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, June 7, 1966, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Brimmer
Mr. Clay
Mr. Daane[1/]
Mr. Irons
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Shepardson
Mr. Scanlon, Alternate for Mr. Hickman
Mr. Treiber, Alternate for Mr. Hayes
Mr. Wayne, Alternate for Mr. Bopp

Mr. Swan, Alternate Member of the Federal Open Market Committee

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

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Eastburn, Green, Koch, Mann, Partee, Tow, and Young, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account
Mr. Cardon, Legislative Counsel, Board of Governors
Mr. Fauver, Assistant to the Board, Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors

1/ Left the meeting at the point indicated in these minutes.

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

Messrs. Hilkert, MacDonald, and Lewis, First Vice Presidents of the Federal Reserve Banks of Philadelphia, Cleveland, and St. Louis, respectively
Messrs. Eisenmenger, Link, Ratchford, Brandt, Baughman, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, New York, Richmond, Atlanta, Chicago, St. Louis, and San Francisco, respectively
Mr. Meek, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 10, 1966 were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period May 10 through June 1, 1966, and a supplemental report for June 2 through 6, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said the Treasury gold stock would remain unchanged this week. The

Stabilization Fund had acquired $50 million in gold from Canada, which increased its holdings to nearly $100 million, but that entire amount seemed likely to be used up over the next few weeks by a sale of $75 million to France, plus other miscellaneous sales. Consequently, it probably would be necessary to show another reduction in the gold stock of $75 or $100 million before midyear. The way things were going, it would not be surprising if the gold stock declined below the $13 billion level by year-end. In fact, recent balance of payments trends suggested that might occur sooner rather than later.

On the London gold market, Mr. Coombs said, demand had been restrained by the very tight money market conditions prevailing throughout world financial markets. Nevertheless, the resources of the gold pool had been drawn down by $94 million since the beginning of the year, and there seemed to be a growing impression that the Russians might be able to hold off selling until the latter part of the year. The situation in that market remained dangerous; serious speculative pressures could materialize from one day to the next. During the past two days, for example, there had been a wave of speculative buying apparently arising out of the British maritime strike and the devaluation of the Indian rupee.

On the exchanges, Mr. Coombs continued, at the beginning of May the Bank of England paid off month-end swaps totaling $100 million with the U.S. Treasury and the German Federal Bank, and in the course of the month it paid off another $50 million of short-term central bank credit to the Bank for International Settlements. In addition to such debt repayments of $150 million, the Bank of England suffered further reserve losses of about $100 million and thus at month-end was down a total $250 million. Their published reserve statistics showed the true loss of $106 million as of the month-end; the remaining $150 million, reflecting central bank debt repayments, was refinanced by new borrowings of $50 million from the System under the standby swap line and $100 million from the U.S. Treasury on a one-day swap. May was the third month in succession in which the published figures had shown Britain's actual reserve loss, with drawings on credit lines limited to refinancing central bank debt.

The main feature in the sterling market, of course, had been the effects of the maritime strike, Mr. Coombs commented. Although negotiations seemed to be more or less on dead center at the moment, the market had been sustained by the hope that the British Government might finally be taking a firm line against a continuation of the wage-price spiral. Meanwhile, however, the payments deficit was deepening as exports were choked off, and the longer the strike continued the greater the danger of a new speculative outburst. In fact, developments of the last few days might reflect the beginnings of a speculative drive. The Bank of England had allowed the rate to drift down in response to selling pressure, and yesterday the rate went through the $2.79 level which had been firmly defended last summer. This morning it was $2.7884. On Friday the British lost $50 million of reserves; on Monday somewhat more than $100 million; and thus far today about $50 million. The New York market had been quiet on Friday and Monday but there was some indication that selling might now develop--the market had been alerted to the fact that there was a problem and might react accordingly.

With respect to other markets, Mr. Coombs continued, the earlier capital outflows from Switzerland had reversed themselves as the Swiss market had tightened, and the Swiss National Bank had taken in $135 million during the past few weeks. That inflow had increased the Bank's uncovered dollar holdings to a level $70 million in excess of their usual ceiling, and further large inflows might occur in connection with window-dressing operations in Switzerland at the end of June. Accordingly, it might be necessary for the System to draw upon the Swiss franc swap line before long. Also, he anticipated very sizable dollar accruals by the Bank of Italy during the summer tourist season, which might necessitate drawing upon the lira swap line again.

In response to a question by Mr. Mitchell, Mr. Coombs said that Britain had not received assistance from central banks other than the Federal Reserve during the past month. At the end of May they considered the possibility of attempting to raise some funds from the Italians, Swiss, and Germans. They decided against that course, however, on the grounds that it might muddy the waters at a time when agreement on the new sterling balance credit package appeared close. Instead, they drew on the System and U.S. Treasury. If their reserves were still down at the end of June, which seemed likely, and if the sterling package was approved, the British probably would draw on the new credit lines, with parallel drawings on the U.S. equaling 31 per cent of the total.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period May 10 through June 6, 1966, were approved, ratified, and confirmed.

Mr. Coombs then recommended renewal of a $50 million drawing on the swap facility with the National Bank of Belgium, which would mature on June 22. As the Committee would recall, the arrangement with the Belgium Bank was unique in that it provided for that $50 million to be fully drawn at all times, with renewals at six-month intervals. There was no use of the swap line at present in the sense of disbursements from the amount drawn.

In response to questions, Mr. Coombs indicated that while the drawing in question was for six months, the underlying swap agreement had a term of twelve months. He had not been able to persuade the Belgians to change the terms of the agreement to conform to those of the System's other swap arrangements, which were wholly on a standby basis until activated by three-month drawings.

Renewal of the drawing on the swap arrangement with the National Bank of Belgium, for a further period of six months, was noted without objection.

Chairman Martin then noted that on June 3 Mr. Coombs had distributed a memorandum to the Committee concerning the Basle negotiations on the British sterling balance credit package as well as copies of the final draft of the agreement itself, and he asked Mr. Coombs to comment on the negotiations.1/

Mr. Coombs observed that, as the Committee knew, it had been hoped for some time that it might be possible for the United Kingdom to negotiate a swap network similar to the System's which would assure that other central banks would join the U.S. in providing support in the event of a sterling crisis, making it unnecessary to rely on last-minute negotiations. The Committee would recall that the November 1964 package of credit assistance was for a six-month period, and that it was not renewed at the expiration date. Thus, in the summer of 1965 the Bank of England was dependent entirely upon the Federal Reserve and the U.S. Treasury for any necessary credits. Efforts had been underway since last fall to develop a supplementary British network with central banks under which credits would be made available for any purpose.

1/ Copies of the documents referred to have been placed in the Committee's files.

The new package that had been negotiated went only part way toward that objective, Mr. Coombs said. Partly as a result of the record of the continuing problems of sterling over the past twenty months, the attitudes of the European central banks toward sterling had hardened. They had taken the line that they would be willing to make credits available to the Bank of England but only to protect sterling against drains resulting from its role as a reserve currency--i.e., drains occasioned by liquidation of foreign-held sterling balances. They were not prepared to offer assured financing for other purposes. In effect, they would underwrite the institutional role of sterling but not Britain's balance of payments deficits. Staff at the New York Bank and at the U.S. Treasury thought that those terms were undesirably restrictive, but they--as well as the Bank of England people--were persuaded that the choice was between such arrangements or none at all.

Mr. Coombs saw one advantage to the nature of the arrangements--the link to a long-run problem increased the likelihood that they would be renewed at maturity. And whatever restrictions might be written into the agreement, in the event of a real crisis the European central banks were likely to permit use of the credits for more general purposes. There would be a real advantage in having the credit lines in being, even if under terms that limited their use. The agreement would not exclude other special ad hoc credits that might be arranged if circumstances justified them.

In conclusion, Mr. Coombs noted that with the latest turn in the sterling situation the System had a real interest in seeing the agreement adopted. The British were likely to have to draw on credit lines in some volume, and existence of the new arrangements would substantially reduce the amounts they would have to draw on the U.S. Treasury and the Federal Reserve. As he had mentioned, the U.S. share under the package would be 31 per cent. At the Basle meeting next weekend Mr. Hayes presumably would be expected to indicate whether or not the proposed arrangements were acceptable to the Federal Reserve, and he (Mr. Coombs) recommended that the Committee note them without objection.

Chairman Martin observed that the negotiations in question had been going on for some time, and he suggested that the Committee members raise any questions they had concerning the proposed agreement.

Mr. Mitchell asked whether there was any doubt as to whether the sterling credit package would be approved, and whether the total amount of credits it provided for, which Mr. Coombs' memorandum indicated was $1 billion, was likely to prove adequate to the foreseeable need.

Mr. Coombs replied that it was his impression that the Europeans, as well as the Canadians and Japanese, had decided to go along with the package, but he could not say whether recent sterling developments would change their attitudes. The British might find themselves subject to a certain amount of questioning when the agreement came up for approval at Basle on June 11-12. As to the adequacy of the package, it was quite unlikely that the British would lose $1 billion of reserves in a single month. It was true that they had lost $500 million in a few days in November 1964, but at that time foreign sterling balances were much larger than they were now. He would hope they could get through the month of June with the European credit lines available. There was no question but that the attitudes of the Europeans had hardened with respect to assisting the British, and he was afraid that some of that hardening also was beginning to be reflected in their attitudes toward the United States.

In response to questions by Messrs. Brimmer and Ellis, Mr. Coombs indicated that the duration of the propsed standby arrangements was nine months, with three-month renewable drawings. There was a provision that all swaps would be terminated by mid-June, 1967, to accommodate drawings made at the end of the term of the standby arrangements. No new credit extensions by the U.S. were involved; the $1 billion total was made up of $75 million from the BIS, $525 million channeled through the BIS by the participating central banks, and parallel arrangements involving a new $90 million facility with the Bank of France and an earmarking of $310 million of the existing U.S. credit lines to the British for proportionate use along with drawings on the other central banks. The U.S. lines, of course, consisted of the $750 million swap arrangement with the System, which had been renewed for another twelve-month term on May 31, 1966, and the $400 million authorized by the Committee and the U.S. Treasury in September 1965. The question of the source of any U.K. reserve loss--and thus the availability of the new credits as a means of financing the loss--would be left to the judgment of the British but, of course, at the following meeting in Basle they would be expected to defend their judgments with data on changes in sterling balances. It was his hope that interpretations in that connection would be reasonably flexible.

Mr. Irons asked whether the earmarked portion of the U.S. lines would be increased by $90 million if the French decided not to extend a new facility to the British.

Mr. Coombs replied that he would recommend against such a procedure. It would be better to have the total package cut back to $910 million if the French did not participate. Of course, if the other central banks agreed to increase their contributions the earmarked part of the U.S. lines might be increased proportionately.

Mr. Galusha asked whether there were indications that the British would adopt policies that would effectively restrain their wage-price spiral.

Mr. Coombs responded that the British authorities obviously were working on that problem, although he did not know what particular measures they were considering. A great deal of pressure was converging on them to take effective steps, and conceivably something might be done by the United States to encourage them further. It was his opinion that they were under no illusions with respect to the seriousness of the situation.

Thereupon, the proposed new sterling balance credit arrangements were noted without objection.

Mr. Ellis then remarked that it had been about a year since the Committee had last discussed the possibility of negotiating reciprocal currency arrangements with Venezuela and Mexico. Those two countries had made substantial progress in improving their financial positions and he asked whether the Committee should not consider the question again.

In response to the Chairman's request for comment, Mr. Coombs said the main development in the area since the Committee's earlier discussion was that the U.S. Treasury had negotiated swap arrangements with the central banks of Venezuela and Mexico. It would be useful to learn what the Treasury's experience had been under those arrangements, and whether the Treasury intended to maintain the relationships or might prefer to have the Federal Reserve share in them. To his mind, however, the key question was whether negotiation of swap lines with the two countries would expose the System to pressures for similar arrangements with other countries in Latin America that were in less strong positions. If there was some basis on which a clear line could be drawn separating Venezuela and Mexico from the rest of Latin America, a good case might be made for having swap lines with the two countries. If not, the System might be well advised not to enter into such arrangements. In any case, he thought a study would be useful.

Chairman Martin agreed that such a study should be made.

The Chairman then suggested that the Committee consider further the proposed new instruments governing foreign currency operations that had been discussed at the past several meetings. He asked Mr. Holland to comment on the memorandum on the subject distributed by the Secretariat on June 1, 1966.1/

Mr. Holland said that on the basis of the discussion at the meeting of the Committee on May 10 and subsequent conversations with Mr. Mitchell, the staff had recommended a revision of paragraph 2(B) of the proposed new foreign currency directive distributed on April 28, 1966. In addition, the staff had noted a possible alternative revision in which the second sentence of paragraph 2(B) would be deleted and a new paragraph 5 added. The revision recommended in 2(B) was as follows:

> B. To temper and smooth out abrupt changes in spot exchange rates, and to moderate forward premiums and discounts judged to be disequilibrating. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions shall be modified, OR

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

curtailed, ~~or-eventually-discontinued-pending-a~~ UNLESS UPON REVIEW AND reassessment OF THE SITUATION ~~by~~ the Committee ~~of-supply-and-demand-forces~~ DIRECTS OTHERWISE;

Mr. Treiber remarked that the provisions of paragraph 2(B) represented a statement of general principles relating to conditions under which operations in foreign currencies should be undertaken. In his judgment the language of the paragraph contained in the staff's April 28 draft was more appropriate than the new language now suggested.

Mr. Daane noted that his view was similar to Mr. Treiber's. He did not think any useful purpose would be accomplished by the suggested change and if adopted he would be concerned about the possibility of adverse reactions when the new language was published.

Mr. Mitchell commented that he felt the proposed revision of paragraph 2(B) did not involve a substantive change. He thought that it did involve an improvement in language, and that the Committee had nothing to lose by adopting it. In his judgment, however, the principal issue concerned the possible new paragraph 5 noted in the Secretariat's memorandum. That paragraph read as follows:

> 5. The System's foreign currency operations are not designed to counter the effects of basic and persistent economic forces on flows of international payments or on movements of exchange rates. Operations undertaken to deal with forces deemed temporary or transitional shall be modified or curtailed, unless upon review and reassessment of the situation the Committee directs otherwise, if the forces persist (a) for six months, or (b) for a lesser period if the Special Manager concludes that they can no longer be considered temporary.

In Mr. Mitchell's opinion that suggested paragraph reflected a position that the Committee should take publicly, and he recommended its addition to the directive.

Mr. Daane agreed that the suggestion to add the new paragraph 5 represented the more important issue, but observed that there were differences in judgment concerning it. In his opinion, to whatever degree the paragraph would affect the flexibility of operations it would work in the wrong direction, and he did not think it should be adopted.

Mr. Treiber concurred in Mr. Daane's view. It was highly difficult, he said, to distinguish between forces that were temporary and transitional, on the one hand, and those that were basic and persistent, on the other; the duration of particular forces often would depend on the actions of the Governments involved. It had been the practice of the Committee to review all credit extensions every three months and to get the judgments of the Special Manager concerning them at those times. It seemed to him that the workability of the present arrangements had been demonstrated and he preferred them to those that would be called for under the suggested paragraph 5.

