A meeting of the Federal Open Market Committee was held on Monday, July 11, 1966, at 10:30 a.m. This was a telephone conference meeting, and each participant was in Washington except as otherwise indicated in parentheses:

PRESENT:	Mr. Hayes, Vice Chairman	(New York)
	Mr. Bopp	(Philadelphia)
	Mr. Brimmer	
	Mr. Hickman	(Cleveland)
	Mr. Irons	(Dallas)
	Mr. Maisel[1/]	
	Mr. Robertson	
	Mr. Shepardson	
	Mr. Swan, Alternate for Mr. Clay	(San Francisco)

Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Koch, Partee, Solomon, and Young, Associate Economists
Mr. Holmes, Manager, System Open Market Account (New York)

Mr. Cardon, Legislative Counsel, 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

Vice Chairman Hayes said that today's meeting had been called in light of the strike that had begun at a number of major airlines on July 8, 1966. The purpose was to discuss a technique

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

for open market operations that the System Account Manager thought might be needed under existing market conditions to cope with the emergency circumstances, involving a large rise in float and thus in reserve availability, that were likely to result from the strike.

Note: On July 8, 1966, the Secretariat had transmitted the following message to members of the Board of Governors and (by telegram) to all Reserve Bank Presidents:

The following outlines a proposal by the Manager of the System Open Market Account to offset the large increase in float that is likely to result from the airlines strike. Vice Chairman Hayes has called a telephone conference meeting of the voting members of the Federal Open Market Committee for 10:30 a.m., EDT, Monday, July 11, to discuss the proposal, with the understanding that no meeting will be required if a strike settlement is reached over the weekend.

The airline strike which began this morning threatens to produce a sudden and substantial bulge in float and thus in reserve availability. In order to maintain the firm money market conditions desired by the Committee, large scale open market operations may be required to absorb these reserves--operations which would likely have to be reversed within a short span of time. Under current operating practices, the only course open to the Desk to accomplish the desired objectives would be to engage in large scale outright sales of Treasury issues and subsequent purchases of roughly the same magnitude when the strike is terminated. Given current market conditions, such operations may be difficult to accomplish, heavily taxing the facilities of the market and possibly causing sudden, large, and undesirable rate fluctuations.

It is proposed, therefore, that the System utilize a new technique to accomplish the absorption and yet provide an automatic subsequent reprovision of reserves. The technique involves sale of securities combined with a simultaneous purchase of the same securities for delivery at a later date. This mechanism would make clear to the market the temporary nature of the reserve absorption and would eliminate the possibility that the intent of the operations would be misunderstood. It would also provide a broader base for operations since the dealers would be able to reverse the transactions with other investors, particularly banks which acquired reserves from the float bulge and would, therefore, be in a position to acquire such short-term investments.

There are a number of possible procedures which the Desk could utilize in undertaking such operations. The most clear-cut and simple approach would be an offer to dealers of short-term Treasury bills at the current market price together with a request that the dealers state the price at which they would be willing to resell the same issue for delivery at a fixed future date. This would provide a competitive criterion for determining the distribution of transactions among individual dealers and insure that transactions were executed on a best-price basis. The prices that would be established on the forward contracts would, of course, be influenced by the expected level of money rates over the intervening period.

Transactions of this type would be processed in the same manner as all other outright transactions, with the usual allocation among the Reserve Banks. No change in the continuing authority directive appears necessary to carry out the operations envisioned. The continuing authority directive authorizes the Federal Reserve Bank of New York "To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices. . ." Sales would be made for cash in the ordinary manner and the purchases for deferred delivery would be made under separate contracts. While there is no present established market price for deferred delivery contracts, a market

> price would, in effect, be established as the result of the competitive reofferings to the System envisioned in the proposal. No change in the authorization to increase or decrease the amount of securities held in the Open Market Account would be necessary, since the $1.5 billion leeway presently authorized is on a commitment basis, and no net change in the Open Market Account on that basis would be involved. Because of the unusual nature of these operations, however, the matter is being submitted to the Committee for expressions of views.

Mr. Hayes stressed that no change would be required in the Committee's continuing authority directive for the proposed technique to be employed. In his judgment, however, the suggested operations were sufficiently unusual in nature to make full discussion by the Committee desirable.

