foreign accounts. During the early part of the period the money market had a bit firmer tone than was intended as reserve availability persistently fell short of expectations and the distribution of reserves ran against banks in the money centers. Part of the firmness was due to a faster rise in required reserves than had been projected as estimated bank credit expansion turned out at the upper end of the 10 - 13 per cent range (annual rate) anticipated at the last meeting of the Committee. In the period ahead a substantial reserve need is projected and, as the blue book[1/] notes, the credit proxy for October is now expected to rise at an annual rate of about 12 - 15 per cent.

Treasury financing, of course, will be the dominant feature of the period immediately ahead. The Treasury will be meeting today and tomorrow with its IBA and ABA Government borrowing committees to set the terms for refunding $10.1 billion of issues maturing November 15, of which $2.6 billion are held by the public. The Treasury also has a substantial cash need to meet before the end of November and is thinking in terms of combining that operation with the refunding. On Treasury estimates, an additional $2 billion will be required, assuming that $1-1/2 billion of participation certificates can be sold by year-end.

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

The market has been thinking in terms of a short-term--say, 15 - 18 month--anchor and a longer maturity, although there is no unanimity as to how long a maturity or how much would be feasible. There has been a fair amount of sentiment for a convertible Treasury note--that is, an issue maturing in 2 - 3 years with an option to the holder to convert it on or before maturity to an issue (presumably with the same coupon) with an additional 3 - 4 years to maturity. I believe there is little doubt that such an issue would be attractive to investors. It would have certain disadvantages for the Treasury, however, and some market observers feel that the Treasury need not resort to such an innovation at this stage. The Treasury will, however, be considering the pros and cons of a convertible note, as well as other financing combinations, over the next two days.

Needless to say, setting the terms in the Treasury financing poses some delicate problems, given the unsettled state of financial markets. It would be highly desirable for the Treasury to raise as much cash as possible along with the refunding, and thus avoid another trip to the market before year end. One can only hope that the Treasury's estimates of cash needs are accurate; our own projections suggest a somewhat larger need.

Given the Treasury's cash needs in coming months, the possibility that some adverse development on the tax-spending front or in the international area could seriously interfere with the success of a Treasury operation cannot be overlooked. While there is no need to borrow trouble, the System should be prepared to lend assistance if it should prove necessary. Contingency planning cannot be precise, but there are two kinds of situations that we should be alert to. One possibility--I hope a remote one--is that the Treasury would not receive enough subscriptions to cover an offering. In such an event it might prove desirable for the System to lend directly to the Treasury on a special certificate to cover any shortfall in subscriptions, so that the market would not feel that the Treasury would be under the gun to return with a new cash offering as soon as possible. A second possibility is that a disturbance would arise after the subscription books had closed and investors had underwritten the offering. In such an event the System should be prepared to buy when-issued and perhaps outstanding issues under the usual understanding about actions to be taken in disorderly market conditions. In either case, it would be desirable to minimize the reserve impact of special System operations by selling short-term securities to the extent feasible.

As for the current Treasury financing, the System holds $7.3 billion of the maturing issues and I might want to make suggestions to the Committee by wire for entering the System's subscription after the terms have been decided on.

Mr. Mitchell asked whether there was any evidence that funds leaving the stock market were going into municipal and corporate securities.

Mr. Holmes replied that while there might have been flows of that type, he knew of no evidence that they had been strong.

Mr. Brimmer asked Mr. Holmes to amplify his remarks concerning the course that might be pursued if subscriptions in the Treasury financing did not cover the offering.

Mr. Holmes responded that the best course of action in that event would depend so heavily on the surrounding circumstances at the time that a detailed program could not be spelled out in advance. In general, however, the market was aware that the Treasury had to raise the cash by one means or another, and it might be reassured if the System made up any shortfall in the offering by buying a special certificate with a maturity longer than usual. That would make it clear that the Treasury would not have to return to the market immediately. The Treasury would, of course, have the option of repaying the System sooner if possible.

Mr. Mitchell asked whether his understanding was correct that the Manager would contemplate offsetting the effect of such an action on bank reserves by sales of bills.

Mr. Holmes said he would hope to do so, but whether it would be possible to sell enough bills to offset the full effect would depend on the circumstances.

Mr. Maisel noted that the provisions of the Federal Reserve Act regarding System acquisitions of securities directly from the Treasury did not include any limitation on the maturity of such securities. However, the System had tended to use that authority to cover very short-term emergency needs of the Treasury, such as over a weekend. He asked whether there was anything in the legislative history of that part of the Act to suggest that only such short-term credits were contemplated.

Mr. Hackley observed that while the language of the Act did not include a specific maturity limitation, statements made in Congressional committee reports at various times when the authority was being extended indicated that it was the intent of Congress that it should be used only to meet temporary cash needs of the Treasury.

In reply to questions by Mr. Wayne, Mr. Hackley said that he did not recall any specific definition of "temporary" in the Committee reports to which he had referred. In his opinion, however, a 90-day maturity on a special certificate would not be contrary to the intent of Congress.

Mr. Holland noted that the authority in question had been used for periods as long as several weeks during World War II.

Mr. Brimmer asked whether the Treasury trust accounts might be able to expand their takings of the new issues somewhat if there was a short-fall in public subscriptions, and Mr. Holmes indicated that that was one possibility that no doubt would be considered by the Treasury.

In response to a further question by Mr. Brimmer, Mr. Holmes expressed the view that the probability was small that public subscriptions in the refunding would not be large enough to cover the issue. Nevertheless, the probable consequences of such an eventuality were sufficiently serious to warrant contingency planning. As he had indicated, the small margin of cover on the recent issue of June tax bills was sobering.

Mr. Wayne then asked if the Special Manager would comment on the likely international reaction to the use of emergency devices of the sort under discussion in connection with a Treasury financing.

Mr. Coombs replied that he would not expect the reaction to be good. In his judgment, however, the greater damage would be done by the failure of the Treasury offering rather than by the particular devices used to compensate for such a failure.

Mr. Hickman asked whether the Committee should not at some point renew its discussion of the steps that might be taken to deal with the flows of funds from Britain to the Euro-dollar market and then to the United States. He assumed that the Board and its staff were considering possible courses of action.

Chairman Martin commented that the developments to which Mr. Hickman had referred were very much on the minds of the Board members. He agreed that the situation had to be watched closely.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period October 3 through 23, 1967, were approved, ratified, and confirmed.

Chairman Martin then called for the staff economic and financial reports, which at this meeting were in the form of a visual-auditory presentation. Copies of the charts displayed have been placed in the files of the Committee.

The introductory portion of the review, presented by Mr. Brill, was as follows:

> Some time back, we selected this date for a chart show in the expectation that by now the dimensions of the fiscal restraint program would be clear. But despite the old adage, neither "debt" nor taxes is certain.
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> Nevertheless, there is value in another tour of the horizon today. The economy has been moving up vigorously, price pressures have been mounting, and financial markets increasingly reflect the conviction that fiscal restraint will, at best, be inadequate. While the odds on fiscal restraint have diminished, we do not think they have vanished. An assessment of the outlook based on a significant package of fiscal restraint still seems appropriate.

Our policy assumptions include an 8 per cent surcharge effective January 1, and Federal expenditures, measured on a national accounts basis, held to $172 billion. This is $2 billion less than implied by the January budget, but adjusted upward for $4 billion of additional Vietnam outlays and an extra $1 billion in Government pay increases not allowed for last January. Of course, the actual tax might be less and the spending cuts more, or vice versa, but fiscal restraint of about these dimensions still seems a reasonable presumption.

We also assume that monetary policy maintains a level and structure of interest rates approximating their averages during the first half of October, before financial markets began to get rattled. This is not a policy recommendation, but an assumption designed to clarify whether the postulated fiscal restraint is sufficient, or whether some need for monetary restraint would remain. Of course, the odds on having to depend primarily on monetary policy in the period ahead are not negligible. We are prepared to discuss with you later some of the consequences if this should prove to be the case. But let us begin the presentation with an analysis of nonfinancial developments as we see them under conditions of fiscal restraint.

Mr. Wernick made the following comments on nonfinancial developments:

Quarterly GNP growth has already accelerated appreciably since midyear, and we project a rise of $20 billion for the fourth quarter, as indicated in the green book.[1/] The restrictive fiscal policy assumed in effect by year-end would slow the upward momentum, reducing the quarterly increase in GNP in the first two quarters of 1968 to about $16 billion.

GNP growth in real terms has been accelerating since the first quarter and is expected to reach a 6 per cent rate in the current quarter. Fiscal restraint would help moderate real growth to just over a 4 per cent annual rate, which is more consistent with our long-term growth potential.

Supporting the rapid comeback in economic activity this year has been a large and fairly stable rate of

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

advance in total final sales, in sharp contrast to the lower, and more erratic, growth last year which culminated in a heavy inventory pile-up at year-end. Fiscal restraint would bite quickly into final sales, but the growth rate in the first half of next year would remain relatively high.

Inventory accumulation has stopped declining, and in fact rose a little in the third quarter of this year. With continued strength in final sales, auto stocks depleted, prices higher, and a possible steel strike in mid-1968, a further step-up is projected to more normal rates of accumulation. Our estimates take account of the likelihood that defense inventories may well be declining next year, reflecting the slower advance of defense expenditures.

Fiscal restraint during this period of more rapid inventory building would have its main impact on disposable personal income and consumer expenditures. With personal tax rates increased the growth of disposable income, estimated at over $11 billion for the fourth quarter, would be cut back to about $8 billion. Although growth in consumer expenditures would also decline from the projected fourth-quarter rate, gains in the first half of 1968 would be as large as the increases in disposable income.

