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, July 26, 1966, at 9:30 a.m.

PRESENT: Mr. Hayes, Vice Chairman
Mr. Bopp
Mr. Brimmer
Mr. Clay
Mr. Hickman
Mr. Irons
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Shepardson

Messrs. Scanlon, Francis, and Swan, Alternate Members of the Federal Open Market Committee

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

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Messrs. Eastburn, Green, Koch, Mann, Partee, and Tow, 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
Mr. Hersey, Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors

Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Mr. Forrestal, Senior Attorney, Legal Division, Board of Governors

Messrs. Heflin and Kimbrel, First Vice Presidents of the Federal Reserve Banks of Richmond and Atlanta, respectively
Messrs. Link, Ratchford, Brandt, Baughman, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of New York, Richmond, Atlanta, Chicago, St. Louis, and San Francisco, respectively
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meetings of the Federal Open Market Committee held on June 28 and July 11, 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 June 28 through July 20, 1966, and a supplemental report for July 21 through 25, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that the Treasury gold stock was being reduced by $100 million today in order to replenish the Stabilization Fund. In June the French took in nearly $100 million and they were converting all of it to gold this month. In addition, the U.S. share of gold pool losses in July would cost some $25 million. Pressure had been extremely heavy on the London gold market, but had tapered off in the last few days after the announcement of the new British program. If the program did not go well, however, the pressure was likely to resume.

The gold pool had suffered a great deal of attrition so far this year, Mr. Coombs noted. The pool's resources were now down to $94 million from $312 million at the start of the year, and an effort was currently being made to negotiate agreement on new contributions of $100 million by the pool members. It was not clear, however, whether those negotiations would be successful; the European members of the pool were becoming extremely discouraged and restive, and at the next Basle meeting in September there might be some fairly strong opposition to further calls upon their gold reserves to maintain a ceiling on the London market price. Moreover, thus far in July the French had taken in $140 million which they presumably would convert to gold next month. If there were other official conversions of dollars to gold as well as heavy drains on the gold pool over the next few months the gold situation could rapidly become serious. As the Committee knew, for some time he had felt that the greatest potential threat to the dollar was a breakout in the London gold price.

On the exchange markets, Mr. Coombs continued, the speculative attack on sterling witnessed during the past month was more sustained in intensity than that of November 1964, and in certain respects more dangerous. Perhaps he could best summarize the magnitude of the crisis by noting that, from July 1 through Friday, July 22, the drain on British reserves amounted to roughly $1.1 billion, and it would have been increased by $145 million if the New York Reserve Bank had not undertaken market operations for Treasury and System Account to support sterling. In addition, the Bank of England entered into new forward contracts in the amount of approximately $750 million. All told, therefore, official intervention in the spot and forward markets for sterling from July 1 through July 22 came to very nearly $2 billion, on top of similar intervention during June of $500 million or so.

The sheer magnitude of those figures--which, of course, were extremely confidential--suggested a remarkably wide swing of the leads and lags against sterling and the buildup of a huge short position. Before the new British program was announced there was some hope on both the British and U.S. side that strong market action to push up the sterling rate might force some quick covering of short positions. An abrupt swing, such as had occurred last

September, did not seem likely, however. For one thing, the deterioration in sentiment this year was considerably greater. Secondly, last September's announcement concerned a new international package of assistance for sterling, the significance of which could be quickly grasped by the market, in contrast to the announcement now of a complicated new Government program with much uncertainty remaining as to whether it could be implemented effectively.

The New York Reserve Bank began market operations in sterling a few minutes after the program was announced, Mr. Coombs said. On Wednesday, Thursday, and Friday of last week it bought a total of $145 million, in the process pushing the rate up from $2.7875 to a peak of $2.7912. Very strong resistance was encountered as sterling continued to be sold in heavy volume through the Paris bourse and other European markets. Although the pressure receded a little on Friday, the operations clearly had not yet succeeded in inducing short covering; there was a general feeling in the market that devaluation of sterling was a foregone conclusion, and such an attitude was hard to combat. On the other hand, both the New York Reserve Bank and the Bank of England felt that the operations had had a useful stabilizing effect on expectations during a period of acute uncertainty. They had also provided concrete evidence of official U.S. support for the British program by backing up with money the statement the Treasury had issued. In addition, the operations had probably succeeded in sweeping the market reasonably clean of the last remnants of sterling available for sale, thus setting the stage for a natural recovery of the rate if there was even a minor return of confidence. The British had no reserve losses on Monday and so far today, which might suggest that they were slowly rounding the corner. If and when a more buoyant tendency appeared in the market, it might be useful to give an additional push through market operations.

Mr. Coombs remarked that the skepticism of the market regarding the new British program did not seem to arise out of any widespread feeling that the program was not sufficiently drastic; it certainly was that. Rather, the continuing concern of the market was based on fears that the Government might be confronted with a revolt by the trade unions and so be unable to carry through the most important element of the program--namely, the wage freeze. That issue now hung in the balance, but by tomorrow there might be some indication of whether the trade unions would go along or would rebel. If trade union support, however grudging, could be secured, there might be a major turn for the better. If not, a major challenge to the entire international financial system might eventuate.

As he had mentioned, Mr. Coombs said, the cost of the intervention by the Bank of England this month had been very heavy indeed, and they would face the prospect, in the absence of further central bank financing, of having to show a reserve loss of roughly $1 billion for the month of July. As the Committee knew, the New York Reserve Bank had strongly urged the Bank of England at the end of June to minimize their use of the Federal Reserve swap line and to show a sizable reserve loss so as to point up the cost of the seamen's strike, and thereby bring home to the British public the necessity of drastic corrective action. They chose to follow another course. With respect to the end of July reserve problem, however, the market was in such a speculative mood that he feared a report of heavy additional reserve losses could trigger a panic which might quickly get out of control. He had, accordingly, been urging the Bank of England to round up central bank financing from all sides, and it now appeared that they might be able to raise approximately $500 million from various European sources. Assuming that they would wish to show a reserve loss of no more than $100 million, they would still need another $400 million. The Treasury might be prepared to provide $200 million on an overnight basis, and he would be hopeful that the System could provide the remaining $200 million through the swap line, also on an overnight basis. In a situation as dangerous as the existing one he could see certain advantages in avoiding three-month commitments until it was clear whether the tide had begun to turn.

In reply to a question by Mr. Mitchell, Mr. Coombs said that the Bank of England now had drawings of $250 million outstanding on its swap line with the System, all on a three-month basis. As he indicated, they might wish to draw an additional $200 million at the month end, and his recommendation was that that drawing be made on an overnight basis, to be repaid August 1.

Mr. Mitchell then asked whether Mr. Coombs thought the British would soon be able to make some repayment on their existing $250 million drawings if developments unfolded as now expected.

Mr. Coombs replied that the main need was for the British to implement their program effectively--although it was possible that even if they were forced to give way on the wage-price freeze the rest of the program would prove sufficiently strong to lead to a turn in the situation. In any case, the turn was likely to be slow. The British were faced with a high degree of disillusionment in sterling and in the policies of their Government, and once confidence was lost it was hard to restore.

Mr. Mitchell asked what implications an abandonment of the gold pool operation would have for the British.

Mr. Coombs said that Britain's share in the pool was relatively small. Moreover, since they had used up so many dollars over the last few months they might have to sell gold in any case, so an abandonment of the pool operations would have no particular implications for them on that score. Countries in a surplus position, however, preferred to buy rather than sell gold, and calls by the pool upon their gold reserves created a difficult problem for them domestically. More generally, a break-out of the London gold price would have ominous speculative implications for all currencies, including sterling and the dollar.

In answer to another question by Mr. Mitchell, Mr. Coombs said that in London, the prime market for gold, daily turnover might be on the order of seven or eight tons, and on occasion as high as twenty-five tons. In contrast, other markets--such as Beirut--typically handled only about one or two tons a day. All South African and Russian gold was channeled through London. There had been some indications recently that the South Africans were trying to establish alternative marketing locations, but that effort would probably be resisted by the European central banks. The big question was whether the breakdown in confidence in sterling would ramify throughout the whole system. In his judgment that was a clear and present danger, and if it eventuated the market demand for gold might reach such proportions as to make the cost of the gold pool operation prohibitive. The U.S. share in the pool was 50 per cent, and if the Europeans pulled out the U.S. would have to carry the full burden. The U.S. gold stock was now down to $13.3 billion and market demands plus official conversions by France and possibly by others might result in further heavy losses. If the pool arrangement was discontinued because the cost of intervention had become prohibitive and the price of gold moved up, the situation would be much like that of late 1960. In fact, it would be much worse; in 1960 the U.S. gold stock was over $18 billion and the position of the dollar was still relatively unchallenged. In present circumstances a wave of apprehension might well be set off, with pullbacks of dollar balances and panicky purchases of gold by smaller countries. In effect, a sharp rise in the London price would be regarded as a direct challenge to the $35 U.S. parity.

Mr. Mitchell then asked whether Mr. Coombs thought the U.S. should not plan to withdraw from the pool if the Europeans were planning to do so and if it seemed clear that this country could not handle the market alone.

Mr. Coombs responded that there had been a good deal of quiet technical discussion of the gold pool during the past year. It had been hoped during that interval that the U.S. balance of payments position would improve and that sterling would strengthen. Instead, there had been a steady string of unfavorable developments and increases in pressures. He had not meant to imply that the Europeans were going to withdraw from the pool, but rather that they were becoming discouraged and highly restive. The U.S. faced a problem in that area that might require some basic decisions in the next few weeks.

Mr. Mitchell asked if the British had the legal authority to close the London gold market.

Mr. Coombs replied affirmatively, but added that they probably would strongly resist such a suggestion. Moreover, he was not sure that they should be encouraged to close the market. The London market would be subject to a measure of responsible control even if it were on its own. Such control was not feasible in Middle East or other markets. To shift gold trading out of London thus might contribute to further instability.

Mr. Mitchell then asked whether the London gold market might not function more effectively if trading there were confined to Governments and monetary authorities.

Mr. Coombs replied that it was not possible to exclude private buyers from the gold market. If they were kept out of London they would shift their demands to other centers, and the price in, say, the Middle East would become sufficiently attractive to draw South African gold there.

Mr. Hayes noted in that connection that a dilemma had existed since 1960. On the one hand all central banks, including the Federal Reserve, were reluctant to see a large proportion of the gold supply absorbed by private demand. On the other hand they were acutely aware of the effect a large rise in the price of gold in London or elsewhere could have on confidence in the dollar. He agreed with

Mr. Coombs that if the London market were closed to private buyers a large part of new gold production would flow to them through other markets.

Mr. Coombs recalled that in the late 1940's and early 1950's the price of gold in Beirut, Tangiers, and other markets was high--on the order of $75 an ounce. In those days, however, no one considered such prices to pose a challenge to the dollar. The experience in 1960 demonstrated that that assumption no longer held good, and it was even less valid at present. He recalled that an official of a large bank in New York City had made a speech in 1960 in which he suggested that the free market price of gold had little to do with the position of the dollar. That official had been subjected to a barrage of criticism from financial market participants who thought otherwise. There were, however, certain protective measures that could be taken.

Mr. Mitchell observed that Mr. Coombs' position seemed to him to be unrealistic. The series of unfavorable developments to which Mr. Coombs had referred was quite likely to continue, and he (Mr. Mitchell) did not see any basis for expecting an easing in the demand for gold. If the Europeans were becoming restive it behooved this country to make positive plans now for dealing with the situation.

Mr. Coombs said he had made a series of recommendations a year ago for that purpose. The problem had not come as a surprise to him or to the Committee.

Mr. Shepardson said he shared Mr. Mitchell's concern. The Committee's whole program of foreign currency operations, as he had understood it, was geared to operating against foreseeably reversible trends, but in his report today Mr. Coombs had indicated pessimism about the prospects for reversal of present trends. That posed a real question as to what actions would be appropriate.

Mr. Hayes asked if Mr. Shepardson was referring to the gold or the sterling market situation, and Mr. Shepardson replied that in his judgment the two were related. Mr. Hayes then commented that he thought there was a good possibility of reversal with respect to the sterling situation, although that was by no means certain.

Mr. Shepardson commented that in view of the press reports regarding the resistance of British labor to the new program he questioned whether there was any basis for optimism regarding sterling.

Mr. Hayes observed that the System had a delicate role to play in the present situation. In his view the Committee was entitled to feel a growing skepticism. At the same time, he believed it would be a mistake to conclude that the System should now withdraw assistance on the grounds that the whole effort was futile. The British might now be rounding the corner, and the situation might be at a point at which patience would pay large dividends.

Mr. Coombs concurred in Mr. Mitchell's observation that decisions with respect to U.S. participation in the gold pool were the responsibility of the Treasury. He had mentioned the subject because any serious difficulties in the gold market would lead to sizable flows of funds which in turn might necessitate heavy System drawings on the swap lines.

In reply to a question by Mr. Galusha, Mr. Coombs said that those who had been closely following developments in the gold market felt that the basic forces of supply and demand probably were beginning to move against the pool. Whereas in 1963 and 1964 the pool had accumulated large surpluses, on the order of $650 million a year, the trend of private buying was rising and South African production was leveling off. Industrial uses of gold were expanding rapidly, and with the rise in real incomes throughout the world private individuals were increasingly attracted to holding gold in jewelry and other forms. In due course private demand would probably exceed the new supply. The annual report of the Bank for International Settlements had detailed the supply-demand situation, which previously was not widely appreciated, and probably had been an important contributing factor to recent speculative buying.