Mr. Holmes supplemented the message of July 8 with the following remarks:

> A quantitative estimate of the impact of the airline strike on float is hard to come by. It will obviously be very large and the best guesses at the moment range upward from $0.5 billion to something in excess of $1 billion, with the possibility of large and erratic day-to-day fluctuations.
>
> Operating on the assumption that the Committee would not want the full impact of the increased float to be reflected in an easing of money market conditions and a rise in reserves in the banking system, we should try to offset as much as possible through open market operations.
>
> Given the atmosphere in the Government securities market, outright sales of Treasury bills on the scale needed do not appear feasible. On Friday, dealers had to pay as much as 6-1/2 per cent for bank money, and they are naturally reluctant to carry any substantial inventories at current rate levels. Some of the major dealers are as worried about the availability of financing as they are

about the cost. While a large bulge in float would tend to produce lower financing costs, dealers would know that this would be only temporary, and they could not be sure that they could dispose of--or finance--any bills they took on now after the strike was settled.

The proposal that was outlined in Friday's wire was made because, in my judgment, we could not do very much in the way of substantial reserve absorption, given all the circumstances, without creating close to disorderly conditions in the Government securities market. While an upward push in Treasury bill rates would not be disturbing, I do not believe the System can reasonably expect the dealers to run excessive risks in the current environment.

To spell out the technique we would propose to use a bit:

1. We would offer all dealers (including bank dealers) specific Treasury bill or bills at the going market price.

2. We would ask dealers to reoffer these bills to us for delivery in two to three days.

3. We would select from those reofferings those that would be lowest in price.

We are assuming that we will have to pay a higher price on the bills we repurchase in order to make an allowance for financing costs. We expect competition to keep this differential to a minimum, but cannot be certain, until we operate, just how much this will be. On a three-month bill, for example, a three basis point spread would cover dealer financing costs of 5.5 per cent for 3 days. On shorter bills the spread would widen out substantially.

If the Committee approves the proposal we would contemplate starting operations tomorrow when, according to our staff estimates, the first major impact of the strike will be felt. This would permit us to explain the new technique to all dealers this afternoon and give them ample time to determine the basis on which they might operate.

Mr. Robertson said he was highly reluctant to approve the Manager's proposal. The suggested technique would, in effect, convert dealers to brokers, and it risked creating windfall profits for them. If the objective was simply to avoid publishing reserve figures that might be taken to imply a shift to an easier monetary policy, he did not think it was worth running the risk of creating such profits. Sophisticated market participants were not likely to be misled by shallower net borrowed reserve figures since they would be fully aware of the impact of the strike on the level of float; and, in any case, the published figures could be accompanied by an explanatory statement indicating that the change did not reflect a policy shift. Moreover, a rise in float might increase banks' demands for Treasury bills sufficiently to enable the Desk to sell bills in the usual way.

Mr. Robertson indicated that he would not object to the proposed technique if there was a real problem rather than simply one of possibly misleading the public on the stance of policy. At present, however, it was not known whether the strike would be of long or short duration, and Mr. Farrell of the Board's staff had reported at the Board meeting this morning that a spot check suggested that the rise in float thus far was small. Perhaps float would increase as much as Mr. Holmes had suggested, and a real problem would exist; but that should not be taken for granted, nor should it necessarily be assumed that the strike would be an extended one. In sum, he would be inclined to avoid using the proposed technique if at all possible.

Mr. Hayes commented that decisions with respect to use of the technique obviously would have to be taken in light of actual developments. However, the Board's staff was projecting an increase in float by Wednesday of this week on the order of $1 billion, which was a very large amount. He agreed that no special measures would be required if there was to be only a small fluctuation in the figures, but if the change was large it would lead to excessive ease in the market of a type he thought the Committee would want to avoid.

Mr. Hickman said that the greatest difficulty appeared to be in estimating the change in float. The estimates available now were highly uncertain, and whatever the method the Desk employed to reduce reserves it might overshoot the mark. Accordingly, he thought that for the time being operations should be conducted in terms of the tone and feel of the market, while an effort was made through a canvass of the individual Reserve Banks to develop better figures on float.

In general, Mr. Hickman continued, his view was somewhat similar to that of Mr. Robertson. He would not be overly concerned if shallower net borrowed reserve figures were published while an effort to get better estimates of float was underway. If some special measures then proved necessary, those proposed by the Manager seemed reasonable, assuming they were agreeable to the dealers. He would not want to see the proposed technique used, however, unless there was a real need.