This is based on the assumption that consumers would not reduce their expenditures by the full amount of the tax increase, but would lower their savings rate moderately. Nonetheless, we expect the savings rate to remain well above the average for the years 1963-1966. This seems to be in line with the temperate spending habits of consumers in evidence over the past year. A sharper decline in the savings rate could, of course, occur, and this would mean consumer purchases rising still more rapidly.

Growth in private housing starts slows down during the projection period. Rates of increase from earlier lows have been sharp--starts in September were already close to their level in 1965. With high costs of borrowing acting as a restraining influence, little further advance in starts seems in prospect. Construction expenditures would continue to rise, however, reflecting both rising costs and completion of projects currently under way.

Business fixed investment showed some decline in the first half of this year, but these expenditures have turned around and are beginning to move up. We are projecting continued moderate growth into 1968, at a rate about in line with the 5 per cent gain suggested by recent private surveys of expenditure plans. But with prices rising, real growth would be much less.

This projection also seems in line with the recent upturn in new orders for machinery and equipment. These orders are now back to their 1966 peak. Past increases in material and labor costs and fear of further pressures on profit margins apparently are providing incentives for continued high levels of investment, despite lower levels of capacity utilization.

Our fiscal assumptions imply a slowdown in the growth of Federal expenditures on a national income accounts basis. If Vietnam outlays are kept to the $4 billion over the budget that we assume, and modest cuts are made in other defense purchases, growth in total defense expenditures would slow markedly. We have also assumed other moderate budget cuts that would temper the growth of nondefense expenditures.

Meanwhile, receipts accelerate as a result of higher income levels and higher tax rates on personal and corporate income. Consequently, the NIA deficit--currently at an annual rate of about $13 billion--shrinks rapidly to about $2-1/2 billion in the second quarter of 1968.

The increase in manufacturing output, interrupted in September and October by work stoppages, is expected to resume following settlement of the auto and other labor disputes. Our projection assumes full resumption of auto production in early November. From now until mid-1968, output increases at an annual rate of little over 5 per cent.

Growth in capacity over the projection period would be only a little less than anticipated gains in output. Capacity is expected to grow at about a 5 per cent annual rate--somewhat slower than the trend of recent years--as a consequence of the decline in investment spending earlier this year and the modest rise projected in these outlays. Capacity use would thus rise only gradually, and remain well below the peaks of 1966.

Manufacturing employment is likely to respond sensitively to this change in the pace of output, as it did earlier this year. The recovery that began in the third quarter was held back by strikes, but employment should be rising again as output advances.

Nonmanufacturing employment gains this year have reflected the continued upward trend in trade and services. These gains were large during the earlier period of weakness in manufacturing. Now, growth in employment is expected in both sectors, and total employment increases would exceed the growth in the labor force between now and mid-1968.

This suggests continued tight labor markets, with unemployment declining moderately to 3.7 per cent. For adult men, the unemployment rate would remain close to the current low 2 per cent rate.

The carryover of past wage pressures, the major wage negotiations scheduled, and the recent rebound in consumer prices all portend continued large wage gains throughout the economy. Hourly compensation in manufacturing rose about 6 per cent from mid-1966 to mid-1967, and should increase slightly faster in the next twelve months as recent large settlements in autos, rubber, and railroads spread.

Slower growth in output resulted in a marked dip in productivity gains in late 1966 and early 1967. The anticipated recovery in output will be accompanied by increased utilization of more efficient plant and equipment and should lead to a recovery in productivity to more normal rates of advance. But with wage gains remaining above productivity growth, unit labor costs would continue to rise, perhaps at over a 3 per cent annual rate. While this is an improvement over the record of the past year, it is a far cry from the stability of the early 1960's.

With demand expanding, a significant part of these cost increases is likely to be passed through to prices of industrial commodities, which began rising again in July. For sensitive materials, world supplies are now relatively ample, but with increasing economic activity here and in Europe, these prices should be turning up again.

However, with bumper harvests in prospect or under way, prices of foods have declined again since midyear, and little rise is foreseen over the projection period. This may hold down the increase in the total index to less than a 2 per cent annual rate.

In consumer markets, prices of nonfood commodities should continue rising under the impetus of increased industrial commodity prices. Retail food prices have risen sharply since April, but this rise should slow down.

But the inexorable increase in service prices seems sure to continue--possibly faster than in recent months if home ownership and rental costs accelerate further. Altogether, the total CPI may be increasing at an annual rate of around 3 per cent.

We turn now to the implications of these price and output developments for financial markets.

Mr. Gramley made the following comments on financial developments:

The monetary policy assumption underlying our economic and financial projection implies sufficient reserve provision to halt the rise in interest rates, and to maintain these rates through mid-1968 at approximately the levels of early October. This assumption was adopted for two reasons--first, to determine whether the package of fiscal restraint would be sufficient, and second, to gauge the impact of the GNP projection on financial flows.

Fiscal restraint would have its most important effect on credit flows through a reduction in Federal borrowing. In the current half year, total Federal borrowing (including PC's) is projected at a $26 billion annual rate, a large share of which has already taken place. It then declines to an annual rate of about $11 billion in the first half of next year--still very high by historical standards.

Private borrowing rose significantly in the first half of 1967 from the depressed levels of late 1966, when credit availability was low. Another rise is under way in the current half year, but the further increase expected for first half 1968 is small. This temperate behavior of private borrowers depends crucially on the assumption that fiscal restraint would curb the scramble for funds we have seen in recent days.

Household borrowing often follows closely the movements in net investment in new homes and durable goods. Both net investment and borrowing are rising strongly in the second half of 1967, but projected growth moderates thereafter.

The timing of business net investments and borrowing does not always coincide so well. Thus, business borrowing shows no further growth in the projection period, despite sharply rising net investment in fixed capital and inventories during the first half of next year.

This projection reflects a judgment that the current level of corporate borrowing in the capital markets is heavily anticipatory, and is being accompanied by an unusually high rate of liquid asset accumulation. Fiscal restraint, we assume, would relieve the capital markets of this rush for funds.

We are, accordingly, projecting a marked decline in flotations of bonds and stocks by nonfinancial corporations--to a little over a $10 billion annual rate in the first half of next year. This would be a high rate of long-term borrowing compared to years prior to 1966, but a level one-third lower than in the last half of 1967.

Corporate bank loans, however, would begin to show more strength in early 1968 as levels of inventory investment increase. Other types of corporate borrowing also would rise moderately. But with bond and stock issues declining, total corporate borrowing would be reduced somewhat.

This projected decline in corporate borrowing tempers the rise in total private borrowing during the first half of next year. Consequently, total funds raised would recede with the projected drop in Federal borrowing. But this decline in total credit flows occurs from a new record level in the current half year. The projected total for first half of 1968 is still large--about equal to the level in the first half of 1966.

Financing this total flow of funds at early October interest rate levels would require continued substantial growth of total bank credit, though the increase in loans and investments early next year would be at a slower pace than we are seeing currently.

Movements in Federal borrowing are the key factor. Banks are acquiring a substantial portion of the huge increase in Federal securities during the last half of this year. As Federal borrowing declines, bank purchases of Federal securities would fall, and so would growth in total bank loans and investments.

Bank loans, excluding security loans, are expected to pick up a bit in early 1968, mainly reflecting bank financing of the projected rise in inventory investment.

However, funds would be available to permit substantial net investment in municipals, as banks reduce their purchases of Federal securities.

These bank credit projections imply continued growth in money and time deposits at relatively high rates. Public demands for money would be bolstered by rapid increases in income, and we expect corporations to maintain their money balances--if not increase them--to protect their access to bank credit. But the stimulus from falling short-term interest rates and depleted liquidity positions that led to high rates of increase in money holdings early this year will no longer be present. On balance, we expect the growth rate in the money stock to be slightly lower in the first half of 1968 than in the last six months of this year.

Time deposits are also expected to grow more slowly than in the first half of this year--more in line with the 12-13 per cent of the past two months. The projection suggests that banks would not have much incentive or pressure to bid aggressively for CD's. And at current market interest rates, the flow into time and savings deposits from households would be less than earlier this year.

Growth of nonbank savings accounts at current market interest rates is likely to parallel movements in commercial bank time deposits held by households, since competition among institutions for these funds is limited by rate ceilings. The projected decline in inflows to these institutions is moderate, and supplies of mortgage funds thus seem likely to be forthcoming at yields and in quantities sufficient to finance the projected volume of residential construction.

These inflows to banks and nonbank institutions would permit the institutional share of total funds supplied to remain at relatively high levels. Banks would supply about one-third of the total during the first half of next year, and nonbank financial institutions a little more. But these shares would be much lower than in the first half of 1967.

In that half year, the public was, on balance, liquidating market securities in large amounts and channeling flows through institutions, as short-term market rates were falling. The reversal of the public's position to a net supplier of funds to credit markets has already begun this summer, in response to sharply rising market interest rates. The slight decline in the public's share projected for the first half of 1968 reflects mainly the expected moderation in corporate borrowing and liquid asset accumulation mentioned earlier.

We turn now to the implications of these domestic developments for the U.S. balance of payments.

Mr. Reynolds made the following comments on the U.S. balance of payments:

The balance of payments has continued in substantial over-all deficit this year. The surplus on goods and services has improved since late 1966; but it is still smaller than it was early last year, and much smaller than in 1964 and 1965. The net outflow of U.S. private capital has remained fairly steady. And there have been increased outflows under such headings as Export-Import Bank loans and private remittances.