Mr. Coombs agreed that the key issue concerned the proposed paragraph 5; the language revision suggested in paragraph 2(B) was a subsidiary issue. He would note first that foreign central banks had primary responsibility for influencing the exchange rates of their currencies against the dollar. The System could intervene in the exchange markets, but it did so only in rather extreme circumstances. The only two occasions on which strong actions had been taken to influence exchange rates were at the times of the Cuban crisis and of the assassination of President Kennedy. In sum, he thought the Committee need not be overly concerned about possible efforts by the Account Management to influence exchange rates.

Thus, Mr. Coombs continued, the issue to which the proposed paragraph 5 was essentially directed was the duration of swap drawings. He agreed with Mr. Treiber that there was a certain ambiguity in terms such as "temporary" and "persistent" because the nature of Governmental policy was decisive in determining whether particular forces lasted two months or twenty. At the outset of a particular development it often would be impossible to predict its duration. The real question was how much breathing space should be provided for effective Governmental actions to deal with the development. The general policy of the Committee, which he thought was a proper one, was to allow a six-month breathing space, and to become progressively more concerned if drawings stayed on the books for a longer period. Preparations were made to shift to some other form of financing as drawings approached a six-month term. Some 94 per cent of all drawings had been repaid within six months and none had gone on for more than a year.

Mr. Mitchell remarked that he thought the paragraph in question said essentially what Mr. Coombs had been saying. The Committee should be prepared to defend itself against critics by indicating in the directive that it was not trying to rig markets when there were basic forces at work that should be dealt with by appropriate Government policies. If, for example, it appeared that some foreign country's basic situation was deteriorating, the responsibility for deciding whether to offer support should lie with the Committee rather than with the Special Manager. The proposed paragraph said, in effect, that the Committee should make the decision in such cases.

Mr. Shepardson observed that he did not read the proposed language to call for a determination at the outset that a particular development was temporary.

Mr. Coombs said that the opening phrase of the second sentence--"Operations undertaken to deal with forces deemed temporary or transitional"--conveyed such an implication to him. In a typical case, however, some central bank in the swap network might take in a substantial volume of dollars in a short period and suggest that the System absorb those dollars by a swap drawing, as an alternative to a gold sale. It was appropriate, he thought, to make the drawing to absorb the initial impact of the development and then to study the situation to determine whether it reflected a temporary phenomenon.

It was his practice to report to the Committee before renewing central bank drawings at the end of their three-month terms.

Mr. Mitchell commented that the procedure Mr. Coombs described was much like that followed when a domestic bank came to the discount window; the Reserve Bank accommodated the bank automatically and then studied the situation. The fact that Mr. Coombs reported to the Committee on proposed renewals of drawings seemed to him to have nothing to do with the matter at issue, which concerned publishing a statement of the principle under which the Committee operated.

Mr. Robertson indicated that he shared Mr. Mitchell's position.

Mr. Coombs remarked that if the proposed paragraph appeared in print it could be used against the United States by foreign countries who might ask, for example, why the U.S. was still employing short-term credit facilities when its balance of payments deficit had persisted for nine years. Borrowing as well as lending by the U.S. was involved, and he would hope that the Committee could preserve a reasonable degree of flexibility for dealing with possible developments. By way of illustration, he recalled that early in 1966 System credits to the Bank of England were reaching the end of their six-month terms. In the immediately preceding period the System put considerable pressure on the British to pay off their drawings. That was rather difficult for them because it required liquidation of a large part of their portfolio of U.S. securities. Under other circumstances he could visualize the U.S. having to borrow and--if the suggested language was adopted and published--being pressed by foreign central banks to clear up its debt within a certain time and under certain conditions that could prove to be highly inconvenient. Hence, he would not recommend hardening the requirement that credits be kept short and repaid within some specific period such as six months. He thought there should be a general understanding within the Committee to that effect, but if the Committee could avoid printing such a rule it would be in a better position to deal with possible emergencies in which some departure from general rules might be desirable.

Mr. Daane referred to the final clause of the proposed paragraph, which read, "or for a lesser period if the Special Manager concludes that they can no longer be considered temporary." In his judgment that clause imposed an unreasonable burden on the Special Manager. Moreover, the Europeans were extremely sensitive with respect to the short-term nature of swap drawings, and to adopt the paragraph would simply give them more ammunition to use against the United States. If, as he believed, the Committee had adhered to the principle that the swap arrangements were short-term credit facilities and had maintained proper surveillance over their use, he saw no reason to change the directive. To do so, in his opinion. would be hurtful rather than helpful.

Mr. Mitchell replied that the purpose of the proposed paragraph was to set forth the practice the Committee had in fact followed so that the public would be aware of it. He thought the point was not adequately stated in the record.

Mr. Ellis said he had found that academicians tended to rely on the Committee's published instruments for an understanding of the objectives of its foreign currency operations. He had some sympathy for the proposed paragraph because it provided a clearer description of the nature of the forces with which the Committee was attempting to deal. It was true that one could not know at the outset of a development whether it would prove temporary but whether or not operations were continued would depend on a subsequent judgment on that point.

Chairman Martin remarked that he thought the Committee was dealing largely with questions of intentions and language. Mr. Mitchell was correct in noting that the suggested paragraph described the Committee's general policy, and there was merit in Mr. Ellis' point regarding academicians. It was difficult, however, to formulate such a policy statement in precise terms and he was not persuaded that it was necessary to incorporate the paragraph.

Mr. Wayne noted that the network of swap arrangements had been developed originally primarily because of problems with respect to international payments of the United States, and that the proposed paragraph would apply to drawings by the U.S. as well as by the other parties to the arrangements. He thought those facts warranted careful consideration, and he wondered whether the Committee ought to put the proposed paragraph into the directive. He personally had been impressed by the points Mr. Coombs had made today.

Mr. Mitchell remarked that he considered odd the argument that the Committee should do the right thing in limiting the duration of swap drawings but at the same time it should avoid saying it was doing the right thing. The Committee did in fact extend swap drawings beyond six months only with great reluctance, and it did look to more basic policy measures to deal with persistent problems. The proposed paragraph specified exactly what the Committee had been doing.

Chairman Martin observed that in view of the differences of opinion expressed today the Committee probably would not want to change the substance of the directive unless it was convinced that the change involved an improvement. He then suggested that the Committee members indicate whether or not they favored adding the proposed paragraph. Messrs. Mitchell, Robertson, and Shepardson noted that they did and the other members indicated that they did not.

Chairman Martin then asked whether there would be any objection to incorporating the revisions in paragraph 2(B) recommended by the staff in its June 1 memorandum, and no objections were heard.

The Chairman then observed that, as indicated in the Secretariat's memorandum of June 6, 1966, Mr. Swan had offered some suggestions for change in the language of the proposed authorization and the proposed directive.1/ He invited Mr. Swan to comment.

Mr. Swan said his suggestion for the authorization involved some small changes in wording in paragraph 1B(2) that he thought were clarifying, as follows:

> (2) ADDITIONAL ~~Other~~ currencies held spot or purchased forward, up to the amount necessary for System operations to exert a market influence BUT ~~and~~ not exceeding $150 million equivalent; and

His suggestion for the directive was simply to omit from the list of purposes of System foreign currency operations the statement in paragraph 1(B), which read "To aid in making the system of international payments more efficient." The meaning of that statement, taken by itself, was not clear to him, and unintended implications might be read into it. The intended meaning seemed to be covered adequately by paragraphs 1(C) and 1(D).

Mr. Treiber said he thought the System's operations did contribute to the efficiency of the international payments system by making additional sources of credit available. The statement in 1(B) of the directive had been included in the Committee's existing authorization for some time and he would prefer to retain it in the new directive.

1/ A copy of the memorandum referred to has been placed in the Committee's files.

Mr. Daane remarked that the revision in the proposed authorization that Mr. Swan had suggested seemed to be an improvement. He agreed with Mr. Treiber, however, that it would be desirable to retain paragraph 1(B) of the directive, noting that the forthcoming report of the Deputies of the Group of Ten would make a statement along the same lines.

Chairman Martin proposed that the Committee accept Mr. Swan's suggested revisions in paragraph 1(B)(2) of the proposed authorization but not his suggestion for the directive, and no objections were heard.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the Committee replaced its previously existing instruments governing foreign currency operations, namely, the authorization regarding open market transactions in foreign currencies, the guidelines for System foreign currency operations, and the continuing authority directive with respect to foreign currency operations, with two new instruments, namely, an authorization for System foreign currency operations and a foreign currency directive, reading as follows:

AUTHORIZATION FOR SYSTEM FOREIGN CURRENCY OPERATIONS

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, and with the Bank for International Settlements:

Austrian schillings
Belgian francs
Canadian dollars
Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Netherlands guilders
Swedish kronor
Swiss francs

B. To hold foreign currencies listed in paragraph A above, up to the following limits:

(1) Currencies held spot or purchased forward, up to the amounts necessary to fulfill outstanding forward commitments;

(2) Additional currencies held spot or purchased forward, up to the amount necessary for System operations to exert a market influence but not exceeding $150 million equivalent; and

(3) Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $200 million equivalent.

C. To have outstanding forward commitments undertaken under paragraph A above to deliver foreign currencies, up to the following limits:

(1) Commitments to deliver to the Stabilization Fund foreign currencies in which the United States Treasury has outstanding indebtedness, up to $200 million equivalent;

(2) Commitments to deliver Italian lire, under special arrangements with the Bank of Italy, up to $500 million equivalent; and

(3) Other forward commitments to deliver foreign currencies, up to $275 million equivalent.

D. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign Bank	Amount of Arrangement (millions of dollars equivalent)	Period of Arrangement (months)
Austrian National Bank	50	12
National Bank of Belgium	100	12
Bank of Canada	250	12
Bank of England	750	12
Bank of France	100	3
German Federal Bank	250	6
Bank of Italy	450	12
Bank of Japan	250	12
Netherlands Bank	100	3
Bank of Sweden	50	12
Swiss National Bank	150	6
Bank for International Settlements (System drawings in Swiss francs)	150	6
Bank for International Settlements (System drawings in authorized European currencies other than Swiss francs)	150	6

3. All transactions in foreign currencies undertaken under paragraph 1(A) above shall be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces. Insofar as is practicable, foreign currencies shall be purchased through spot transactions when rates for those currencies are at or

below par and sold through spot transactions when such rates are at or above par, except when transactions at other rates (i) are specifically authorized by the Committee, (ii) are necessary to acquire currencies to meet System commitments, or (iii) are necessary to acquire currencies for the Stabilization Fund, provided that these currencies are resold forward to the Stabilization Fund at the same rate.

4. It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested insofar as practicable, considering needs for minimum working balances. Such investments shall be in accordance with Section 14(e) of the Federal Reserve Act.

6. A Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) is authorized to act on behalf of the Committee when it is necessary to enable the Federal Reserve Bank of New York to engage in foreign currency operations before the Committee can be consulted. All actions taken by the Subcommittee under this paragraph shall be reported promptly to the Committee.

7. The Chairman (and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors) is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities; and

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currenty operations for System Account in accordance with paragraph 3 G (1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

10. The Special Manager of the System Open Market Account for foreign currency operations shall keep the Committee informed on conditions in foreign exchange markets and on transactions he has made and shall render such reports as the Committee may specify.

FOREIGN CURRENCY DIRECTIVE

1. The basic purposes of System operations in foreign currencies are:

A. To help safeguard the value of the dollar in international exchange markets;

B. To aid in making the system of international payments more efficient;

C. To further monetary cooperation with central banks of other countries having convertible currencies, with the International Monetary Fund, and with other international payments institutions;

D. To help insure that market movements in exchange rates, within the limits stated in the International Monetary Fund Agreement or established by central bank practices, reflect the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public; and

E. To facilitate growth in international liquidity in accordance with the needs of an expanding world economy.

2. Unless otherwise expressly authorized by the Federal Open Market Committee, System operations in foreign currencies shall be undertaken only when necessary:

A. To cushion or moderate fluctuations in the flows of international payments, if such fluctuations (1) are deemed to reflect transitional market unsettlement or other temporary forces and therefore are expected to be reversed in the foreseeable future; and (2) are deemed to be disequilibrating or otherwise to have potentially destabilizing effects on U.S. or foreign official reserves or on exchange markets, for example, by occasioning market anxieties, undesirable speculative activity, or excessive leads and lags in international payments;

B. To temper and smooth out abrupt changes in spot exchange rates, and to moderate forward premiums and discounts judged to be disequilibrating. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified or curtailed unless upon review and reassessment of the situation the Committee directs otherwise;

C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension,

(2) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions. Whenever exchange market instability threatens to produce disorderly conditions, System transactions may be undertaken if the Special Manager reaches a judgment that they may help to reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. In such cases, the Special Manager shall consult as soon as practicable with the Committee or, in an emergency, with the members of the Subcommittee designated for that purpose in paragraph 6 of the Authorization for System foreign currency operations; and

D. To adjust System balances within the limits established in the Authorization for System foreign currency operations in light of probable future needs for currencies.

3. System drawings under the swap arrangements are appropriate when necessary to obtain foreign currencies for the purposes stated in paragraph 2 above.

4. Unless otherwise expressly authorized by the Committee, transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken only (i) to prevent forward premiums or discounts from giving rise to disequilibrating movements of short-term funds; (ii) to minimize speculative disturbances; (iii) to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders; (iv) to allow greater flexibility in covering System or Treasury commitments, including commitments under swap arrangements; (v) to facilitate the use of one currency for the settlement of System or Treasury commitments denominated in other currencies; and (vi) to provide cover for System holdings of foreign currencies.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period May 10 through June 1, 1966, and a supplemental report for June 2 through 6, 1966. Copies of both reports have been placed in the files of the Committee.

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

> The Committee directive adopted at the last meeting has, I believe, generated a constructive dialogue within the System on the nature of staff reserve projections and their use in helping to shape day-to-day open market operations. Over the recent period, actual results have been in line with the staff estimates of a reversal during May of the sharp increases in aggregate reserves that had occurred in April. In fact, over most of the period required reserves tended to fall a bit short of the estimates, suggesting no need to speed up the process of attaining gradual reduction in net reserve availability. Thus, net borrowed reserves and borrowings from the Reserve Banks each increased by about $50 million in the weekly averages.
>
> I believe most of the staff would agree that we need much more work and experience before a judgment can be reached about the effectiveness of permitting short-run fluctuations in aggregate reserve measures to influence the course of open market operations between Committee meetings. June, for example, may prove a more difficult month than May because of the uncertainties spelled out in the blue book.1/ The changed pattern of tax payments, the problems that face the thrift institutions as they

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

come into their midyear interest payment period, and the continued pressure of Government agency financing are all factors to be reckoned with in coming weeks.

With bank reserve positions under greater pressure, the Federal funds rate has moved into new high ground. Last Friday the effective rate reached 5-1/4 per cent, and offerings at 5-3/8 per cent made their appearance for the first time. The funds rate continues to be influenced by CD and other short-term money rates, and by the desire of many banks to avoid borrowing at the discount window. The discount rate is exerting little influence. Given the taut reserve situation, banks have tended to manage their positions cautiously, with considerable pressure in the funds market and heavy borrowing before the weekend a typical, but not exclusive, pattern. Over the long Memorial Day weekend borrowing from the Reserve Banks exceeded $1 billion, and very large excesses were built up, particularly at New York City banks. In fact, the New York City banks ended that statement week with more than $0.5 billion in surplus reserves, even though country banks took advantage of the break in the Federal funds rate to accumulate $1.3 billion in excess reserves on Wednesday to carry over into the final week of their statement period or to resell on subsequent days to their sophisticated city cousins at higher rates.