Mr. Shepardson asked whether the purpose of the proposed overnight credit extension to the British was to allow them to window-dress their reserve statement.

Mr. Coombs replied affirmatively, but added that the more basic purpose was to save them from bankruptcy. The market had no inkling of the actual size of their July reserve loss, and if the British published figures showing a large loss a panic situation was likely to result that might lead to either the imposition of exchange controls or devaluation.

Mr. Robertson asked whether the Treasury had already agreed to provide a $200 million overnight credit, and Mr. Coombs said he thought that the decision was fairly solid. He noted that the Treasury had extended a $100 million overnight credit at the end of June.

Mr. Shepardson then asked how long the situation might be papered over.

In reply, Mr. Coombs noted that the British had not revealed their actual reserve losses for three months in mid-1965. They had then shown true figures, by and large, from September 1965 through May 1966. Actual losses had not been disclosed in June, and they would not be again in July. If the Government remained in power and there was no general strike, the new program should begin to have an effect in the next few months and could bring about a gradual turn in the situation. He was not suggesting that the outlook was hopeless, but rather that there were serious risks of which the Committee should be aware.

Mr. Shepardson then asked what Mr. Coombs would expect if the hoped-for turn did not eventuate and there was a break-through in the sterling situation in August or September.

Mr. Coombs replied that under such circumstances short-term central bank credits would do no good whatever. That was why he had suggested making the additional $200 million swap drawing an overnight arrangement. Of course, the British still had about $1 billion in medium-term credits available, including $500 million in drawing rights on the International Monetary Fund, a $250 million Export-Import Bank credit, and $250 million in possible credits from the BIS. They also had about $500 million in their portfolio of American securities. He did not think any problem need be anticipated in connection with repayment of British drawings already outstanding. But on new credits in present circumstances he thought it would be best to arrange, whenever practicable, for repayment in one day to keep the pressure on the British.

Mr. Robertson said that it might be the better part of wisdom for the British to camouflage their reserve losses. On the other hand, it might very well be that publication of the true reserve loss was necessary in order to win public acceptance of the wage-price freeze, and that the System would be doing the British a disservice in helping them to paper it over. He did not feel he knew enough about the situation to reach an independent judgment on the question, but he thought the fact that it had two sides should be recognized.

Mr. Coombs agreed, but added that, in the judgment of the Bank of England and the British Treasury, publication of a reserve loss as large as $200 or $300 million for July might prove disastrous.

Mr. Hayes noted that in June, during the seamen's strike, the Federal Reserve Bank of New York had thought it would be desirable for the British to show most of the loss they incurred in that month. The market situation then was not as acute as at present and there was an advantage seen in bringing home to the public the seriousness of the strike's effects. However, in the judgment of many people the present situation was too dangerous to take the chance of showing a large loss for July.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period June 28 through July 25, 1966, were approved, ratified, and confirmed.

Mr. Coombs recommended renewal of two standby swap arrangements that would mature soon: the $250 million arrangement with the German Federal Bank, having a term of six months, and maturing August 9, 1966; and the $100 million arrangement with the Bank of France, having a term of three months, and maturing August 10, 1966.

Renewals of the two standby arrangements, as recommended by Mr. Coombs, were approved.

Mr. Coombs then noted that two three-month, $50 million drawings by the Bank of England on its swap line with the System would mature July 29, 1966, and August 31, 1966, respectively. He recommended renewal of each for another three-month period if the Bank of England so requested. Both would be first renewals.

Renewal of the two drawings by the Bank of England, as recommended by Mr. Coombs, was noted without objection.

Mr. Coombs reported that a $40 million, three-month swap with the BIS of guaranteed sterling against lire would mature on August 25, 1966. The swap had been renewed once and he would recommend a second renewal unless the U.S. Treasury executed a lira drawing on the IMF in time to permit repayment before maturity. In any event, a lira drawing by the Treasury was scheduled for late summer which would provide lira availabilities for paying off System debt to the Bank of Italy. The Committee might recall that in a memorandum of April 1965 he had recommended that the

Treasury draw foreign currencies from the Fund when necessary to enable the System to repay swap drawings that were running on for unduly long periods. A number of System drawings were paid off in that manner last summer, and some technical problems encountered then had since been resolved. Thus, a major source of medium-term financing had been opened up that should enable the Treasury to backstop any System drawings that did not prove reversible within six months.

> Renewal of the $40 million swap of sterling against lire, as recommended by Mr. Coombs, was noted without objection.

Mr. Coombs said he would conclude with one final observation. Earlier today he had cited the risks of a crisis in the gold pool that could result in a challenge to the dollar, and the risks that lay in the sterling situation. Unfavorable developments in those areas or in the U.S. balance of payments might result in a substantial buildup of dollar holdings at European central banks, causing the System to draw heavily on its swap network. The System already had drawings outstanding on the swaps with the Swiss, Italians, and Dutch, and a further large drawing on the Italians might be required shortly. The U.S. might well be confronted with an emergency situation requiring drastic action by the System; but unless supporting measures were taken by the Government, such drastic action by the

System, acting alone, might backfire, just as the British Bank Rate increase in November 1964 had done. He thought strong Government action in two areas would be desirable under such circumstances. His first suggestion would be to control, through licensing, direct U.S. investment in Europe. Secondly, he thought a strong appeal should be made to American tourists to stay at home for a year or so. Both actions would be welcomed by European central banks, although there might be some complaints from European business interests if American tourism was reduced. Unless some such measures were taken by the Government, the System might find itself operating in a vacuum.

Mr. Heflin asked how widely the true British position was known.

Mr. Coombs replied that the recent British reserve figures were reflected on the books of the Federal Reserve Bank of New York, but were not known by other central banks; each such bank saw only a small piece of the whole picture. Conceivably, the Bank of England might disclose the figures to a European central bank in an effort to obtain credits, but otherwise they were not likely to do so.

Mr. Hayes observed that that fact underscored the confidential nature of the figures. It was extremely important, he said, that they not be disclosed outside of the meeting room.

Mr. Shepardson asked whether authorization by the Committee was required for the proposed overnight accommodation of the British.

Mr. Coombs replied in the negative. In effect, he had suggested that he should take a more restrictive position in his discussions with the Bank of England than the Committee had approved generally for swap drawings. It was possible that the British would object to that position, and that he would have to consult on the matter before the next meeting of the Committee with the available members of the Subcommittee designated for such purposes in the Committee's foreign currency authorization.

Mr. Shepardson commented that he still did not like the window-dressing involved but he supposed that it was necessary.

Mr. Robertson remarked that no members liked it, but if it was necessary a short period presumably was better than a long one.

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 June 28 through July 20, 1966, and a supplemental report for July 21 through 25, 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:

Interest rates have moved sharply higher since the Committee met on June 28. At the close of business last night the three-month Treasury bill rate was about 1/2 per cent above its level on the eve of that Committee meeting. During the interval yields on intermediate-and long-term Treasury coupon issues moved above their end-of-February highs by 10 to 15 basis points and corporate and municipal yields rose further. The prime rate was raised 1/4 per cent early in the period, Federal funds, bankers' acceptances, finance paper, Government agency securities, and dealer loan rates all moved into new high ground, while 30-day negotiable certificates of deposit became quite generally available at the 5-1/2 per cent ceiling. There were widespread market expectations of an increase in the discount rate, and in the absence of such action most rates have moved lower over the past week with some sentiment apparently arising again that this time the peak of rates may have been reached. In yesterday's Treasury bill auction rates on three- and six-month bills were established at 4.82 and 4.92 per cent respectively, 18 basis points lower than the high rates set in last week's auction.

The conduct of open market operations was affected by a number of diverse factors, including market apprehension about the course of interest rates after the prime rate increase, continuing strong loan demand, the Fourth of July holiday reserve needs, exceptionally wide swings in country bank excess reserves, and the airline strike. The mid-year interest payment period for savings and loan associations and mutual savings banks fortunately created no special problems, and with the higher rates offered by many of these institutions a rough competitive equilibrium appeared to have been attained among the major financial intermediaries. High yields on a variety of marketable securities, however, continued to attract funds from the financial intermediaries.

Net borrowed reserves fluctuated widely from week to week, reflecting the behavior of required reserves growth, the swing in country bank excess reserves, and more recently, the $1 billion in extra reserves provided by the airline strike. Thus, in the week ending July 6, when required reserves were growing more rapidly than anticipated, net borrowed reserves were moved up above $450 million. In the week ending July 13, when required reserves were showing less strength than expected, the country bank build-up of excess reserves was inhibiting the flow of reserves within the banking system, and the airline strike was beginning to supply reserves, net borrowed reserves fell to $95 million. In the following week, net borrowed reserves moved back up to $479 million, but in a considerably easier money market atmosphere as country banks moved their abnormally large accumulated excess reserves into the money centers.

In view of the special report submitted to the Committee, I will not comment in any detail on the large volume of matched sale-purchase transactions carried on over the period.1/ I would like, however, to reiterate that the matched sale-purchase transaction has proved to be a very valuable instrument for absorbing reserves in size for temporary periods with a minimum of market disturbance. It has worked even better than we had expected, and I believe that the lively competition between dealers kept the cost of these transactions to a minimum.

Banks and the market generally feel that money is tight and that the Federal Reserve is really determined to keep bank credit expansion within reasonable bounds. It is somewhat disturbing to hear some leading commercial bankers talk in terms of a possible money panic, but it is clear that the financial community is feeling the pressure of continued loan demand in a period of monetary restraint. Against this background, and with the stern reality of high financing costs, Government security dealers are understandably reluctant to carry any substantial inventories. As a result we should be prepared to see a continuation of erratic fluctuations in interest rates as temporary supply and demand forces or specific economic, political, or financial developments push the market first one way and then the other.

1/ A memorandum from Mr. Holmes entitled "Use of Matched Sale-Purchase Contracts, July 13-20, 1966" was distributed to the Committee on July 22, 1966. A copy has been placed in the Committee's files.

Given the state of the markets and the many uncertainties involved, we should try to be as flexible as possible in our approach to open market operations, so that the routine alternation of the Federal Reserve as buyer or seller of securities does not unnecessarily exacerbate interest rate swings. Looking ahead, our current projections indicate a need to supply something over $1.5 billion of reserves in the next two weeks, assuming that the airline strike is settled by the first of the month. A continuation of the strike would, of course, supply a major portion of these reserves, while the reserve outlook is further clouded by the international financial uncertainties described by Mr. Coombs. As you will recall, the Committee at its June 28 meeting amended the continuing authority directive to permit repurchase agreements to be made against Government securities of any maturity rather than limiting them to Government securities maturing in 24 months. The understanding at that time was that this added degree of flexibility would remain in effect only until the next meeting of the Committee when Committee action would be required to restore the continuing authority directive to its original form. I would now recommend that the Committee not take action today to so restore the directive, thereby continuing to authorize repurchase agreements against Government securities of any maturity.

I would like to turn to one vexing question in connection with any repurchase agreements that may be made in the period just ahead. I am troubled by the fact that the discount rate, which is the rate at which RP's would normally be made, is so far out of line with other dealer financing costs and is well below the three-month Treasury bill rate. As you know, the Committee has set no upper limit on RP rates, but there is a distinct danger that setting a rate above the discount rate might well be detrimental to the Treasury financing operation and could possibly set into motion renewed speculation about an early increase in the discount rate. At this time, therefore, I see no good alternative to continuing to make RP's at the discount rate. I would hope that we would not have to lean too heavily on RP's during the coming weeks, but we will have to be guided by events as they develop.

In addition, in view of the heavy need to supply reserves indicated by the projections, I recommend that the Committee increase the leeway for changes in the System Open Market Account from $1.5 billion to $2 billion. Such an increase would not be needed if the airline strike continues or if a substantial volume of repurchase agreements were made, but it would appear a useful measure to take in order to allow room for necessary operations if the reserve need turns out to be greater than expected.

As you know, the Treasury will be announcing tomorrow the terms for the refunding of $9.1 billion outstanding Treasury securities maturing on August 15. With only $3.2 billion of the outstanding issues held by the public this should be a routine operation--but there is no such thing as routine in the markets at the present time. Market thinking is quite diverse on the appropriate terms for the issue, with different views as to appropriate maturity or maturities, as to coupon, and as to whether there should be a simultaneous prerefunding of November 1966 and February 1967 maturities. All of these issues will be under discussion with Treasury advisory committees today and tomorrow, and the decision will not be easy in the light of recent market gyrations. Dealer underwriting interest in the refunding has been minimal, but somewhat more investor interest has developed with the improved market performance of the past several days. How long this sentiment will last is problematical, and a rather difficult even keel period will lie ahead. A definition of even keel is not easy when extraneous developments may have more effect on interest rates than minor swings in reserve aggregates or other factors under Federal Reserve control. But I believe it is clear that we should try to be as neutral as possible in our effect on the money market through the August 15 payment date and perhaps for some period beyond.

Mr. Hickman, referring to Mr. Holmes' final remark concerning the Treasury refunding, asked how long an even keel might have to be maintained to stabilize the after-market.