The published liquidity deficit has been held down by large placements of foreign official funds in long-term U.S. time deposits. But even so, that deficit has exceeded $2 billion at an annual rate during the first three quarters of 1967, more than in either of the two preceding years. And the deficit on the official reserve transactions basis, which has swung widely from quarter to quarter, has averaged about $2-1/2 billion at an annual rate, more than in any year since 1962.

Uncertainties about the future course of business activity here and abroad have diminished in recent months. At home, vigorous economic expansion has now become an actuality. And in both Germany and Britain, cyclical recoveries have also gotten under way since midyear and seem likely to continue. Hence, international transactions in goods and services can be projected with some assurance. However, unusually large uncertainties continue to overhang financial markets and flows of short-term capital.

On U.S. merchandise trade--the largest element in our international transactions--there has been considerable improvement this year. Exports have continued to increase, despite recessions in Europe, and imports have fallen off a little as a result of the earlier slackening in domestic demand. As a result, the trade surplus has increased.

It seems likely that the trade surplus can be maintained at about its third-quarter level of $5 billion, annual rate, through mid-1968; but one cannot count on further significant gains. The advance in U.S. exports is expected to accelerate, as economic activity revives in Western Europe and in Canada and continues to advance in Japan, and as agricultural exports recover from this year's slump. But imports will soon be turning up again in response to the accelerated advance in domestic activity.

On current transactions other than trade, there should be a sizable improvement. Direct investment income is likely to resume the rise that was interrupted in 1966-67. And the "other" current transactions category will improve sharply when the travel drain from EXPO '67 ends and the bulge in personal remittances to Israel subsides. On the adverse side, the net outflow on military transactions may increase further, but probably only slowly. On all current transactions, the surplus may rise by about $1-1/2 billion, annual rate, from the first half of 1967 to the first half of 1968.

The net outflow of U.S. private capital is not expected to change much over the next few quarters. Under the new balance of payments program to be announced soon, the Commerce Department program for direct investments will be tightened to reduce net outflows to developed countries. But flows to less developed countries will continue to increase, and the net flow this year was reduced by a few unusual liquidations. Thus the net outflow of direct investment capital to all areas may not change much next year. Since 1965, the Commerce program--primarily by inducing U.S. companies to borrow more abroad--has achieved a reduction in net outflows of U.S. funds even though the plant and equipment expenditures of the foreign affiliates of U.S. firms have been advancing rapidly. With expenditures still rising, it will take increasing restraint merely to keep outflows from rising.

There will probably be moderate net outflows of U.S. bank credit from now on. These will continue to be subject to the restraints of the VFCR program, the IET, and the high domestic interest rates. But after an extended period of exceptional reflows, there was a moderate outflow in the second quarter of 1967, and this has continued into the current half year. It seems reasonable to count on some further outflow in 1968--perhaps as much as $1/2 billion at an annual rate--much of which may be used to finance the increase in U.S. exports.

On balance, the net outflow of U.S. private capital of all kinds may change little, and the expected increase in the surplus on goods and services will tend to reduce the payments deficit. However, it will be difficult to arrange special official transactions on anything like the scale achieved in the first half of 1967. Hence, the published liquidity deficit will probably remain greater than $2 billion at an annual rate, despite some underlying improvement. The deficit measured by reserve transactions could range fairly widely on either side of the liquidity deficit, and hence is not projected here.

The size of that deficit will depend greatly on the change in the liabilities of U.S. banks to their foreign branches. Given the domestic financial conditions assumed in today's projection, the U.S. banks would not become very aggressive bidders for foreign funds. Also, we would expect the supply of liquid funds from Germany to diminish as domestic activity picks up there, and we have assumed for purposes of today's projection that some revival of market confidence in sterling during the winter will staunch the flow from sterling into Euro-dollars. Under all these conditions, further net inflows from the branches would probably be small. However, this is a particularly uncertain area. Hence we project liabilities to branches at mid-1968 ranging anywhere from $1/2 billion below to $1/2 billion above their mid-October level.

The outlook for sterling is, of course, a key element in any international projection. The aim of the British Government is to bring Britain's basic payments balance--on current and long-term capital transactions--into surplus, in order to repay short-term debts and rebuild official reserves. In the light of progress made in 1965 and 1966, and of domestic policies of restraint, a surplus had been confidently expected for this year. But this goal has been frustrated by a severe set back on trade account, by the effects of the Middle East crisis on service transactions as well as trade, and more recently by strikes. A succession of disappointing monthly trade figures has brought market confidence in sterling prospects to a very low ebb, and this--together with the pull of rising U.S. and Euro-dollar interest rates--has caused large short-term capital outflows and reserve losses. In coming months, some improvement on trade account should result from rising economic activity in the United States and Europe. We have assumed that it will come soon enough, and be large enough, to bring some revival of market confidence in sterling during the winter.

In summary, given early enactment of a fiscal restraint program in the United States, we see a tendency toward modest improvement in the U.S. payments position during the quarters immediately ahead. But the deficit will remain uncomfortably large. While it may be fairly easy to finance for a limited time, through further additions to foreign official dollar holdings and a decline in our sterling holdings as Britain begins to reverse its swap drawings, the need to reduce the deficit will remain. With the outflow of U.S. private capital already restrained, the main improvement will probably have to come on current account, including military spending.

In this setting, it will be particularly important over a longer period--beyond mid-1968--to avoid any marked increase in domestic pressures on manufacturing capacity, and to limit advances in costs and prices. The ratio of imports to GNP rises sharply when the percentage capacity utilization rate in manufacturing gets into the high eighties, as in 1965-66. And once foreign suppliers gain a foothold in U.S. markets, they are difficult to dislodge, as we know from the case of autos and other consumer goods, and also steel, and machinery.

Mr. Brill then made the following concluding remarks:

This review of prospective developments to mid-1968 does not, unfortunately, offer obvious solace to monetary policymakers. Despite the assumed package of fiscal restraint, projected growth in GNP would still be uncomfortably rapid. Real growth would be proceeding at close to a 4-1/2 per cent annual rate and, with our labor resources under considerable pressure, both costs and prices would likely be continuing to rise.

Nor would the tax increase remove all pressures from financial markets. Although the corporate bond market would likely cool off somewhat, and some business bank loan demand might be withdrawn, financing a GNP expanding at $16 billion per quarter calls for large credit flows. The projected total of funds raised remains high, and to accommodate these flows at interest rates no higher than those currently prevailing would require substantial further expansion of bank credit.

Finally, the assumed fiscal restraint program would not magically erase our balance of payments difficulties. Some modest improvement in the current account may be achievable, and we may be able to hold the line on outflows of private capital, but it is difficult to see the source of any significant improvement over-all next year, and it is easy to see possibilities of deterioration as a result of continued advances in U.S. costs and prices.

Given the still unsatisfactory developments in prospect, can one then conclude that the projected fiscal package is inadequate? Will additional monetary restraint be needed as a supplement? There are no simple answers, and there are some obvious difficulties. Having missed the boat on getting fiscal restraint last July, and missing it again this fall, we have allowed stronger upward pressures to become embedded in our cost and price structure.

It would take Draconian measures, indeed, to produce significantly better price performance than is projected here. The new pattern of wage settlements will be spreading, keeping upward pressure on commodity prices at both wholesale and retail. And it is hard to visualize the restraint program which would slow the rise in service prices in a short period. What the assumed fiscal package can do in the short run is to prevent these embedded pressures from accelerating and becoming cumulative.

It also holds out some hope for later in 1968, for the restraint exercised on final sales should limit the extent of inventory demands. The most significant source of stimulus in the first half of 1968 is projected to be the return of inventory investment to a more normal relationship with final sales. We almost always emerge from a period of inventory adjustment on the dead run, but this initial spurt is often short-lived. Given restraint on final sales, the inventory build-up could be of short duration in this upswing, particularly if defense spending and defense inventories stay within the confines of our assumptions.

And what has been happening to interest rates since last spring certainly has to be taken into account. Long-term rates have risen to new record levels, minimizing prospects for further gains in residential construction beyond midyear 1968. Moreover, it is hard to foresee a sharp revival of business fixed capital spending in this kind of financial climate, especially given that manufacturing capacity in the period ahead would remain in relatively abundant supply.

Thus, the assumed fiscal restraint, coming perhaps six months later than it should, cannot be expected to produce miracles over the next six months. It should, however, contribute promptly to dampening the psychology of inflation, and, in time, to a substantial reduction in the fiscal stimulus which is currently overheating the economy. We would expect a more reasonable pace and pattern of economic activity to emerge as next year progresses.

These economic prospects, it seems to me, do not argue for any significant relaxation of credit market conditions in the near future, but neither do they suggest a compelling case to add a significant monetary tightening to the fiscal restraint we are still hopefully--prayerfully--anticipating.

In the very near term, there is not likely to be much opportunity to shift the stance of monetary policy in any event, for the Treasury is entering the market shortly to refund and to raise cash at a time when financial markets are still churning. As best as we can gauge trends in this turbulent background, holding the line on money market conditions would imply a 3-month bill rate in the 4.40 to 4.70 per cent range, and a funds rate ranging around 4 per cent. This would be roughly consistent with free reserves in a $150 million to a $300 million range. Whether intermediate-term Governments are more toward the upper or the lower end of the expected 5.50 - 5.75 per cent range will depend on the Treasury's choice of refunding issue.