Rates on bankers' acceptances, finance paper, commercial paper, and short-term agency issues, and dealer financing rates have all pushed into new high ground over the period. Treasury bills, on the other hand, have been on a course of their own despite dealer financing rates that have touched as high as 5-5/8 per cent. Strong demand from corporations and public funds, together with System buying and the investment in bills by investors seeking a liquidity haven until the course of long-term rates becomes clearer, has pressed on market supplies. In yesterday's auction, average rates of 4.57 and 4.74 on three- and six-month bills, respectively, were established.

At these levels, however, dealers were cautious in their bidding and there was an unusually wide spread between the average price bid and the lowest price accepted by the Treasury.

A heavy atmosphere pervaded the capital markets for most of the period as investors were choosy in the light of the growing calendar, and only very attractively priced issues were well received. The corporate market was under particularly heavy pressure, with yields on both new and outstanding issues pushing into new high ground. Some improvement in atmosphere occurred late in the period when a triple-A telephone issue with 5-year call protection priced to yield 5.45 per cent--nearly 30 basis points above yields on a comparable issue a month ago--was well received. The weakness in the corporate market adversely influenced the market for Treasury notes and bonds, as did the diminishing expectations of a tax increase and Secretary Fowler's remarks about the possibility of some revision of the 4-1/4 interest rate ceiling. Despite these developments, there was a considerable body of sentiment in the Government market that the February-March interest rate peaks might be tested, but that rates might be in the process of bottoming out. Uncertainties about the future course of monetary and fiscal policy together with Congressional and Administration expressions of concern about the competitive position of the savings and loan associations and the mutual savings banks have tended to produce an air of caution but no firm sense of direction in the Government bond market.

In the meantime, the relentless pressure of new offerings has created a number of problems in the market for Government agency issues. Prices have given ground and it has become increasingly difficult to place each succeeding new issue in investors' hands. On Thursday, FNMA will be pricing an offering of $350 million Small Business Administration participation certificates maturing in 1-5 years and $180 million of their own new participation certificates maturing in 13-15 years. Current market talk is for a 5.70 - 5.75 rate on the shorter issues, with underwriters having only moderate success in lining up buyers even at these rates. For the longer maturities there appears to be good demand at a 5-3/8 - 5.40 per cent yield range. The very high rates on shorter agency issues is becoming a matter of increasing concern to the Administration, but is the natural outcome of the crowded calendar of issues that has been forced into the market. Given the continued pressure on bank reserve positions, the coming weeks--which include the dividend and tax dates, a substantial calendar of Government agency, corporate, and municipal offerings,

> possible Congressional action on CD rates, the midyear interest payment period for savings and loan associations and mutual saving banks, and the current pressure on sterling mentioned by Mr. Coombs--will provide a considerable test for both the money and capital markets.

Mr. Swan asked whether the Manager expected the large disparity between the bill rate and other short-term rates to continue indefinitely or whether he thought bill rates would advance and narrow the gap.

Mr. Holmes replied that at current levels of other short-term rates there was an air of caution about the bill rate, as evidenced in yesterday's auction. It was hard to forecast bill rates at present because of uncertainties about the volume of funds seeking havens in bills. It was known, for example, that some corporations were instructing their treasurers to place funds only in bills, and if that continued it could keep rates depressed for some time. He would imagine, however, that with all of the other pressures existing in short-term markets bill rates would move up sooner or later.

Mr. Mitchell noted that System purchases had contributed to downward pressures on bill rates, and asked whether the Desk should not be buying other types of securities. For example, would it be desirable for the Committee to authorize purchases of agency issues?

Mr. Holmes agreed that System purchases had contributed to the recent downward pressure on bill rates, although he thought such purchases were not the main factor. As to trading in other securities, the Desk had bought coupon issues from time to time. There were a number of problems connected with buying agency issues. First was the legal question of the System's authority to buy particular types of issues. Secondly, there were difficulties relating to the issues themselves; most were small and were not tradable on any scale. Third, what might be called an "even keel" problem existed. Five or six agency issues might be offered in a single month, as well as issues of the new participation certificates, and there was likely to be a serious risk of giving false signals to the market by trading in them. Both purchases and sales by the System could affect rate expectations and operations might have an undesirably large influence on the market. Finally, the present period, with the crowded agency calendar and with the problems being encountered in pricing some issues, would be a difficult one in which to begin operations in agencies.

In response to a question by Mr. Mitchell as to whether the Committee should consider operating in commercial paper, Mr. Holmes replied that the System could, of course, trade in any obligations authorized by law if that served its purposes. He would not want to make an off-hand judgment on the desirability of trading in commercial paper; the question warranted careful study.

Mr. Mitchell then asked what was known about the sources of funds that were being invested in agency issues.

Mr. Holmes replied the dealers handling such issues had made good progress in broadening the market, although further broadening would be desirable. Recent participants included corporations and financial institutions such as savings banks and commercial banks. Good strides also had been made in interesting pension and trust funds as well as other institutional investors, and there had been some foreign buying.

Mr. Mitchell then referred to the draft directives[1/] the staff had prepared for this meeting, particularly to the phrase in alternative A for the second paragraph reading "provided, however, that if required reserves expand sharply more than seasonally expected . . . ." He asked how the Manager would interpret that phrase.

Mr. Holmes said the first problem would be to specify what was seasonally expected in June. Seasonal factors based on experience of prior years would be of only limited usefulness this year because of the changed pattern of tax payments. As the blue book indicated, the Board's staff expected the daily average bank credit proxy to be about 6-1/2 per cent higher, at an annual rate, in June than in May, and bank credit to rise about 10 per cent from the end of May to the end of June. The New York Bank staff was projecting increases of 7-1/2 and 15 per cent respectively, in the two series. Those

1/ Appended to these minutes as Attachment A.

differences reflected the degree of uncertainty in expectations.

Mr. Daane noted that the blue book indicated that a deepening in net borrowed reserves beyond $400 million could lead to pressure on the discount rate and Regulation Q ceilings. He asked whether the Manager thought there was much room left to reduce net reserve availability further without forcing an increase in the discount rate.

Mr. Holmes replied that, while it was difficult to judge how much such room existed, he did not think it was very much in view of the many pressures in the market. He was inclined to agree that net borrowed reserves consistently deeper than $400 million would affect expectations and might lead the market to conclude that a change in the discount rate was inevitable. That was a personal judgment, of course, and one that might be changed by developments.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period May 10 through June 6, 1966, were approved, ratified, and confirmed.

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

Mr. Brill made the following statement on economic conditions:

> My predecessor in this job, Mr. Noyes, was always a source of sage advice. But the soundest of his counsel was a parting message to me, warning against the perennial risk of overstaying a tight monetary policy.
>
> I have taken this message to heart and searched each nugget of information for signs of economic weakening that should trigger a change in policy. The slowdown in auto sales beginning in April caused my antennae to quiver, and their vibrations intensified with news of the drop in new orders, the further cutbacks in auto production, and the reports of housing construction grinding to a halt. They shook violently when the May rise in the unemployment rate was reported.
>
> What does it add up to? Is the economy really slowing down? I think the answer to this is a qualified yes. Is the Fed overstaying its tightening? I think the answer to this is an unqualified no.
>
> Let me elaborate on this paradox, first giving some reasons for qualifying the answer on the state of the economy. The weak spot in current economic activity is autos. Soon residential construction will be in this category, but, at the moment, the slowdown in activity and spending is largely limited to the auto sector. It's showing up in a variety of economic indicators, however, and followers of driblets of economic intelligence have a tendency to add these fragments, rather than to question whether they often are multiple reflections of the same phenomenon. For example, autos account for the April-May drop in retail sales, the May drop in the workweek, and the second-quarter slowing in GNP. If one abstracts from autos, retail sales in May continued to rise as rapidly as earlier, the workweek stayed at its postwar peak, and the

second-quarter rise in GNP is proceeding as fast as that in the first quarter.

One has to be cautious, therefore, to avoid going overboard about the auto slowdown, particularly when consumer anticipation surveys suggest the possibility of some rebound in auto sales later this year, and particularly because consumers currently are showing no signs of keeping their wallets closed with respect to other types of spending. Appliance and furniture sales have been very strong, and consumer purchases of nondurable goods continue to rise steadily.

Buttressing consumer spending plans in the months ahead is the scheduled introduction of Medicare payments at midyear, and the likely rise in Federal civilian and military pay. Even if auto sales do no better than level off at current rates--a more pessimistic outlook, indeed, than that held by most observers--the rise in other consumer spending should keep businessmen happy with their plans for new plant and additional stocks.

On the other hand, the housing dip lies ahead of us. Housing activity currently is being maintained on the basis of financial commitments made earlier. Judging from Reserve Bank reports on new commitment flows, we should expect the residential construction figures to slide more rapidly and by autumn to show a decided reduction. Some temporary relief may be afforded by an enlarged FNMA purchase program, if Congress appropriates the funds, and by possible actions to limit commercial bank invasion of savings and loan fund sources. But short of a major shift in the posture of policy, or an unexpected decline in other credit demands, housing will probably turn out to be a much weaker area of activity over the balance of this year than our current worry--automobiles.

Now let's turn to some of the bright spots (depending upon what one construes as a good omen these days). The new plant and equipment survey shows no indication of a cutback in business capital outlays. True, during booms we have gotten accustomed to expecting business spending plans to rise in successive surveys, and the fact that the two most recent surveys are not far from the February reading suggests somewhat less than usual ebullience, cyclically adjusted. Perhaps monetary restraint is having some effect--along with Presidential exhortations, delivery delays, and rising machinery prices and construction costs. But before chalking up plant and equipment as another victim of tight money, let's keep in mind that at close to midyear, business plans call for plant spending to remain a driving force for economic expansion over the next two quarters.

One always hesitates to go out on a limb about so volatile an area as business inventories, but at the moment it's hard to see this as a major drag on the economy. Some involuntary accumulation of auto stocks at dealers is in process, but these should be worked off during the model changeover period. Outside of autos, inventory-sales ratios continue low and favorable to maintenance of the recent pace of inventory investment.

Hovering over all judgments as to the economic future is the question of defense spending. The January Budget Message implied a pattern for defense spending of a fast rise in the first quarter, a slowing in the second quarter, and an abrupt leveling off after midyear. Such an abrupt change in the defense tempo would undoubtedly give private spending plans a jolt, but it appears unlikely to develop. Not that we as yet have any definite clues on the course of military needs. But piecing together the available information on new defense orders and on draft calls, it seems more likely that defense spending will continue to rise next quarter at least as rapidly as it has in the current quarter.

Adding this to the prospects for private spending noted earlier, and abstracting from the possibility of a financial crisis stemming from the situation with respect to savings and loan associations, one comes up with a picture of a still-strong economy, one in which real output would be rising less rapidly than in

> the first half of the year, but with resource use sufficiently intense to maintain pressure on costs and prices. Even with capacity continuing to grow, manufacturing plant would continue to be used intensively--a 92 per cent rate is our guess for the third quarter. With unemployment among experienced workers continuing at rockbottom levels, wages would likely continue to drift up and productivity to drift down, and, as a result, unit labor costs to rise further. In the context of continuing strong over-all demand, it would not be surprising if these cost increases were passed through into rising prices. It's hard for me to see any significant slackening in the rate of advance in industrial prices over the summer and fall.
>
> In time, we might expect a deceleration in defense spending, substantial growth in industrial capacity, and the training of new workers--all factors favoring a return to price stability. Unfortunately, neither the domestic nor the international situation affords the time to permit natural forces to work their way through the economy. Important wage contract negotiations begin this summer and carry through next year; the price and profits background surrounding these negotiations will not be conducive to moderate settlements. Monetary policy may be a poor tool to use to ward off a cost-push inflation threat, but in the absence of more efficient restraints, it doesn't seem to me that the Fed can abdicate its responsibilities. Indeed, if it weren't for the financial market conditions Mr. Axilrod will be discussing in a moment, I would submit that this would be an appropriate time to tighten the policy screw another notch.

Following his presentation Mr. Brill responded to questions on the consumer savings rate.

Mr. Mitchell then noted that the first sentence of the staff's draft directive read, "The economic and financial developments reviewed at this meeting indicate that the domestic economy is continuing to expand, with industrial prices rising further and credit demands remaining strong." He asked whether, in view of the projection for a lower rate of growth in GNP in the second quarter, it would not be more accurate to say, " . . . although the domestic economy is expanding at a less rapid rate than in the first quarter, industrial prices are rising further and credit demands remain strong."

Mr. Brill replied that he would be reluctant to see the directive cast in terms of projections because they often were highly uncertain. Moreover, it appeared likely that GNP growth would return to the first-quarter pace in the third quarter. In view of the apparent slowdown in the second quarter, however, the staff did suggest dropping the word "vigorously" in describing the current pace of the expansion.

In response to questions by Mr. Maisel, Mr. Brill said that the latest survey results on planned business capital outlays implied less of an increase in real investment than the previous survey because of the rise in machinery prices and construction costs. Capital spending was still expected to be a strong expansive force, however. The GNP price deflator was projected to rise substantially in the third quarter, from about a 3 per cent annual rate of increase to 4.2 per cent. That was mainly because of the expected Federal pay raise and the inauguration of the Medicare program, which together contributed significantly to the third-quarter figure.

Mr. Maisel then asked whether growth in real GNP in the second quarter was less than the staff had projected early in the year. Mr. Brill indicated that he was not certain, but would undertake to determine the facts on the question. (Note: Following the meeting Mr. Brill informed Mr. Maisel that the staff's estimate of second-quarter GNP in current dollar terms had proved accurate but growth in real GNP had been overestimated; there had been a larger than expected rise in the price deflator.)

Mr. Axilrod made the following statement concerning financial developments:

> Since around mid-April interest rates on virtually all securities and financing instruments outside the Government securities market have either regained earlier highs or continued their advance to new highs for the year. Demand pressures have been a driving force in some markets, but restraints on supply appear to be more pervasive than earlier, particularly in the mortgage market.
>
> Yields on U.S. Government securities have recently lagged behind the rise in other market rates. Apart from the impact of the 4-1/4 per cent interest ceiling on Treasury bond yields, the relatively low level of U.S. Government security rates can be mostly explained by the unusually large cash surplus the Federal Government is running in the second quarter--projected to be about $9 billion, or $4 billion more than a year ago--and the consequent relatively large reduction in debt outstanding--some inadvertent, as in the May refunding--which has been only partially

replaced by new agency issues for cash. Part of this large surplus is the result of tax speed-ups and some is the result of a faster growth in GNP than was anticipated in the January budget document. But while tax speed-ups and the more rapid GNP growth have taken some pressure off the Government securities market, they have generated additional private credit demands in the market and hence a widening of rate spreads between private and U.S. Government securities.