Mr. Holmes said it was almost impossible to make a prediction on that point at a time like the present, when market conditions were tending to go through wide swings over short periods.

Mr. Brimmer asked whether the Manager was including the expected Treasury cash financing among the operations for which he thought an even keel should be maintained.

Mr. Holmes replied that he was not. The cash operation, which probably would involve an offering of tax bills with tax and loan account privileges, would be announced before August 15, with payment to be made sometime later in the month. While it might present a problem for a short period the problem was not likely to be sufficiently serious to extend the time for which an even keel would be required.

Mr. Hickman asked whether the Manager thought that the refunding would preclude a policy change in the latter part of August.

Mr. Holmes replied there might be an opening for such a change in the latter part of August, but at this point it was difficult to make a firm prediction.

Mr. Hayes remarked that in an informal discussion a week or so ago the Treasury people had shown a willingness to consider the possibility of the System's not maintaining an even keel after the refunding. While they might change their minds, that was at least a possibility.

Mr. Mitchell referred to the concern Mr. Holmes had expressed about the spread between the discount rate and dealer financing costs, and asked why he was reluctant to use a rate higher than the discount rate on any repurchase agreements he might make.

Mr. Holmes commented that in the midst of a Treasury financing market participants would be unusually sensitive to anything that suggested a change in System policy, and they might interpret a higher rate on RP's as foreshadowing a change in the discount rate. At the moment the market did not expect an immediate change in the discount rate.

Mr. Mitchell asked whether the rate on System RP's with dealers had been out of line with dealer loan rates at times in the past.

Mr. Holmes replied that the rate on RP's had been well below dealer loan rates for some time now. The Account Management had considered raising the RP rate, but had decided not to for the reason he had mentioned--a higher rate might be taken as a signal of an imminent change in the discount rate. There also had been periods in the past when the discount rate was out of line with dealer financing costs.

Mr. Ellis asked whether a rate above the discount rate had ever been set on RP's by the Desk.

Mr. Holmes replied that that had been done on one or two occasions, but that in each such case an increase in the discount rate had been announced a few days later.

In response to a question by Mr. Robertson, Mr. Holmes said his intention would be to continue to set the rate on repurchase agreements at the discount rate if any RP's were made during this period, although he had expressed his concern over the fact that that rate was out of line with current dealer financing costs.

Mr. Robertson said he shared Mr. Holmes' concern. He would recommend that the Desk avoid the use of RP's to the fullest extent possible, recognizing that some might be necessary. He did not think, however, that in present market circumstances a rate on RP's above the discount rate would necessarily be construed as signaling a change in the discount rate.

Mr. Mitchell commented that the System could well be criticized if it made RP's with dealers at so large a differential below their alternative financing costs.

Mr. Holmes agreed. At the same time, he said, he would not like to take any action that could be pointed to, rightly or wrongly, as having upset a delicate Treasury financing operation. The Desk had felt constrained in the use of RP's in the recent past because of the rate differential, but it might have to use them to some extent in the weeks ahead because, with dealer inventories small, exclusive reliance on outright purchases could push the bill rate very low. Of course, if the airline strike continued and float remained high there would be very little problem, but the period ahead was a highly uncertain one.

Mr. Brimmer remarked that precisely because of the existing uncertainties he would keep innovations to a minimum. If the Manager felt that he had to make RP's, he (Mr. Brimmer) would favor setting the rate on them at the discount rate.

Mr. Maisel commented that the Committee's primary concern was with monetary policy and not with the cost of operations. Moreover, the cost to the System of outright purchases followed by sales probably would be greater than that of making RP's at the discount rate. It seemed to him, therefore, that if the Manager concluded that making RP's at the discount rate was desirable for reasons of monetary policy, he should proceed to make them.

Mr. Mitchell remarked that the question was not one of costs to the System but rather of profits to the dealers, and Mr. Maisel rejoined that they were the two sides of the same coin.

Mr. Hayes said that he was struck by two facts. First, the System was making funds available at a 4-1/2 per cent rate to banks through the discount window. Secondly, the Desk made RP's with dealers in amounts and for periods of its own choosing, and it policed them effectively. He could understand the concern that had been expressed, but he personally felt that the Treasury financing was sufficiently delicate to warrant the Committee's living with the existing situation for a few weeks more. Recent RP's had been made at the discount rate, so no change from present practice was involved.

Mr. Shepardson noted that his feeling was similar to Mr. Mitchell's; the procedure might be necessary but he thought it was not desirable.

Mr. Hayes summed up by saying that in light of the discussion the Manager was fully aware of the unfavorable aspects of the procedure and would try to avoid making RP's to the extent possible. The Committee's consensus, as he understood it, was that decisions in the matter should be left to the Manager's judgment, although some members were reluctant to have RP's made at the discount rate.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period June 28 through July 25, 1966, were approved, ratified, and confirmed.

Mr. Hayes then noted that while the Committee had amended the continuing authority directive at the previous meeting to remove the maturity limitation on securities held under repurchase agreements on the understanding that the directive would be restored to its original form at this meeting, the Manager now recommended that the Committee not take such action today. He asked whether there was any objection to retaining the existing form of the directive, and none was heard.

Mr. Hayes then asked whether there was any objection to the Manager's recommendation that the leeway for changes in the System Account holdings of Government securities between meetings of the Committee be increased from $1.5 billion to $2.0 billion, and none was heard.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, paragraph 1(a) of the continuing authority directive to the Federal Reserve Bank of New York was amended to read as follows:

> (a) 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 and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.

Mr. Hayes 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. Partee made the following statement on economic conditions:

A good many business analysts seem recently to have turned less bullish on the future course of economic activity. Doubts are heard increasingly about the underlying strength of private sector demands, and forecasts of marked slowing or even downturn around year-end or a little later are now not uncommon.

Weakness in the second-quarter GNP figures, much of which reflected the substantial setback for the automobile market and its widespread ramifications for supplier industries, has helped fuel this concern. But many analysts view past and present spending levels as excessive in other lines as well--for plant and equipment, business inventories, consumer durable goods generally--and point to the auto setback as a harbinger of things to come. Concern is also frequently expressed variously about the effects of tight money, rising costs and prices, the evident weakness in the stock market, and the balance of payments situation--all with forebodings for the future.

To the extent that these forebodings are transmitted to businessmen, investors, and consumers, they will in themselves tend to bring a moderation in future plans and actions. But I cannot go along with the view that a near-term economic reversal is now shaping up. We would all agree, I think, that imbalances in the economy have broadened and intensified over the past six months or so. Plant and equipment expenditures look increasingly vulnerable, expectations of rising prices have become a more important part of the picture, and inventory accumulation may well be proceeding at an unsustainable rate if the uptrends in new orders and sales continue to moderate.

But the continued expansion in spending associated with the war in Vietnam--which appears to have hardened further over the past month--provides a powerful support to the economy and a deterrent to cutbacks in private spending flows. The Federal budgetary position is now shifting abruptly to a more expansive stance, reflecting not only higher defense spending, but also the Federal civilian and military pay raises, the start-up of Medicare, and the phasing out of tax payment speed-ups, which raised receipts sharply in the second quarter. We estimate that, on the revised national income basis, the Federal Government's net position will move from surpluses of $2.3 billion in the first quarter, and $3.6 billion in the second quarter, to approximate balance in the third quarter and a small deficit in the fourth.

This shift figures prominently in the Board staff's projections of third-quarter GNP, which show a rise of $14 billion as against $11 billion and $17 billion in the last two quarters, respectively. The main feature of the projection is a pick-up in consumer spending, the expansion in which slowed markedly in the second quarter.

The slowdown last quarter took the form of lower auto sales and reduced growth in nondurable goods, but it also reflected a somewhat slower expansion in personal incomes and a sharp increase in Federal tax payments, as the new withholding schedules took effect. Conversely, in the current quarter, personal incomes should rise faster--mainly because of higher transfer payments and the Federal pay raise--and the increase in the tax take will be more moderate. Hence, disposable income will rise sharply faster than in the second quarter, providing strong support to consumer spending. Higher retail sales in June and thus far in July, though tentative, provide some confirmation of the expected resurgence in consumer demand.

Inventory accumulation accelerated last quarter, on the other hand, and in this case a slowing in the current quarter seems almost inevitable. Much of the increase reflected the dealer build-up in auto stocks, and these should be worked down in the weeks immediately ahead as output is cut sharply for model changeovers. But manufacturers' inventories have also accumulated more rapidly in recent months, and whether there will be any slowing here is less certain; not much has been allowed for in the projection.

Another clearly weak spot--and on more than technical grounds--is in residential construction. Private housing starts in May and June were at an annual rate 20 per cent below the peak three-month average last winter, and the recent figures on building permits have been noticeably weaker than those for starts. The staff projection allows for some further decline in residential building expenditures, but it may still understate the drop in store.

On balance, it seems to me that the green book[1/] projection could turn out to be a little high for the third quarter. But even so, the general impression of recovery to a somewhat more rapid advance in GNP after midyear, with much more of it coming in final demands, seems correct. If so, the existing strong pressures on resources can be expected to be maintained. Industrial production rose at a 6 per cent annual rate in the second quarter, even with the slowdown in output and demand. And an extraordinary number of teen-agers were absorbed into the labor force in June with no increase in the unemployment rate. It would appear from this that there are substantial backlogs of labor demand, even for relatively unskilled workers.

Prices also continue under pressure and, with aggregate demands continuing to mount, no real let-up is in sight. The June rise in the consumer price index brought the increase for the first half to 1.7 per cent, substantially more than in the same period last year. Much of the increase was accounted for by foods, reflecting in part special supply factors, but nonfood commodities also rose somewhat and the increase in services was the largest since 1957, paced by higher medical costs. Wholesale prices of industrial commodities also have continued upward, at a 3.5 per cent annual rate in the second quarter. Some sensitive materials prices recently have shown less strength, but it would take very little additional increase in other materials and products to make up the difference in the over-all industrial index.

Under these circumstances--which include the prospect of a resurgence in consumer spending, continuing strong pressures on resources, and upward movement in the price indexes--public policies that will hold in check expansion in aggregate demand at about the current rate clearly are still in order. Monetary policy, for its part, now appears to be biting, not only in construction but in other lines affected marginally by the restricted availability and increased costs of credit. And further effects are likely to appear with the passage of time, given the time lags required to influence spending decisions and actual outlays.

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

In view of these lags, and taking into account the apparent recent dampening in business expectations, it seems to me that a good case can be made for avoiding further escalation in monetary restraint for the present. But the situation bears unusually careful watching; either a breakout of the economy on the upward side or a spreading of unexpected weaknesses are long-shot possibilities.

Mr. Koch made the following statement concerning financial developments:

A major uncertainty at the time of our last meeting was the extent of mid-year liquidity pressures that savings and loan associations and mutual savings banks might have to face. Deposit withdrawals have been substantial for the saving and loans, but fortunately less than had been widely feared. A factor helping to limit withdrawals was the increase in interest rates posted by the nonbank financial institutions, particularly in California and New York.

But despite the less intense than feared recent pressure on major real estate lenders, mortgage financing and residential construction remain under great strain. This is indicated by the continuing evidence of sharp reductions in new commitments of lenders and in new permits to build. Although it is likely that the near crisis atmosphere that has been evident in mortgage markets in recent weeks is dissipating, market conditions no doubt will remain tight in the months ahead and flows of mortgage credit will diminish further, mainly reflecting commitment cutbacks.

Commercial banks have benefited to some extent by the July withdrawals from competing institutions. Time and savings deposits at commercial banks are expected to be up at a seasonally adjusted annual rate of over 13 per cent this month, as compared with an average of about 10 per cent in May and June. Savings deposits, at least at city banks, continue to decline and growth in large negotiable CD's has been slower, but small denomination time deposits have increased substantially further. We have no comprehensive information as to how banks have reacted to the recent change in Regulation Q, but the reports we have heard are that many banks are converting their time deposits to single-date maturities and continuing to pay the higher permissible rates.

Looking at the domestic financial scene more broadly and over a longer time span, there is growing evidence that restraint is biting. Total net funds raised in financial markets by the private sectors of the economy decreased considerably in the second quarter. Mortgage financing and corporate security financing showed particularly sharp declines, but part of the corporate decline may have been due to earlier anticipatory borrowing.

Total funds raised is a more meaningful indicator of over-all restraint than bank credit expansion alone, for bank credit reflects not only the effects of monetary restraint but also the changing role of banks as financial intermediaries for savings. Even the bank portion of total credit flows has fallen sharply--from about 45 per cent in the second half of last year to around 25 per cent in the first half of this year.

The effect of Federal Reserve restraint on the commercial banking system can also be seen in the recent course of the aggregate measures. Total reserves, for example, increased at about a 5 per cent seasonally adjusted annual rate in the first half of this year, as compared with 7 per cent in the first half of last year. The rate of growth of the bank credit proxy--total member bank deposits--declined from 10 to 7 per cent, reflecting mainly a reduced rate of increase in time deposits. Growth in the narrowly defined money supply, on the other hand, has remained in the 4 to 5 per cent range that has prevailed over most of the past two years, but this rate has been below that in the GNP. I think it is fair to say we have been achieving the moderation in the rate of growth of the "reserve base, bank credit, and the money supply" sought in recent directives.