Bank credit expansion could slow somewhat in November, given these credit market conditions, but this depends largely on the amount of additional cash raised by the Treasury and on business demands for loans. There are no signs yet, in either sales or banking data, that inflationary fears are stimulating vigorous inventory stock-piling, or a significant raising of capital spending plans, or a consumer stampede to acquire new cars or other durables. But these are not inconceivable developments, and we must remain alert to the possibility. At the moment, however, the November aggregates projected in the blue book are not far from the levels we would think appropriate to maintain, on average, over early 1968 if we get fiscal restraint by year end.

An extended discussion followed the presentation, in the course of which the staff responded to various questions. Among the matters discussed were the nature and purposes of particular assumptions employed in the model, the methods by which certain of the projected figures were developed, the plausibility of some of the projected figures, and the internal consistency of various elements of the model.

Also discussed at some length was how the projections might appear under alternative policy assumptions. Mr. Brill indicated that the Board's staff had done some exploratory work on projections involving the assumption of no tax increase, but that the work was still in a preliminary stage.

At the conclusion of the discussion it was agreed that the staff should be asked to pursue its work on developing projections employing the assumption of no tax increase and also, if feasible, to extend the projection period beyond mid-1968, with a view to presenting the results to the Committee later.

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

The underlying economic situation continues to be strong. Housing construction has been advancing, and the inventory adjustment has probably been accomplished. The outlook for inflationary economic expansion remains unchanged. Although some economic indicators have weakened, this development appears to be due primarily to special factors such as strikes. The generous terms of the proposed Ford settlement are likely to add to the inflationary pressures.

The United States balance of payments deficit on the liquidity basis worsened in the third quarter, but the underlying deficit was reduced from the unusually high level of the second quarter. The underlying deficit, however, remains very heavy at a seasonally adjusted annual rate of over $3 billion; and no improvement is in sight. Sterling continues in difficulty despite the 1/2 per cent increase last week in the British Bank rate; and pressures on the London gold market are very heavy.

The capital markets are heavy. The demand for funds on the part of corporations and municipalities continues to be large; and the U.S. Treasury will have to come to the market for additional moneys in November and perhaps in December. Long-term interest rates are at record high levels. There is some risk of decreased financial intermediation even though inflows into depositary institutions have remained high in the face of the recent advance of market interest rates.

Bank credit has grown rapidly this year. Following a 13 per cent annual growth rate through September, October's growth appears to be substantial. Continuation of the expansion at such a rapid rate would add fuel to demand pressures.

The stimulus provided by the Federal budget coupled with business and credit developments cry out for restraint. But the outlook for restraint in fiscal policy is uncertain. With action on the tax bill suspended, both the Congress and the President are apparently taking active steps to achieve significant cutbacks in Federal spending.

The delay in raising taxes is contributing to the upward pressure on prices and to the heaviness in financial markets. I trust that we may see a tax increase combined with curtailment in Federal spending, but the timing of such action is uncertain. Resolute action before the year end could help restore confidence in financial markets, a confidence that is now sadly lacking.

The Federal Reserve must, of course, continue to consider the extent to which action by it may enhance or impede the chances of getting a tax increase. In addition we must be mindful of the Treasury's financing problems. Since the Treasury expects to announce this week the terms of its November financing, an even keel in the money market is called for. Therefore, with some reluctance I conclude that there should be no change in Federal Reserve policy.

The draft directive[1/] submitted by the staff is satisfactory. Because of even keel considerations, I doubt that there will be occasion for action under the proviso clause.

Mr. Francis said that at the last two meetings of the Committee it had seemed to him that majority agreement was observed on three points: First, that there was a clear and present danger of inflation stemming from demands for goods and services rising more rapidly than the productive potential. Second, that the excessive demands were fostered by unduly expansive fiscal and monetary conditions. Third, that there was a clear-cut need for stabilization policies to curb those inflationary pressures and to protect the U.S. foreign trade balance. Since the last meeting, no new evidence had been received which, to his mind, altered that assessment of the current situation.

As early as its meeting on July 18 of this year, Mr. Francis noted, the Committee had expressed considerable concern about the

1/ Appended to this memorandum as Attachment A.

high rates of growth of bank credit and the money supply. So far the rates of increase had not been abated significantly. Increasing interest rates had been cited as evidence that the Committee actually had tightened policy. But the rise in rates apparently had been an unintended development arising from demand forces, since the Committee had not called for any tightening in money market conditions or any rise in interest rates in its recent directives.

Mr. Francis observed that failure to restrict the present excessive expansion of money and bank credit was sometimes justified on the grounds that there must be no interference with Treasury financing. To his mind, that was a pernicious doctrine. In general it meant that when the Federal budget was excessively stimulative and was running deficits, instead of getting the needed complementary monetary restraint, monetary actions were also excessively stimulative.

The idea that monetary restraint had to be avoided today because of the present condition of the pound seemed shortsighted to Mr. Francis. The plight of sterling was serious, and a case could be made that it was in this country's self-interest to help the United Kingdom. But a more or less chronic sterling crisis had existed since the fall of 1964, and there was no reason to assume that it would soon disappear. To provide effective support for sterling it was necessary to look beyond the next few weeks. The best thing the Committee could do for sterling was to follow policies which would restrain U.S. interest rates over the next year or so rather than for the near future. In the long run, the Committee could help the United Kingdom more by following policies which were appropriate to achieve its domestic goals. It was quite possible that a restrictive policy on the Committee's part would contribute temporarily to pressures on sterling. However, it seemed to him that the network of international monetary arrangements which had been carefully developed over the past five or six years should be used to handle that type of temporary problem.

There seemed to Mr. Francis to be some reluctance to cease the extraordinary rate of expansion of bank credit and money on the grounds that to do so would bring about a repetition of the developments in the late summer of 1966. In his opinion, history would conclude that monetary restraint during 1966 was desirable, although the degree of restraint might have been too strong. Less restraint might have been adequate if begun earlier or if there had been appropriate fiscal policy. Possibly the Committee should have operated less vigorously by permitting some expansion of bank credit and money. But on the whole, as the last Annual Report of the Council of Economic Advisers in effect said, the Committee had done a good and necessary thing for the well-being of the whole economy.

The Committee should indeed learn a lesson from 1966. The lesson, it seemed to him, was that it had done a good thing that should be repeated as called for, not that it had done a bad thing which must be avoided at all costs.

If the Committee failed to act now, Mr. Francis continued, the System might be tempted to try selective credit controls to curb inflation. It was his belief that such a course would be highly undesirable and injurious to the efficient working of the economic system. He seriously doubted the System's administrative ability to perform the rationing function of free markets in the allocation of scarce funds and resources. In the past, the System's experience with selective credit controls had pointed up many administrative and economic problems which arose when it attempted to interfere with the free play of the markets. Now the tenor of public attitudes was even less propitious for successful administration. Everyone disliked the restraint on freedom inherent in such controls. There were more desirable alternatives open to the System and time enough to adopt them.

Mr. Francis believed the Committee should adopt a directive calling for real monetary restraint. The forthcoming Treasury financings should not prevent a change in policy today. The change he was suggesting was a reduced rate of monetary and bank credit expansion over the next three months. The Manager could be allowed leeway in his implementation of that policy during Treasury financing periods; nevertheless, he should be directed today to achieve whatever firmer money market conditions were necessary to moderate growth in money and bank credit between now and the year's end. The directive should provide for whatever tightening was necessary to assure that bank credit expansion would not be more rapid than about a 6 to 8 per cent annual rate--in contrast to the 14 per cent rate of recent months and the 12 per cent rate of the first nine months of this year. The suggested rate of growth would still be as high as the trend rate prior to 1965.

It seemed important to Mr. Francis that the Committee act now, not only because restraint was long overdue in the interest of economic stabilization, but also because the Committee would soon come to the time when it was likely to be said that nothing could be done pending the Economic Report and the Budget Message. The Committee must act when it was in the national interest to act, and it seemed clear to him that the national interest called for action now.

Mr. Patterson commented there were only a few developments in the Sixth District worth mentioning today. The first was a further increase in residential and other building contracts. It indicated construction was still expanding, although some slowing down in homebuilding remained a future possibility. A second was the increase in auto buying during September, despite a decline in sales of Ford Motor Company cars.

Another development of interest, Mr. Patterson said, was the recent greater than seasonal rise in business loans at large banks. Other types of loans had increased as well. But it would be premature to characterize that upturn in bank lending as exuberant. That also appeared to be the situation nationally.

Mr. Patterson observed that the latest monthly business statistics and third-quarter GNP figures, adjusted for strikes and price changes, indicated the economy was gaining in strength but had not attained boom proportions. On the other hand, inflationary undertones were visible and disturbing. Therefore, in his opinion, it was no longer a question of whether monetary policy should become more restrictive but when, to what degree, and in what manner.

Furthermore, Mr. Patterson continued, he was skeptical that even a 10 per cent surcharge on income taxes would be enough to halt inflation. As things stood, the tax increase--if passed at all--would be delayed and would be smaller than 10 per cent. Half a loaf was, of course, better than none, so he could appreciate to some extent the reluctance to alter monetary policy while the tax bill was before Congress. But inasmuch as others judged the System by whether it used the tools at its command, the Committee might be treading on dangerous ground if it failed to exercise monetary restraint. Therefore, the sooner the Committee could extricate itself from its present dilemma, the better. For the longer it waited, the more difficult it became to accomplish the desired results with the same degree of restraint.

Obviously, Mr. Patterson said, an overt move at this time was out of the question because of the impending Treasury financing. But the Committee should be looking down the road and considering what it might do when Treasury financing was not an obstacle. If at that point the Congress still had not acted on the tax bill, the Committee would be facing the same dilemma it had faced at previous meetings. He would hope that by then the Committee would have further explored the alternatives that might lead it out of that dilemma and at the same time avoid severe financial dislocations. Today, there was no choice of directives and he had no objection to the draft directive prepared by the staff.

Mr. Bopp said it was evident that the upturn was gathering steam in spite of the depressing impacts of the automobile strike and continuing strife in both the copper industry and in steel transportation. As it did so, inflationary pressures were also picking up steam. In the Third District, although some of the indicators continued to oscillate, the picture was also one of gathering strength. Manufacturing output in August was up 3 per cent and the highest it had been since January. In September unemployment rates dropped. Nonresidential construction was strong, and consumer credit showed a larger increase than in the previous two months.

Large Philadelphia banks reported that they were expecting a pick-up in loan demand during this quarter, Mr. Bopp continued. They were reasonably comfortable with respect to their liquidity positions even though there was some concern about the overhang of unused lines of credit and about the impact of a tightening of monetary policy.

In spite of the accelerating recovery, Mr. Bopp remarked, the list of reasons for not moving to less monetary ease was long and impressive. The same arguments made earlier for not jeopardizing the possibility of tax action could still be made, although they were getting weaker. The Treasury had heavy financing needs between now and the end of the year. Disintermediation was still very much of a threat. Although helped by the increase in Bank rate, the position of the pound was precarious, and a further run-up of U.S. interest rates could further weaken it.

But the case for a move to less ease was also growing more impressive, Mr. Bopp observed. Price increases were continuing and becoming more widespread. A further large rise in bank credit and the money supply was projected for October. The U.S. balance of payments problems persisted and might worsen if prices continued to rise.

In addition to the purely economic factors pointing to a need for tightening, Mr. Bopp said, there were also expectational reasons.

The longer some tightening was postponed, the greater was the danger that people would become convinced that no change was contemplated. Should such expectations be allowed to develop, it might be difficult to dampen the impact of anticipatory buying on prices. The even keel policy encouraged the development of such expectations. The Treasury would be a heavy borrower during the months ahead, and the market might already be convinced that that fact precluded any move toward less ease.

For expectational as well as purely economic reasons, Mr. Bopp thought such a move was warranted. But for the next three weeks there was the problem of Treasury financing. In recent go-arounds, some members of the Committee had mentioned the possibility of taking action toward less ease despite even keel considerations. He believed this would be an appropriate time for the Committee to take a new look at the even keel policy. In view of the rapidly growing need to move toward less ease, he would urge that the staff be asked to prepare a statement prior to the next meeting which would include the rationale of even keel, the costs of moving from it, and possibilities of modifying it without jeopardizing the success of Treasury financing operations. For example, the Committee might consider the possibility of buying whatever quantities of a new issue might be necessary to assure success of the offering and offsetting those purchases with sales of other issues. That proposal was, of course, different from the one

Mr. Holmes had advanced today. It might also be desirable to see whether the period during which Treasury financings typically were in process--from the announcement date to the issue date--could be shortened.

In the meantime, Mr. Bopp concluded, conditions in the money market should be maintained essentially unchanged.

Mr. Hickman commented that the economy continued in a rising phase, despite the dampening effects of lingering strikes in the auto and trucking industries. When those temporary dislocations were out of the way, he expected the economy to expand even more vigorously than in the third quarter.

That forecast clearly continued to call for moderation in the rates of expansion of money and credit, Mr. Hickman remarked. Unfortunately, the Committee's hands were tied today. Because of the forthcoming Treasury financing and the fiscal stalemate, he supported the staff's draft directive which called for no change in policy.

If by the time Congress adjourned, Mr. Hickman continued, no agreement had been reached with the Administration on appropriate restraining action with respect to taxes and expenditures, then he, for one, believed the System should move promptly towards less ease, or perhaps even towards outright restraint. The timing and degree of tightening would depend both on what Congress did and on the schedule of Treasury financings for the rest of the year. Unfortunately, those were issues that could not be resolved today. When the time arrived at which they could be resolved, projections such as had been presented today would be helpful to the Committee in formulating its policy decision. In his judgment today's presentation had been excellent.

Mr. Sherrill said he favored the directive as drafted by the staff. He did not believe there were any surprises in the presentation this morning; the staff's projections were consistent with what the Committee had been anticipating. He continued to believe that the Committee's primary objective should be to encourage enactment of the tax increase by Congress.

Mr. Brimmer said he also favored the directive as drafted by the staff, and he, too, would compliment the staff on its presentation.

He had only two further observations to make, Mr. Brimmer continued. The first related to Mr. Reynolds' comment that a new balance of payments program would be announced soon under which the Commerce Department's program for direct investments would be strengthened. That, of course, would be a desirable development. At the same time it might put the System in a paradoxical position. For some time the System had been campaigning for a tightening of the Commerce program while holding its own program unchanged, and that situation might well be reversed in 1968. Depending on how banks behaved and on what policies the System pursued, bank credit might be a major source of problems in the area of capital outflows next year. Also, as Mr. Reynolds had mentioned, increased direct investment flows to less developed countries would subtract from the effectiveness of the change in the Commerce Department program. He would not expect any quick response to those higher outflows in the form of additional exports. In sum, he did not feel comfortable about the probable joint impact of the two programs on the U.S. balance of payments next year.

Mr. Brimmer's second observation related to the Treasury financing. He was disturbed by the possibility that subscriptions might not cover the offering in the forthcoming financing--a development which probably would be referred to in the market as a "failure" of the financing. He hoped it would be possible to avoid such a development. In his judgment it would be far better to prevent the failure than to deal with it afterwards.

Mr. Maisel remarked that the economic and financial developments projected in the staff's excellent presentation today were quite similar to those that had been anticipated at the two previous meetings of the Committee. Accordingly, he would stand on the statements he had made at those meetings. He approved the draft directive submitted by the staff.

Mr. Mitchell said he thought the staff presentation supported the view that as much monetary restraint was required as was consistent with accommodating the Treasury's financing problem and avoiding any actions that might trigger disintermediation. With respect to the latter, an inflection point had already been passed in the flows to financial intermediaries--the rate of increase in those flows had stopped rising--and the point might be at hand at which that rate of increase would begin to decline. He suspected that market interest rates were close to the levels at which they would begin to have serious effects on the inflows to financial institutions, effects which should be avoided if at all possible.

Mr. Mitchell thought that it was important to distinguish between the pressures placed on interest rates in capital markets by anticipatory borrowing on the one hand and by borrowing for immediate spending purposes on the other. He was a little disturbed on repeatedly hearing the view that there was no monetary restraint now. Many would-be municipal borrowers had been withdrawing from the market as long-term rates rose to levels higher than they were prepared to pay. Mortgage lenders had become increasingly reluctant to make loan commitments because they were uncertain about their future flows. Such developments suggested that the existing degree of restraint was substantial.

Mr. Mitchell said he differed from Mr. Brimmer with respect to the best means for dealing with a possible failure of the forthcoming Treasury financing. There would be difficulties with any method of dealing with a shortfall of subscriptions to the offering, including that of direct borrowing by the Treasury from the Federal Reserve. But such an action would represent one of the less disagreeable means of bringing the debt management crisis into focus, and it might have a salutary effect on Congressional attitudes regarding fiscal policy.

Mr. Mitchell observed that he had some sympathy with those who were concerned about the rate of growth of bank credit and the money supply. In his judgment total credit flows probably would be a better guide to policy than either of those variables, as Mr. Brill had suggested in his recent excellent memorandum.[1/] But he (Mr. Mitchell) did not think enough was known as yet about the probably consequences of using total credit flows as a policy guide.

In a concluding observation, Mr. Mitchell said that it probably was clear from the kinds of questions he had raised in the discussion of the projections this morning--concerning such matters as the plausibility of the growth projected for consumer durable

1/ This memorandum, from Mr. Brill to the Committee, was entitled "Directives and Staff Projections," and dated October 17, 1967. A copy has been placed in the Committee's files.

goods expenditures and residential construction, and the GNP growth rate that would be consistent with an absence of a need for a tax increase--that he was beginning to entertain some small doubts as to whether GNP would rise as sharply in the fourth quarter as the projections indicated. Because of those doubts he would suggest that the words "continue strong" be deleted from the first sentence of the draft directive, so that the final clause of that sentence would read "underlying economic conditions and prospects favor more rapid growth in the months ahead."

Mr. Wayne reported that Fifth District business over the past few weeks had shown no notable change in trends. The Richmond Reserve Bank's latest data suggested a further slight improvement in the demand outlook for textiles and a moderate upturn in furniture orders. In other manufacturing lines, however, new orders and backlogs had apparently fallen off somewhat, although inventory positions appeared to have improved substantially. Manufacturers in virtually all lines complained of rising costs and dimmed profits prospects. Coal and lumber production continued to show good gains, and agricultural prospects had improved substantially. Except for some weakness in automobile sales, retail trade in most reporting centers appeared to be picking up. Construction in the District continued definitely weaker than for the nation as a whole. Recent gains in District employment had been relatively small and concentrated exclusively in nonmanufacturing lines. The Reserve Bank's latest survey showed a slightly higher degree of optimism among businessmen but little change in sentiment among bankers.

On the national scene, Mr. Wayne said, the current work stoppages continued to complicate interpretation of the latest data. The staff presentation this morning was excellent and he could not argue with the projections. He assumed that aggregate demand was strong now and would strengthen further when the present labor difficulties were resolved. The latest flurry of price markups, however, seemed to be related less to current demand levels than to recent cost increases and to expected developments in demand. Data on capacity utilization rates and on labor force growth suggested to him that the demand-pull problem was still prospective rather than actual.