The general upward movement in the over-all level of rates has been accompanied by a reshaping of the yield curve. It now once again shows yields relatively high at the short end and lower at the long end. In the U.S. Government securities market, this is the result of the rise of yields in the 1 - 3 year area to new high levels for the year. That was the end of the market hit hardest by the recent rash of agency issues and it also was the area of the May refunding. And at the very short end of credit markets, while the 3-month Treasury bill rate is relatively low, yields on commercial paper and bankers' acceptances have risen over 1 percentage point since the December discount rate increase and are more representative of pressures in the short-term sector.

Barring any change in the economic weather or in the outlook for fiscal policy, I would suspect that over the next few weeks there will be a tendency for the yield curve to flatten out more as a result of an upward rate movement at the long end rather than a downward movement at the short- and intermediate-end. Such a conclusion is consistent with what we know about the corporate, municipal, and Federal agency calendar ahead and with the generally restrained availability of investment funds at some major financial institutions.

It is also consistent with the view that the relatively high cost of short-term funds to banks may impel them, as it did in early winter (before the prime loan rate was raised), to make portfolio adjustments or to tighten loan terms as strong loan demand continues. This, too, would add to upward pressures on long-term market rates, not to say on banks' own lending rates.

The pressure for banks to undertake further portfolio adjustments and to restrain lending would become very intense if growth in aggregate reserves was considerably restrained. The leeway banks have under Regulation Q ceilings to become aggressive in competing for short-term funds in the CD market has been progressively reduced and the competition of other short-term instruments is becoming more fierce. Banks have been offering the 5-1/2 per cent ceiling rate on shorter maturities (some reported in the 3 to 4 month area) and secondary market trading in CD's is taking place above the ceiling rate in the 3 to 6 month area. Thus, banks are close to becoming very cramped in their ability to accommodate loan demand, especially if investors find it increasingly preferable or necessary to utilize competing instruments such as Treasury bills for liquidity purposes.

By combining the picture described above with uncertainties facing nonbank savings institutions after midyear interest crediting, with legislative uncertainties overhanging banks, with the possibility that credit demands in June and July will be very large partly for temporary reasons, with the need for the agency market to digest a very large supply in a very short period, and with sizable bank CD maturities, one is driven to the conclusion that open market policy should chart an unusually cautious course in the period immediately ahead--recognizing that a considerable amount of restraint is already in the financial system.

It is possible, though, that net borrowed reserves could be deepened somewhat further--say closer to $400 million--in the face of a tendency for reserve aggregates to grow rapidly without leading to a substantial risk of a short-run bind in the money markets. Any significant further tightening beyond that point threatens to bring up a whole host of problems very similar to those the Committee, and monetary policy generally, faced last December. In principle, the problem is that the availability of bank reserves cannot be very much more constrained without raising very difficult further issues about the sustainability of time deposit ceilings and the discount rate--and all the complicated questions of timing that are involved in the relationship of such rates to open market policy and to other actions by the Administration and the Congress.

I think the problem of relationships between official and market rates is most dramatically seen in the Federal funds market, where the trading level recently has often been 50 basis points or more above the discount rate as large city banks have used this market rather than the discount window to obtain additional reserve funds. If the flow of nonborrowed reserves to the banking system is reduced while loan demand stays large, it is very likely that the availability of Federal funds will decline. The volume of Federal funds transactions has shown signs of declining in May even with the Federal funds rate rising to 5-1/4 per cent at times. Intensification of such a development would make it more necessary for large city banks to borrow at the discount window.

Thus, a further tightening of monetary policy will be accompanied by stronger demands on the discount window from all classes of member banks at the same time as market interest rate adjustments are occurring--and time deposits are becoming harder to buy. It seems clear, therefore, that open market policy's next significant step toward restraint will mean that Regulation Q will produce anguish from banks, as they find their CD's squeezed into shorter and shorter maturities, as well as from nonbank savings institutions. And the discount rate and discount administration will become even more of a problem than they are now.

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

Last March, Mr. Hersey reported to this Committee that Government technicians foresaw a payments deficit on the liquidity basis of as much as \$2-1/2 billion this year--double last year's deficit--if aggregate demand were allowed to produce a GNP of \$735 billion. At the time, the \$2-1/2 billion figure seemed startling. And such an outcome still seemed avoidable, provided that the domestic boom were brought promptly under control by an appropriate mixture of fiscal and monetary restraints. But this was not done. And now we are having to become accustomed to the \$2-1/2 billion figure, and even to brace ourselves for the possibility of a larger figure.

The liquidity deficit in the first four months of the year was already at a rate of about \$2-1/2 billion. It would have exceeded a \$3 billion rate if the Treasury had not persuaded some foreign central banks and international institutions to shift from liquid dollar assets into over-one-year time deposits and into Federal agency securities--items that are classified in the statistics as nonliquid.

The alternative measure of the deficit, based on official reserve transactions, is not a suitable one for identifying recent trends, because special influence have caused it to swing widely from quarter to quarter. In the fourth quarter of last year, it was the largest it had been in nearly three years. Not only were private holders giving up dollars to shift back into sterling, but there were very large year-end shifts by foreign commercial banks out of dollars into their own currencies, with consequent accretions to central bank holdings of claims on the United States. In January-April of this year, the rate of deficit measured by official reserve transactions was roughly \$1-1/2 billion, but it would have been higher if there had not been reversals of the previous year-end shifts.

If the domestic boom should roar ahead in the second half-year after the current slight hesitation passes, as projected in the green book,1/ it would be prudent to expect some further

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

increase in the payments deficit, on either basis of calculation. The only source of improvement about which one can now feel at all confident is a decline in new Canadian security issues, following the January-April bulge. Against that, and probably outweighing it, further deterioration seems likely on at least five fronts.

(1) Further shrinkage of the surplus on merchandise trade is a strong possibility. The trade surplus was already down to an annual rate of less than $4 billion in January-April, compared with more than $5 billion in the fourth quarter of 1965.

(2) Direct investment outflows are thought to have fallen off to an annual rate of about $2-1/2 billion in the first quarter; they will probably be larger than that during the rest of the year.

(3) The available evidence points toward a further expansion of U.S. military expenditures and economic aid outlays in Asia.

(4) Even with Treasury encouragement, shifts of foreign funds from liquid to nonliquid assets will not continue at the April-May rate of some $200 million a month.

(5) The reflow of U.S. bank credit may not be sustained at the $1 billion annual rate that has prevailed since last fall, at least not without a further substantial tightening of domestic credit conditions. The recent sharp tightening of credit in several foreign countries, reported in the green book, makes a relative tightening in the United States more difficult to achieve.

If all that were at stake was another one-year setback in our progress toward payments equilibrium--this time attributable mainly to a war that will someday end and a boom that is sure to fade--one might hope to ride it out with equanimity. One could take comfort in the fact that some other leading countries have also been experiencing accelerated inflation. Also, reserves are now accruing more to the developing countries and less to the traditional gold-buying countries (although sometimes developing countries also buy gold). Further U.S. recourse to the International Monetary Fund could limit our gold losses for a time, as it has during the past year, permitting other countries to exchange unwanted dollars for claims on the IMF instead of for gold.

But, unfortunately, much more than a one-year setback is likely to be at stake. If, as seems possible, we are now seeing the beginning of a domestic price-wage spiral that could gather momentum right into the next recession, as happened in the late 1950's, and if some other leading countries are about to be successful in slowing down their inflations, also as in the late 1950's, then we may be risking a ten-year setback rather than a one-year setback. It is unlikely that we shall be allowed to repeat the gradual, one-decade approach to payments adjustment. We would be starting this time from a much weaker reserve position than in 1957, and against a long background of doubt and disappointment.

It seems to me that the risk of a lasting setback on the payments front is very much more serious than the opposite risk of stepping a little too hard on the brake.

Chairman Martin reported briefly on the recent meeting of the American Bankers Association in Madrid, which he had attended along with Messrs. Bopp, Daane, and Hayes. The meeting was the ABA's thirteenth Monetary Conference. About 125 people had attended, including about 30--a larger than usual number--from foreign countries.

There was an underlying note of concern at the meeting of a kind that he had not seen for some time, the Chairman remarked. The concern was hinged on the belief that the balance of payments problem of the U.S. was out of hand. A number of foreigners had commented during the course of the meeting about the necessity for increasing the gold holdings of their countries and reducing their dollar holdings. While it would not be right to say there was any real distrust of the dollar in Europe as yet, the seeds of such distrust were there. And the latest sterling developments might well have been forecast from the discussions at the meeting.

One competent commentator had remarked, Chairman Martin said, that America's present problem in Vietnam was analogous to France's problem in Algeria; despite French claims that the Algerian hostilities were not a real war, they eventually led to the devaluation of the franc. The Chairman did not think the analogy was necessarily an accurate one, but it pointed up European apprehensions about the U.S. situation. Those apprehensions should be borne in mind because they could lead to serious consequences unless some means was found for dealing with inflationary pressures in the U.S. It was possible that the crest of the domestic boom had been passed, although he personally was not ready to pass a judgment on that question. But the interesting point was that virtually all of the Europeans who had been through a similar experience were convinced that whatever pause was occurring in the economy now was just a prelude to another strong upswing. Also to be borne in mind was the possibility of real financial pressures developing over the next several months.

In response to an inquiry by Chairman Martin, Mr. Daane said he had nothing to add regarding the Madrid meeting. He thought the Chairman's report reflected accurately the feeling of pessimism in Europe regarding U.S. efforts to resolve its balance of payments problem.

The Chairman then invited Mr. Daane to comment on the Rome meeting of the Deputies of the Group of Ten that had been held prior to the ABA meeting in Madrid.

Mr. Daane noted that the Deputies had met in Rome on May 17, 18, and 19. The meeting was held against the background of a rather sharp exchange of views, which had been reported in the press, between Chairman Emminger of the Deputies and Mr. Schweitzer of the International Monetary Fund. Mr. Schweitzer had charged publicly that the Group of Ten was dragging its feet on the whole question of international monetary reform. Also, he had scathingly compared the proposal for a set-aside, for the use of countries outside the Group, of any new reserve assets created to the outmoded "separate but equal" accommodations treatment of minority groups in the U.S. In his reply Chairman Emminger had emphasized that, because the Deputies were engaged on a long-run task, the difference of a few months one way or the other in completing their preparatory work was not of great importance. With respect to the "separate but equal" charge, he observed that the ten countries of the Group would always have to bear the main responsibility and financial burden involved in the functioning of the system.

Mr. Daane noted that Chairman Emminger had prepared a draft report, organized into five chapters, for the consideration of the Deputies. The introductory chapter referred to the need for a better balance of payments adjustment mechanism, the instability in the present system related to shifts in composition of reserve assets, and the probable inadequacy of gold for future reserve needs. The flavor of the introduction was that there was no general shortage of international liquidity now but that it was the consensus of the Group that there was likely to be a problem in the future. The introduction also referred to the role played and the contribution made by short-term credit facilities, and to their potential for further development.

The second chapter dealt with possible improvements in the international payments system, Mr. Daane said. It included considerable discussion of the need for strengthening the process of multilateral surveillance to bring about better adjustments, perhaps even going as far as suggesting review and coordination of national reserve policies. Chapter 3 dealt with the elements of various proposals for the creation of reserve assets. There was little discussion of the first three chapters at the Rome meeting.

Chapter 4, Mr. Daane continued, involved an attempt to get away from a simple cataloguing of views on individual elements of various proposals and to put forward the most desirable "package plan" or plans. Most of the attention at the meeting was centered on a draft of chapter 4 prepared by the British delegation in an effort to get the Group to coalesce around a proposal for a reserve unit for the limited group, setting aside for future discussion appropriate provision for other members of the IMF. While the British proposal would retain the principle that an expansible inner group would have responsibility for insuring the acceptability of the new reserve units, it would permit units to be issued to nonparticipating countries. On the unresolved issue of acceptability the proposal provided for a compromise involving upper and lower holding limits. If a country accumulated new units above an upper holding limit it could convert them, 100 per cent, into gold. Transfer of units below the lower limit would be at a ratio to either gold or dollars. Thus, the proposal contained some of the acceptability elements of both the U.S. proposal and that of Chairman Emminger.

The Group did not coalesce around the British proposal, Mr. Daane remarked. The French took their usual position that there was no need to do anything at present, particularly in view of the continuing U.S. balance of payments deficit. The U.S.

delegates demurred on the grounds that they still preferred their own "dual" proposal, which included provisions for drawing rights as well as new reserve units. The conclusion was that chapter 4 would still leave open the options of going toward drawing rights, new units, or some combination of the two. The European view now involves new units for the limited group and possible drawing rights for others, while the U.S. proposal involves drawing rights for everyone. The issue of universality was definitely in the minds of the Deputies as well as of the people at the IMF.

There was some discussion also of the form and content of chapter 5 on Conclusions and Recommendations, Mr. Daane observed. An understanding was reached that a new draft of this Conclusions chapter would be prepared by Chairman Emminger on the basis of suggestions sent in to him before the next meeting of the Group, scheduled for Frankfurt, Germany, June 21-24, 1966.

The other question discussed, Mr. Daane reported, was how and when to move ahead into the second stage. His personal view was that the U.S. balance of payments picture might well affect the willingness of the Europeans to take that step. The U.S. had proposed moving into a second stage involving an Advisory Committee of Ministers and Governors in the Fund, with about 38 Ministers and Governors to cover the whole Fund membership. He understood that in Fund Board discussions subsequent to the Group of Ten meeting the IMF Executive Directors had resisted that idea.

He might note one other point, Mr. Daane said, that might have partly reflected the effects of the current U.S. balance of payments position. When the Deputies turned to chapter 3, dealing with elements of reserve asset creation, the discussion brought out clearly the considerable interest on the part of the continental Europeans in establishing preconditions, both procedural and substantive, that would prevent early or excessive activation of machinery set up to create reserves. In that respect they were moving in the direction of the French position. Among the suggestions made for preconditions for activation were a rule of unanimity, an initial date not earlier than 1970, or a two-year period in which there were no net additions to world gold stocks. In addition, the Europeans talked about setting up some qualitative criteria that would very rigidly limit the amount of reserves created. The restrictive flavor of the discussion of activation was similar to that evident in the questioning of the desirability of moving into the second stage and in the repeated emphasis on the need for tighter multilateral surveillance.

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:

Business activity continues strong. The demand for autos is less intense than earlier, but it is too soon to say whether this is more than a temporary dip. More striking are the indications that capital spending plans continue to be very strong--despite moral suasion, tighter credit, shortages of labor, and slower deliveries. A rapidly growing aggregate demand for goods and services continues to press on the limitations imposed by more slowly growing capacity.

The most recent survey of consumers' buying intentions shows no significant change; while consumers have reduced their automobile buying plans from the very high level of the previous survey, their buying plans still are at the high level of a year ago. On the price front, nonfood prices--at both wholesale and retail--moved sharply higher in April. The highly tentative May figures indicate that industrial wholesale prices have held about constant. There has perhaps been some reduction in inflationary psychology, but the inflationary pressure of demand on resources continues to be present.