Financial conditions have been getting more restrictive for some time now, but it is only in the last couple of months that real tightness has developed. This is shown most clearly by recent changes in the cost and availability of various types of credit and capital.

I have already commented on the tight situation prevailing in the mortgage market. The tightness has spread to the municipal market where interest rates have risen over 35 basis points since mid-April. Many banks, particularly the larger ones, are either cutting back on their acquisitions of new municipals or are liquidating some of their existing holdings. Specialized municipal dealers are finding the going very rough and there have been postponements and cancellations of new issues. There is even some evidence of lower municipal spending on capital projects as a result of the credit squeeze.

Financing of brokers and dealers in both private and Government securities is more expensive and less readily available. Consumer credit terms are also more restraining at both banks and sales finance companies.

Business borrowing from banks continues to be the area where restraint is less evident. The increase in such borrowing was at a seasonally adjusted annual rate of about 20 per cent in the second quarter and has continued brisk in July. One has to be careful, however, in basing monetary restraint on the course of business loans, for this type of lending is notoriously sluggish in its response to restraint.

Small banks also seem to be under less pressure than large banks. Loan demands on them have been less intense and their liquidity remains greater. Yet it is difficult to see how additional pressure can be brought against these smaller banks without intensifying the already very tight situation of the large city banks. Discount policy may be a possibility, but it is a hard one to administer.

As for the immediate future, our policy until the next meeting seems quite clear, namely, one of an "even keel." Although the Treasury refunding is relatively small, it occurs in a highly uncertain market, one in which even a well-priced, routine, short-term, rights refunding could result in high attrition and further upward pressure on longer-term interest rates. In this situation, it seems to me that the Manager should be instructed to hold to a steady course, using money market conditions as his main guide to operations.

Mr. Mitchell said he had been under the impression that June and July were periods of exceptionally large demands for bank loans because of corporate tax payments and accelerated payments of withheld taxes, and that there would be some slack in loan demand in August. Mr. Koch's remarks suggested, however, that the slack was not likely to materialize. He (Mr. Mitchell) asked whether that did not imply that the Committee should increase the degree of monetary restraint.

Mr. Koch replied that it would be difficult, in his judgment, to reduce the growth in business loans. Business loan demand was continuing strong partly because of the inventory situation, although the decline in the rate of accumulation of new car inventories should give some relief.

Mr. Holmes noted that, as the blue book[1/] indicated, the Board's staff expected the bank credit proxy to rise at an annual rate between 4 and 6 per cent in August. That, roughly, was only half the July rate, although the seasonal adjustment factors used might be more than ordinarily subject to question. Moreover, a good deal of current business borrowing might be anticipatory, as a safeguard against the possible unavailability of funds later. He added, however, that the New York Reserve Bank's projections of bank credit growth in August were higher than those of the Board staff.

Mr. Hayes commented that the New York Bank staff also expected loan demands to be somewhat stronger in August than did the Board staff.

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

Mr. Mitchell said he thought the Committee would want to tranquilize strong loan demands. He was concerned about the possibility of another surge in bank credit in August if the Committee adopted a posture of even keel today.

Mr. Maisel remarked that the basic question at issue concerned the interpretation the Committee intended to place on the proviso clause of the second paragraph of the directive, assuming it adopted a directive today along the lines of that proposed by the staff.[1/] A similar question had been raised near the end of the June 28 meeting but was not completely resolved, and perhaps it was best to have it raised early in the meeting today.

Mr. Brimmer said he had been concerned about the growth of business loans. He was particularly apprehensive about the prospective growth rates in July and August, especially in light of the New York Reserve Bank projections. He thought that for several months the Committee had been led to believe that business loan growth would moderate, and that it should now discount such expectations and work on the assumption that the bulge would not prove to be temporary, for whatever reasons. Moreover, he felt that focusing on the expansion of total bank credit might divert attention from the shift that was occurring toward business loans at the expense of other categories of bank credit.

1/ Appended to these minutes as Attachment A.

Mr. Maisel said that it had been his understanding at the June 28 meeting that the proviso clause of the directive adopted then would become operative if growth in the bank credit proxy exceeded an annual rate of about 9 or 10 per cent in July. The latest estimates for July suggested that actual growth was a little higher than that, but not much. He asked whether it was contemplated that the proviso in the proposed new directive would become operative if the credit proxy rose at an annual rate in excess of 4-6 per cent in August.

Mr. Holmes said that 4-6 per cent represented the Board staff's expectation; the projection of the New York Bank was close to 9 per cent.

Mr. Maisel then asked whether there was a similar disparity in the projections of required reserves.

Mr. Holmes replied that, speaking generally, that was the case, although one could not directly translate divergencies in estimates between one series and the other for various reasons, including differences in the seasonal factors.

Mr. Maisel then noted that the proviso clause of the staff's suggested directive began, "provided, however, that if required reserves are stronger than expected. . . ." He asked how Mr. Holmes would interpret that language.

Mr. Holmes replied that he would hope the members would express their opinions on the appropriate interpretation of the language in question when they commented on the directive today. The staff's projections were before the Committee; and if the members would note whether or not they thought the indicated growth rates were appropriate he would find it helpful in understanding the Committee's intent.

Mr. Hayes suggested that the members return to the subject under discussion in the course of the go-around.

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

> I find it today more than usually difficult to sum up the present state of the balance of payments. In the first place, the figures that have been coming in for increases in U.S. liquid liabilities in recent months have been heavily affected by foreign and international acquisitions of agency securities and time deposits with original maturity over 1 year. As a result, the preliminary press release at mid-August will show a second-quarter seasonally adjusted liquidity deficit greatly reduced from the first quarter's level. The average rate of deficit in the first half of 1966 will appear to have been less than the average rate in the second half of 1965, which was $1-3/4 billion. Yet we know very well that there was a deterioration in the merchandise export surplus by $1 billion annual rate, and we think we know that the changes in other parts of the current account and in the private capital account were not, on balance, anywhere near favorable enough to offset this trade deterioration between the second half of last year and the first half of this.
>
> That is my first difficulty. My second difficulty is quite different. In the very recent data on changes in U.S. reserve assets and liquid liabilities--that is, the data for June and the first two-thirds of July--I sense a hint

that something of a more favorable kind may have begun to happen. The usual summer-time bulge in the deficit does not seem to be developing. Yet, it is much too early to have corroborative evidence. And the indicators of weekly and monthly deficits themselves are incomplete and subject to revision, and they may be affected by any number of accidental or at least nonregular factors.

One reason for hesitance in taking seriously the hints of a favorable turn is that perhaps additional large shifts of foreign official and international funds may have been made in June and July into long-term time deposits and agency securities. Our estimate of the total of such movements in the second quarter has just been raised from a little under $500 million to nearly $550 million; the June figures are still not complete, and there is still a possibility that the shift into non-liquid assets will prove to have been larger in June than it was in April or May.

However, assuming that the hints of an improvement in the balance of payments in June and July do not eventually get explained away in that manner, we may find that the tight money situation and the slowing of the domestic economic advance in the second quarter have had measurable effects. One sector in which improvement could be hoped for is imports. The June import figure is being released today. It proves to be moderately encouraging: though it is up a little from May, it is no higher than the April-May average. It does leave the second-quarter total about 4 per cent above the first quarter, but the higher level was reached early in the quarter. If we group the last four months by pairs, imports in May and June were no higher than those of March and April.

What I wish to convey is simply the thought that it is possible that the balance of payments may show a turn for the better as the overheated economy begins to cool off. Whether a significant change has already occurred in the balance of payments is still a moot question, only to be answered with statistics that are not yet in.

It is also possible that the backlash of the distrust of sterling may have generated abnormal net payments to this country on various current transactions or to acquire assets here other than those that are counted as liquid. But probably the largest effects of the sterling crisis are not on the liquidity balance at all, but rather only on the official reserves transactions balance--on which I will say a little later.

But suppose the hypothesis of a July drop in U.S. imports were to be confirmed. Even then there would be no immediate implications for policy, in my opinion. Just as the rise in imports <u>may</u> have ceased for the present with the recent slowing of the rise in domestic output, income, and expenditures, so the new acceleration of domestic expansion that seems to be in the cards for the third quarter can be expected to bring a new acceleration in imports, perhaps with a lag of a month or so. The balance of payments case for as restrictive a combination of monetary and fiscal policy as the economy can stand will continue to hold until the economy is firmly on a track of expansion at a sustainable rate without appreciable inflation.

I should like to add a footnote on the official reserve transactions balance, partly to correct a misstatement on page 5 of the summary part of the green book. We can now estimate the seasonally adjusted annual rate of this balance in the second quarter, not "somewhere between $1 billion and $2 billion," but at about $0.6 billion. The difference between this relatively small deficit and the liquidity balance at a rate of about $1 billion, a difference of $0.4 billion, is explained as follows. Because shifts between liquid and nonliquid assets do not, in general, affect the official reserve transactions calculation, this balance would have been very much larger than the liquidity balance, if it had not been for a still larger factor working in the other direction. This was an increase in U.S. liquid liabilities to commercial banks abroad and to other private holders, amounting to half a billion dollars before seasonal adjustment and $650 million seasonally adjusted. This was mainly a reflection of the run on sterling.

Some of the drain on U.K. net reserves from their over-all deficit on current account, long-term capital, and short-term capital had its counterpart in reserve gains for European countries, and had no effect on the U.S. net reserve position on either of our two styles of calculation--though it does increase our liabilities to central banks who may be unwilling dollar holders. But a very large part of the flight from sterling was into dollars, and especially into Euro-dollar deposits. Given the tight money market in the United States, banks in the Euro-dollar market receiving these deposits placed in this country much of the dollar funds they had gained, rather than lending out dollars in Europe to end up in the holdings of European central banks. Thus, there was a very large increase in the balances owed by banks in the United States to their branches abroad (and perhaps also to other banks) operating in the Euro-dollar market. The increase in these balances owed to banks in the Euro-dollar market would apparently have been even larger than it was if the Bank of England had not swapped out part of its spot dollar losses to the market, causing banks operating in London to put back into sterling, on a covered basis, some of the dollars that had come to them.

Presumably these processes continued to work during the first three weeks of July, at a more violent pace. The whole business illustrates very well the good standing of the dollar under present conditions as a currency into which some people are willing to move their funds out of a currency that is under attack.

> Note: Immediately following the meeting, information was received that the estimate of the June deficit on the liquidity basis had been revised downward to correct a reporting error by a commercial bank. For the second quarter, the seasonally adjusted annual rate was changed from about $1 billion to about $0.6 billion. The estimate for the official reserve transactions deficit given in Mr. Hersey's statement ($0.6 billion, seasonally adjusted annual rate) was unaltered. The increase in U.S. liquid liabilities to commercial banks abroad and to other private holders was changed from $650 million to $550 million, seasonally adjusted quarterly amount.

Mr. Hayes then began the go-around of comments and views on economic conditions and monetary policy with the following statement:

The business expansion continues to proceed at a less hectic pace than in the first quarter. It looks, however, as if the advance in aggregate demand in the third quarter will be stronger than in the quarter just completed. The prospective advance is rapid enough to maintain strong upward pressure on prices. Federal Government expenditures, particularly on defense, are now clearly the most powerful force propelling the economy forward, and business outlays on plant and equipment are another important stimulant. We look for a renewed acceleration of consumer spending in the current quarter.

A most disturbing feature of the second quarter was the fact that over-all prices recorded the same large increase as in the first quarter--a 3-1/2 per cent annual rate--while real GNP rose at a rate of only 2-1/2 per cent. We see no reason to look for a slowdown in the rate of price rise, although no acceleration is visible at this time. Cost-push pressures on prices are likely to increase. Unemployment continues to be relatively low and is likely to remain so.

The further deterioration of the balance of payments in the second quarter, apart from special "cosmetic" adjustment, is an additional reason for serious concern. The dominant factor has been a weakening of the trade account, with a rapid rise in imports and a slowing in the growth of exports. Rapidly rising aggregate demand in this country is of course the main source of the import increase. Rising Government outlays abroad, tourist expenditures, and direct investment must also share the responsibility for our poor payments showing. In view of the prospect of further domestic business expansion, and considerable restraint on demand in many other countries, there is little hope of improvement in our trade balance unless efforts to dampen aggregate demand in the U.S. are more successful than they have been to date. It does seem clear that some decisive new program of action to deal with our payments deficit is badly needed.

Last week witnessed the most serious of the crises that have beset sterling over the past couple of years. It is still too early to know whether the latest crisis has been surmounted, but there is at least ground for hope that the immediate danger is past, partly because of vigorous action by the System and the Bank of England. Of course Britain's longer-range problem is far from solved, and the sterling situation will continue to contribute to an atmosphere of uncertainty in international financial markets. However, the Wilson program is an impressive one, and, if effectively implemented, would set the stage for a long-run solution. Of course, pressure on the gold market and concern over our own payments are enhancing the uneasy international atmosphere.

Bank credit growth seems to have been around an 8 per cent annual rate for the first half of this year, as compared with about 10 per cent for the full year 1965.

Thus we have perhaps made a beginning toward our objective of slowing the pace of credit growth. In New York, at least, the demand for bank loans has remained very strong in July, despite the passing of the June tax and dividend dates. Although the banks' liquidity has reached a very low level, New York bankers feel that the quality of a great many borrowers whose requests are received is so high, and competitive factors so strong, that substantial loan increases are bound to continue short of considerably more severe reserve stringency than they have experienced so far. On the other hand, there is some fear that any sudden intensification of the pressure could lead to very serious problems, such as possible inability to honor commitments, or rapid forced liquidation of investments.