Mr. Holmes remarked that better estimates of float obviously would be helpful. However, even the minimum estimates of the expected rise were very large, and it was likely that the Desk would have to be in a position by early tomorrow to decide on operations.

Mr. Irons expressed approval of the proposed technique, which seemed to him an ingenious means of avoiding a disturbance in the market. He assumed, however, that it would be employed only if there was a substantial rise in float--on the order of $500 million or $1 billion--and not if the increase was only $200-$300 million or so. He was not worried about possible adverse reactions because he thought it would generally be realized that the operation had been undertaken to enable the Committee to resolve the problem with minimum disturbance. At the same time, he would not be concerned about publication of somewhat shallower net borrowed reserve figures if they resulted from a substantial rise in float. In any case, the strike might not last for more than another day or two.

Mr. Holmes said that the Desk obviously would not propose to use the suggested technique unless it appeared necessary. At the moment, however, it was his judgment that the technique would have to be employed unless the Committee was prepared to see marginal reserves rise well into the free reserve area.

Mr. Shepardson commented that the point Mr. Robertson had made on the possibility of windfall profits to dealers was an important one. Conceivably, the rise in float could get out of hand and an operation of the type proposed might be required, but at the present time he thought it would be most unfortunate if it were undertaken. With the knowledge that the banking community would have of the source of whatever degree of ease developed, and with publication of a statement to inform the more general public, there was little danger that anyone would be misled with respect to the Committee's policy by published figures. Thus--for the short-run, certainly--he thought it would be unwise to undertake an operation of the type proposed.

Mr. Maisel said that he was somewhat concerned about the possibility of excessive ease in the market. However, he would suggest a different technique--that of asking the Treasury to increase its balance at the Reserve Banks by about $1 billion. If that large a volume of reserves were withdrawn the Desk presumably would have to operate to ease rather than to firm, and it could buy securities in the usual manner. Under the approach he suggested the possibility of windfall profits to dealers would be avoided.

Mr. Holmes said that plans called for having the Treasury balance increase somewhat during this period, perhaps by several hundred million dollars, to help absorb reserves. However, he thought there was grave risk in relying on changes in the Treasury balance to meet a problem that was essentially the System's; on other occasions the Treasury might want to change its balance at a time when the Committee thought that inadvisable. Thus, while there was some room for such an operation it was quite limited. Moreover, at the present time Treasury calls to increase its balance would fall on the large "C" banks. This week the city banks were under extreme pressure, not only because they were in large basic deficit positions but also because country banks would be running their excess reserves up to very high levels. Since the rise in float would be rather evenly distributed throughout the banking system, offsetting it by calls on the large banks alone would be discriminatory.

Mr. Brimmer said he was as concerned as other members were with the possible embarrassment to the Committee if substantial windfall gains accrued to dealers as a result of System operations. On the other hand, he thought it would be appropriate for the Committee to view such gains as a necessary cost of effecting the type of transactions deemed most helpful in producing the desired level of reserves. He was prepared to support the proposed technique with a clear understanding that the Manager would use it only if necessary. He suspected that float would be somewhat higher than Mr. Farrell had implied, partly because of pessimistic readings of the outlook for a quick settlement of the strike. He thought the Committee should focus not only on the size of the increase in float but also on the likely duration of the problem. He was impressed by the reluctance of dealers to increase their positions in bills, given their high financing costs and the uncertainties regarding the availability of financing. In his judgment the Manager needed additional techniques, and he was confident that the Manager would use them only if necessary.

Mr. Brimmer noted that the Manager had mentioned the desirability of holding conversations with the dealers today in the expectation that it would be necessary to operate soon thereafter. It appeared, then, that it would be inappropriate to postpone a decision until better estimates of float were available, a possibility mentioned earlier. He did not believe that refinement of the statistics would improve the grounds for decision sufficiently to warrant delay; the information at hand was adequate to justify a decision, particularly since prospects for a prompt settlement of the strike were not good.

Mr. Holmes said that he would expect the forces of competition among dealers to minimize the probability of windfall profits for them. The Desk would be able to assess the spread between the price at which bills would be sold to the dealers and those at which the dealers reoffered the bills to the System for deferred delivery, and to judge whether those spreads were excessive in light of current financing costs. If the offers turned out to involve excessive spreads a decision could be made not to enter into the contracts.