The balance of payments outlook is unsatisfactory, and the prospects are gloomy. The annual rate of the deficit for the first quarter of 1966 was much greater than the deficit for the year 1965. The trade balance has deteriorated and could deteriorate a good deal more unless inflationary forces at home are checked. There appears to be little prospect of any significant reduction in direct investment outflows, and the tourist gap is likely to widen. The Vietnam conflict promises to be a continuing drain. It seems probable that there will be a substantial increase in the balance of payments deficit for 1966 as compared with 1965. Success in the Treasury's effort to induce a further shift of foreign official and international funds out of liquid dollar instruments into nonliquid assets will serve merely to improve the balance of payments statistics. The worsening of our balance of payments could undermine foreign confidence in the ability and determination of the United States to rectify its balance of payments problem; and attempts at window-dressing are not likely to help the situation.

Bank credit growth slowed in May. The rise so far this year is still very substantial, though less so than in 1965. In April the loss of funds at thrift institutions was large. The mortgage market is very tight. But so far the effects on residential construction activity have not been great. Bank liquidity has dropped further as banks have continued to liquidate U.S. Government securities. The demand for business loans continues strong. There is concern about financial strains that may occur at the June tax payment date and at the end of the first half of the year when thrift institutions will be crediting interest on savings accounts.

The present situation calls for coordinated restraint by fiscal policy and monetary policy. Monetary policy has been working. The big policy issue, it seems to me, continues to be fiscal policy. The Federal Government is still providing a considerable fiscal stimulus in a setting marked by excess demand. It seems to me that the prompt announcement and enactment of a program for a simple increase in Federal individual and corporate income taxes would help to reduce the inflationary pressures and to promote the maintenance of an orderly and balanced economy now, thus contributing over the long run to sustainable economic growth and the expansion of employment. More fiscal restraint would, of course, lessen the need to place too great an anti-inflationary burden on monetary policy, and would reduce the inevitable pressure on interest rates.

Continuing monetary restraint is called for. With interest rates on time deposits pressing closer to Regulation Q ceilings, with the recent advance in several money market interest rates, and with a generally taut tone in the money market, there is not much room for increasing the pressure on bank reserve positions without endangering the current viability of the discount rate and Regulation Q ceilings. It seems to me that it would be desirable to maintain as much restraint as is feasible without creating strong expectations of a change in the discount rate. Such a course would involve continued firm conditions in the money market and continued pressure on bank reserve positions, with net borrowed reserves perhaps in the $350-$400 million range.

Alternative A of the draft directives prepared by the staff with the proviso clause would seem to fit the prescription I have in mind. The proviso clause constitutes a fitting reminder in the directive of the basic thrust of policy. Under the proviso, we should move toward lesser reserve availability and firmer money market conditions if bank credit expands more rapidly than expected. Yet the Manager should not be expected to react automatically to purely statistical short-range changes in required reserves. With the stresses of the tax date and the approaching interest payment date for thrift institutions, a further increase in restraint under the proviso clause should be approached with caution.

I will now comment on member bank borrowing in the Second Federal Reserve District.[1/]

As regards borrowing by country banks, the System's program of monetary restraint is now finally reaching down into the country banks, and beginning to bite. The country banks, like the reserve city banks, are faced with a continuing heavy demand for loans, which they have met and are continuing to meet through whatever means are available. Traditionally, country banks have maintained an excess of reserves over borrowings or a net free reserve position. Since the middle of March, however, country banks have been showing a net borrowed reserve position. Since large correspondent banks are no longer in a position to meet the needs of the country banks, the country banks are relying more and more on the discount window to avoid

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1/ In transmitting the agenda for this meeting the Secretary of the Committee had indicated that "interest has been expressed in hearing any comments the Presidents might care to make concerning the factors underlying the recent substantial increase in country bank borrowing at the Federal Reserve Banks, and whether any banks borrowing at the discount window were also selling Federal funds to others during the same period."

liquidating securities, in the face of continuing high loan demand. As our discount window policy begins to be applied to these borrowings, a restrictive effect upon expansion of credit by country member banks should follow.

As regards banks borrowing at the discount window and selling Federal funds to others, we have taken the position that the large correspondent banks who are acting as dealers in Federal funds should not borrow from the discount window during any reserve period in which they are net sellers of Federal funds. Recognizing the fact that in order to maintain a market in Federal funds these banks must be sellers of Federal funds as well as purchasers, we have not considered borrowing inappropriate as long as the bank was a net purchaser of Federal funds. On only three occasions (one country bank and two city banks) were banks borrowers at the discount window and net sellers of Federal funds in the same reserve period. We satisfied ourselves in each instance by direct contact that the situation was inadvertent and not for the purpose of obtaining a rate differential. In none of the three cases has the practice been repeated. We have seen no instance of a net sale of Federal funds by a bank which has borrowed from us with the objective of gaining the benefit of a rate differential.

There is still another matter in which I think the Committee would be interested. It concerns the problem of possible withdrawals from savings banks at midyear.

Yesterday the President of the Savings Banks Trust Company, which serves as a kind of central bank for the mutual savings banks of New York State, and the Presidents of three of the large New York City savings banks called at the Federal Reserve Bank of New York to discuss a possible savings bank crisis in July. At the end of the first quarter of 1966 the savings banks of New York State experienced rather large withdrawals; they fear even larger withdrawals at midyear. The savings banks are comparatively illiquid, with limited access to commercial bank credit and the capital markets. Emergency sales of their holdings of U.S. Government securities and agency securities would not only bring them substantial losses but could disrupt the U.S. Government securities market.

While they do not predict a crisis, they think that a crisis is possible unless there are alternative means for prompt relief, possibly through the Federal Reserve System, in the event of the withdrawal from the savings banks of several hundred million dollars in a couple of days. A crisis for the savings banks would, of course, have adverse repercussions on the entire banking and financial system.

There was a discussion of the possibility of setting up a mechanism whereby the Federal Reserve System could provide relief, if needed, to avoid a crisis. For example, to the extent that the larger savings banks in New York City have available for pledge direct obligations of the United States, such banks might, after exhausting their normal borrowing facilities, borrow from the Federal Reserve Bank of New York on the security of those obligations, pursuant to the thirteenth paragraph of Section 13 of the Federal Reserve Act. If additional borrowings from the Federal Reserve Bank become necessary on the part of those banks or any other New York State savings banks whose needs cannot be satisfied by the Savings Banks Trust Company, an arrangement might be made whereby a member bank in New York City could act as a medium or agent for the Savings Banks Trust Company in borrowing from the Federal Reserve Bank of New York, it being contemplated that the collateral would not qualify for use in connection with advances under Section 13, but rather under Section 10(b), of the Federal Reserve Act. Permission of the Board of Governors would, of course, be necessary for such a borrowing under the ninth paragraph of Section 19 of the Federal Reserve Act and Section 201.5 of Regulation A.

The savings bank representatives agreed to furnish us promptly with a memorandum outlining the problem and possible solutions, to the end that another meeting be held and further discussions had within the next ten days. Stress was placed on the desirability of setting up the machinery for handling the problem as far in advance as possible, and also of having the operating rules clearly understood by all, as soon as the way is open. We indicated a generally sympathetic attitude toward the savings banks' problem, and will be working closely with them and the Superintendent of Banks of New York. As soon as we receive the memorandum we will be discussing the subject further with the Board of Governors.

Last week we met with the President of the Federal Home Loan Bank of New York. He was not alarmed about the savings and loan situation in his district. The Federal Home Loan Bank of New York is prepared to provide financial assistance to associations to help them meet any unusual withdrawals that may arise at midyear. From the supervisor's viewpoint he saw much to be gained in the current experience; higher standards of lending and operations are being promoted.

Mr. Ellis reported that the basic posture of the First District economy continued to be one of firm pressure against available resources. With factory output rising, with capital expenditures rising, with construction activity rising and jobs seeking workers, more attention was being directed toward the financial reflection of such pressures and their immediate outlook.

In construction, Mr. Ellis said, new contracts during the first four months of this year were 43 per cent above year-ago levels. Nonresidential building contracts in April registered a 45 per cent year-to-year gain. Residential contracts posted a 47 per cent gain, mostly due to a sharp rise in apartment buildings. In partial reflection of those trends, real estate loans of the District's weekly reporting member banks stood 12 per cent higher than a year ago, and in late May were increasing at a 10 per cent annual rate. It seemed fair to conclude that financing had been available in New England.

There was some evidence, Mr. Ellis continued, that the first quarter brought a rush of loan commitments that would require a period of digestion. At least one insurance company reported that during the first quarter it committed all the funds it expected to have available during 1966. A period of reduced loan commitments also faced the mutual savings banks--considered as a group. While some individual banks still had funds to invest out of State at net yields of 6 per cent or better, others found their slight dip in deposits during April brought their loan-deposit ratios up to or even above the 85 per cent legal loan limit in Massachusetts. If presently scheduled deposit withdrawal notifications for July materialized in historical patterns, several more of the mutuals would be pushed above their loan ceilings, and would be under the same kind of pressure as Mr. Treiber had indicated was possible in New York. The mutuals had been "refreshing" their loan commitments for member banks.

Mr. Ellis went on to say that the Boston Reserve Bank's May 11 survey of time deposits at New England member banks provided evidence of continued efforts to attract time and savings deposits. One-quarter of the member banks now issued non-negotiable CD's, and their outstanding volume had increased 15 per cent since December. A full third issued negotiable CD's in denominations of less than $100,000 and had lifted the outstanding level by 25 per cent since December.

Along with their 23 per cent year-to-year gain in total savings deposits (and 2 per cent gain in demand deposits), weekly reporting member banks in New England had found increasing difficulty in meeting their reserve requirements. In the three statement weeks ending last Wednesday (June 1), the banks were borrowing on average four times more than a year ago. The green book indicated that "the factors occasioning the recent sharp increase in borrowing by country banks . . . are not completely clear." In the First District's case, the number of country banks borrowing had doubled in the past three weeks. As the large correspondent banks drew near the acceptable limits of their borrowing at the Federal Reserve Bank they had curtailed their willingness to provide Federal funds on call of their small correspondent banks, who in turn showed up at the discount window.

The Boston Bank had reviewed the borrowing and Federal funds activities of those banks making daily reports to it, Mr. Ellis said. Having regard to the fact that the funds sales and Reserve Bank borrowings occurred at different times in a reserve period, no convincing evidence was found of banks making a deliberate policy of borrowing at the discount window to sell Federal funds. Borrowing seemed directly related to the basic factors of peak seasonal deposit and loan pressures superimposed on cyclical conditions of strong loan demand and tightening monetary policy.

About the same words came to his mind, Mr. Ellis said, in appraising the national scene. Concern seemed greatest in the financial reflections of a surging economy. Capital investment was surging ahead in spite of the Presidential plea. Vietnam impacts were showing up ever more broadly as the effects of defense spending were imposed on top of business and consumer demands. However slight its real effect on release of the pressures on resources, he was inclined to regard the cutback in auto production as a welcome relief from a prevalence of excesses.

Starting with the premise that the strong upward thrust of the economy was continuing, as he did, Mr. Ellis continued, it remained a critical but still unresolved issue as to whether a tax increase might be forthcoming. Facing that uncertainty, the major alternatives of monetary policy lay in holding the present degree of tightness or continuing to move gradually in firming further. While reluctant to lose momentum, he was persuaded that it was time for a pause in the tightening process. Three factors predominated in his conclusion: first, the projected tightness in money markets in June and early July as corporations had to meet accelerated tax payments out of reduced liquidity; second, the exposed position of savings institutions having deposit losses and July dividend payments while the Government enlarged its enticements for savers' funds by issue of attractively priced participations; and third, recent moves in policy that added another degree of tightness in a market increasingly affected by cumulative effects of past tightening.

Those factors persuaded him, Mr. Ellis said, to urge a pause in which further tightening would be foregone to allow the markets to work their way through present difficulties and to allow the Committee another assessment of what it could accomplish by further moves. Those views led him to select alternative A of the second paragraph of the draft directive, with the proviso clause included in order to forestall loss of ground. As to the first paragraph, he would prefer to substitute the word "the" for "our" in the references to the U.S. foreign trade surplus and the deficit in international payments.

Mr. Irons reported that conditions in the Eleventh District continued strong. There was, perhaps, some slight moderation as a result of developments in housing and automobiles, as was the case nationally. On the other hand, employment, production, and distribution (as reflected by department store sales) had continued to show steady increases, with indications of further moderate increases in the months ahead. Employment had been rising at a rate of about one per cent a month. The advance was rather general and the total had reached a new record. Production in the District was up about 0.8 per cent in the past month, with increases outnumbering declines in about a two-to-one ratio. Construction contracts were down; cumulatively, for the year to date, they were about 6 per cent below the same period a year ago. Department store sales were running seven to eight per cent over a year ago and were continuing to show strength. For the first time in a long while, however, there had been a slight decline in new car registrations. The agricultural situation was quite favorable. Moisture conditions were generally good, although there were some spotty areas, and the livestock conditions were good. Cash farm receipts in the first quarter were 22 per cent above a year ago, with livestock accounting for about 30 per cent of the rise and crops the remainder.

In the financial area, Mr. Irons continued, bankers continued to talk about the lack of liquidity and the strength of loan demand, although loans in total and in most individual categories declined in the period and were running below the same period a year ago. Investments showed a slight decrease as holdings of Governments were reduced and other securities were acquired at a low rate. As in the preceding period both time and demand deposits declined, but negotiable CD's advanced to a record level for the District. Federal funds purchases were down a bit but still exceeded sales.

Both the number of member banks borrowing at the discount window and the amount of borrowings had shown increases, Mr. Irons said. In reviewing recent discount window activity he had found that two reserve city banks borrowing from the Reserve Bank sold Federal funds in the same period. That was not a regular practice, however; the banks in question happened to be caught with surplus funds at the end of the period. He believed that some of the District's small country banks, although not a great many as yet, probably were coming to the discount window because their city correspondents were suggesting that conditions were tighter. Three or four of the banks that had come to the window in the last few weeks had not borrowed from the Reserve Bank for several years, and he suspected that they were giving their correspondents a breathing spell. Still, the number of banks borrowing and the total volume of borrowings in the District were not large; in the week ending June 1, 17 country banks and one reserve city bank were at the window for a total of $18 million.

In trying to trace the reasons for country bank borrowings, Mr. Irons continued, he found that seasonal agricultural demands were a contributing factor, and were likely to continue to be so. There was no evidence that the small banks were dealing in Federal funds one way or the other. He did not find the increase in discounting activity to pose a particularly difficult problem, and in some respects it was desirable for a few more banks that had not borrowed in some time to come to the window. The present level of discounting reflected a combination of seasonal, cyclical, and money market considerations, and he saw no evidence of efforts to arbitrage interest rate differentials.

Mr. Irons commented that the national economic situation had already been discussed fully, and all members were aware of the balance of payments problem. With respect to policy, his position was quite close to that taken by Mr. Ellis. The next three or four weeks would be a period of rather intense uncertainties and severe pressures in the money market. The Committee had made reserves less readily available and had contributed to the rise in market interest rates. It was not possible to say what lay ahead, but the Committee had achieved a considerable bite with its recent policy actions. At this time, he thought, caution would be prudent. He would like to see net reserve availability not deepened further but held at about its recent level. He did not believe that the Committee could strain the existing position much further without giving rise to pressures for action with respect to the discount rate and Regulation Q ceilings. He agreed that coordination of fiscal and monetary policies would be desirable to relieve financial pressures, but he saw no indications that fiscal policy action would be taken.

Mr. Irons favored alternative A of the draft directives which, he noted, called for maintaining net reserve availability and related money market conditions in about their recent ranges. He would interpret that language to call for net borrowed reserves of around $350 million. While he did not feel strongly on the matter, he would prefer to omit the parenthetical clause in the staff's draft.

Mr. Daane left the meeting during the course of Mr. Irons' remarks.

Mr. Swan reported that in April the unemployment rate in the Twelfth District had declined again, to 4.3 from 4.5 per cent, to a considerable extent as a result of another substantial increase in aerospace employment. Retail sales continued to do less well than in the rest of the country and, of course, residential construction was weak. Lumber prices declined in mid-May following a further decline in orders; Government purchases were off and it had become evident that new labor contracts would be negotiated without strikes. District agriculture seemed to be in good shape, although the annual question of the availability of labor for the summer and fall was again being raised. The first authorization for Mexican labor, issued in May, called for 1,000 workers to be brought in for the strawberry harvest. In that connection, it was interesting to note that strawberry plantings were up sharply in Mexico this year. During the first quarter of 1966 imports of fresh strawberries from Mexico were double those of a year ago and frozen strawberry imports were up about one-third.

Mr. Swan said he would not take the time to review recent developments with respect to the mortgage market and nonbank savings institutions in the District because they had been covered in his Bank's report on the recent special survey.[1/] He would add only that the figures the Reserve Bank had obtained for the first ten days of May indicated a further loss in the share accounts of California State-chartered savings and loan associations, which accounted for about 70 per cent of total share accounts in the

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1/ A report entitled "Current Mortgage Market Conditions as Reported in Special Surveys by the Federal Reserve Banks" had been distributed to the Committee prior to this meeting in the form of a special supplemental appendix to the report, "Current Economic and Financial Conditions."

State. The decrease amounted to $28 million, much less than the loss in the corresponding period in April. While the decline was far from welcome and there still was a good deal of concern about what might happen in early July, there was some feeling of relief that it was not larger.

Mr. Swan went on to say that the Home Loan Bank Board's recent ruling raised to 5 per cent the rate that California savings and loan associations could pay on share accounts without having their borrowing privileges at the Bank restricted. That ruling was followed by widespread announcements by the associations not already paying 5 per cent that they would begin doing so on July 1. The associations that had gone to 5 per cent in April came out much better in terms of changes in their share accounts than others, although it was not clear whether their experience reflected the higher rate or their greater strength. There naturally was some hope on the part of other associations that 5 per cent would prove to be a viable rate.

Savings deposits at weekly reporting member banks continued to decline in May, Mr. Swan said, although the decrease in that case also was much less than in April. Other time deposits of individuals, partnerships, and corporations rose substantially more than savings accounts declined. The net growth in total time and savings deposits in May was somewhat greater than in April, although both gross amounts were considerably smaller. The District's larger banks finally appeared as net interbank purchasers of Federal funds for two weeks in May, although the amounts involved were not large. In the other weeks of the month they were net sellers, as they had been previously, but in relatively small amounts.

In checking on the questions that had been raised regarding borrowing banks, Mr. Swan continued, he had not learned of any such banks in the District that also were net sellers of Federal funds in the same period. Some borrowers had operated on both sides of the funds market, but that was not a concern as long as they were not net sellers. Borrowings by country banks were somewhat higher in May than in April, and they also were higher in the two weeks ending June 1 than in the first half of May; but the total still was not large. The week ending June 1 saw a larger number of country banks borrowing than any other recent week, but that number was only five, and those country banks accounted for only 20 per cent of total borrowings from the Reserve Bank in the week. It was difficult to find any common thread in their reasons for borrowing. In the past month there had been two cases resulting from agricultural developments, such as delays in harvesting, and one or two cases reflecting unexpected losses of public deposits. Two of the five country banks were large institutions whose positions were not markedly different from those of the large reserve city banks.

Turning to monetary policy, Mr. Swan said that national developments since the last meeting of the Committee seemed to be about in line with what had been anticipated. He gathered from Mr. Holmes' remarks that despite problems of measurement operations had worked out rather well under a directive that referred to aggregate reserves as well as to net reserve availability. He found it was not easy to reach a conclusion regarding policy for the period ahead. The balance of payments situation was serious; indeed, if that were the only consideration before the Committee it probably would call not for gradual tightening but rather for overt action that would affect attitudes abroad. However, in light of the domestic situation--the uncertainties in credit markets, the seasonal needs, the problems facing savings institutions, and so forth--he came out about about where Mr. Irons had, with the feeling that the Committee should avoid any further tightening, at least until its next meeting. He would accept alternative A of the draft directives and would definitely include the parenthetical phrase. He thought the Committee should continue to recognize the aggregate reserve question even though there was some problem of measurement, and that it should refer to the seasonally expected change despite the problem of definition. He agreed with Mr. Treiber on the need for caution in applying more restraint under the proviso clause, and he would favor a rather liberal interpretation of seasonal changes. It was necessary, he thought, to meet the additional demands that were expected in the next few weeks.

Mr. Galusha said that except for developments in the Ninth District mortgage market, on which a report had been distributed, there were no District developments of such interest as to require being reported at this time.

As to country bank borrowing, Mr. Galusha said there appeared to be nothing unusual going on in the District. The volume of such borrowing was considerably higher in May of this year than in May of last year, and quite a bit higher than in April. But the increase from April to May was just about what the established seasonal pattern would have led one to expect. If anything, Ninth District country bank borrowing was surprisingly low in May, for the loss in total deposits was much greater than seasonal. Nor had any evidence been found that during May District country banks, whether in debt to the Reserve Bank or not, entered the funds market on the selling side. The country banks had not yet become generally active in the funds market.

Mr. Galusha mentioned that the Reserve Bank's recent effort to dissuade a few of the city banks from using the discount window as much as they had been was crowned with considerable success. Those banks which were, by the Reserve Bank's standards, being a bit too free with discount credit had stopped being so.

Turning to open market policy, Mr. Galusha said it appeared to him that the Committee could do no better for the present than to aim at maintaining the status quo in money and credit markets. In his judgment, the objective from now until the next meeting should be to hold short-term rates about where they had been lately, on average, and not pay too much attention to the level of the bill rate, to net borrowed reserves, or, for that matter, to aggregate reserves or bank credit. Fortunately, a holding action against pronounced changes in the complex of short-term rates should not involve sharp deviations from recent average values for the bill rate or the level of net borrowed reserves. Medium- and long-term rates could well move somewhat higher, but that would not seem to be an implication from which the Committee ought to shrink.

Mr. Galusha noted the concern about the upcoming tax date and, more important, the implications of generally and markedly higher interest rates for nonbank intermediaries and the residential construction industry. In his opinion, the need for further monetary restraint, as measured by purely economic criteria, had not lessened. GNP, as valued in current prices, would undoubtedly increase a good deal less this quarter than it had in the last two, but at the moment the expectation must be for a return, whether in the next quarter or in the fourth quarter, to unsustainably large increases. Even if the likelihood of a rebound in auto sales were to decrease and the likelihood of the worst fears about residential construction being realized were to increase, there would still be the twin problems of a clearly unsustainable pattern of investment demand and sectoral inflation. He observed, in that connection, that the upcoming Governmental sale of financial assets could hardly be thought of as making the Committee's task easier.

For unsustainably high investment demand, greater monetary restraint was an obvious solution, Mr. Galusha continued. It could not be an inviting one, however, nor even a realistic one, until ways of lessening the effects on nonbank intermediaries and the residential construction industry were found. The System could therefore do worse than to lead the search for such ways. He did not know what answers there might be, but there was a legitimacy and urgency in the questioning.

Mr. Galusha favored alternative A of the draft directives. But in opting for that alternative, he was assuming that the emphasis over the period until the Committee's next meeting would be on money market conditions. He objected to the proviso because it presented, it seemed to him, an unreasonable restraint on the Desk because so many things could happen that would have effects on required reserves.

Mr. Scanlon reported that with the exception of passenger cars, output of all major Seventh District industries either increased further in May or held at the high levels of earlier months. While fears of accelerating inflation appeared to have been dampened somewhat in recent weeks, no significant apprehension was detected among observers in the Seventh District concerning a possible early end to the current boom. Automobile people were projecting auto assemblies for the calendar year 1966 at 8.7 million, 7 per cent less than in 1965 but substantially more than in any previous year. They pointed out that the figure was close to projections made last fall shortly after the 1966 models were introduced. Truck production was still pressed to capacity, and June output was expected to reach a new high of 175,000 units.

Promised delivery times on most types of flat-rolled steel products had been reduced sharply, Mr. Scanlon noted, mainly because of curtailed requirements of auto firms. As yet, there was no indication of reduced shipments of steel to other users. For the year as a whole, local steel experts estimated total ingot tonnage at a record 134 million tons, with output in the four quarters as follows: 33, 35, 32, and 35 million tons. Additional finishing capacity should ease supply schedules further by year-end, assuming that sufficient workers were available.

Labor markets in the Seventh District evidently tightened further in the second quarter, and it was apparent that heavy demands for labor were strengthening the hands of unions in negotiations with management. It was said that fear of a wage freeze was often given as one reason for the higher labor demands. In the construction trades, recent three-year contracts called for 30 to 40 cents per hour additional each year in wages and fringe benefits, and some contracts were for even longer terms, with annual wage increments.

The Chicago Reserve Bank's recent survey, Mr. Scanlon said, indicated sharp cutbacks in most areas in new commitments for mortgages on both residential and nonresidential properties, as was the case in other Districts. However, demand for construction in the Seventh District was very strong. While housing permits were off sharply in April in the north central region, that was caused, in part at least, by strikes and unusually heavy rainfall. The availability of labor and of materials such as copper and brass conduits and fittings, plywood, and some aluminum products, as well as the availability and cost of funds, would largely determine the level of construction activity in the Seventh District this summer. Several of the major savings and loan associations in the Chicago area had boosted loan rates, effective this week, with the "standard" single family mortgage now limited to 20 years, with a [illegible]5 per cent downpayment and a contract interest rate of 6-1/4 per cent.

In that connection, Mr. Scanlon commented that while savings and loan associations in the Chicago area had generally indicated sharp cutbacks in forward commitments for mortgage funds, the reason for the cutbacks was not illiquidity in all cases. For example, the head of one of the largest associations in the middle west said that while his association had funds to lend to qualified borrowers it had cut back forward commitments more than 25 per cent because, with all the talk and press comment about what was going to happen July 1, he wanted to build up substantial liquidity so he could operate on his own resources under the most severe conditions foreseeable at this time. The savings and loan executive mentioned particularly that he could not be certain what help would be forthcoming from the Federal Home Loan Bank, so he wanted to play it safe.

Turning to weekly reporting banks, Mr. Scanlon reported that loans to manufacturing firms had been rising strongly while new loans to trade establishments and finance companies had not kept pace with repayments. He found no evidence to date of significant slowing in either real estate or consumer loans. The weekly reporting banks continued to liquidate Governments during most of May, though at a moderate pace, but they acquired a relatively large amount of other securities, probably agencies.

Through mid-May, Mr. Scanlon continued, the smaller banks in the District continued to show more rapid loan growth and faster liquidation of Governments than the weekly reporters. Borrowing at the discount window in recent weeks had been largely by country banks, and the number of such banks seeking accommodation had risen to a new high. It was understood that some country member banks were being encouraged by their city correspondents to use the discount window in preference to their correspondent. The Reserve Bank knew of one correspondent bank that loaned to nonmembers at the discount rate but charged the prime rate to member banks. It was not aware of any unusual amount of downstream participation of loans.

The recent survey of time deposits had confirmed the long-standing practice of many small banks in the Seventh District to use time certificates of deposit as well as passbook savings as vehicles for acquiring deposits. In Iowa, for example, 44 per cent of total time deposits were in certificates, and only a negligible amount ($3 million) were negotiable certificates of $100,000 or more.

Aggressive postures on interest rates were revealed by relatively few banks, Mr. Scanlon said. Only 38 per cent of District member banks paid as much as 4 per cent on savings deposits, only 11 per cent paid in excess of 4-1/2 per cent on time certificates of deposit and open account time deposits, only

4 per cent paid in excess of 4-1/2 per cent on savings certificates, and only 2 per cent paid in excess of 4-1/2 per cent on other nonnegotiable certificates. Excluding negotiable CD's of $100,000 or more, only 8 per cent of the District member banks paid more than 4-1/2 per cent on any type of time deposit. Slightly more than half the member banks--532--paid 4-1/2 per cent on some kind of time deposit, excluding large negotiable CD's.

Reserve positions of the money market banks in the Seventh District still were not showing strong pressure, although they were less easy than a month ago. The amount of their CD's maturing in June was smaller than in March. Judging by past experience, those banks appeared in a position to meet any reasonable volume of credit demands in the period just ahead.

As to policy, it appeared desirable to Mr. Scanlon to limit monetary and credit expansion to not much more than normal seasonal growth. If such expansion became inconsistent with the existing rate of net reserve availability, he would like to see some further reduction in the latter. He realized that the Committee did not have a great deal of elbow room, and he certainly would not want to move overtly, but he believed, if staff projections were correct, that the Committee must continue gradually to exercise more restraint. While he could accept alternative A, with the proviso, he believed alternative B of the draft directives best suited the objectives for which he would strive.

Mr. Clay commented that some sectors of the economy, principally automobiles and housing, had slackened their pace somewhat. At the same time, the over-all level of economic activity was increasing at such a rate that the growth in aggregate demand for goods and services pressed hard on the economy's resources and capacity to produce. As a reflection of those developments, nonagricultural prices continued their upward movement at the more rapid rate of recent months.

The future pattern of economic activity could not be known with certainty, Mr. Clay observed, particularly without full knowledge of the course of defense expenditures. What was known about probable economic developments, however, suggested that the pressure of demand on resources and capacity would continue and that price inflation would also remain a problem. Under the circumstances, monetary policy should continue to apply pressure on the commercial banks and the financial markets.

Developments in reserve aggregates and monetary variables during May had placed those measures in a more satisfactory position relative to monetary policy objectives for recent months, Mr. Clay continued. Staff projections indicated a substantial expansion in aggregate financial measures in June. However, forthcoming developments surrounded the period with considerable uncertainty as to financial pressures in view of the large volume of scheduled private and public financing, the tax and dividend requirements in the period, and the problem of the pattern of savings flows in the economy. The uncertainty probably would be intensified if Congress should pass restrictive legislation with respect to time deposits.

Draft directive A appeared to Mr. Clay appropriate for the period ahead, provided a less emphatic word such as "considerably" was substituted for the word "sharply" in the provisional clause. Whether or not specified in the directive itself, it also seemed to him that there should be an interest rate or money market constraint to avoid monetary policy actions that would precipitate a discount rate increase at this time.

Mr. Clay said the Kansas City Reserve Bank did not have evidence that borrowers at the discount window were net sellers of Federal funds. The factor underlying the recent substantial increase in country bank borrowing appeared to be the high demand for agricultural and business credit during a period of tight money. The country banks felt the bite in that situation because (1) they lacked equal access to the CD market, and (2) city correspondent banks were limiting borrowing by their country correspondents and were referring them to the Reserve Bank. A total of 172 banks had borrowed from the Kansas City Bank this year compared to 120 last year. Forty-two of those did not borrow at any time during 1965, and several had never borrowed before from the Federal Reserve. That might be proving that there was some real advantage to System membership.

Mr. Wayne said that the latest information contained rather definite evidence of slower growth in some sectors of Fifth District business. Building permits, curbed by a dwindling supply of mortgage money, dropped in April to the lowest level in nearly a year. In the Richmond Reserve Bank's latest survey, manufacturers' new orders showed virtually no increase for the first time since last July, and the rise in factory shipments was considerably smaller than earlier this year. Backlogs continued high, however, and factory employment, hours, and wages showed further gains. Upward pressure on prices also continued.

Mr. Wayne reported that there had been some rise in country bank borrowings in the Fifth District, although the total thus far remained relatively small. A number of banks had been contacted, but regardless of the reasons they advanced for borrowing it seemed to him that the general pattern of borrowings was one that should be expected in a period of tight money with limited opportunities for obtaining funds. No evidence had been found of banks selling Federal funds during a period in which they were borrowing.

With respect to the comments that had been made regarding savings banks, Mr. Wayne noted that there were a few large savings banks in the Fifth District, in the Baltimore area. Several of them had expressed some concern about possible developments in the period ahead, but thus far none had raised the question of obtaining relief through the Reserve Bank.

In the policy area, Mr. Wayne said, the Committee probably was now in the critical phase of the difficult and delicate task of slowing the present boom to a sustainable pace without reversing the direction of the economy. For that difficult period, he suggested a policy of holding about the present level of reserve availability but with a safeguard to insure against inadvertent increases in reserves, bank credit, and the money supply. He would do that by again gearing the directive to required reserves.

Mr. Wayne noted that excess demand continued to show itself in several places. Unfilled orders for durable goods continued their steady and strong rise. Plans for business investment showed some signs of leveling off but still were too high to be sustained. Those and other inflationary factors should not be discounted, but perhaps with a little more time they would yield to a continuation of present monetary pressures.

Mr. Wayne commented that the directive adopted last time seemed to have worked well, perhaps with the aid of favorable market conditions and good projections. He would like to keep that format and maintain about the same level of reserve availability unless required reserves should rise appreciably. If the latter should happen, a move should be made toward larger net borrowed reserves. Alternative A of the draft directives, with the parenthetical phrase included, expressed a position that seemed appropriate, but he would like to see some reference in the first paragraph to the situation in the mortgage market and its implications for housing. Without some such reference, the first paragraph seemed to support alternative B for the second paragraph rather than A.

Mr. Shepardson commented that while there were indications of a slowdown in some sectors of the economy the general level of activity was still advancing, with heavy pressure of demands against resources, a tight labor market, scarcity of skilled labor in many areas, and a continuing rise in prices. At the same time there were pressures ahead around the tax and dividend dates, concern about the mortgage market, and concern about the effects of a possible excessive shifting of funds among financial intermediaries. Those factors presented somewhat conflicting indications. Mr. Reynolds' report on the balance of payments situation seemed highly significant. Current price developments would have implications for subsequent wage negotiations, and any further deterioration in the price and wage situation could have serious effects on the competitive position of the U.S., on the trade balance, and on the total balance of payments.

Mr. Shepardson thought that those considerations, on ba warranted pursuing a policy of further restraint while avoiding overt action. As he understood the discussion, the Committee st had some leeway available to move toward the $400 million level net borrowed reserves. Mr. Treiber had mentioned moving toward that level within the framework of alternative A of the draft directives. However, it seemed to him (Mr. Shepardson) that such a policy was better described in alternative B, and he preferred that alternative.

Mr. Mitchell said he would make just one remark about borrowings before turning to the language of the directive. It seemed to him that the System was not using the discount rate as a restraint; at present levels of the Federal funds rate the disco rate would have to be raised to 5-1/2 or 6 per cent to offer important restraint, and no one advocated such an increase. Thus, it was up to the Reserve Banks to exercise as much restraint as possible by persuading member banks to turn borrowers away. Denyin discounting facilities to banks that were selling Federal funds was one means of doing so. He hoped the Reserve Banks would continue their efforts to restrain member bank lending and perhaps intensify them, because such efforts might be the only way to avoid an increase in the discount rate, which could prove catastrophic.

Mr. Mitchell agreed with much of what Mr. Wayne had said about the directive. He thought it was important to guard against a repetition of the banking developments of March and April, and he would favor some further reduction in net reserve availability if required reserves expanded significantly more than seasonally expected. Unless that happened, however, he would go along without much further change in net borrowed reserves. He still favored the revision in the first sentence of the directive that he had suggested earlier today, and he agreed that it would be advisable to include a statement about the mortgage market.

Mr. Maisel reported that Mr. Daane, who had withdrawn from the meeting earlier to keep another engagement, had indicated before leaving that he favored alternative A of the draft directives.

On the savings bank matter referred to earlier by Mr. Treiber, Mr. Maisel said he hoped there could be a System approach to the problem, which was an important one.

As to the directive, it seemed to Mr. Maisel that banking developments were now on the right path, and he interpreted alternative A as calling for guarding against leaving that path. Therefore he preferred A. Conditions now with respect to the major monetary variables were just about what the Committee had expected. Over the next month or two the Committee would have to face up to the question of what goals it expected monetary policy to achieve.

In his opinion the goals that some people were setting up were not properly goals of monetary policy; the country could not be run through monetary policy alone.

Mr. Brimmer said he favored alternative A of the drafts for the second paragraph of the directive and would leave open for the time being the question of whether to include the proviso.

Regarding the balance of payments, Mr. Brimmer thought the problems involved were for the most part beyond the reach of monetary policy. Of the five problem areas noted by Mr. Reynolds, there was only one about which the Committee could do much in the near future--it might be able to induce commercial banks to lend less abroad. He detected nothing in the Administration's attitude to indicate that it regarded the previously announced balance of payments target as serious. On the contrary, recent speeches by officials suggested that the Administration had decided to run the risk of further losses of gold in preference to calling for corrective but unpopular measures. He would prefer not to see the Committee try to make up for the lack of Administration responsiveness to the balance of payments problem. Thus, unlike Mr. Shepardson, he thought that the deterioration in the U.S. balance of payments position was not a good reason for a further tightening of policy.

With respect to the domestic scene, Mr. Brimmer expressed particular interest in Mr. Brill's opening remark reporting Mr. Noyes' advice not to let the Committee overstay a tight policy. The present was a particularly troublesome time for forecasters. The evidence was mixed, and while he personally believed that the economy was in for another upswing, he was not certain of his judgment. Given the lags in the available data, the Committee might fail to recognize quickly a weakening in the underpinnings of the economy. Accordingly, he would want to be a little cautious. There were various other reasons for caution, including conditions in the mortgage market, concerning which he had a sentence to propose for inclusion in the directive. The financial problems ahead might be more serious than any that had been faced by the present generation, and the Committee should keep in mind its responsibility for the financial system as a whole and not just the commercial banks. In that connection, he was impressed by the imagination shown in New York, and perhaps elsewhere, in looking into the steps that might be taken to deal with the savings bank problem. He agreed with Mr. Maisel that a System-wide approach to that problem would be desirable.

Turning to the directive, Mr. Brimmer suggested retaining the opening sentence of the first paragraph as drafted by the staff, and following it with a new sentence reading, "There is also much uncertainty about the mortgage market and the liquidity of nonbank financial institutions." As he had indicated, he preferred alternative A for the second paragraph and he thought the Manager might focus on $350 million as his target for net borrowed reserve He had not taken a position with respect to the proviso because he was inclined to suggest that the Manager be given substantial leeway to depart from the net borrowed reserve target if unusual circumstances developed in financial markets, letting them fall away from the $350 million figure if necessary. He doubted that the seasonal factors available were adequate for dealing with the situation that lay ahead.

Mr. MacDonald observed that the flow of business news suggested that the economic expansion was proceeding, momentarily, at a less frenetic pace than in the first quarter. Confirmation could be found in the recent behavior of such series as retail sales, new orders and shipments of durable goods, industrial production, construction, industrial prices, and personal income. Nevertheless, those series were erratic--one swallow did not make a summer and one month did not make a trend. To the extent that there had been moderation, it had been helped by the slide in auto sales and cutbacks in car production, which were likely to have further effects as they spread into ancillary industries such as steel, rubber, and glass.

Whether it would be possible to recapture the balance in the economy that prevailed earlier in the business expansion remained to be seen, Mr. MacDonald noted. In any event, there seemed to be less inflationary pressure at the moment than earlier this year. He was glad to see that the restrained performance of monetary measures in May largely counteracted the inflationary April showing, and that projections for June indicated figures reasonably close to the Committee's objective. The desired degree of monetary restraint might thus have been reached, at least for the time being.

Mr. MacDonald reported that most economic developments in the Fourth District had been consistent with the national pattern, although the regional measures had by no means behaved uniformly. On the side of moderation, gains in manufacturing activity appeared to have slackened recently in several major District centers. District steel production had remained high, but new orders received by the reporting steel producers declined slightly in May, on a seasonally adjusted basis. Auto sales and department store sales in the District had slipped thus far in the second quarter, and construction contracts, after climbing through February, turned down in succeeding months.

On a stronger note, Mr. MacDonald added, insured unemployment in major labor markets of the Fourth District had continued to edge down, reaching the low figure of 1.1 per cent; in 5 of the 14 major labor markets the rate was less than 1 per cent. The Reserve Bank's spring survey of capital spending plans in Cleveland and Cincinnati found that business firms had upgraded their estimates of spending for 1966 since the fall survey. The change in part reflected a carryover of capital outlays from 1965 into this year.

Mr. MacDonald reported that banking statistics for January through April showed that credit expansion in the District had been considerably larger at banks outside major cities than at weekly reporting banks, which suggested that, as of April, the full effects of tighter monetary policy were still to be felt by country banks.

With reference to the borrowing of country banks at the discount window, Mr. MacDonald said that during the first five months of 1966 such borrowing was up 40 per cent from the year-earlier period--about the same as in the nation. Daily average borrowings of the District's country banks had more than doubled since March, but still accounted for only about 1 per cent of total country bank borrowing. Ten of the banks that borrowed this year had not borrowed from the Reserve Bank in the past three years. In several cases the borrowing reportedly was caused by increased loan demand stemming from use of credit lines by branches of national corporations that had been unable to obtain sufficient funds in money market centers.

Recent data provided no evidence of a significant shift in the pattern of banks' use of the discount window and transactions in Federal funds. Occasionally, large banks found themselves oversold on Federal funds and turned to the discount window. No country banks had been found that simultaneously borrowed from the Reserve Bank and sold Federal funds.

As for monetary policy during the next three weeks, Mr. MacDonald expressed a preference for alternative A, as drafted by the staff, for reasons already given by others.

Mr. Hilkert reported that several indicators pointed to some slackening of pressures on economic resources in the Third District. Although the labor force in the District was more fully employed than at any time since the Korean War, gains in manufacturing employment had lessened and demand for labor (reflected in help-wanted indexes) had ceased to expand. Also, nonresidential construction in the District had lagged so far this year, and auto registrations for the year to date were under 1965 totals.

Superimposed upon those factors in the real economy, pressures in the mortgage market had been building rapidly in intensity. Inasmuch as the Philadelphia Reserve Bank made a survey of mortgage conditions four weeks ago and just recently updated it, it had been able to observe that build-up. The surveys indicated the same kind of cuts in new mortgage commitments that had already been reported for most other Districts. One difference observed in the Bank's two surveys, however, was in the reasons given for the abrupt change in policy with respect to mortgages. Around May 1, savings and loan officials blamed CD's, nearly exclusively, for the net savings outflow. But since then few had found convincing evidence that the money did go to the commercial banks. Almost all interviewed admitted frankly they did not know where the money was going. Another difference was in connection with mortgage rates. FHA average mortgage discounts were 2 points in March, 3 in April, and 4-1/2 near the end of May. When mortgage lenders were surveyed around May 1, FHA did not expect an average 4-1/2 point discount until midsummer.

During the past week the Philadelphia Reserve Bank also had been in touch with several banks and finance companies to inquire about automobile financing, Mr. Hilkert added. The banks and larger finance companies reported a volume of business roughly similar to last year's, or perhaps a bit higher, though borrowers were being screened more carefully. The medium and smaller-sized finance companies, on the other hand, reported business off considerably, partly because of slipping demand but more importantly because money was harder to get. If those findings accurately reflected developments throughout the nation, further complaints might soon be expressed--this time in the area of consumer financing--about intense competition from the commercial banks.

On the banking front in the Third District, country banks had experienced slower growth in loans and investments so far this year than in 1965, with little pressure on the deposit side of the ledger. That was one reason, together with heavy participation in the Federal funds market, why there had not been the bulge in borrowing at the discount window that had characterized some other Reserve Banks. The number of country banks borrowing in recent weeks had not been out of line with comparable periods of the past two years, and though there had been some pickup in amounts borrowed the increase had not been substantial.

The banks that had been borrowing at the window appeared to have done so for a variety of reasons, Mr. Hilkert said. For example, a few larger country banks had experienced a rising loan demand from large firms that formerly borrowed in the money centers but now were finding conditions there relatively tight. Also, the substantial increase in the Federal funds rate (and at times reduced availability of such funds) had encouraged several banks to seek discount accommodation.

It had been possible, Mr. Hilkert said, to keep close track of borrowing at the discount window in relation to activity in

Federal funds and other borrowing because the Reserve Bank had been getting daily figures since February from all country banks on Federal funds transactions and other borrowing.

Among country banks during the last four bi-weekly reserve periods, some sold Federal funds during the same reserve period in which they were borrowing at the discount window, and a few sold small amounts on days when they were borrowing. However, there was no evidence of that being a regular practice by any country bank. Two of the six city banks that made a market in Federal funds for correspondents had borrowed during the past eight weekly reserve periods. Each bank sold Federal funds during those periods, and on days during which they were borrowing. Typically, city banks reduced their sales of Federal funds when they borrowed at the window.

Although no pattern had emerged, Mr. Hilkert added, the Reserve Bank had noticed some factors responsible on occasion for simultaneous Federal funds sales and borrowing from the Federal Reserve by country banks. There had been a case in which the country bank had an agreement with its correspondent to sell Federal funds daily; then, when a need arose, it borrowed from the Reserve Bank instead of cutting back Federal funds sales. A second case was one in which the country bank used an inflow of funds to sell Federal funds instead of paying off an existing note at the Reserve Bank.

Mr. Hilkert observed that the Reserve Bank would be in a position to see whether or not those practices increased as it obtained more experience with the Federal funds and other borrowing figures on a daily reporting basis. No doubt questions would arise as to proper administration of the discount window. It seemed obvious, however, that uniformity in policing those practices would be desirable.

Mr. Patterson submitted the following statement for the record:

> In the Sixth District we note the same moderating influences evident in the rest of the country. These have extended to a variety of economic and financial series. Declines have shown up not only in retail sales and construction contracts, but also in employment. It may be that some of the employment gains in the early part of the year borrowed from the most recent period. Of course, we still find a considerable shortage of labor, especially skilled help. Nevertheless, it seems to us that the pressures, even for labor, have abated somewhat.
>
> Having said this, I don't want to attach undue importance to the declines that have occurred. The dip in auto sales has not been large. And even in the case of construction the drop has been small, although our survey would indicate that the worst is yet to come.
>
> That there has been a decided change in underlying District developments is quite clear, however. It shows up, for instance, in a reduction in the willingness of consumers to borrow, not only for autos but for other purposes as well. In our large cities there has been a slowing down in the over-all loan expansion. It is hard to tell to what degree that is traceable to a softening in credit demands. It may well be partly self-imposed, and it may also reflect the impact of our own policy actions.

It is always difficult to see the effects of credit restraint when first applied. But as we all know, those become cumulative and eventually show sizable results. We are now seeing some evidence of this in the national housing sector, although the root of the problem there seems to be also partly a matter of bank competition and a decline in the demand for housing per se.

Rather than feeling uncomfortable that there has been a slowing up in the economy, I would think that this is what we hoped would happen, especially since no tax increase seems to be in the offing. If the economy had not responded, I would have been very much disappointed. Therefore, I think it would be a distinct mistake if we were to ease our policy now.

On the other hand, I wonder if housing is not feeling more of an impact than we anticipated and bargained for. This consideration, plus the fact that the economy seems less overheated than it has been, suggests that this is not the time for additional credit restraint. I am further persuaded in this conclusion by the agencies' marketing problems, the mid-June money market pressures, and the Treasury's prospective borrowing requirements.

My feeling is that while caution is the watchword today, some difficult decisions on the discount rate and Regulation Q lie ahead. The number of banks paying 5 per cent on savings certificates seems to have increased sharply, in our District at least, and in some cases banks have gone to 5-1/2 per cent. We, too, have found an increasing number of country banks using the discount window. This increase--only partly seasonal--seems to reflect a certain amount of unwillingness to take capital losses on securities in the face of still relatively strong loan demands and moderating deposit increases. There is little evidence that banks are trying to borrow at the discount window and are also selling Federal funds, but policing may become a problem. For this reason, discount rate action may well become a necessity.

On the matter of open market policy, Mr. Patterson said that in general he favored the approach taken in the directive at the last meeting. Today, however, he would not resist the increase in required reserves for June projected by the staff, unless that increase turned out much greater than presently anticipated. He would go along with alternative A of the draft directives.

Mr. Lewis reported that economic activity in the Eighth District continued to show great strength. Personal income had risen at about a 10 per cent annual rate since last fall, and spending, as measured by the flow of check payments, had increased at a 7-1/2 per cent rate. The greater demand for goods and services was straining production and credit facilities and placing upward pressure on prices. Real output, as estimated from industrial use of electric power, had increased at about a 5 per cent annual rate since late last year, and total employment had risen at a very sharp 7 per cent rate. Particularly rapid gains occurred in manufacturing employment at St. Louis and Memphis. Unemployment, which averaged about 3.4 per cent of the District labor force in late 1965, had been down to about 3.1 per cent since March.

Total credit at Eighth District weekly reporting banks had expanded at an 11 per cent annual rate since December, compared with an 8 per cent rate in the nation. Loans had risen at a 15 per cent rate and bank investments had increased slightly. Business loans in the District had advanced at an unusually large 25 per cent annual rate since December, with an especially strong growth in St. Louis. Firms in most industrial categories were large net borrowers. Bank deposits had expanded at a 6 per cent rate since December, with much of the growth in demand deposits. An exception to the strong growth in bank deposits and loans had occurred in the Memphis area. Deposits in Memphis had shown only a slight rise over the past two years, evidently because those banks had been less competitive in rates paid on time deposits due to a 4 per cent Tennessee limitation. With a lack of growth in funds available, outstanding business loans at Memphis banks had changed little on balance in nearly two years.

Mr. Lewis reported that 25 country banks had borrowed in the first five months of 1966. That was three and one-half times the number that borrowed in the first five months of 1965. The amount borrowed in the past three months had averaged about double the average of last winter. Reasons given for the greater borrowing included strong loan demands and increased difficulty of getting accommodation from correspondent banks. One bank reported that it had lost some deposits because competitors were offering higher rates on time accounts. Only one country bank had sold Federal funds in the same period in which it borrowed; that bank sold on the last two days of the reserve period but then paid out. Several reserve city banks had sold Federal funds during periods in which they borrowed, but were heavy net buyers rather than net sellers.

Upward pressure continued on prices, Mr. Lewis noted. For example, in the St. Louis area there had been marked increases in wages of construction workers, the cost of building materials had risen sharply, and the delivery period on certain key items had lengthened considerably. As a result, builders reported that the cost of constructing a residence was 5 to 10 per cent higher than just a few months ago. Over-all consumer prices in the St. Louis area had risen at a 4 per cent annual rate since last September.

In summary, Mr. Lewis said, demands for goods and services had been unusually strong, probably excessive, in the Eighth District, as in the rest of the nation.

Mr. Robertson submitted the following statement for the record after presenting a brief oral summary:

> It seems to me we are in a continuing strong basic economic situation, but one in which monetary restraint can finally be said to be having some real bite on demands for resources. This is obviously true in the construction field; it may also turn out to be one of the contributing factors to the lower level of automobile sales; and in numerous other areas of spending we hear at least an occasional story of some spending decision altered by the money situation.
>
> As a matter of fact, there is an increased outcry from some of these areas that tight money is biting too much. A good part of this is special pleading, of course, but some of the results of restraint--particularly in housing--may be drastic enough to deserve some attention. I, myself, would prefer any remedial action on this front to come through appropriate amendment of Regulation Q, rather than any easing of our general policy of restraint. But I think such developments do suggest that we might

have carried our progressive tightening about far enough at this juncture, and that a policy of holding firm about where we are might be the best decision for us to reach today.

I am reinforced in this view by the behavior of the banking aggregates during May, when we finally managed to achieve some wiping out of the big March-April bulge. I hope our present degree of tightness will suffice to keep any June bulge smaller in size and more temporary in duration. To guard against any new wave of outsize expansion in bank credit, however, I would again like to tell the Manager to be guided in part by the strength of over-all bank expansion. To be more explicit, thinking of his general operating target as net borrowed reserves in the neighborhood of $350 million, I would have him run net borrowed reserves up to $100 million deeper than that if required reserves should expand substantially more than seasonally expected; and, by the same token, I would be ready to see him work net borrowed reserves down to as little as $250 million if required reserves should be so much weaker than expectations as to produce a seasonally adjusted decline.

I should add that I recognize the month of June may also bring some special money market pressures--from such things as tax date borrowing needs and Federal agency financings--that will complicate the Manager's job. As I said last time, I am sure no one here wants to be recommending actions that would disrupt the markets, and the Manager may have to occasionally take this possibility into account in shaping his operations. But I think this kind of instruction is and always has been implicit in the Committee's directive, and needs no spelling out. Indeed, it would be a very complex job even to try to express its scope and limitations in black and white, and it would be misleading if we tried to subsume all such complexities in the shorthand of a pet phrase like "taking account of money market conditions." Therefore, I would not favor inserting an explicit reference to "money market conditions" in the directive. I think we are better advised in this area to rely upon the Manager's discretion, meanwhile keeping our formal directive aimed consistently at the target of reserve availability.

> All things considered, I would favor alternative A of the directive drafts presented to us by the staff, but I would want to see the phrases referring to money market conditions stricken on the grounds that they either imply too much or are not necessary, depending on which of their two possible meanings one might want to stress. I would, of course, want to see included the parenthetical reference to adjusting operations in the light of the movement of required reserves.

Mr. Robertson added that he shared the view that some reference be made in the first sentence of the directive to factors that would argue for holding the present degree of firmness at this juncture rather than tightening further. He would suggest language such as "the mortgage market is tight, automobile sales have fallen off, and concern exists about the liquidity of nonbank financial institutions."

Chairman Martin noted that a majority of the Committee had expressed a preference for alternative A for the second paragraph of the directive and that, on the whole, the members did not appear to be far apart in their views on policy. He proposed that the Committee proceed by considering the various suggestions that had been made for revising the draft directive. A discussion of wording of the directive ensued.

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

> The economic and financial developments reviewed at this meeting indicate that, while the mortgage market is tight, automobile sales have fallen off, and some concern exists about the liquidity of nonbank financial institutions, the domestic economy is continuing to expand, with industrial prices rising further and credit demands remaining strong. The foreign trade surplus has declined and the international payments deficit has increased. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaing net reserve availability and related money market conditions in about their recent ranges; provided, however, that if required reserves expand considerably more than seasonally expected, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions.

Chairman Martin then observed that the members of the Board of Governors were to appear before the Committee on Banking and Currency of the House of Representatives tomorrow (June 8) regarding legislative proposals affecting financial institutions. A letter dated June 6 had been received from Chairman Wright Patman of the Committee asking for an expression of views on a four-part proposal, one part of which had to do with permitting open market purchases by the Federal Reserve System of any obligation which was a direct obligation of, or fully guaranteed as to principal and interest by, any Federal Home Loan Bank. The Chairman thought that matter should be discussed today since it related to the Committee's responsibilities.

Mr. Treiber inquired about the present eligibility for purchase by the System of Federal Home Loan Bank obilgations.

Mr. Hackley replied that under section 14(b) of the Federal Reserve Act the Reserve Banks could operate only in direct or fully guaranteed obligations of the U.S. Since there was a specific statutory provision that Federal Home Loan Bank obligations were not obligations of, and were not guaranteed by, the U.S. they were not eligible.

Mr. Maisel remarked that if the Board was to comment favorably on any legislation in the area he would hope that it would urge including a broader list of agency issues than simply FHLB obligations.

Chairman Martin said he thought everyone would agree on that point, and Mr. Treiber indicated that his initial reaction also was against a piece-meal approach to the question.

Mr. Cardon noted that in testimony before the House Committee today Under Secretary of the Treasury Barr had submitted a list of agency obligations that were not eligible for purchase by the Federal Reserve Banks. Mr. Barr had expressed the view that it would be consistent to make FHLB obligations eligible and had indicated that the Administration would have no objection to such legislation.

In reply to a question by Chairman Martin, Mr. Hackley categorically how many agency issues were now eligible. Mr. Forrestal of the Board's Legal Division had prepared a memorandum for the Board on April 13, 1966, listing a number of obligations believed to be eligible either because of specific statutory provisions for full guarantee by the U.S. or because they fell within a 1961 opinion by the Attorney General concerning obligations guaranteed by Government agencies. (Note: Subsequent to the meeting copies of Mr. Forrestal's memorandum were distributed to the Committee and a copy was placed in the Committee's files.)

Mr. Maisel commented that while the list of eligible issues was long, it consisted mainly of obligations of minor agencies accounting for a relatively small percentage of all agency issues.

Mr. Swan agreed that the question should be approached in terms of all agency issues rather than FHLB obligations alone. However, in view of the importance of the subject and the likelihood that heavy reliance on agency issues in lieu of direct Treasury obligations would not prove to be a temporary procedure, he thought the Committee should give very careful consideration to the desirability of making all agency issues eligible, and of conducting open market operations in them along with operations in direct obligations of the Treasury.

Mr. Treiber remarked that the Federal Home Loan Banks had authority to borrow directly from the Treasury, and presumably would do so if they were unable to raise needed funds in the market. The System probably would be less subject to pressures if it confined its operations to Treasury securities. Of course, if purchases of FHLB obligations were begun the Committee could still maintain its desired credit policy by not acquiring an equivalent amount of Treasury securities.

Mr. Swan noted that there was a statutory limit of $1 billion on Home Loan Bank borrowing from the Treasury.

Mr. Robertson said that it was difficult to oppose making all agency issues eligible for System purchase on grounds of principle. He agreed, however, that if they were made eligible the System was likely to be subject to a good deal of continuing pressure to buy them.

Mr. Mitchell referred to Mr. Holmes' earlier comment regarding problems in operating in small issues, and asked whether it would not be desirable to have some lower limit on the size of issues that would be made eligible.

Mr. Holmes said that, as he had indicated, there would be many problems in operating in agency issues, including that which he had referred to as the problem of "even keel." He questioned whether the System should be used to enable agencies to avoid paying the rates necessary to float their issues in the market.

Mr. Maisel noted that even if the law was changed the Committee would still have to revise its Regulation and its continuing authority directive before the Account Management would be authorized to operate in agency issues. In the process of formulating those revisions the Committee would have an opportunity to carefully consider the various kinds of operating problems.

Mr. Brimmer commented that the matter of agency issues had been under discussion for some time and he asked if Mr. Holmes had given thought to possible procedures.

Mr. Holmes replied that it probably would be desirable for the System to have standing authority to buy agency issues, and that it was hard to justify having some issues eligible and some not. If the agency market continued to develop it was quite possible that transactions in agency issues would prove workable as long as it was understood that they would be kept moderate in size and that they would be supplemental to operations in Treasury securities. A study might show that it would be easier to arrange repurchase agreements against such securities than to deal in them on an outright basis. The use of RP's would give some support to underwriters carrying enlarged positions, and from a technical standpoint it would be much easier to relate RP's to reserve objectives than would be the case with outright transactions.

Mr. Wayne said he understood that the System could not engage in repurchase agreements involving particular types of securities unless it had the authority to buy such securities outright. The alternatives would appear to be engaging in RP's against agency issues or operating through the discount window, and of the two he would prefer the former. Accordingly, he did not think the System should oppose the legislation in question.

Chairman Martin remarked that he had considerable trepidation about the proposal because the System dealt in high-powered money. He would expect pressures for the System to operate in a wide range of agency issues regardless of possible consequences for the money markets. He doubted that that would be a wise course to follow if it could be avoided. In any case, the question had to be thought through carefully.

Mr. Swan commented that the suggestion that the legislative authority should cover all agency issues rather than the specific issues of Federal Home Loan Banks left open the major question of the moment, as to what might be done if those Banks exhausted their $1 billion authority to borrow directly from the Treasury.

Mr. Maisel noted in response that another alternative was available; the Treasury had legal authority to deposit funds in the Home Loan Banks.

Mr. Brimmer suggested that it would be helpful if the Manager prepared a memorandum on the general subject of operations in agency issues for the Committee's use. It was agreed that such a memorandum would be desirable.

It was agreed the next meeting of the Committee would be held on Tuesday, June 28, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

June 6, 1966

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 7, 1966.

First paragraph

The economic and financial developments reviewed at this meeting indicate that the domestic economy is continuing to expand, with industrial prices rising further and credit demands remaining strong. Our foreign trade surplus has declined and the deficit in our international payments has increased. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

Second paragraph

Alternative A (preserving current firmness, with possible qualification)

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining net reserve availability and related money market conditions in about their recent ranges (; provided, however, that if required reserves expand sharply more than seasonally expected, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions).

Alternative B (continued firming, with degree conditioned by movement in required reserves)

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some further gradual reduction in net reserve availability and attendant firming of money market conditions, and to attaining somewhat greater restraint if required reserves expand sharply more than seasonally expected.