The savings institutions appear to have weathered the mid-year interest period without any serious difficulties. The mutual savings banks were losing funds more rapidly in early July than in early April but have since recouped and at the moment seem to be gaining deposits at a better rate than in July of last year. The savings and loan associations are also said to be gaining funds again. In both cases increases in rates have helped reverse earlier losses. Current efforts in Government circles to roll back rates paid on various types of certificates of deposit seem to me to overlook completely the fact that savings institutions and commercial banks together are already tending to lose out, in the competition for savings funds, to direct investment in securities on the part of the public.

The need for a continued general policy of restraint seems clear in view of the still excessive rate of credit growth, the continuing inflationary danger, and the parlous state of our balance of payments. With no assist from higher taxes in prospect for the near term, I think we should seek an even firmer monetary policy were it not for current even-keel considerations. Under the circumstances, with the refunding likely to be especially delicate and perhaps quite difficult, we can do no more than maintain about the same degree of restraint prevailing in recent weeks. It seems to me, incidentally, that the new technique discussed at our special telephone meeting proved to be extremely useful in enabling us to prevent any undue easing as a result of the airline strike; and we might well consider whether this should not be a permanent addition to our kit of tools. In the coming three weeks we might have in mind a range of free reserves of $450-$500 million, but I think the Manager should be given ample leeway to depart from this range in the light of apparent credit trends and of the Treasury's financing problems.

Perhaps a word is in order at this point on the subject of the discount rate. In spite of the Board's position as stated in their letter of July 16, I am still convinced that the 1/2 per cent increase in the discount rate voted by our directors on July 14 was the right action under all the circumstances; and I was glad to see five other Reserve Banks take similar action. In regard to the point in the Board's letter that 1/2 per cent might not be enough to calm existing uncertainties, I think this doubt was far outweighed by the fact that a 1 per cent rise would very probably have set off a renewed sharp spiral of interest rates, which in turn would have been undesirable both from the Treasury financing standpoint and in the light of current Administration and Congressional efforts to check the escalation of rates. The basic economic and financial reasons, both domestic and international, for the July 14 action are, I think, fairly obvious; and I believe there would have been a real advantage in narrowing the wide spread between the discount rate and market rates before the even-keel period was upon us. The sterling problem was not yet so acute on July 14 that this constituted a sufficient reason for holding our hand, whereas a week later the inflamed and delicate sterling market position did argue strongly against any discount rate action; and for this reason, and this reason alone, our directors voted last Thursday to re-establish the existing rate. I would hope that some opportunity might be found after completion of the refunding to carry out an increase in the discount rate with the Board's blessing. A couple of weeks ago Treasury officials indicated that this might be feasible, and I hope that this possibility will receive careful study during the coming weeks.

I find the draft directive quite satisfactory, except for the wording at two points in the first paragraph. I would substitute "appears to be" for "is" in the first-sentence statement regarding over-all domestic activity; and I would change the reference to the balance of payments to read, "The balance of payments situation continues to reflect a heavy underlying deficit."

Mr. Ellis reported that the New England economy continued to roll along in high gear. Each month saw new production, employment, and income records posted with such monotonous regularity that one tended to overlook their real significance. For example, during the week ending June 18 insured unemployment was the lowest in tabulated records going back over 20 years. In many ways that statistic had greater long-range significance than the more widely publicized fact that not all students found jobs for the summer and the unemployment rate rose slightly. Rising employment, longer hours of work, and expanding incomes were translating into rising consumer spending--except for automobiles. Rising sales, in turn, were generating optimistic sales expectations in the minds of New England manufacturers. The Reserve Bank's regular quarterly survey, covering firms with one-eighth of the region's employment, found them expecting their seasonally adjusted sales level to rise by 1.3 per cent from the second to the third quarter, having declined by that much between the first and second quarters.

In the financial arenas, Mr. Ellis continued, both commercial banks and mutual savings banks were breathing easier now that the July dividend dates had passed. No savings banks had had to draw on lines at the commercial banks to meet deposit losses. In fact, it was estimated that, in the aggregate, the mutuals would gain deposits in July. They were still making a substantial volume of mortgage loans but were buying fewer out-of-State mortgages. While the large commercial banks were determined to meet their loan commitments to the mutuals, they were somewhat concerned about having the funds to do so. For all weekly reporting banks in the District, liquid assets as a per cent of total deposits adjusted fell to 4.8 per cent on July 13, roughly half of the national figure of 8.9 per cent, and loan-deposit ratios reached 77.9 per cent, compared with a national ratio of 73.7 per cent. For Boston banks, the ratio touched 84 per cent. It was quite clear that First District banks were less liquid and were under stronger pressures than was suggested by data reflecting the national scene.

District banks, particularly the larger ones, reported they were rationing their established customers and rejecting prospective new ones they would be delighted to accommodate in normal times, Mr. Ellis remarked. In fact, several had arrived at a point of urging that some guidelines--by total and by type of loan--be formally established to give them more backbone in reaching tough decisions. It was not at all surprising, therefore, to find that District banks were very active participants in the Federal funds market and also showed up frequently at the discount window. During the second quarter as many as 41 per cent of the country member banks borrowed at some time or other and their borrowings averaged 7 per cent of their required reserves, substantially more than in any other

District. In contrast, among country banks, continuous borrowers of six periods or longer borrowed a larger portion of their required reserves in six other Districts than they did in New England. Apparently, while First District banks in general borrowed more heavily and more frequently, the extent of borrowing by the so-called continuous borrowers was below average.

After considering those and related economic facts, Mr. Ellis said, directors of the Boston Federal Reserve Bank voted on July 18 to raise the discount rate by 1/2 per cent. They viewed the move as a desirable step in continuation of a gradual tightening of monetary policy. Realizing that the longer a rate remained out of pattern the greater the distortion it caused and the greater the inertia that had to be overcome, they sought to reduce uncertainty in a market when such action had been fully discounted. In addition, they thought that such a move would reduce, marginally, the rate incentives to borrow from the Federal Reserve; that it would provide another signal to other nations that the United States was determined to pursue monetary restraint; and that it would reserve for later use the possibility of still another discount rate increase if market trends prevailed. The directors considered a possible increase of a full percentage point, but rejected it for two reasons. First, the abruptness of such an action, which would completely close the present gap between discount rate and the Regulation Q ceiling, could be viewed as a divergence from the recognized policy of gradual shifts toward tightness; it could well be described as slamming on the brakes. Secondly, the competitive balance between commercial banks and other financial institutions--Mr. Holmes had used the term "competitive equilibrium"--would be shaken more severely than desirable just as it showed some signs of settling down.

Quite obviously, Mr. Ellis continued, the Treasury financing schedule now blocked action on the discount rate until the last half of August, when it might possibly be fitted in around the expected issue of tax bills. It might be desirable at that time for the Desk to innovate with respect to the rate on repurchase agreements, setting a rate closer to the bill rate.

Meanwhile, Mr. Ellis remarked, the critical issue of policy settled down to a meaningful definition of even keel in the context of present conditions and expectations in the market. The staff memoranda had outlined markets that were expected to fluctuate substantially under the influence of special float factors, changes in tax payment schedules, and other forces. In general, the Committee's objective, in his judgment, should continue to be retention of an atmosphere in which commercial banks felt under considerable sustained pressure to slow their rate of aggregate credit creation. The 10 per cent rate of credit expansion projected for July suggested that banks still had a considerable leeway for expansion, so the basic position of policy should be to continue gradual tightening whenever possible.

The proposed directive apparently was intended to express such an objective, Mr. Ellis said. He thought Mr. Hayes' proposed wording changes in the first paragraph were appropriate. In addition, because the wording of the proviso clause in the second paragraph of the staff draft seemed unnecessarily clumsy, he would urge the Committee to consider some alternative wording such as "provided, however, that if required reserves expand more rapidly than expected and if conditions associated with the Treasury financing permit, ..." As he considered the directive, it instructed the Manager to hold to a posture of tightness insofar as the Treasury financing permitted, and to stiffen restraining pressures if reserve growth tended to accelerate. He would define tightness in the terms of the staff memoranda, with net borrowed reserves in the \$400-\$500 million range, borrowings around \$800 million, the Federal funds rate at 5-1/2 per cent or higher, and dealer loan rates above 6 per cent, as recently. He realized that the three-month bill rate probably would fluctuate rather widely, but he hoped it would fluctuate up--to the neighborhood of 5 per cent--more frequently than down. In general, he thought the Committee had not achieved the retardation of growth in bank credit that it had intended, and he would like to see occasional months in which there was no growth in reserves to offset the months in which reserve growth was unusually high.

Mr. Mitchell asked Mr. Holland what particular expectations the staff had in view in suggesting that the proviso clause of the directive begin ". . . if required reserves are stronger than expected."

Mr. Holland replied that the staff started with the projections contained in the blue book but recognized, of course, that the Committee might conclude that some different objectives were appropriate. Specifically, the staff had in mind the blue book projections for August of a 4-6 per cent annual growth rate in the bank credit proxy and of "small growth"--by which was meant practically no increase--in required reserves.

Mr. Shepardson noted that Mr. Holmes had reported earlier that the New York Bank staff projected an annual rate of growth in the bank credit proxy of 9 per cent.

Mr. Irons reported that economic activity in the Eleventh District was at a high level and continuing to move up, although it was not surging. Most recent indicators reflected further expansion. Department store sales were strong and automobile sales, although not as high as earlier, were generally regarded as very good. The year-to-year increase in employment was 5 per cent and unemployment recently had been running at about 3 per cent of the labor force. Manufacturing employment was expected to rise in July. Construction contract awards were up from May to June and, unlike the situation in other Districts, residential construction continued to rise in the Eleventh District. In June, the latest month for which figures were available, residential construction was 22 per cent higher than in May. According to the Reserve Bank's index, District industrial production was up 2.6 per cent in June and was running 8-1/2 per cent over a year ago. Agricultural conditions were difficult to assess at this time, although it appeared the cotton acreage this year would be about 25 per cent lower than last year.

In the financial area, Mr. Irons said, total loans at District banks declined slightly in the last few weeks. Deposits were up, with demand deposits rising quite substantially. The unfavorable developments that had been feared at savings and loan associations around the mid-year interest-crediting date had not materialized; he had heard of no cases of real hardship. In the last month large negotiable CD's of District banks had increased about $44 million to a total somewhat over $1 billion. Bankers reported that loan demand continued very strong and that they were rationing credit. Perhaps the rationing was not as severe as might be desirable, but the fact remained they were turning down loans they would have made under other circumstances. Bank liquidity was somewhat less than it had been in earlier months. Banks were active purchasers of Federal funds, averaging net purchases of about $500 million in the latest week. The total dollar amount of Reserve Bank discounts outstanding had increased in the last three or four weeks but that could not be described as reflecting a trend; the volume of discounting often rose sharply for a short period if one or two large banks came to the window. The proportion of banks borrowing was not large, although some very small country banks that had not borrowed in long periods were being referred to the Reserve Bank by their city correspondents.

Mr. Irons said that he had thought he had a clear understanding on how to operate the discount window, but was no longer sure that he did after receiving the Board's recent letter on the subject. The Bank was continuing to operate as it had been earlier, while trying to blend in the suggestions made. The problem rested largely on the question of the appropriate definition of "continuous" borrowing. He assumed that that question was being examined in the current fundamental reappraisal of the discount mechanism.

With respect to the national economy, Mr. Irons observed that the rate of expansion had been high during the second quarter and thus far in the third quarter. In light of the staff's projection for a $14 billion increase in GNP in the third quarter, with considerable increases in consumer, business, and defense spending, he did not see any let-up in sight. Pressures on prices were strong, interest rates had moved up substantially, and money market conditions were very firm. There had been some moderation in bank credit growth recently, but demands for bank credit continued strong.

In Mr. Irons' judgment the Desk had handled the float problem created by the airlines strike extremely well, and he approved the technique that had been used of matched sale-purchase contracts. The Eleventh District had been fortunate in not experiencing a large rise in float; the airlines that were not struck had got the mail through, and the float increase was smaller than had been anticipated. That situation was not likely to continue, however, if the strike extended to another major airline.

There was no question but that the recent firmness of monetary policy was biting, Mr. Irons said. While bankers perhaps were trying to find ways to work around the current tightness, they were not expecting conditions to ease. At present, the forthcoming Treasury refunding called for maintaining the status quo. Also, the Desk would have to try to avoid binds in the market. It had been successful in doing so in the period since the preceeding meeting, although he thought that additional firmness had developed in that period. He would like to have the present degree of firmness maintained without a deliberate attempt to tighten further. Net borrowed reserves in the $400-$500 million range would be satisfactory to him, with the structure of interest rates about as at present. The directors of the Dallas Reserve Bank had not considered an increase in the discount rate at their latest meeting, and he had not recommended that they take such action.

Mr. Irons concluded by saying that he could accept the draft directive. He would prefer, however, to omit the proviso clause, as he had noted at another recent meeting. He was inclined in that direction partly because he did not have much confidence in the projections. It would be better, he thought, for the Committee simply to call for maintaining existing conditions, and to plan on deciding at the next meeting whether any change was required. But he did not feel sufficiently strongly on the matter to make a major issue of it.