Mr. Robertson asked whether the proposal was based on the assumption that banks acquiring additional reserves as float rose would simply let their excess reserves build up.

Mr. Holmes replied that the banks probably would use those reserves to repay any borrowings from the System, and would lower their dealer financing rates. In general, there probably would be a temporary easing in short-term money rates.

Mr. Robertson then asked whether the dealers would not be in a better position to carry inventories if banks lowered financing rates.

Mr. Holmes responded that they would be better able to carry present inventories, but he thought they would be unwilling to increase their inventories since they would know that the lower financing costs were likely to be temporary.

Mr. Swan said he felt some reluctance about the proposal. He saw no reason for concern, at least in the short run, if the rise in float resulted in repayment of bank borrowings from the System or in a decline in the Federal funds rate; and if banks invested the funds in securities the Desk should be able to sell bills. In general, he questioned the extent to which the Committee should try to offset the rise in float, particularly since the reasons for that rise would be well known to market participants.

Mr. Bopp said he was prepared to go along with the proposal outlined, recognizing that it carried some risks. Like Mr. Irons, he thought it was an ingenious technique for dealing with the problem.

Mr. Hayes observed that if the technique was not used wisely it obviously could have unfortunate results, but he was prepared to trust the Manager to use it wisely. The uncertainty with respect to the probable size of the increase in float and the question of the degree to which it would be necessary to offset the rise both would call for the exercise of discretion by the Manager, as would judgments as to whether proceeds to the dealers would involve excessive windfall profits. Despite the uncertainties, Mr. Hayes thought it was desirable for the Committee to attempt to deal with possible unfortunate developments. He would be disturbed by the appearance of sizable free reserves even if they could be readily explained, because they might have pervasive easing effects that could result in confusing the general public with respect to the Committee's policy stance. The technique proposed seemed to him to be a useful tool, and he would be inclined to give the Manager leeway and the benefit of any doubts, in the hope and belief that he would use the technique wisely.

Mr. Hickman said he gathered that the Manager would consider the technique to be something to be held in reserve for use only if needed.

Mr. Hayes remarked that that was his understanding also, but the need to use the technique might develop quite soon--perhaps tomorrow.

Mr. Holmes commented that, according to New York Reserve Bank estimates, the strike would result in an increase in float tomorrow of about $600 million. The Board's staff expected the impact to be on Wednesday, and estimated it at about $1 billion. For the next statement week the estimates of the impact ranged from $600 million to $2 billion. In short, the problem appeared to be an immediate one. He added that in preparing their estimates the staffs at the Board and the New York Bank had discussed the situation with various Reserve Banks.

Mr. Hickman observed that the Cleveland Reserve Bank had made special arrangements with certain other Reserve Banks for moving checks. As a result of those arrangements he expected there to be no substantial increase in float in the Fourth District.

Mr. Bopp said that the Philadelphia Reserve Bank estimated that there would be no problem with respect to about 60 per cent of their checks, which moved by truck. The order of magnitude of the float involved in the remaining 40 per cent would be about $40 million. With respect to the general problem, the Board might temporarily change the deferment schedule on one-day city items to cut down the float created by the strike.

Mr. Swan observed that on the basis of advices from the Post Office--which might be overly optimistic--he did not expect any great problems in the Twelfth District.

Mr. Irons commented that at the moment his expectations for the Eleventh District were similar to Mr. Swan's. He would approve the proposal, however, as a standby tool, and depend on the Manager's judgment with respect to the need to use it.

Mr. Hayes remarked the Manager could be expected to keep in close touch with people at the Board and Reserve Banks and to try to stay on top of the situation. He (Mr. Hayes) would be pleased if there was no need to use the proposed technique, and he knew that the Manager was not eager to employ it. Nevertheless it seemed both legitimate and wise to have the tool available if needed.

Mr. Brimmer asked how the Manager would proceed if the Committee did not encourage use of the proposed technique.

Mr. Holmes replied that for the current statement week the Desk would be faced with the prospect of very low net borrowed reserves and some risk--although that was less likely--of positive free reserves. At the start of the following statement week the Desk probably would be looking at free reserves on the order of $500 million or higher. He would try to withdraw reserves by the usual kinds of operations, but he expected that he would not be able to sell any volume of securities in the market. Thus, the Committee would have to be reconciled to the appearance of free reserve figures. In that connection, he was impressed by the operation that had been undertaken on Friday to sell $100 million of bills for foreign accounts. Some major nonbank dealers had been willing to bid for those bills only at yields 15-20 basis points above the market. That represented a measure of the reluctance of the dealers to take on additional bills, despite the fact that the volume involved was not large.

Mr. Maisel noted that he had to leave the meeting at this point to keep another engagement. To state his position briefly, he favored approving the proposed technique, but at the same time he would strongly urge the Manager to avoid its use if at all possible. It should be thought of as a device for use in a more severe emergency than now appeared to exist, and in any case its use should be postponed for at least a day or so.

Mr. Maisel then withdrew from the meeting.

Mr. Robertson noted that the increase in reserve requirements recently approved by the Board, which would absorb some reserves, would become effective at reserve city banks on Thursday of this week. He added that the Board had been considering the possibility of issuing an explanatory statement if the reserve figures published appeared to indicate that the stance of System policy had changed. The statement contemplated might be along the lines of the following draft:

> The movement of checks between cities and between Federal Reserve Districts has been slowed by the airline strike. The Federal Reserve Banks are making every effort to minimize delay of intercity and interdistrict check clearances by the use of air carriers still operating and by the use of ground transportation.
>
> Nevertheless, some effects of the temporary slowdown in check clearings can be expected to be felt in financial markets, and to be reflected in various data, including the weekly Federal Reserve Statistics relating to factors affecting member bank reserves.
>
> An increase in the amount of reserves available to the banking system may be occasioned by the delay in check clearings. While the Federal Reserve should be able to absorb at least part of any reserve increase so occasioned, it may well be that some easing in money market conditions may ensue, and that figures on net borrowed reserves of member banks may be smaller than otherwise might be the case. Such occurrences should be temporary, and should not be interpreted as reflecting any change in monetary and credit policy.

Mr. Robertson commented that the Board had not yet decided to issue a statement of that kind, but had had the draft prepared for possible use if the need arose.

Mr. Swan asked whether it might not be desirable to postpone any discussions of the proposed technique with dealers if the Committee decided that it should not be used immediately.

Mr. Holmes agreed that it would not be wise to discuss the technique with the dealers if it was not clear that it was likely to be used. He added that he had just been informed that the latest projection of net borrowed reserves for the current week was $140 million. That projection allowed for the estimated impact of the strike on float tomorrow and Wednesday.

Mr. Hayes commented that he understood that the projections also made allowances for the reserve requirement increase. He then suggested that the Committee be polled on the question of whether the Manager should use the proposed technique if necessary. There had been enough expressions of concern today to make it quite clear that if used it should be only with reluctance, and as the least undesirable of the available alternatives.

In the course of the poll all members of the Committee indicated that they would approve use of the proposed technique, but a number supplemented statements to that effect with further comments.

Mr. Swan said his position was based on an understanding that the technique would not be used until the evidence of its need was considerably stronger than it was at present.

Mr. Robertson said he approved the proposal with great reluctance and with the hope that it would be used only if the situation worsened considerably.

Mr. Shepardson associated himself with Mr. Robertson's position.

Mr. Brimmer said it would be agreeable to him for the Manager to proceed with the discussions with dealers tomorrow if he found that necessary.

Mr. Hickman said he would prefer some delay in use of the technique, and that any use be reluctant. He hoped that it would not be necessary to use the technique at all.

Mr. Hayes said that the Committee's intent seemed clear; the Manager could use the proposed technique but he should recognize the high degree of reluctance expressed by individual members. Since the Committee had unanimously approved the proposal, however, he thought it should be prepared to rely on the Manager's judgment and analyses. He asked whether any members disagreed with that statement.

Mr. Swan commented that not only would he prefer to delay implementation pending further developments, but he also thought that the Desk should not necessarily offset all of the expected increase in float.

Mr. Hayes acknowledged that individual members had expressed various kinds and degrees of qualification. Nevertheless, the Manager was faced with the need to make operating decisions, and he had to know whether he was free to use the technique if in his judgment it was necessary.

Mr. Robertson said there was no question in his mind on that point. All members had confidence in the Manager, and he had been empowered to use the technique. The hope had been expressed that it would be used with reluctance and that its use would be avoided if possible.

Mr. Hayes commented that Mr. Robertson's observation could stand as a statement of the Committee's consensus.

Thereupon the meeting adjourned.

Assistant Secretary