Nonetheless, given the lags in policy, Mr. Wayne remained convinced that some restraint on total spending in the near future was necessary to the maintenance of stable growth. He also continued to feel strongly that that restraint appropriately should come from fiscal policy and he was not yet prepared to abandon hope that fiscal action in the right direction would be forthcoming. On the other hand, he was prepared to risk the chance of overstaying the present easy posture if that held out a promise of contributing to a policy mix more conducive to stable growth next year.

As a more immediate consideration, Mr. Wayne felt that existing conditions in financial markets both here and abroad continued to tie the Committee's hands. In domestic markets, expectations patterns appeared even more sensitive to the Committee's actions than was the case three weeks ago and market rates had edged even closer to the point where disintermediation became a serious danger. Moreover, the problem of the pound had become further aggravated since the Committee's last meeting and, despite the recent hike in the Bank rate, that currency remained vulnerable to rate increases in the United States. In that connection, the possibility of a perverse reaction to the latest Bank rate change should not be overlooked.

For the next three weeks, Mr. Wayne concluded, even keel considerations clearly dominated the policy decision the Committee had to make today, and he accordingly favored maintaining about the same market conditions that had been experienced over the past several weeks. But quite apart from the Treasury's refinancing, he thought there were compelling reasons for recommending no change in policy at this time. The draft directive appeared altogether appropriate to him.

Mr. Clay commented that the immediate factor shaping the Committee's formulation of monetary policy for the period ahead was the forthcoming Treasury financing. That was the type of situation in which the Committee customarily avoided any overt change in policy.

Under present circumstances, that approach was underscored by the unsettled conditions in the credit markets and the very sensitive market situation in which the Treasury financing apparently would be undertaken. Accordingly, it should be the aim of open market operations to maintain prevailing money market conditions, such as set forth by the staff description on page 3 of the blue book.1/

Mr. Clay remarked that the basic economic situation and prospects, including the price inflation threat, clearly called for economic restraint. Fiscal policy action, leading to a coordinated policy of fiscal-monetary restraint, was vital. What could be expected on that approach was highly uncertain. Under the economic conditions and prospects prevailing, it appeared that the System must stand ready to initiate restraining action on its own part when it could find an opening to do so.

The draft economic policy directive appeared satisfactory to Mr. Clay.

1/ The blue book passage referred to read as follows: "Setting aside the extremes of recent fluctuations, prevailing money market conditions might be thought of as including a Federal funds rate ranging around 4 per cent; member bank borrowings averaging around $100 million; and free reserves in a $150 - $300 million range. Given these money market conditions, the 3-month Treasury bill rate is expected to remain in a 4.40 - 4.70 per cent range over the balance of October and into the first half of November."

Mr. Scanlon said that in the interest of time he would summarize the remarks he had prepared regarding Seventh District developments. He then summarized the following statement:

> Strikes and threats of strikes are exerting a pervasive impact upon production and current planning in the durable goods industries in the Seventh District. The over-all effect is to reduce output and efficiency and to promote stockpiling of certain kinds of goods. Given the over-all environment, this tends to put upward pressure on prices.
>
> The long copper strike is beginning to affect operating schedules in some plants, particularly those producing electrical goods. If continued another month or two the effects will be quite widespread. Meanwhile, premium prices are being paid for copper and components containing copper.
>
> The steel haulers' strike has appreciably affected delivered tonnages in September and October. Smaller plants without rail sidings have been most affected.
>
> Used car prices have risen, reflecting the effects of the Ford strike and the increase in prices of new cars as well as the general strength of demand. There is a widespread view that other auto strikes will occur now that agreement has been reached at Ford.
>
> In addition to the auto, copper, and steel haulers' strikes, the District has been affected by a strike at a number of important Caterpillar plants in Illinois, now settled on the basis of the pattern established in the Ford settlement.
>
> Even with the widespread labor unrest and its secondary effects on layoffs at suppliers' plants, insured unemployment in District States in late September was only slightly more than one per cent of covered workers. This is a very low level when compared with similar periods prior to 1965.
>
> Construction workers are reported to be in short supply in virtually all building trades--especially in the case of electricians, carpenters and plumbers. Chicago, Detroit, Milwaukee, and Indianapolis have been listed among the ten United States centers with the most

serious shortages. The recent high levels of new construction contracts make it almost certain that labor shortages will worsen in 1968.

We are told that employers in the Chicago area find it very difficult to recruit workers from the ranks of the unemployed having even minimum qualifications in ability to read and add.

Orders for machinery and equipment have been rising since February. Currently, the uptrend in orders for equipment is quite general, and includes construction equipment, where orders had drifted down after reaching a peak more than a year ago. Despite the revival in orders it is still believed that any rise in spending on plant and equipment next year will be moderate, with much of the gain traceable to higher prices.

Price increases in recent weeks have heavily outnumbered declines. Prices have increased for finished and semi-finished products containing steel, copper, and nickel, and a variety of chemicals, electrical components, machinery, foods, and textiles. The upward price trend for manufactured goods appears to have considerable momentum, although some of the posted price increases do not "stick."

There is still no evidence in data for the Seventh District that the resurgence of business loan demand expected by bankers is materializing. In the past six weeks business loans of our weekly reporting banks have expanded somewhat slower than the nationwide figures, but this seems to be mainly due to the failure of farm product dealers and processors in our area to increase their borrowings in the usual seasonal pattern. Other types of loans at these banks likewise have shown less vigor than in the nation as a whole. Moreover, the loan growth at smaller member banks for the third quarter has been considerably below that in the past three years. Rapid growth of bank credit is explained principally by the acquisition of securities. In addition to the bills acquired in the recent Treasury financing, some District banks have resumed their acquisition of municipal and other issues.

While the major Chicago banks have returned to their more customary position as net buyers of Federal funds in recent weeks, they do not appear to be under strong pressure for near-term money. One bank has reduced its Euro-dollar borrowings substantially and we have received

> some information indicating that it expects to be less active in this market for the rest of the year. Nevertheless, the large banks appear to be trying to build up additional liquidity in preparation for expected pressures ahead. Most of them are posting 5-1/2 per cent for CD money 9 months or more in maturity, and one or two show this rate on six-month money.

Mr. Scanlon then noted that he continued to think the available evidence on current and prospective economic developments indicated that monetary policy should be directed toward lessened ease. Inflationary developments were becoming more firmly established day by day. It was sometimes argued that a little inflation was helpful for achieving both full employment and rapid economic growth. Whatever the merits of that argument, it had little relevance to the current situation. Abstracting from the impact of the current labor strikes, the economy was operating at levels generally believed to represent full employment and was growing at well above the average long-run rate of growth. An acceleration in prices and continued rapid growth of credit at this time could only serve to redirect investment into short-term and speculative channels and threaten orderly expansion. Inflation, of course, further reduced the possibilities of achieving improvements in the balance of payments.

As for policy, Mr. Scanlon continued to favor a marked slowing in total reserves and would expect that to result in a slower expansion in money and bank credit. While the current strikes had moderated the growth of a number of the economic indicators, that was not a problem that could be solved by liberal availability of credit and should not be given any significant weight in the Committee's policy action. Continued preoccupation with market interest rates could only restrict the Committee's vision of changes occurring in total credit and money. The current high level of interest rates, while discouraging some firms from tapping the capital market, seemed not to have curbed the total demand for credit. Marketings of new corporate issues continued in large volume and the additions to bank reserves made possible the lodging of large amounts of Treasury and municipal debt with the banks. Continued accommodation of those issues at current yields might well result in a continuation of the current rapid rates of monetary and credit expansion and further strengthening of spending and price pressures for periods ahead. While the forthcoming Treasury financing would appear to preclude any substantial change in policy now, he hoped the Committee could find some means soon of slowing what he believed to be an excessive rate of growth of bank reserves, bank credit, and money.

While Mr. Scanlon agreed that little could be done in the period immediately ahead, he would prefer a directive that called for some moderation in the rate of growth to the extent permitted by Treasury financing. If the Committee was truly basing its decision for even keel on the Treasury financing, it seemed to him that that would make a better record.

Mr. Galusha said he could be very brief this morning in his remarks about the Ninth District economy. It was still having labor troubles, and he had heard little optimism expressed for an early end to the copper strike. In a minor point of variance with the green book statement on the subject,[1/] his observation was that cattle prices had weakened this month and were down $2.00 per hundredweight. According to his reports, there still were unseasonably high numbers of cattle in the western ranges, and at present there was little contracting going on.

Mr. Galusha went on to say that with the Treasury about to announce terms for a refunding and, as the blue book suggested, possibly a cash financing as well, an even keel policy was indicated. He had no objections to such a policy, especially if when translated for the Manager's benefit it meant aiming at the targets set out in the blue book. He noted that the authors of the blue book expected that interest rates would continue their upward course even if those targets were achieved. That should not be surprising. The Committee had maintained the same policy for several months, and over that period of unchanging policy interest rates on Treasury securities had increased 70 or so basis points. Perhaps, therefore, the Committee

1/ The statement referred to read as follows: "Cattle slaughter and beef production have eased below a year earlier and prices have moved up fairly steadily."

should not feel uneasy about having overstayed its policy of monetary ease or about adopting an even keel policy for the coming weeks.

With the continuing increase in interest rates, Mr. Galusha added, the threat of disintermediation and of commercial banks' becoming badly pinched grew greater. What should be done with Regulation Q ceilings if and when a deliberate and fairly sharp increase in monetary restraint became necessary might therefore be explored in this Committee, even though, as he fully appreciated, the Board had responsibility for administering Regulation Q. He appreciated very much receiving a copy of Mr. Brill's excellent memorandum. Although he was not prepared to comment in detail today, he would like to say that he personally was at least as fearful as Mr. Brill of the Committee's "apparent tendency to use staff projections . . . more finely than is warranted by the state of the (forecasting) art." And he would add that he had misgivings about putting such emphasis on bank credit as the Committee seemingly had. The extraordinary efforts of the Board staff to refine the statement of probable alternatives should be encouraged even though there might be a risk of conveying a greater degree of certainty than intended. He was all for giving Mr. Brill comfort, but no relief. He would hope that there might be a convenient occasion for serious discussion of the issues Mr. Brill had posed.

Mr. Swan reported that the employment picture had improved in the Pacific Coast States in September. The unemployment rate had declined by two-tenths of a percentage point and was at its lowest level since February. Employment increased in the aerospace industry and in construction, but the over-all improvement was due to some extent to a contraseasonal shift of employment from August to September in both agriculture and the food processing industry as a result of later than usual harvests. Housing starts rose again in September and prospects were for continued strength. The copper strike was having a considerable effect on the inter-mountain area. One small Arizona company had reached an agreement with the union on terms that were between the union's demands and the offer of the larger companies, but the implications of that settlement for the rest of the industry were not clear.

There had been no major changes recently in the financial area, Mr. Swan observed. Major banks in the District still indicated that loan demand currently was not strong. Relative to their earlier projections, loan demand was quite disappointing.

Mr. Swan remarked that he had nothing to add to the discussion today of the national economic situation. As to policy, to some extent he shared the sense of frustration regarding the constraint imposed by the Treasury financing. Nevertheless, he thought that at this time an even keel policy was even more necessary than it might ordinarily be because of the unsettled conditions in financial markets and the general atmosphere that would surround the financing, as spotlighted by the Manager's earlier comments.

With regard to the directive, Mr. Swan suggested a revision in the second paragraph that, he thought, would represent a small step in the direction of the policy course Mr. Scanlon had proposed. Specifically, following the phrase "To implement this policy," he would have the directive read "and in view of forthcoming Treasury financing activity," rather than "while taking account of forthcoming Treasury financing activity." In his judgment that revision would make the directive more consistent with the actual posture of policy.

Mr. Irons remarked that there had been no particularly significant business developments recently in the Eleventh District. Strength continued in industrial activity and retail trade, and construction activity had been rising. Employment had increased and unemployment had fallen; the unemployment rate was down to 2 per cent in some of the larger cities of the District. He had the impression from bankers that loan demand had not been as large as they had expected. However, they were still expecting some further increase in loan demand during the remainder of the year. On the whole, the situation in the District was about as he had reported at the previous two or three meetings.

As the Committee would recall, Mr. Irons continued, at the last few meetings he had favored a policy of some moderate lessening of ease. Perhaps there had in fact been some degree of increased restraint, as Mr. Mitchell had suggested. However, given the inflationary pressures prevailing, he still thought it would be in order to probe in the direction of a somewhat lessened availability of reserves. He recognized that the Treasury financing was the dominant factor in the policy decision today, particularly with the unsettled conditions in financial markets. Accordingly, he thought there was little alternative to an even keel policy, and he favored maintaining the prevailing conditions in the money market through the period of the financing. He would add, however, that insofar as feasible in light of the financing, the Desk should undertake operations directed at checking the expansion of bank credit, lessening the availability of reserves, and probing toward a little less ease in the money market. He would accept the directive as submitted in the hope that by following the situation closely the Desk would find it possible to make some move in that direction.

Mr. Irons added that in his judgment a failure of subscriptions to cover the new issues in the forthcoming Treasury refunding would be very damaging to the market and to the country's international financial position. Serious consideration had to be given to possible means of dealing with that potential problem. He was not sure, however, that the best way of meeting it would be to change the traditional concept that direct borrowings by the Treasury from the Federal Reserve should be of a very short-term nature.

Mr. Ellis reported that during the past several weeks the Federal Reserve Bank of Boston had conducted a series of area conferences that had provided opportunities for face-to-face discussion with officers and directors of about 40 per cent of the country banks in New England. The Committee would not be surprised if he reported extensive ambivalence in attitudes toward the Federal Reserve. Almost without exception they endorsed the active position the System had assumed in support of slowed Federal expenditures and tax increases. But they also were deeply fearful of the future impact of monetary policy in view of the problems created by the fact that both fiscal policy and monetary policy had been so stimulative this year. They were perfectly aware that member bank reserves with the Boston Federal Reserve Bank had increased 22 per cent in 12 months. They were pleased to have expanded their holdings of U.S. Government obligations by 55 per cent and their holdings of other bonds and stocks by 37 per cent. But they were also aware that since last June the consumer price index in Massachusetts had risen at a seasonally adjusted annual rate of 6 per cent.

He would add only two other bits of New England economic information, Mr. Ellis said. First, the final results of the Boston Reserve Bank's regional capital expenditures survey indicated, after due adjustment for past biases in reporting, that manufacturers in the region would reduce their 1968 outlays by a projected 2 per cent. Spending estimates for 1967 had been revised upward by 1 per cent since the spring survey and gave a 4 per cent increase between 1966 and 1967. Secondly, the Bank's regular survey of September experience of insurance companies in New England indicated that policy lending was back down to 1965 levels and that new residential mortgage commitments during the third quarter were 50 per cent above year-ago totals.

Concerning monetary policy, Mr. Ellis commented that the absence of any discussion of alternatives in the blue book and the submission of a single draft directive revealed an attitude that any shift of policy was not only undesirable but also unthinkable. Even though he conceded the practical desirability of not attempting a policy shift before the impending Treasury refunding, there had been two developments that strengthened the odds that the Committee should be able to adopt a new policy three weeks hence.

One of those developments, Mr. Ellis continued, was reflected in the Manager's report this morning that market interest rates were gradually firming in spite of the Committee's willingness to pour in reserves at an annual rate of nearly 20 per cent during October. The Committee might very well find that the market had so discounted the obvious logic of a move to less monetary stimulation that eventual action would be anticlimactic, having little effect on interest rates. With respect to the point that the recently higher rates were exerting some restraining influence, he would note that that was a result not of the Committee's policy, but of the market's reaction. The Committee's policy had been to supply reserves in an effort to avoid rate increases.

The other development, Mr. Ellis said, was the fact that Congressional debate over fiscal policy had settled into a struggle over whether or not cutbacks in current spending should precede a tax increase. The only thing clear in the struggle was that both sides expected monetary policy to play an important role in coordination with whatever fiscal policy emerged. It no longer seemed that the outcome of the tax debate hinged on whether or not the Committee acted. In a presidential election year, and with the country engaged in an inconclusive war with a record of escalation, he thought it was highly unlikely that Federal expenditures would turn out to be less than projected. Experience suggested that expenditures would exceed projections.

Mr. Ellis went on to say that with upward pressures on prices apparently mounting, he found it difficult to accept the projection presented today that the annual rate of increase in the GNP deflator would decline, from the peak of 3.8 per cent reached in the third quarter of 1967, in each of the three following quarters. He did not think that the inflationary threat would be contained by a belated 8 per cent surtax if the System continued to expand the money supply at a 5.5 per cent annual rate in the first half of 1968, as the projections suggested, or if it expanded reserves fast enough to halt any further rise in interest rates, as had been assumed in the model. The question of the rate of growth of total reserves that would be required to hold interest rates steady was a significant one, but projections on reserve expansion had not been reported in the presentation today.

In conclusion, Mr. Ellis said that he agreed with Mr. Irons that the Committee should do what it could to probe toward firmer conditions even in the period of Treasury financing. Also, he agreed with Mr. Bopp that the Committee should carefully think through the meaning of "even keel."

Mr. Robertson made the following statement:

> With probably the entire three weeks between this and the next meeting of the Committee blanketed by clear-cut even keel considerations in connection with the Treasury financing, obviously no change in policy should be made at this time.
>
> I think it is wise, however, for us to be thinking very seriously about the kind of policy we may want to adopt as soon as that even keel period is over. The business expansion is continuing strongly, and with a

disturbingly large element of price increases accompanying it. Unless a significant move toward fiscal restraint seems near to achievement, it could be advisable for us soon to introduce a greater degree of credit restraint, recognizing that this might subsequently need to be either wholly or partially reversed at a later date if and when some additional restraint from other quarters is forthcoming. I do not mean to be prejudging future actions on our part, but I do think that it is possible that we could reach a stage where it would be better for monetary policy to move in advance of some delayed fiscal restraint, rather than holding off action for weeks or months longer until the current fiscal tug-of-war is settled--possibly by a compromise which will produce fiscal restraint too inadequate to forestall further monetary tightening--notwithstanding the probability that some people may have supported the compromise in the belief that it would avoid further monetary tightening.

Furthermore, I think it would be wise for us to use this interval, not simply to plan the next step for monetary policy, but to do some longer-range thinking as to the whole sequence of policy measures that might be called for by the range of possible adverse developments that could unfold as we move into 1968. Serious risks lie ahead of us, both domestically and internationally, and some careful contingency planning now may save us from some costly missteps in the heat of the moment.

Finally, I cannot let this meeting pass without a word of commendation to Mr. Brill not only for the staff presentation this morning but also for the commentary he distributed to the Committee on the uses and limitations of the proviso clause in the directive. I think he was right in emphasizing that its basic role is not as a supplementary policy target, but rather as an indicator of shifting credit demands to which the Manager should adjust. I am less concerned than some about the shortcomings of "bank credit" or "required reserves" as the variable on which the proviso should be keyed. Partly this is because these are the only demand-related aggregates that we can follow on a day-to-day basis, and partly because, as I see it, bank credit typically plays a marginal role

> in the financial system and thereby is among the first measures to reflect any change in the tempo of credit demands. But as I stated to this Committee last July, ". . . which aggregate is chosen is less important than that some aggregate be chosen for the proviso."
>
> With these considerations in mind, I am in favor of adopting the "no change" directive as drafted by the staff, including the proviso clause for whatever limited application it may have in this Treasury financing period.

Chairman Martin observed that in his view inflationary pressures once again had gotten ahead of stabilization policy. Inflation was no longer prospective; it was a present reality. At the meeting of the Business Council this past weekend, which he and Mr. Daane had attended, he had found that the members were virtually unanimous on the necessity for prompt fiscal policy action. Even though most of them would be adversely affected in their own affairs by a tax increase, they thought one should be enacted. In personal conversations with him many of the members had expressed their concern about the dilemma facing the Federal Reserve, indicating that they did not know how it could be resolved.

Chairman Martin went on to say that he also was unsure how the dilemma could be resolved. However, with due respect to those who felt that a shift toward a less easy monetary policy should have been begun some time ago, he thought the Committee had been following the proper course.

In the Chairman's view, a conjuncture of domestic and international circumstances, including simultaneous large deficits in the Federal budget and in the balance of payments, were rapidly and steadily generating inexorable forces that might prove more important than any decisions the Committee would take. Nevertheless, the Committee had to continue to deal with its problems as best it could. He agreed with Mr. Robertson that while the Committee should not prejudge future policy decisions the members should be giving serious thought now to the risks that lay ahead. No one could say what would happen in the international financial area, but the problem was not likely to be just that of the pound; the role of gold, and the means of international payments generally, were likely to come into question. Unfortunately, there was a good deal of wishful thinking, both political and economic, in that area. He did not know the answers, but he felt that it was important for the Committee to appreciate the nature of the problems and to train its best judgment on them. Some actions were likely to be required, although doing nothing also was a course of action. The moment of truth for Federal Reserve and Governmental policy was approaching.

The Chairman then said that he favored adoption of the draft directive submitted by the staff, and thought that a majority of the members did also. He suggested that the Committee vote on that directive.

With Mr. Francis 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, apart from the effects of strikes in the automobile and other industries, underlying economic conditions continue strong and prospects favor more rapid growth in the months ahead. Upward pressures on costs persist, average prices of industrial commodities have risen further, and the rate of increase in consumer prices remains high. While there recently have been large inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large. The volume of new security issues is expanding again and interest rates have risen further, reflecting in part increased uncertainties in financial markets concerning enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

To implement this policy, while taking account of forthcoming Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified, to the extent permitted by Treasury financing, to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Mr. Scanlon indicated that while he was opposed to a basic policy of no change he agreed that for the next few weeks the Committee had to maintain an even keel because of the Treasury financing. He had voted favorably on the directive on that basis.

Chairman Martin said he assumed that Mr. Treiber's favorable vote had been cast on the same basis, and Mr. Treiber agreed.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, November 14, 1967, at 9:30 a.m.

Chairman Martin then noted that two staff memoranda[1/] had been distributed that considered the issues raised in the discussion at the preceding meeting of the tentative schedule of Committee meetings in 1968. It was clear that almost any schedule would involve some difficulties, and both the members of the Board and the staff members who had considered the question had concluded that the original tentative schedule, distributed on September 22, probably was more satisfactory than the alternatives that had been considered.

Mr. Ellis said he was inclined to the view that one of the alternative schedules mentioned in the Secretariat's memorandum--that which called for meetings on the third Tuesday of each month--came the closest to satisfying the consideration relating to the availability of economic and financial data. As the memorandum indicated, such a schedule would involve conflicts with meetings of the Federal Advisory Council with the Board if those meetings were

1/ These were a memorandum from the Secretariat, entitled "Possible 1968 meeting schedules," and a memorandum from the General Counsel, entitled "Question regarding date of organization meeting." Copies of the two memoranda, both of which were dated October 18, 1967, have been placed in the Committee's files.

held at the times contemplated by the FAC's present by-laws. However, it involved virtually no other conflicts of significance, and he did not think that the FAC would find it difficult to change its regular meeting dates.

Mr. Mitchell noted that when the Board had discussed this question recently members of the Research Division had indicated that under present procedures no one time of the month appeared to be markedly superior to other times in connection with data availability.

Chairman Martin suggested that the Committee plan on pursuing the matter of tentative meeting dates for 1968 at its next meeting. There was general agreement with that suggestion.

The Chairman then noted that a policy paper entitled "Availability of individual dealer statistics to the Trading Desk," addressed to both the Committee and the Treasury by the Steering Committee for the U.S. Government Securities Market Study, had been distributed to the Committee on October 17, 1967.[1/] He asked Mr. Koch to comment.

Mr. Koch noted that prior to mid-1960 the Trading Desk had had access to daily reports by individual Government securities dealers, with the exception of one major dealer. Under the policy adopted in mid-1960, however, except in special circumstances only

1/ A copy of this paper, together with two attachments, has been placed in the files of the Committee.

aggregate data were made available to the Desk by the Market Statistics Division of the Federal Reserve Bank of New York. The Desk had found that its lack of access to individual dealer statistics on positions, trading, and borrowings had reduced its ability to discharge its operational and advisory responsibilities to the Committee and the Treasury, and the Steering Committee recommended that senior personnel at the Desk be granted access to individual dealer statistics.

Mr. Koch added that he thought the recommendation was not particularly controversial. Because of the past position of some dealer firms, the Desk recently had made an informal survey of their present attitudes. It was found that while some dealers had reservations on the matter, none felt that those reservations were sufficiently strong to warrant objections on their part. If the Treasury and the Committee agreed with the recommendation of the Steering Committee, it was proposed that the dealers be advised by letter of the procedure that would be followed in the future.

> By unanimous vote, the recommendation of the Steering Committee for the U.S. Government Securities Market Study, that daily reports of individual Government securities dealers regarding their positions, trading, and borrowings be made available to senior personnel at the Trading Desk of the Federal Reserve Bank of New York, was approved.

Secretary's note: On November 3, 1967 the following letter was sent to Government securities dealers over the signatures of Secretary Fowler and Chairman Martin:

In January 1960 the then Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System wrote the Government securities dealers requesting their cooperation in an information program covering the Government securities market. The program provided for the collection, by the Federal Reserve Bank of New York, of dealer figures on positions, volume and borrowings with appropriate safeguards to assure the confidentiality of individual dealer information.

In this connection Mr. Alfred Hayes, President of the Federal Reserve Bank of New York, wrote the dealers on May 17, 1960 to the effect that the dealer data would be collected and retained in the Market Statistics Department of that bank and that data on individual firms would be released outside the Department only under certain conditions which included the following:

1. Summary figures requested by the Manager of the System Open Market Account for individual dealers seeking repurchase accommodation;

2. individual dealer reports requested by the Manager of the Open Market Account in market situations determined to be disorderly; and

3. other circumstances of an exceptional nature.

Under these arrangements the Manager of the System Open Market Account and his assistants have had access to the individual dealer data only on a few unusual occasions, whereas prior to 1960 dealers had reported directly each day to the Desk. With the passage of time it has become apparent that the quality of information available to the Trading Desk for interpreting the state of the market has deteriorated considerably because of the lack of access to these figures. Given the Trading Desk's responsibilities as the eyes and ears of the Treasury and the Federal Reserve in the market, the importance of full information should be obvious to all market participants. The current joint Treasury-Federal Reserve study of the Government securities market confirms the Manager's need for more detailed information on dealer market activities.

Accordingly, the Federal Open Market Committee and the Treasury have approved the release of the daily reports of the individual dealers on positions, volume and borrowings to the Manager of the System Open Market Account, and to a restricted list of officers and senior staff of the Federal Reserve Bank of New York directly responsible to the Manager. We understand that Mr. Alan Holmes has discussed the proposed policy change with all dealer firms, and that while some dealers have reservations about the change in procedure, none of these is of a nature that would cause any firm to object to the change.

We stress again that the purpose of the change is to provide more accurate information about the state of the market. No change in the data to be submitted by your firm to the Federal Reserve Bank of New York is involved nor is there any change in the procedures currently in effect with respect to the supply and publication of data. These data will not be used in connection with particular transactions to be carried out in the market with individual dealer firms, apart from exceptional market circumstances of the sort where the existing rules already provide for the release of individual dealer figures outside the Market Statistics Department. The Treasury and the Federal Reserve stand ready to discuss any aspect of the statistical program with any dealer firm at any time.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) October 23, 1967

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 24, 1967

The economic and financial developments reviewed at this meeting indicate that, apart from the effects of strikes in the automobile and other industries, underlying economic conditions continue strong and prospects favor more rapid growth in the months ahead. Upward pressures on costs persist, average prices of industrial commodities have risen further, and the rate of increase in consumer prices remains high. While there recently have been large inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large. The volume of new security issues is expanding again and interest rates have risen further, reflecting in part increased uncertainties in financial markets concerning enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

To implement this policy, while taking account of forthcoming Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified, to the extent permitted by Treasury financing, to moderate any apparent tendency for bank credit to expand significantly more than currently expected.