Mr. Swan said that total employment rose only slightly in the Pacific Coast States in June, despite an unexpectedly large increase in employment reported by aerospace firms. With the labor force rising somewhat faster, the rate of unemployment increased by one-tenth of one per cent for the second successive month. Housing starts in the western States, as in the rest of the country, declined in June and in the second quarter were 7 per cent below the first quarter. The extent to which the decline in housing starts of the past few years had been concentrated in the west, particularly California, was evident from the figures. From 1963 to the second quarter of 1966, starts in the western States dropped more than 40 per cent, compared with a decline of between 5 and 10 per cent in the rest of the country. Within the area there had been some recent crosscurrents. In the Northwest--the States of Washington, Oregon, and Idaho--residential construction contract awards in the first five months of 1966 were higher than in the same period of any of the previous four years. Washington, in particular, had experienced a sharp increase in residential building from a low point in early 1965. The other component of total construction--nonresidential construction--was continuing at relatively high levels. While resources were not completely transferable between the two kinds of construction, obviously there was some transferability.

California chartered savings and loan associations did much better in the first eleven days of July than in the corresponding period in April, Mr. Swan said, and much better than they had feared. While exact figures were not available, their share accounts apparently declined by about $100 million in the first third of July, compared with over $300 million in that part of April, and there were some indications of an increase in subsequent days of July, although data were not yet available. The California experience differed from that elsewhere; in the country as a whole the decline in association share accounts in early July was considerably larger than in April. The regional Federal Home Loan Bank had indicated that it had been able to make some loans recently to provide for an expansion in mortgage lending activity, rather than simply to help associations meet withdrawals. The relative improvement at California associations apparently was related to the higher rates they were now paying. By the first of July the typical rate on passbook accounts had risen to 5-1/4 per cent, and on bonus accounts to 5-3/4 per cent. Like banks, savings and loan associations had found that advertising higher rates on bonus accounts led to a substantial shift to such accounts from passbook accounts. He suspected that most of the associations' customers did not realize that the 5-3/4 per cent rate was not guaranteed, but that rates would be established quarter by quarter; any reduction in the rate probably would come as a surprise to them.

In any case, Mr. Swan continued, the California associations were no longer worried, as they had been some weeks ago, about the possibility of an immediate massive outflow of funds. Their concern had now shifted to the longer-run problem of the profitability of operations at the existing rate levels. A few noninsured savings and loan associations in Idaho and Utah had experienced difficulties recently; one had closed and at least two others had invoked the

30-day withdrawal notice provision of State law. Those events, however, apparently had not had any significant secondary effects.

In the two weeks ending July 13, Mr. Swan continued, the District's weekly reporting banks gained considerably more IPC time deposits than they lost in passbook savings deposits, but the net increase was offset to a considerable degree by a decline in public deposits. As elsewhere, indications were that loan demands continued strong. He suspected, however, that some of that demand reflected anticipations of higher interest rates and lessened credit availability rather than current needs for funds. The District's major banks continued to be net buyers of Federal funds. Borrowings from the Reserve Bank had been quite moderate for some time and were negligible in the week ending July 13. As Mr. Irons had indicated was the case in the Eleventh District, the borrowing figures for the Twelfth District fluctuated sharply in the short-run depending on whether a large bank or two came to the window.

As far as policy was concerned, Mr. Swan said, the Committee was faced with the Treasury refunding, and there did not appear to be grounds for any course other than maintaining an even keel. Like others who had already expressed their views, he favored net borrowed reserves in the $400-$500 million area. He would hope that the kind of increase in the bank credit proxy that was projected by the staff would be realized. Given the uncertainties associated with the Treasury financing, however, he thought the Committee would have to rely on the Manager's judgment to some degree. With respect to the proviso clause of the draft directive, while he agreed with those who favored some specific indication in terms of the change in required reserves, he felt that the second condition mentioned--relating to the Treasury financing--was the significant one, and that it rendered the condition with respect to required reserves less important. With that qualification, he would note that the phrase, "if required reserves are stronger than expected" struck him as unclear. Instead, he would suggest the wording, "if required reserves increase measurably and conditions associated with the Treasury financing permit. . . ." Such language would appear appropriate in light of the blue book projection for virtually no increase, and at the same time it would avoid the use of a specific figure.

Mr. Galusha said he would first make a few brief observations about the Ninth District economy. Appearances were that the economy's growth also moderated somewhat in the second quarter; but he would hastily add that second-quarter gains in production and employment were still impressive. He was unable at this time to say whether the District economy's growth accelerated again in June, but from his travels about the area he could report that the dominant mood was one of ebullience. That was particularly so in rural areas. And, all things considered, perhaps that mood was fitting for an economy with a relatively important agricultural sector. The economic implications of the philosophic revolution now taking place in the U.S. Department of Agriculture were only dimly perceived, but they were enormous and far-reaching for the District economy. In any event, if he had to predict national economic activity on the basis of the soundings he had taken about the District, he would have to join with the authors of the green book and say that the recent slowing up was not to be taken very seriously.

Mr. Galusha remarked that he, too, could be ebullient--or nearly so, since he found the mood a hard one to manage under the best of circumstances--if it were not for the country bankers, some of whom persisted in a dim view of System membership. The threat of withdrawal continued very real in the District. And a change in the structure of reserve requirements, therefore, continued as something very much to be desired.

Before turning from District developments, Mr. Galusha said, he would respond to the Board's letter of July 19, 1966, and comment briefly on country bank borrowing. On trend, it had been increasing--largely, he suspected, because monetary restraint had been increasing. This year, however, country bank borrowing in the District had increased a little less in relative importance than one would have expected on the basis of seasonal forces. The normal seasonal pattern was for an increase in the relative importance of country bank borrowing through July. But, in June, before the airlines strike, it was a bit under the seasonal expectation. Naturally, that pleased him. It confirmed what he had been told--that administration of the Reserve Bank's discount window had not changed.

As to open market policy, the present seemed to Mr. Galusha to be a time for temporizing and, he thought, it would be so even if there were no announcement of Treasury refunding terms in the immediate offing. As recent events had made clear and coming events would, he believed, make clearer, a considerable increase in monetary restraint had already been affected. Moreover, the quarterly increases in GNP projected by the Board's staff did not greatly exceed those which would likely be consistent with near-stability in important components of over-all price indexes. And one could not be sure that the projections captured the full effect of what had already been done by the Committee and the Board. In light of the relatively weak quarter just past, the Committee would therefore do well to wait for additional confirmation of a return to more rapid growth before tightening further.

He, for one, fully expected that that additional confirmation would be rather quick in coming, but he still would prefer to temporize now.

Mr. Galusha concurred in Mr. Irons' statement on the directive proviso. In introducing just one of the additional factors to which the Desk might have to respond in order to maintain a quality of credit stringency the Committee members were all agreed was essential, there might be a danger of limiting the Desk's response to other factors in the present time of uncertainty. Like Mr. Swan, he was bothered by the word "stronger" in the staff's draft. He supposed it was meant qualitatively as well as quantitatively, but some clarification would be helpful. He said he would prefer deleting the whole proviso.

Mr. Scanlon reported that the economic picture in the Seventh District in July did not differ appreciably from that of June. New housing starts had been reduced sharply and unemployment had increased temporarily in auto centers. No general improvement in the availability of experienced labor had occurred, however, and upward price pressures continued dominant in markets for industrial goods. The principal concern of District bankers and businessmen--other than international uncertainties--was the extent of labor demands in negotiations later this year and in 1967. Labor costs were widely expected to rise appreciably, thereby tending to erode profit margins and push prices up further.

Delivery times on steel and aluminum products had eased in the past month, Mr. Scanlon noted, and current and prospective meat supplies had risen. Some building materials were more readily available, and freight car shortages had eased. Those factors, together with new industrial facilities coming into production, were helping to restrain inflation but were not sufficient to warrant complacency. Despite the influx of students to the labor force, labor shortages continued. Over 60 per cent of Chicago employers reported that their production was limited by their inability to obtain an adequate labor force.

District savings and loan associations appeared to have weathered the crucial midyear period with much less loss of funds than had been feared, Mr. Scanlon continued. Since April many of those associations had been building liquidity and arranging credits with commercial banks. Although many associations were forced to reduce liquid asset holdings substantially to satisfy net withdrawals of funds in July, there was relatively little need to resort to borrowing. Some associations that had been "out of the mortgage market" since April were beginning to take an active interest in new loan requests. During the second quarter housing permits in the Chicago area were 10 per cent below the same period a year earlier, in contrast to a rise of 40 per cent in the first quarter. Average interest rates on new mortgages had continued to increase throughout the District.

The banking statistics, coupled with further upward movements in interest rates, indicated that credit demands remained very strong, Mr. Scanlon said. Loans had declined less than seasonally this month following the unusually large expansion that occurred in June, despite higher interest rates and more restrictive loan policies. Loan patterns at District banks had been similar to those for the U.S. for the June-July period, with substantial increases in loans to business and finance companies accompanied by a reduced pace of real estate and consumer lending. Major Chicago banks reached a near-record basic deficit position in the second week of July, but had since become somewhat more comfortable, with borrowings at the discount window sharply reduced. Their outstanding CD's had increased over the past month but by less than the tax period outflow.

Mr. Scanlon commented that estimates through the first half of July indicated continued rapid growth of bank credit and total reserves. The concurrent sharp rise in interest rates indicated continued strong demand for credit. The increase in interest rates, coupled with the rise in net borrowed reserves, was consistent with the policy directive adopted at the Committee's June 28 meeting, which called for reductions in net reserve availability if required reserves expanded more than expected. It appeared, however, that credit demands were so strong that the recent policy posture had not been sufficiently restrictive to slow reserve growth significantly. He would like to see further pressure on reserve availability and money market conditions in an effort to achieve some further slowing in growth of required reserves. The Reserve Bank directors continued to feel an increase in the discount rate would be helpful in that respect. Their only question now was whether any increase should be more than 1/2 per cent.

Mr. Scanlon concluded by saying that he realized that, for the present, Treasury financing dictated no change in policy. The draft directive was acceptable to him with some of the amendments that had been suggested. He had interpreted the clause in the second paragraph reading "if required reserves are stronger than expected" to refer to the statement in the blue book that the expectation was for no growth or only a very small growth in required reserves.

Mr. Clay observed that for the period ahead Treasury financing had to be taken into account in formulating and executing monetary policy, thus leading to the desirability of an even keel policy. Apart from Treasury financing considerations, a further effort to gradually reduce reserve availability would appear to be in order. Developments and prospects in the domestic economy gave continuing evidence of pressure on resources and upward movement of prices. That was a matter of concern in terms of both the domestic economy and the international balance of payments. The goal was not one of increasing interest rates, but further action to reduce reserve availability presumably would have such an impact on interest rates.

One rate change that was needed was an increase in the Federal Reserve discount rate, Mr. Clay said. There were understandable reasons for not raising the discount rate in early July, and forthcoming Treasury financing activity was an additional factor that would seem to prevent such action in the next few weeks. Unless economic and financial developments led to a substantial reversal in money and capital markets, he thought that serious consideration should be given to an increase in the discount rate following the Treasury financing. The present situation put a large premium on borrowing at the Federal Reserve Banks and placed too much reliance on discount window administration. The draft economic policy directive was acceptable to Mr. Clay.

Mr. Heflin said there had been no really significant changes in the Fifth District except for a number of developments that underscored the difficulties of projecting Government expenditures. The textile industry continued under pressure from military demands for a wide range of goods, and the tobacco industry apparently was receiving a significant stimulus from military demands for cigarettes for shipment to forces overseas. It was highly unlikely, however, that the pressures on textiles and tobacco would continue at present levels; in both industries there was a feeling that, because of the heavy recent buying, future Government purchases would not be as large as had been thought.

More generally, Mr. Heflin continued, economic activity continued at a high level in the District. The Reserve Bank's latest business survey showed further employment gains in both the manufacturing and nonmanufacturing sectors. In early June insured unemployment was at or near record lows throughout the District. Dealers at the recent Southern Furniture Market were reported to be bullish regarding the fall sales outlook, and the lumber industry was currently enjoying prosperity, but both were concerned about the probable effects on them of the slowdown in housing starts.

Loan demand was heavy and growing, Mr. Heflin remarked. However, there had been practically no pressure at the discount window except on the part of a few banks that had tended to borrow heavily in the past. The Reserve Bank had discussed the situation with a number of those banks recently, as it had had to on previous occasions.

At the national level, it seemed to Mr. Heflin that the moderating trend that had started in April was continuing. That conclusion differed from the one reached by the Board's staff in the green book, perhaps because the staff at the Richmond Bank emphasized past performance while the Board's staff emphasized future prospects. That made it appear that two different periods were under consideration, as, to some extent, there were. To him, there was real significance in the second-quarter drop-offs in growth rates of GNP by a third, industrial production by a half, and payroll employment by somewhat more than half. The production and sale of automobiles had continued down except for a modest rise in June, and housing starts and expenditures for new construction continued to fall. New orders for durable goods had registered small declines in two of the past three months and, while unfilled orders continued to grow, the rate of growth in the second quarter was appreciably below that of the first quarter.

On the other side of the picture, Mr. Heflin continued, there were only a few major series which showed an accelerating upward trend. Inventories seemed to be moving up, if somewhat erratically. Outlays for Medicare would be large and rising and the recent increases in military and civil service pay scales would add to purchasing power. There also was the ever-present possibility of sharply higher defense expenditures because of escalation in Vietnam. But, while the picture was not clear, on balance the areas that showed declines or slower rates of growth seemed to outweigh those that showed strength.

With respect to policy, Mr. Heflin remarked that money conditions now were the tightest in a generation. Two months ago the Committee had adopted essentially a holding policy, waiting to see if the emerging trends toward moderation would continue and grow. It seemed to him that those trends had continued and had not been offset by accelerating inflationary trends elsewhere. With interest rates and credit availability at their present levels, monetary policy would seem to be doing about all it could to restrain inflation without taking undue risks of precipitating a collapse. The forthcoming Treasury financing and the new austerity program recently inaugurated by the British Government also argued against further tightening.

Mr. Heflin said he would associate himself with Mr. Irons' position that it would be desirable to eliminate the proviso clause in the draft directive.

Mr. Shepardson said that, notwithstanding the lower rates of expansion in some areas that had been mentioned, it seemed to him that the over-all pressures in the economy were continuing and that the prospects were for further expansion at an excessive rate. Were it not for the constraint imposed by the Treasury financing he would consider it entirely in order to press for a reduction in credit availability. Given that constraint, however, he thought the proviso clause of the draft directive was appropriate. He would interpret the directive in terms of figures similar to those mentioned by Mr. Ellis. He thought it important, to the extent the Treasury financing permitted, for the Desk to avoid slippages such as had occurred from time to time in the past when the Committee had been seeking to maintain reduced reserve availability.

Mr. Mitchell remarked that he did not have quite as much confidence as the staff did in the projections. Nevertheless, like Mr. Shepardson he thought a little more firming of conditions would be desirable. Mr. Hayes' amendments to the first paragraph of the draft directive were acceptable to him. In the second paragraph he (Mr. Mitchell) would replace the language after the semicolon with the following: "however, if conditions associated with the Treasury financing permit, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability, some further firming of money market conditions, and a lesser growth in money supply and required reserves than projected." He had some question about the desirability of accepting a projection as a policy goal. Also, he believed that there was real danger of some slippage in August, and he would like to avoid it.

On the question of the discount rate, Mr. Mitchell said, he was not in town when the Board acted on the increases voted by the directors of several Reserve Banks, and he had not yet had an opportunity to review the Board's reasons for not approving those increases. He could say, however, that in his view a discount rate increase of 1/2 per cent would not make much sense at this time and he doubted whether a 1 per cent increase would make sense as of today. But, if there were to be an increase, he would consider a rise of 1 per cent to be far more appropriate than one of 1/2 per cent.

Mr. Maisel said that the period since the June 28 meeting had been more favorable with respect to credit expansion than the Committee had feared. While in his view the expansion was slightly larger than that contemplated in the proviso implementation clause, the Desk was to be congratulated particularly because of the emergency conditions under which it had to work. The Committee was rapidly approaching a point where its major monetary variables would be on the proper growth path. If the projected changes shown in the blue book for required reserves and the bank credit proxy were held to from now until the next meeting, the Committee would have come close to that path. From then on, a normal growth in those variables should be maintained. That might allow the credit markets to stabilize.

In the current situation, Mr. Maisel continued, variables such as total deposits at all institutions and liquid assets were already below a desirable growth path. The staff had made clear that there had also been a slowdown in growth in total credit. The main difficulties were in business loans, where the rate of increase was still far above a normal and satisfactory level.

In considering a possible discount rate change, Mr. Maisel said, it was necessary to be certain that the decision was made in the light of the total economy and not primarily for technical market or monetary reasons. What seemed reasonable on technical grounds might be drastic in terms of the economy. The past two weeks had shown that the market could adjust technically to the System's action or lack of action. As the Manager had made clear, the problems of the market were not primarily that of the discount rate. Since there was no way of estimating, even roughly, what the announcement effects of a change would be, the utmost efforts should be made to avoid having to run the danger of a move concerning whose impact the System was basically ignorant. The increased flexibility of Desk operations and market moves gained in this period should be extremely advantageous for the future.

The Committee should not be concerned even if the rate of borrowing at the discount window doubled, Mr. Maisel continued, nor about the fact that the discount rate might be advantageous for borrowers. The Committee's concern was clearly with the economy. It should not place undue importance on minor costs or profit factors in comparison to the whole market. Larger borrowings would give the opportunity to each of the banks in the System to stress the need for more careful rationing of business loans and other loans that had a major inflationary impact at the moment.

In concluding, Mr. Maisel said that the total impact on both the economy and monetary policy of maintaining the present posture should be advantageous in comparison to a change.

Mr. Brimmer said he would like to second Mr. Hayes' expression of concern regarding the balance of payments. In fact, he would suggest that the directive show that the Committee had taken explicit note of the extent to which the U.S. balance of payments figures were being window-dressed. There had been considerable discussion of British window-dressing today, and it would be desirable to recognize that the U.S. was doing the same. For that purpose he suggested revising the balance of payments sentence in the first paragraph of the draft directive to read as follows: "Despite the apparent statistical improvement resulting from special official transactions, the balance of payments situation continues to reflect a heavy underlying deficit."

Statistics apart, Mr. Brimmer continued, he agreed that the underlying balance of payments situation was serious and the need for progress was as real as ever. But he did not necessarily agree with Mr. Coombs that U.S. direct investment abroad and the tourism gap were the most important areas for attack. In his judgment there were some other areas that would have to be considered if the present serious situation was to be combatted, but he would not take time to catalogue them now.

Mr. Brimmer indicated that he, too, thought the Desk's recent performance had been admirable--especially the manner in which the technique of matched sales-purchase contracts had been used to deal with the rise in float. He thought the Committee had made the right decision in approving use of that technique at its July 11 telephone conference, and that it should take note of how well the operation had been carried out. He had suggested that the Desk keep close track of the costs of the operation, and he was pleased to note from Mr. Holmes' memorandum of July 22 that the costs were quite small.

Mr. Brimmer remarked that he had gone to some lengths recently to make public in specific fashion his views on what should be done about growth in bank loans. He felt as strongly now as he had a week ago that the Committee should not simply focus on over-all bank credit--although he thought that was growing too rapidly--but should consider its composition, to ensure that restraint did not bear unduly heavily on any one sector. It also was important to note the extent to which monetary policy was carrying the burden of restraint. While he did not expect a tax increase nor elimination of the investment tax credit in the immediate future, he felt that sight should not be lost of their desirability.

With respect to policy, Mr. Brimmer thought it was necessary to look beyond the coming four weeks; indeed, he hoped the Committee's procedures would evolve in the direction of planning ahead for two or three policy periods rather than for the single period until the next meeting. Thus, while he recognized the need for even keel during the Treasury financing, he thought that further restraint would be required after the financing. Because any slippage in the coming period would make subsequent firming more difficult, he urged the Manager to keep slippage to a minimum. A very modest increase in required reserves would be good, and no increase at all would be better. Net borrowed reserves should be at the deeper end of the $400-$500 million range. In sum, he would hold to as much firmness as possible during the financing and plan on proceeding with further gradual and orderly tightening afterward.

Mr. Brimmer said he would not go into the subject of the discount rate today except to note that he personally did not consider it obsolete as an instrument of monetary policy. In his judgment it should continue to be used along with the other policy instruments, and it would be appropriate for the System to again consider the desirability of an increase when the time was propitious.

Finally, Mr. Brimmer said, the Committee should take into account the current discussions in Congress of possible means to moderate rate competition among financial institutions. While bills currently under discussion would not necessarily be enacted in their present form, it was quite likely that some expression of a Congressional intent to moderate competition would be forthcoming soon, perhaps before the Committee met next.

Mr. Hickman commented that although business activity moderated in the second quarter, June was decidedly stronger than April and May, and the latest readings indicated a fast pace for July. While average second-quarter performance might be acceptable if it could be maintained, danger signals continued to predominate in major sectors. Defense spending and business spending were pointing sharply upward and indications were that GNP advances in the third and fourth quarters would accelerate.

Price developments continued to be disquieting, Mr. Hickman said. The 0.9 per cent increase in the GNP deflator during each of the past two quarters was well above tolerable limits. Price rises had accounted for increasingly larger shares of recent quarterly gains in GNP, from 20 per cent of the gain in the fourth quarter of last year to 40 per cent in the first quarter, and to 60 per cent in the second quarter. The share of the GNP gain in the second quarter accounted for by price changes was the largest since the first quarter of 1961, except for the abnormal fourth quarter of 1964. Prices of producers' equipment, in particular, continued to rise at an uncomfortably high rate and prices of consumer services were increasing steadily. With the labor market tight and with a large number of wage contracts to be renegotiated in the months ahead, the country could easily drift into cost-push inflation in 1967.

Given that environment, Mr. Hickman thought it was fortunate that some economic series were declining and others were showing little further advance. Signs of moderation were evident in such areas as construction spending, housing starts, length of the average workweek, new orders for durable goods, and retail sales. The airline strike, now in its third week, was bullish on float but had provided some fortuitous assistance in cooling off the economic advance.

With the Treasury refunding operation in August scheduled to be announced later this week, Mr. Hikkman felt that no change in monetary policy was indicated for the next few weeks. Nonetheless, the July projections for reserves and bank credit were very strong, and everything possible should be done to prevent the System from losing ground. Once the Treasury refunding was out of the way, the directors of the Cleveland Reserve Bank would probably vote once again to increase the discount rate by one-half per cent to help restrain excessive use of the discount window, which was occurring in some Districts. No further change in Regulation Q was indicated. The present ceiling, in combination with higher money rates--induced by the higher discount rate, if and when it was approved by the Board of Governors--would serve as a check on bank lending, particularly in the money centers, where it had been too buoyant.

In addition, Mr. Hickman continued, some sort of fiscal policy action was needed, as Mr. Brimmer had suggested, to help maintain balanced growth in the period ahead. His own preference would be for an across-the-board increase in income taxes, both personal and corporate. The great danger now facing the U.S. economy was another surge of demand such as had been experienced in the fourth quarter of 1965 and the first quarter of 1966. The deterioration in the U.S. trade account was an additional reason why prompt action should be taken now to prevent the economy from further inflationary overheating.

Mr. Hickman said he favored the staff's draft directive, including the proviso, with the hope that the credit proxy would be held in August to an annual rate of increase of no more than 4 or 6 per cent.

Mr. Bopp remarked that despite continued evidences of some slowing--particularly in autos and housing--no significant relief from pressures at work in the national economy had yet appeared. A month ago there were signs that some sectors of the Third District economy might be slackening, but latest information suggested they were a false alarm. In that kind of atmosphere, perhaps the best kind of news that could be expected was failure of fears to materialize. That seemed to have been the case with savings flows in July. In the Philadelphia area, commercial banks gained substantially, mutual savings banks lost fairly heavy amounts, and savings and loan associations lost still more. But all of the mutuals held off from raising rates from the level of 4-1/4 per cent which now had prevailed for a considerable time, and a few savings and loan associations also held their rates at that level. The general feeling of savings institutions in the area was that, given their relatively low rates, they had passed through the period with no dire results.

Having been on the conference call since the last meeting of the Committee, Mr. Bopp said, he had worried along with the Manager during the airline strike and had shared his relief at the way things had worked out to date. The innovation of matched sale-purchase contracts looked like a useful addition to the tool kit.

When it came to the outlook for the flow of money and credit, Mr. Bopp wished he could see equally favorable outcomes. Although the money supply certainly looked better for July, bank credit was probably a more meaningful measure at this time. As nearly as he could determine, demands for bank credit were still very strong and were likely to remain so. To get some quantitative idea of what might lie ahead, the Reserve Bank had asked the Philadelphia commercial banks for their forecasts of loan volume. The state of their forecasting art was rather rudimentary, so the results had to be interpreted with allowance for considerable error. They indicated, however, that loan volume was expected to rise further in the third quarter but at a slower rate than in the second quarter. That was partly seasonal, but it also reflected management policy of restraint and confirmed what the Reserve Bank had learned from the survey of lending practices.

Given the stubbornness of credit flows in responding to restrictive policy to date, Mr. Bopp said, it was perhaps questionable whether the current degree of pressure on marginal reserve positions would achieve a more reasonable rate of growth of credit in the future. But net borrowed reserves had, after all, been increased to the highest level since 1959, and if the Committee simply maintained its present posture increasing credit demands would force still greater tightness. Rising rates would press harder on Regulation Q ceilings and force more banks to the discount window. On the other hand, if bank credit and required reserves continued to increase rapidly, it might be necessary to push somewhat further in reducing marginal reserve availability. On that reasoning, and in consideration of the forthcoming Treasury financing, he accepted the staff's draft directive, as modified by Messrs. Hayes, Mitchell, and Brimmer.

Mr. Bopp thought that an increase in the discount rate of 1/2 per cent would be desirable at the earliest feasible time. He noted that the directors of the Philadelphia Reserve Bank had voted for such an increase on July 21.

Mr. Kimbrel observed that four weeks ago he had reported that expansionary forces in the Sixth District had diminished in intensity. The signposts now seen still did not indicate a return to the ebullient growth of last winter. Yet, it was also evident that business activity had advanced more swiftly in June than in early spring. Employment gains had become larger, and automobile sales increased 7 per cent to just a shade below last year's level. Looking ahead, the auto sales picture was clouded by heavy dealer inventories, which for some major makes were equivalent to a two-months' supply. A definitely distressing factor was the airlines strike, which already had had noticeable effects on Florida's tourist industry. Should that walkout be settled on terms greatly in excess of the guidelines, its impact, of course, could become far more serious than it was now.

Mr. Kimbrel said that bright expectations in residential housing were hard to find. Significant cutbacks had occurred in many places, especially in New Orleans, Nashville, and Huntsville.

Except in Atlanta, the chief depressants had been overbuilding in the past and reduced demand due to location shifts in defense and space activity. Only in Atlanta had tight mortgage money been a critical factor. On conventional mortgages of savings and loan associations, the most frequently reported rate in Atlanta was now 6-3/4 per cent, while for some associations the minimum lending rate was 7 per cent. Fierce competition between banks and savings and loan associations had subsided somewhat. And because of the issuance of new 5 per cent certificates, most savings and loan associations managed to get by the June 30 dividend period with smaller savings losses than last quarter. Construction volume, as indicated by housing starts, however, did not yet fully reflect the lagging effects of stringency in the mortgage market.

Mr. Kimbrel indicated that the banking data were difficult to interpret because of revisions in coverage, but there was some indication that loan growth at the larger banks slowed down in the first half of July, as some banks had difficulty in retaining their negotiable CD's. On the other hand, smaller banks were still experiencing very strong loan expansion, and their time deposit growth continued without letup. Although credit tightening affected the smaller banks last, it would appear that they should soon begin to feel those pressures to an increasing extent even without more credit restraint. Greater prevalence of those conditions in the

District would perhaps suggest that the greatest concern should be with maintaining the present momentum rather than with intensifying restraint.

Mr. Francis noted that total demand for goods and services had risen about 9 per cent in the past year. That sharp rise in demand had been excessive in view of the limited amount of idle capacity and the growth rates in labor, capital, and technology. As a result the economy had suffered many inefficiencies due to the strain on its resources, the nation's balance of payments with other countries had deteriorated, and prices had been rising at an accelerating rate. During 1965, each 1 per cent annual rate of increase in real output had been accompanied by a 0.2 per cent rise in prices; from the fourth quarter of last year to the first quarter of this year each 1 per cent gain had been accompanied by a 0.6 per cent rise in prices; from the first quarter to the third-quarter figures projected by the staff, each 1 per cent rise in real product would be accompanied by a 1.1 per cent rise in prices.

The strong rise in total demand had been in part the result of very stimulative fiscal actions flowing chiefly from the Vietnam conflict, Mr. Francis said. The high employment budget, which apparently was the best measure of the influence of Government actions on total demand, ran at about a $7 billion surplus in the first half of 1965 and had since been at about a $1 billion surplus level. Also, considered after the fact, it was possible that in the absence of appropriate fiscal restraint monetary actions could have prevented so great a rise of total demand. Bank reserves, bank credit, and the money supply had all risen very rapidly during the past year. Although market interest rates had gone up, the rise had not been reflected in the real price of borrowed funds to the lender and the real return to the saver since the effect of the higher rate of inflation on the value of money had more than offset the rise in interest rates.

Now the use of resources was becoming still more strained, Mr. Francis continued. Investment plans of business were unabated, and it appeared that the Federal budget stance was becoming increasingly stimulative. He noted that the staff estimate for current-dollar GNP in the third quarter was an annual rate of $746 billion, up at an 8 per cent annual rate. It seemed to him that, unless Government policy was altered, the prospects were for greater surges of total demand. He feared that with the more stimulative Federal budget and acceleration of personal income, consumer spending, and business fixed investment, total demand would push forward more rapidly than at any time in the past few years, while the available resources for expansion of real product would be less than at any other recent time. Also, the prospects were for continued deterioration of the U.S. international payments situation.

Accordingly, Mr. Francis remarked, there was even greater need for fiscal restraint, and pending that, for monetary management to do whatever it could to restrain total demand. It was necessary to keep total demand from rising at an 8 or 9 per cent rate when potentialities for increasing real product were expanding at only a 4 per cent rate. It would seem appropriate for bank reserves, bank credit, and money to rise at much slower rates than they had over the past year. Recently there appeared to have been some moderation in the growth rate in money, but the slowdown might have been only the temporary result of an unusually high Treasury balance. He thought that slower growth in money was desirable and that the Committee needed to consider the desirability of keeping down the growth rate as Treasury balances were again reduced.

Mr. Francis observed that the St. Louis Reserve Bank's board of directors, as expressed by their action on July 14 in raising the discount rate by one-half on one per cent, viewed the current situation about as expressed by Messrs. Hayes and Ellis on behalf of their directors. He noted that he had already responded to the Board's letter with reference to discounts and would not comment further on that subject. No problems had developed at Eighth District savings and loan associations during the recent period.

Mr. Robertson then made the following statement:

Clearly, open market operations between now and the next meeting of the Committee are going to have to be governed by "even keel" considerations. Just how long and how severely restraining those considerations will be cannot be predicted as yet, for we do not even know the Treasury's proposed refinancing terms for certain, let alone the question of market response thereto. Basically, therefore, we shall have to rely on the Manager's judgment of the severity of the "even keel" limitations as events unfold.

However, the developments I see taking place in the economy at large make me want to urge the Manager to maintain as tight a money and credit tone as he can within that "even keel" constraint. The resurgence in business activity following the second quarter slowdown, the continuing substantial rise in prices, and the evident labor market pressures all argue for a policy of monetary tightness. Looking at the financial system, one sees a good many signs of tightness already present--enough so that I would not want to add substantially to those pressures just now--but I certainly favor keeping up the pressure on reserve positions to guard against any backsliding in the posture of monetary restraint. In fact, if expansion in bank credit and aggregate reserves threatens to get out of hand, I would not hesitate to deepen net borrowed reserves to $500 million or even a shade beyond. I would not want to countenance any more than a very short run expansion in reserves at a time of a Treasury financing, for cash or otherwise. Neither domestic economic activity, price movements, nor the balance of payments gives any reason for lessening our concern over the pace of aggregate reserve expansion.

Since our instructions to the Manager are often cast in nautical terms, let me say that I am prepared to have us maintain an "even keel" during this period, but I also very much want us to keep a "taut ship" as well. In landlubber language, this means that I favor the draft directive as presented by the staff, including the proviso.

Now for a word concerning the proviso. What we should be aiming at, in our deliberations, is the way in which to reduce or absorb some of the excess demand in the economy. We should seek to do this by curbing the expansion of bank credit--not just by helping to shove interest rates higher. Since December, our record in this regard (i.e., contracting the expansion of credit) has not been too good. But it has been better since we began using the proviso--since we began focusing attention on the rate of expansion of bank credit as evidenced by increases in required reserves.

As I understand the proviso, what we are trying to do is to build into the directive some protection against an unduly large expansion in bank reserves. At other times, it might be protection against an unduly small expansion. Under current circumstances, all we are doing is saying to the Manager that if required reserves look as though they are growing faster than some rate, he should deepen net borrowed reserves in order to discourage faster growth. Our ability to do this obviously does not depend on whether staff projections turn out to be right or wrong. While current projections provide a starting point for our decision, the rate of growth in required reserves that is of concern to the Manager is evidently the rate the Committee chooses.

For my part, I would be willing to tolerate whatever small growth in "required" is consistent with 4 to 6 per cent bank credit growth--which happens to be the expectation of our staff. With such growth over the next few weeks, I would not make special efforts to deepen net borrowed reserves beyond the $400-$500 million range. But if growth in required reserves and bank credit became more rapid, I would not hesitate to deepen beyond $500 million, bearing only in mind the limitations necessitated by the Treasury financing operation.

Mr. Robertson added that since a number of comments had been made on the discount rate he thought he should comment also. In his judgment every board of directors should make whatever decision it thought was right. So long as he was in his present position--in the absence of Chairman Martin--he would never tell any Reserve Bank President what his Bank should do with respect to discount rates. On the other hand, the Board itself had to make decisions in the light of the picture as it saw it, and the decision of the Board might differ from that of the Banks. That should not create any animosity between the Board and the Banks. The Board's decision could not be based solely on whether the discount rate was out of line with market rates; the problem was much deeper than that. It was necessary to recognize that there was sentiment in the Administration against escalation of interest rates, and a tendency to view discount rate increases as contributing to such escalation. The System had to have a strong case before risking any enlargement of that feeling. If the case was good, the risk should be taken; otherwise, it should not be. The discount rate obviously was out of line with market rates, but no one had made a case persuasive to him that additional price action was needed to operate the discount window effectively. The volume of borrowing had not been unusually large for a period such as the present; it was not nearly as large as it had been in 1959, for example. It was his personal view that the System would have much more control over lending by member banks if they were borrowing in larger amounts and open market operations were being relied on less to supply reserves. Of course, in saying that the price mechanism was not needed now to operate the discount window effectively he was assuming that the situation was still as reported by the Presidents recently--namely, that the smaller banks, which were doing much of the borrowing, were not borrowing and concurrently selling Federal funds to the large city banks, And he assumed that the discount windows were being watched with that possibility in mind.

The next time the discount rate came up for consideration, Mr. Robertson said, the Reserve Banks should make their own decisions. The Board would do the same in light of what action it thought, from its own vantage point, would be in the best interests of the country. While there might be differences of opinion reflecting differences in points of view, he would hope that there would be no resulting animosity.

The whole Administration was involved in the effort to stop the escalation of interest rates, Mr. Robertson continued, and recently he had attended many meetings on the subject with representatives of various parts of the Government. The general feeling was that the "rate race"--if one might call it that--had to be stopped, because if it were not nonbank financial institutions would find themselves in great difficulty perhaps 6 months or a year hence, and ultimately irreparable harm would be done to the whole financial system, including banks. It also was thought that the impact of restrictive monetary policy was being felt too much in one area. In sum, the view was that the rate race had to stop. As the Committee knew, the Board had taken action with respect to multiple maturity time deposits, and it also had recommended legislation that would give the Federal Reserve, the Federal

Deposit Insurance Corporation, and the Federal Home Loan Bank Board discretionary authority to set ceiling rates on any reasonable basis they deemed appropriate.

Mr. Robertson then summarized recent discussions with the Administration, and between the Administration and members of Congress, regarding alternative forms of possible legislation on deposit interest rates.

Mr. Hayes commented that there were a number of reasons for profound concern at present, including the uncomfortable international position of the dollar, the absence of tax action, and the lonely position of monetary policy. He was happy that Mr. Robertson had said what he had about the discount rate, and he (Mr. Hayes) was sure that there was no animosity on the part of the Reserve Banks as a result of the Board's recent decision.

The Committee's consensus on policy today seemed relatively clear, Mr. Hayes said. There was a general wish to keep a tight rein on credit expansion, and a general awareness that the Committee's ability to act in that area was considerably restricted by the Treasury financing and the consequent need to maintain an even keel. He thought it would not prove too difficult to develop language for the directive that would meet the wishes of a majority of the Committee.

A discussion of the wording of the first paragraph of the directive followed, in the course of which it was agreed to accept

Mr. Hayes' suggestion for the first sentence and a modified version of Mr. Brimmer's suggestion for the sentence referring to the balance of payments.

Mr. Hayes then noted that a number of changes had been suggested in the staff's draft of the second paragraph of the directive, most of which were primarily matters of wording. However, Mr. Mitchell had suggested a more substantive change, calling for further firming to the extent that the Treasury financing permitted. As he understood the views expressed, a majority wanted to make any further firming contingent on developments with respect to required reserves as well as on conditions associated with the financing.

Mr. Mitchell said that he would be prepared to accept a second paragraph along the lines of the staff draft if it was clear that a majority did not favor language such as he had proposed. He suggested that an expression of views be called for with respect to his proposed language.

Mr. Shepardson also spoke in favor of a poll of the Committee on the question.

At Mr. Hayes' request, the Secretary then polled the Committee. Messrs. Bopp, Brimmer, Mitchell, and Shepardson indicated that they would prefer the language Mr. Mitchell had proposed, and the other six members indicated that they would not.

The Committee then agreed upon a second paragraph consisting of the staff draft with wording changes of the kind suggested by Mr. Ellis.

> 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 over-all domestic economic activity appears to be expanding somewhat more rapidly than in the second quarter despite weakness in residential construction, with industrial prices rising further. Total credit demands continue strong and financial markets, particularly for mortgages, remain tight. Despite the statistical improvement resulting largely from special transactions, the balance of payments situation continues to reflect a sizable underlying deficit. 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, while taking into account the forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current state of net reserve availability and related money market conditions; provided, however, that if required reserves expand more rapidly than expected and if conditions associated with the Treasury financing permit, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 23, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) July 25, 1966

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on July 26, 1966.

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding somewhat more rapidly than in the second quarter despite weakness in residential construction, with industrial prices rising further. Total credit demands continue strong and financial markets, particularly for mortgages, remain tight. The balance of payments continues in deficit. 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, while taking into account the forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current state of net reserve availability and related money market conditions; provided, however, that if required reserves are stronger than expected and conditions associated with the Treasury financing permit, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions.