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, August 23, 1966, at 11:30 a.m.[1]

PRESENT: Mr. Hayes, Vice Chairman
Mr. Bopp
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Hickman
Mr. Irons
Mr. Maisel
Mr. Mitchell
Mr. Robertson[2]
Mr. Shepardson

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

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

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hexter, Assistant General Counsel
Mr. Brill, Economist
Messrs. Garvy, Green, Mann, Partee, Tow, and Young, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

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

1/ This meeting was preceded by a joint meeting of the Board and the Reserve Bank Presidents to discuss certain proposals regarding discount administration. Copies of the minutes of the joint meeting have been placed in the Board's files.
2/ Withdrew from meeting at point indicated in minutes.

Mr. Garfield, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Adviser, Division of International Finance, Board of Governors
Mr. Gramley, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Mr. Bernard, Economist, Government Finance Section, Division of Research and Statistics, Board of Governors
Mr. Furth, Consultant, Board of Governors

Mr. Strothman, First Vice President, Federal Reserve Bank of Minneapolis
Messrs. Taylor, Baughman, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of Atlanta, Chicago, St. Louis, and San Francisco, respectively
Mr. Monhollon, Assistant Vice President, Federal Reserve Bank of Richmond
Mr. Deming, Manager, Securities Department, Federal Reserve Bank of New York
Messrs. Arena and Rothwell, Economists, Federal Reserve Banks of Boston and Philadelphia, respectively

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 26, 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 July 26 through August 17, 1966, and a supplemental report for August 18 through 22, 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 gold stock was being reduced by $75 million today in order to replenish the Stabilization Fund, which had been hit by a French gold order of $145 million. On the London gold market, recurrent buying pressure had now reduced resources of the gold pool to $76 million, representing a drain of $236 million since the first of the year. What he found most ominous was the large suppressed demand for gold. Such demand had been suppressed by the very tight money conditions throughout the world, but it could break through into the market if there was any serious disruption in the circle of parities.

At the time of the previous meeting of the Committee, Mr. Coombs recalled, the fate of sterling was hanging in the balance. If a collapse had occurred, the System probably would have been struggling today to halt a speculative onslaught against the dollar. However, a number of acute uncertainties present at the time of the previous meeting--the risk of a breakdown of the Wilson Cabinet, the risk that Chancellor Callaghan would fail to support the wage-price freeze, and the risk that the trade unions would revolt--had all receded, at least for the time being. The British program was about as drastic as could have been expected, and it should soon begin to bite. Nevertheless, the general atmosphere in the exchange market remained almost as

despondent as before; everyone who could stay short of sterling continued to do so. In that atmosphere, sterling remained highly vulnerable to any new setback, and selling pressures had resumed during the past few days, perhaps reflecting some speculation associated with the forthcoming Fund-Bank annual meetings. On the other hand, if something could be done to trigger a shift in expectations, and if the enormous short position in sterling that had been built up over the past few months could be exploited, the situation might turn around.

During July, Mr. Coombs continued, the British ran a deficit of $1,120 million, of which $1,050 million was covered by central bank and other assistance. They chose at month-end to show a reserve reduction of only $70 million. That report was greeted with derision in the market, but the market also took the report as a sign that the British apparently still had plenty of credit resources at their command and sterling actually improved a little after the figures were announced. To cover the total deficit the Bank of England made a three-month drawing of $100 million on the Federal Reserve swap line; it drew another $100 million on the Bankfor International Settlements, and $130 million on the sterling balance credit package negotiated at Basle last June. In addition the Federal Reserve and the Treasury supplied $145 million through purchases of guaranteed sterling. Finally, at month-end the

Federal Reserve and the Treasury supplied $400 million of overnight credit, and an additional $175 million of such overnight credits were obtained from four other central banks. Of that total of $1,050 million of credit assistance, the British repaid $575 million on August 1, so in effect they began the month of August facing a deficit of $575 million. So far this month they had suffered sizable further losses, which by month-end might easily come to $400 million. Perhaps half of that amount, i.e. $200 million, might be covered by further drawings upon the sterling balance package, and they might want to cover the bulk of the remaining $200 million by further three-month drawings on the System swap line, under which $250 million was already outstanding.

Reverting to the total of $575 million of overnight money provided at the end of July by the Treasury, the Federal Reserve, and four foreign central banks, Mr. Coombs said he could see no alternative but to repeat that operation at the end of August. He would hope that the $175 million obtained at the end of July from four foreign central banks would again be available. If August 31 fell on any other day but Wednesday, he would also have recommended at this meeting that the Federal Reserve join with the Treasury in overnight credits of $200 million from each agency. But since an overnight credit extended by the System on a Wednesday would show

up dollar for dollar in the "other assets" item in the weekly statement, it had seemed to him preferable to recommend to the Treasury that they take over the entire $400 million of overnight money. The Treasury had agreed to do so. What was foreseeable, as far as the System was concerned, between now and the end of the month was a possible drawing by the British of $100, or even $150 million, on the Federal Reserve swap line on a 3-month basis.

Mr. Coombs also mentioned that the System Account yesterday bought $250 million of lire from the Treasury, which had acquired the lire in a special borrowing from the International Monetary Fund. Of the amount purchased, $225 million had been used to pay off the outstanding drawings under the swap line with the Bank of Italy. In effect, the Treasury had provided the System with a backstop for swap drawings which, in the case of Italy, were threatening to run on too long. He would hope that was a precedent for operations in other currencies. There was now open access to the Fund, through the technique developed in the case of lire, and that should help to relieve the worries Committee members and the Account Management had felt about getting involved in swap drawings that might go on too long. The remaining $25 million of lire obtained from the Treasury was used to pay down the System's forward commitment to the Bank for International Settlements, totaling $40 million, to deliver lire for sterling.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period July 26 through August 22, 1966, were approved, ratified, and confirmed.

Mr. Coombs noted that the $100 million standby swap arrangement with the Netherlands Bank, having a term of three months, expired September 15, 1966. He recommended renewal for another three-month period.

Renewal of the standby swap with the Netherlands Bank was approved.

Mr. Coombs then commented on his memorandum dated August 18, 1966, on sterling and the gold market, a copy of which has been placed in the Committee's files. In that memorandum, he recalled, he had pointed to the risk of a new crisis in either sterling or the gold market, or both, which could be triggered by speculation about a devaluation of sterling during the course of the annual Fund and Bank meetings. Those meetings often stimulated speculation about changes in parities, and this year such speculation probably would focus on sterling. Since the memorandum was prepared, the risk had, in his judgment, become more imminent and more menacing. In fact, he was beginning to think there might be some serious trouble immediately following the publication on September 2 of the British reserve figures for August. Earlier the Bank of England had been hopeful that through market swaps and similar arrangements

it might be able to show a small gain for the month and to indicate simultaneously that no additional recourse to central bank credit had been made during the month. They would then have reported a true figure, and that could have had a useful effect in tilting the balance of expectations in favor of sterling.

But the way things looked now, Mr. Coombs said, on September 2 the British would have to announce either a reduction of reserves, an acknowledgment of further recourse to central bank credit, or both. The market reaction to such an announcement, coming as it would 40 days after the new policy package was announced on July 20, might well set off a new burst of selling, which undoubtedly would be aggravated by speculative talk associated with the Fund and Bank meetings. As the Committee could see from the figures he had quoted, the British had been utilizing their credits at a rapid clip, and it might not take much longer to run through all of them. If a final effort was to be made to defend not only sterling but, more particularly, the dollar, through enlarging the swap network, he thought it was necessary to begin moving right away.

Mr. Coombs said he would like to make one point clear: it was quite true that the immediate reason for suggesting a massive increase in the swap network was the speculative pressure on sterling, but the basic reason was to avoid the pressure on the dollar that

would result from a sudden collapse of sterling. The dollar would become the target if sterling were to collapse, and the pressure would be reinforced by the probability of a breakout on the London gold market. If sterling did go down, the System would have already in place the additional borrowing facilities with the continental central banks that would be indispensable to a successful defense of the dollar. Of course, there was the possibility of last-minute negotiations, but such negotiations during the past few years had involved finding the right people on hand at the time they were needed; the next time they might not be there. In summary, whether sterling stood or fell, he saw an urgent need for swap line increases of the kinds suggested in his memorandum.

There was admittedly a risk, Mr. Coombs added, that such a major reinforcement of the swap lines might suggest a spirit of desperation, and thus alarm the market further. However, that had not been the market reaction to other recent announcements of central bank credit arrangements. Those announcements had invariably been received as evidence of the determination of the central banks to act together in defense against speculative pressures. At present the market was aware of the virtual breakdown of the Group of Ten negotiations looking toward the creation of additional reserve assets. It was aware of the pressure on sterling and the situation with respect to Vietnam. There was a growing feeling

that the whole system of international financial solidarity was beginning to come apart. Announcement of a new large effort demonstrating to the market that it was not coming apart--in fact was being strengthened--should do a lot to change that psychology.

The greater risk, Mr. Coombs said, was that a new package of credit facilities might suggest to the market that the existing facilities had been virtually exhausted. But that risk could readily be averted if all outstanding drawings under the swap network were reported as of the end of August. It would be highly useful, in the event of an increase in the British swap line, for the British to publish exactly what they owed under it. That would make it clear to the market that not only were those credit facilities being increased but that a large unexpended balance was available for intervention.

In summary, Mr. Coombs said, he thought there was the clear danger of a breakdown of the international financial system within the next month or 6 weeks. He saw very little that the Group of Ten could do to stop it; their negotiations had reached an impasse. The U.S. Treasury was not in a position to do a great deal about it. The Stabilization Fund had only limited amounts of money and the Treasury was set against providing medium-term credit through the Export-Import Bank. The burden therefore fell directly on the Open Market Committee.

Mr. Hayes, after stressing the highly confidential nature of the subject, noted that in the past few weeks there had been discussions by a Governmental committee centering in the Treasury as to the type of emergency that might develop and the part that the swap arrangements might play in dealing with it. Mr. Daane had attended those meetings, and Mr. Hayes asked him to comment.

Mr. Daane said that the particular group (usually called the Deming Committee) was set up in response to a directive from the President in June 1965. The main concern of the group was the international monetary reform question and the whole program of the Group of Ten. However, the President also requested that this group keep under surveillance the sterling problem, then clearly developing, which eventuated in the September assistance package. At intervals, whenever the British situation seemed to be particularly difficult, the committee had taken a look at the various possible approaches. In connection with that, the Secretary of the Treasury had in the past requested Mr. Coombs and Mr. Hayes to come down and discuss with the group and with him the question of various alternatives. A couple of weeks ago the same request was made of Mr. Coombs with respect to a question from the Treasury side as to whether there were ways of preventing or avoiding an emergency that could, as Mr. Coombs had noted, react upon the dollar as well. In response, Mr. Coombs had pointed up the

possibility of increasing the swap lines, always making clear, however, that that particular mechanism was the responsibility of the Open Market Committee. The interagency group was not entirely of one mind, but he (Mr. Daane) thought the real differences were more in terms of timing and technique than substance. The Treasury seemed to lean toward Mr. Coombs' suggestion as a most feasible and desirable approach. There was some feeling within the group that it might be preferable to attempt to put together a more direct package of assistance, but he thought it was fair to say that the Treasury view, shared by Mr. Coombs and himself, was that it would be unrealistic to think of that sort of credit in any major magnitude being arranged under current circumstances. In general, the principal difference in views turned on whether one could better put together a larger swap package, and get the kind of psychological boost that could come from it, now or after an emergency had actually developed. There was some feeling that perhaps the package could be put together more readily after an emergency had developed than in advance. There was also some feeling that putting together such a package would relieve some of the continentals from direct assistance to sterling. That more or less countered an alternative approach favored by some, which would be to wait for the emergency, go on unilaterally, and then turn to the continentals for reciprocity. In any event, no

clear-cut Administration view had evolved from those discussions. As he had said, he thought the differences involved mainly timing and technique, but it was clear to him that the Treasury was leaning heavily toward the view that the best way of proceeding was along the lines suggested in Mr. Coombs' memorandum.

Mr. Daane added there was one further difference of view. Some of the group felt that the market would get a psychological boost, but there was some feeling that announcement of an increase in the swap lines might have a perverse effect, for reasons Mr. Coombs had discussed. Mr. Daane stressed that the committee operated on a confidential basis and that its deliberations should be held in close confidence.

In response to a question as to his personal view, Mr. Daane said he felt strongly that Mr. Coombs had outlined the best procedure under current and foreseeable circumstances. He was highly skeptical, from his contacts with central bankers in the Group of Ten sessions and otherwise, that it was realistic to expect them to put up any substantial money directly. He thought the existence of this backlog of credit lines would prove reassuring to the market. In his judgment, it would be inadvisable to wait for an emergency to develop and then go hat in hand to the continentals. If the suggested course was followed, there was a good chance of forestalling such an emergency. Aside from simply reassuring the

market, the System would acquire a right to currencies that could be useful in dealing with any dollar movements that would constitute a real threat to the status of the dollar.

Mr. Hayes remarked that it was clear to him that this was one of the most crucial issues the Committee had had to face in some time. It warranted full discussion. In his own view, there was no workable alternative to the type of program that had been set forth unless the Committee wanted to take the risk that all of the past efforts to preserve sterling parity would come to naught, with all that could mean for the dollar and the financial structure that had been built up in the postwar years. The idea of a direct multilateral package of assistance was something that he had discussed informally from time to time with various influential people on the continent, and he did not think it could be worked out. In a discussion last week the Governor of the Bank of England indicated that he was of the same opinion. That was an important factor, because obviously no one would want to seek a multilateral package unless the British wanted to obtain it.

Mr. Hayes also stressed that the great merit in the scheme proposed was that it would provide important new protection for the dollar whatever happened to sterling. The pressure on the gold market and the continuing serious U.S. balance of payments problem made it important to do everything possible to reinforce the

defense of the dollar. It went without saying, of course, that the Committee would not want to pursue the Coombs' proposal, or anything else of the kind, without the full blessing of the Treasury. The Committee had followed that policy since the inception of its foreign currency operations.

Mr. Hayes also said that he had discussed the matter with Secretary Fowler and Under Secretary Deming, both of whom were favorably disposed toward the program, although the Secretary indicated that he was not in a position at the moment to give a formal Treasury approval. Over the weekend he (Mr. Hayes) had also talked briefly with Chairman Martin about the proposal. The Chairman had authorized Mr. Hayes to tell the Committee that, while he obviously had not had an opportunity to consider all of the details, he was in sympathy with the basic program objectives and felt it desirable to make the effort to prevent what could be a disintegration of the present financial system. The Treasury had indicated that it hoped the Committee would have a full discussion today and would be prepared to go ahead with the program on short notice if and when final Administration clearance was obtained, which might be a matter of weeks, days, or hours.

Mr. Robertson stated that he had talked to the Secretary this morning about the matter. The Secretary was inclined to favor the approach and hoped the Committee would approve the use

of the particular instrument, subject to action being triggered by notice from the Secretary to the Chairman or Acting Chairman of the Board of Governors, so that if it was necessary to move it would be possible to move fast, without a need to reassemble the Committee.

Mr. Hickman asked whether there had been any indication of the attitude of the major European central banks, and Mr. Coombs expressed the view that the attitude of the Bank of Italy would probably be favorable. In the case of the Bundesbank, as the Committee would recall, several approaches had been made to them over the past year about the possibility of increasing the swap line to $500 million. He had not been able to determine what was blocking those efforts, but he thought the Group of Ten deliberations may have been a factor. He hoped the Germans would accept a swap-line increase. If they did, the rest probably would fall in line rather quickly.

Mr. Mitchell asked about the role of the IMF in such a situation, and Mr. Coombs replied that its main role was that of a fall-back to provide medium-term credit. In the present situation there were two important limitations. First, so far as the British were concerned, their drawing rights were pretty well used up. Mr. Mitchell asked if there was any provision for emergency assistance, and Mr. Coombs said he did not believe so; none had been

granted to date. The second difficulty about the Fund, he added, lay in its slow-moving machinery, which in the process of turning over gave wide advertisement to the problems under consideration. An advantage of the swap network lay in the ability to move fast. It could absorb day-to-day pressures, and most important of all was the impression it gave to the market of central bankers having a common interest in maintaining the present parity system and being prepared to put up money to support it.

Mr. Mitchell remarked that from Mr. Coombs' document and comments he gathered that the contingency involved was the possible devaluation of sterling; without that contingency there would be no need to expand the swap network. Mr. Coombs replied that nothing, so far as the defense of the dollar was concerned, worried him more than a breakout in the gold market, which could be triggered by a devaluation of sterling or by other causes.

Mr. Mitchell suggested that enlarging the swap network on a crash basis might stir up a great deal more anxiety than would be desirable. He wondered whether it might not be better to go about the process more deliberately, perhaps on occasions when swap lines came up for renewal, and take the chance that some action on an emergency basis might be necessary.

Mr. Mitchell noted that a serious domestic crisis might be impending. If on top of that a broad effort was undertaken to

rescue sterling from its present difficult position, the combination of problems might be more than could reasonably be handled.

Mr. Coombs expressed agreement on the domestic side and said that was the foundation of his suggested approach on the international side. A breakdown on the international financial sphere could not be afforded; and if nothing was done, such a breakdown was likely to occur.

Mr. Mitchell then raised the question whether the point had not been reached where "papering-over" operations should be stopped.

Mr. Hayes replied that that would almost amount to saying that one was willing to throw the door open to "every man for himself" in the international financial field.

Mr. Mitchell commented that a large package of credits for the British already existed. He was not against enlarging it further. However, if the continental central banks did not go along, other efforts were likely to be ineffectual.

Mr. Coombs noted, in reply, that the lines of credit now being extended to the U.K. by the continental central banks came to $1.1 billion, or roughly equivalent to what the U.S. was putting up.

On the matter of timing, Mr. Hayes said that if the Committee were in a position to proceed deliberately, that might be well and

good. Whether or not that would have a better effect psychologically, he did not know. He was inclined to think that announcement of a simultaneous massive increase of the swap lines was more likely to make a favorable impression, but in any event the time element did not permit the deliberate approach.

Mr. Daane, stressing the confidentiality of the observation, said that within the Government there were two assumptions. The first was that a likelihood existed of a major crisis in September, and the second was that in the event of such a crisis the U.S. would do something with respect to it in terms of providing financial resources, unilaterally if necessary. It really came down to the question of how best to proceed; whether the U.S. would be in a better position to meet the situation if the enlarged swap network was put in place now.

Mr. Coombs commented that if he had been in a position to negotiate gradual increases in the swap network, with periodic announcements, that might have been the best way. But the opportunity for that had passed. Even though there was a risk of backfire from announcement of a package of large swap increases, the alternative was so bad that he thought it necessary to take a chance.

Mr. Bopp noted that only a short while ago negotiations with the Bundesbank for a more modest increase than now envisaged

had been unsuccessful. Mr. Coombs commented that the next renewal of the swap agreement with the Bundesbank would not occur until February 1967, and that would be too late to attempt to negotiate an increase.

Mr. Ellis referred to the extremely large short positions in sterling and the question whether something could be done to turn the situation around. He asked whether an announcement of enlargement of the swap lines would be likely to have an effect on the short positions.

Mr. Coombs replied that he would hope that it would help to turn things around. What the market feared at present was that the British credit resources were almost gone, and that no more would be forthcoming.

Mr. Ellis noted that the memorandum also referred to the possibility of negotiating an enlargement of the gold pool, and Mr. Coombs replied he had been working on that for the past month or six weeks. He believed that the Germans and Italians would agree to increases in their shares sufficient to expand the pool's resources by $100 million. He had not approached anyone else, but if the Germans and Italians agreed, others probably would go along. Then it would be possible to continue to intervene for a while longer in the gold market.

Mr. Ellis inquired whether the possible backlash effect of a failure to negotiate a simultaneous doubling of several major

swap lines should not be taken into account, and Mr. Coombs said he would contemplate negotiating with the Germans first. If the Germans were not prepared to go along, he might suggest calling a halt at that point. He thought he would know after contacting no more than one or two central banks whether the plan could be negotiated or not. Therefore, the risk of a leak should not be too great.

Mr. Ellis noted that the memorandum indicated that no approach to the French was contemplated, and Mr. Coombs said the swap line with the French was useless. The only purpose in continuing the swap line was to symbolize some continuing link between the Bank of France and the Federal Reserve, and to avoid an overt disruption of relationships which might lead to market distrubances.

Mr. Shepardson noted that a memorandum from Mr. Furth dated August 17, 1966, a copy of which has been placed in the files of the Committee, contained an alternative suggestion for dealing with the British situation. Mr. Coombs' proposal would involve a straight increase in the swap line, while Mr. Furth had suggested certain possible offsets to such an increase.

Mr. Coombs expressed the view that the market effect of a swap-line increase would be negated if any of the other credit arrangements were to be canceled out. He added that some of them were not actually available to the British at the present time,

for example, the Export-Import Bank line. As to canceling the September 1965 package, a considerable amount of money had in fact already been committed under that authorization. He thought the main objective was to improve confidence. If the market received the impression that the central banks were standing back of the British program, it might be hoped that the British would not have to draw further on the credits available to them. Otherwise they might have to draw all that was left, and that would add up to a tremendous amount of short-term debt.

Mr. Shepardson asked Mr. Daane whether, in the discussions of the interagency Government group, there was indication of further effort on the part of the Administration in regard to dealing with the U.S. balance of payments problem.

Mr. Daane noted that, as Mr. Coombs had pointed out, consummation of the increased swap lines would put this country in a stronger position in case there was any speculative ricocheting against the dollar. If the outflow of dollars continued, it would clearly have an implication there also. But he did not think there had been any real linkage of the two problems in the discussions. That did not mean, of course, that the Government was saying there was no further problem on the U.S. balance of payments. They were working, and would be continuing to work, on a program to improve the balance of payments situation.

Mr. Coombs commented that it was not known what the Administration would or would not do on the balance of payments side if dollars flowed out and it was necessary to draw on the swap lines to mop them up. The most the Committee could do was to make every effort to be sure that the System did not get locked in on swap drawings. An avenue had now been opened up for the Treasury to go to the Fund for help. If, for example, the System drew guilders in order to forestall a loss of gold, the Treasury acquired some responsibility to take the System out if the drawings went on for too long, by going to the Fund.

Mr. Brimmer commented that he had been participating in some of the discussions in Washington about the balance of payments situation. Some effort was being made to look beyond ad hoc programs. However, those possibilities were still under consideration at a secondary level. Some people were raising questions about the longer-run viability of the Department of Commerce program on direct investments. Some people were talking about taxes, but that had not gotten any blessing one way or another. There was also some feeling that the question of tourism should be looked into, along with the deployment of troops on the European Continent. Likewise, there had been some discussion of the use of swaps, the Group of Ten negotiations, and other matters. Some of the differences of opinion seemed to reflect variations in the basic interests of

people participating in the discussions and the agencies they represented. That helped, he thought, to explain the differing views on how to deal with the balance of payments problem. In any event, no new program had as yet come up to the Cabinet Committee on the Balance of Payments.

Mr. Clay said it seemed to him that the fundamental difference between the present proposal and other papering-over operations was that on this occasion the British had taken definite steps of a fundamental nature to correct their basic problem. If their internal political situation permitted them to persevere, the new program should bring about some correction of the situation. The papering-over technique was giving them time to achieve results from the basic steps taken. As to the papering-over of the U.S. problem, he thought whoever was talking with Administration people should emphasize that there must be a fundamental program for dealing with the balance of payments problem. That should be a part of the package. It should be emphasized that the objective was not just to save the pound but to give the dollar more time and to shore up the foundations of the British situation.

Mr. Clay noted that the Coombs' proposal would involve increasing the swap lines to a maximum aggregate amount of $5.2 billion. He asked what the System's financial risk would be if sterling should fall.

Mr. Coombs said that first of all there would be the financial risk involved in the credits extended to the British under the swap arrangement. Last fall there had been some basic discussions with the Bank of England and the Chancellor of the Exchequer. The result was an understanding that a banking obligation of the Bank of England was involved and that it would have to be paid off if that took every dollar of their reserves. They still had more than $3 billion of reserves plus the remainder of their securities portfolio. So if sterling went down, and they owed the System $600 or $700 million, the System should be able to get its money back.

In event of a devaluation of sterling, Mr. Coombs said, the French might move quickly to parallel the British action. The Scandinavians and others might also move. So there could be a crumbling of the parity system around the world. Talk of an increase in the price of gold and a new set of parities would generate a drive against the dollar. Foreigners might pull money back from the U.S., including money in the stock market, or increase their demands on the gold market. Here again there would be a direct challenge to the dollar. The dollar would be under tremendous pressure if sterling went down, and the best hope was to work out some clear understandings with the countries that it was felt could be relied upon to develop a firm defensive network.

Mr. Hayes then remarked that he gathered it would be appropriate for the Committee, if it so desired, to authorize Mr. Coombs to commence negotiating enlargement of the swap lines, but only if and when a formal approval of the program was received by the Chairman or Acting Chairman of the Board of Governors from the Treasury.

Mr. Wayne suggested that conceivably the Secretary of the Treasury might not give a formal approval.

Mr. Hayes said the only thing the Committee had thus far was an indication of favorable leaning on a personal basis. The negotiations should be started only if the Secretary of the Treasury formally asked the System to undertake the program as a matter of U.S. policy.

Mr. Daane remarked that no U.S. policy position had yet been formulated. The question would have to go to the top level. Mr. Wayne commented that the matter was too important to go ahead under a kind of gentlemen's agreement.

Mr. Hayes repeated that he would propose that the program become operative only if and when formal approval of the Treasury was received, and Mr. Mitchell raised the question whether "approval" or "request" was the more appropriate term.

Mr. Mitchell also asked whether it was conceived that the System would be acting just as an agent of the Treasury, and

Mr. Hayes said he thought it was recognized that the System did not have to do anything it considered unsound, and the Committee had never accepted the thesis that it would take any action it thought was wrong. That was different from saying that even if the Committee considered a program sound, it would not undertake the program unless it was consistent with U.S. international financial policy as expressed by the Treasury. He saw little difference, in that context, between an approval and a request. It was his recollection that the System's foreign currency activities had been undertaken from their inception with the full approval of the Treasury.

Mr. Robertson remarked that the question whether to undertake the program was one for the Committee to decide, but any action must be triggered by a specific notification from the Secretary of the Treasury that it was time to act.

Mr. Hayes then suggested that the Committee authorize negotiations to increase the swap lines with the understanding, however, that the negotiations would not be activated until there was specific notification from the Treasury that they wished the Committee to proceed.

Mr. Scanlon noted that Mr. Coombs had indicated that if negotiations with either of the key countries failed, the program probably should be called off. Suppose the Germans were willing

to go to only $500 or $600 million instead of $750 million? Would the proposed Committee action give Mr. Coombs enough leeway?

Mr. Coombs responded that he hoped it would. If the Germans agreed to only $500 or $600 million, he would not consider that a fatal blow to the negotiations. His memorandum had only referred to the $5.2 billion aggregate figure as a maximum.

Mr. Hayes then said that all the Committee would be granting, subject to notification from the Treasury, was authority to Mr. Coombs to attempt to negotiate the proposed swap-line increases within the suggested maximum amounts. He assumed that Mr. Coombs would furnish the Committee a full report of the results, with a request for formal ratification of whatever actions seemed feasible as a result of the negotiations.

Mr. Daane expressed the view that the record should be clear that the Committee was authorizing the negotiations subject to notification from the Treasury that such action was fully consistent with U.S. international financial policy, and that the timing was appropriate.

Mr. Shepardson asked whether it would seem appropriate, in further discussion with the Treasury concerning the swap program, to use the occasion to press for Administration concern on the total balance of payments problem.

Mr. Hayes said he thought it might be a mistake to try to tie that in as a quid pro quo. However, he would not lose any

opportunity to stress informally the need for action on the balance of payments. Mr. Daane said that insofar as he, Governor Robertson, and Governor Brimmer had participated in any Governmental review of the balance of payments position, they had always stressed the need for correction through the development of a broad-gauged program. He thought it was quite appropriate to continue to press the matter whenever opportunities presented themselves.

The consensus of further comments was that it would be inadvisable to tie the proposed program regarding the swap lines to a request for more vigorous efforts on the balance of payments problem, but that System representatives should properly use all appropriate opportunities to stress the need for fundamental correction.

Mr. Patterson asked whether Mr. Coombs was being authorized to proceed to negotiate swap arrangements which, however, would not be put into effect until the Treasury requested, and Mr. Hayes said Mr. Coombs was not to begin negotiations until word was received from the Treasury.

Thereupon, upon motion duly made and seconded, and by unanimous vote, Mr. Coombs was authorized to negotiate for an enlargement of the swap network along the lines proposed in his memorandum of August 18, 1966, subject to the understanding, however, that such negotiations were not to be begun until the Chairman or Acting Chairman

> of the Board of Governors received specific notification from the Secretary of the Treasury that the proposed program was fully consistent with U.S. international financial policy and that the timing was considered appropriate.

At Mr. Hayes' suggestion, Mr. Daane then presented a brief summary of the Group of Ten meetings held at The Hague, Netherlands, on July 25-27, 1966. The first order of business, he said, was a meeting of the Deputies on the morning of the 25th, at which they finalized the report that would be made public this Thursday. He thought he had given enough of the flavor of that report at previous Committee meetings to make it unnecessary to go into detail concerning it. It did represent a considerable agreement and consensus on the elements of contingency planning for reserve creation. But the real meat of the meetings at The Hague was in the sessions of the Ministers and Governors, which involved a debate between the U.S. Secretary of the Treasury and the French Finance Minister on whether or not to go forward into the second stage of contingency planning and, if so, under what conditions. The Secretary clearly came off best in the debate. The communique issued at The Hague, which would be sent to each Committee member along with the report of the Deputies, indicated that U.S. interests were fully protected in getting into the second stage of the negotiations, which would involve wider participation. It pointed

out that one of the principles involved was that the interest of all countries in the smooth working of the international monetary system was recognized. That was the U.S. position, and had been all the way through the negotiations. The communique said that it was appropriate to look now for a wider framework for consideration of questions that would affect the world economy as a whole, and it recommended a series of joint meetings in which the Deputies would take part along with the Executive Directors of the Monetary Fund. It indicated that a report should be expected no later than the middle of 1967. Nine of the countries of the Group of Ten had agreed to go into the second stage, and the French had been isolated in their negative position.

The meeting then recessed and reconvened at 1:50 p.m., with the same attendance as at the morning session.

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 July 26 through August 17, 1966, and a supplemental report for August 18 through 22, 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 in an atmosphere of considerable market apprehension since

the Committee met four weeks ago. The continued weight of credit demand, including two Treasury financing operations, further signs of inflationary pressure as evidenced by the steel price rise and the terms of the airline strike settlement, the rise in the prime rate, the cloudy outlook for CD's in the weeks ahead, and the Board's action to raise reserve requirements combined to put inexorable pressure on the financial markets. All sectors of the financial markets and all maturity ranges were affected. Rates on Federal funds, Treasury bills, bankers' acceptances, commercial and finance company paper, dealer loans, Federal Government agency obligations, and corporate and municipal securities all moved into new high ground, while stock market values declined about 7 per cent.

With dealer financing costs high and prices eroding, the underwriting of new issues has become a highly uncertain undertaking, and this in turn has contributed to the movement of prices and rates. There are many illustrations of the pressures the market is facing. To cite only a few: (1) On August 9 a $239 million issue of short-term notes--tax-exempt and fully Government guaranteed--by the Public Housing Authority was placed at an average cost of 4.61 per cent, up half a per cent from the rate on a comparable issue a month earlier. Major underwriters joined forces to enter a single bid for a major portion of the issues and exacted as much as a 1/2 per cent underwriting spread. (2) On August 16 the Urban Renewal Authority was able to place only $55 million of a $130 million offering, either because no bids were received or because the rates involved were in excess of rather flexible legal limitations. (3) A relatively new firm selling computer services was forced into the capital market after having been refused credit by a number of major banks, and paid up to 8-1/4 per cent for a 1970 maturity. (4) The syndicate handling the $250 million A.T.&T. issue, originally offered on August 3 to yield 5.58 per cent, was terminated with only two-thirds of the issue sold. The issue closed yesterday at a yield of 5.86 per cent, up a quarter of a per cent in 20 days.

In the Government securities market, rates on three- and six-month Treasury bills reached peaks of 5.10 and 5.49 per cent, respectively, last Friday, 30 and 60 basis points higher than at the time of the last meeting of the

Committee. A technical rally Friday afternoon and yesterday erased only part of this rise. Yields on intermediate-term Treasury issues rose by as much as 60 basis points, with the 4 per cent note of February 1969 reaching a peak of 5.88 per cent. Long-term issues were up as much as 15 basis points in yield, with the "bellwether" 4-1/4 per cent bonds of 1987-92 hitting a peak of 4.97 per cent. In yesterday's auction, average issuing rates were set at 5.02 and 5.41 per cent on the three- and six-month bills, down 3 and up 9 basis points from the rates set a week earlier.

Despite alarms and excursions and an underlying tone of gloom and weakness, the markets continued to perform. Securities were traded and funds were raised at the successively higher yield levels reached. At each higher level, rates have proved irresistible to some investors; there has been some short covering by professionals, and there are always a few optimists who become convinced--at least temporarily--that a turning point is at least in sight. While the markets have functioned, the performance has been a shaky one. There remains a substantial risk that some unexpected development or the cumulative pressure of demand on the supply of funds could set off a series of disruptive events in the market that would be hard to control, particularly if psychology got out of hand. Caution, fortunately, is the order of the day in the markets, but we should be alert to the potential dangers in the current situation.

Against this negative background, the Treasury had to carry out a refunding of issues maturing August 15 (to which holders of November maturities were eligible to join) and then raise $3 billion in cash in an auction of March and April tax bills on August 18. The initial reactions to the Treasury's offer of a 5-1/4 per cent note and a 5-1/4 per cent certificate were quite favorable, with Government securities dealers generally adopting a more constructive attitude than in recent Treasury operations. But as time went on the atmosphere soured, and when the books closed on August 3 both new issues were quoted at par bid, down 5/64 from their peaks. They have since declined almost uninterruptedly. At last night's close, a week after payment date, the new Treasury note was offered at 99 to yield 5.49 per cent. Those dealers

who stood up to their function of underwriting Treasury financing operations have suffered substantial losses as a result of their participation.

Last week's auction of $2 billion March and $1 billion April tax bills was preceded by a rise in the prime rate to 6 per cent and the Board's reserve requirement action. Despite the eagerness of banks to acquire the tax and loan deposit that comes with successful bidding, there was considerable caution in the bidding, with some banks withdrawing altogether and others cutting back their participation. While both issues were covered, bidding was lighter than in any similar auction in recent history, the range of bids was wide, and some underwriting bids were entered at rates of 6 per cent or more. Average rates of 5.34 per cent and 5.43 per cent were set for the March and April issues, respectively. Secondary market trading started at rates well above the market for outstanding bills and after some decline they closed yesterday at 5.58 and 5.60 per cent. The Treasury's experience with its latest financing raises some fundamental questions about the possibility of carrying out an effective debt management policy in a period when rates are constantly on the rise and the market's ability and willingness to perform an underwriting function are weak. Further tests will be supplied now that Congress has given the go-ahead signal for the issuance of new Federal agency participation certificates, expected to total $4.2 billion in the current fiscal year. The first instalment should be forthcoming soon after Labor Day.

Even keel was, of course, an important consideration during much of the period since the Committee last met. It was fortunate, perhaps, that required reserves and the credit proxy consistently fell below the levels desired by the Committee at the last meeting. If these aggregates had been running strong, there would have been a clear-cut conflict between even keel and the Committee's desire to keep a tight rein on bank credit expansion--a conflict that would have made the conduct of open market operations even more difficult than it was. In the event, estimated required reserves appear to have declined in August somewhat more than was envisioned at the time of the last meeting, and the credit proxy has also been running below expectations even after allowing for the effect of the rise in bank liabilities to their foreign

branches (mentioned in the blue book)[1/] which are not now, but should undoubtedly be, reflected in the credit proxy.

Net borrowed reserves in the three weeks ended August 17 averaged in the lower end of the range that most Committee members mentioned at the last meeting, and in the week ended August 10 the figure turned out after revisions to be $301 million, well below that range, although we had no means of knowing this at the time. At the same time, other money market conditions were tighter than they had been. The effective rate on Federal funds reached 5-3/4 per cent in the week the books on the Treasury financing were open, and moved to 5-7/8 per cent with some trading at 6 per cent in the week ending August 10 when net borrowed reserves were low. Interest rates rose steadily during the period, as noted earlier. Banks apparently were managing their reserve positions cautiously, and borrowing averaged close to $800 million. There appeared to be a tendency to overborrow at the discount window over the weekends, with some easing in the Federal funds rate at the end of statement weeks as banks found they had more reserves than they needed. This short-lived easing in the funds market had no effect on dealer loan rates at New York City banks, which remained at peak levels throughout the period except for a modest volume of loans against rights to the Treasury financing made by one of the New York banks at a rate just under 6 per cent.

In general, the somewhat lower level of net borrowed reserves--in the over-all context of rate developments--did not mislead anyone into thinking that Federal Reserve policy had relaxed, nor did the repurchase agreements made by the Desk against rights at the discount rate encourage dealers to go overboard in subscribing to the new issues. On the other hand, any attempt to maintain interest rates steady during the even-keel period would have required a massive outpouring of reserves in the face of developments during the period and of the market's conviction that Federal Reserve policy was not only tight but bound to get tighter after the refunding was out of the way.

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

At the moment the market is anticipating that the Federal Reserve will be a large buyer of securities to offset the reserve impact of the settlement of the airline strike, pre-Labor Day holiday reserve needs, and at least part of the reserves to be absorbed later on by the Board's action raising reserve requirements. In light of this, there was some rally in the Government bond market on Friday afternoon and yesterday and Treasury bill rates receded from their recent peaks. Today the bond market is again off; prices that had been moving up are back down again. Corporate rates are tending to affect the Government bond market as well. As we move into September the expected pressure on bank CD positions at a time of expanding seasonal loan demands should lead to growing pressure on financial markets generally. In order to maintain pressure on the ability of banks to expand credit without disrupting the Government securities market, we shall have to be as flexible as possible in the conduct of open market operations. During the period since the Committee last met, we made use twice of matched sale-purchase contracts to absorb reserves on a temporary basis--the operation last Tuesday being conducted at the lowest gross return to the dealers that we have seen. Today, with net borrowed reserves falling below what we thought the Committee intended, the Desk has made some further matched sale-purchase contracts. In my view, this instrument has proved its value as a tool of open market operations. In supplying reserves in the weeks immediately ahead, we would plan to rely first on outright purchases of Treasury bills and other securities to the extent that they are available, but will try to minimize any major impact on rates in a market where the ready supply of all issues is fairly small. Should repurchase agreements become a useful tool I would plan to make them at a rate above the present discount rate, although the precise rate would have to depend on market conditions at the time the contracts were undertaken. In view of the need for flexibility I recommend that the Committee not take action today to restore the continuing authority directive to limit RP's against Government securities to securities maturing in less than 24 months. Similarly, I believe it would be advisable to retain the $2 billion leeway on purchases and sales--authorized by the Committee at the last meeting--between now and the next Committee meeting.

In response to a question, Mr. Holmes verified that if repurchase agreements were made at rates above the present discount rate, it would be the first time that that had been done recently. Probably the rate would be linked to the three-month bill rate, but the precise rate would depend on market conditions at the particular time. He felt that it would be desirable to get away from the discount rate, and he did not think that that would shock the dealers unduly at this juncture.

Asked for his view as to where the net borrowed reserve figure would come out for the current statement week, Mr. Holmes said that last night the Desk had been looking at a figure of roughly $470 million. Today it was found from the country bank sample that required reserves were about $50 million lower than anticipated, and with this and other revisions the Desk was looking at a figure of around $390 million this morning. As a result of the matched sale-purchase contracts made today, he would expect a figure around the $470 million level, but tomorrow there might be trouble again.

Mr. Hickman commented on the fact that required reserves were again falling below the target, and Mr. Holmes replied that recently that had been the case consistently. When he last checked, the credit proxy showed about a 2 or 3 per cent growth in August, compared with the 4-6 per cent growth estimated at the time of the

last Committee meeting. Required reserve figures were still coming in lower than anticipated, which would mean that, if anything, the credit proxy would be revised further downward.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period July 26 through August 22, 1966, were approved, ratified and confirmed.

Mr. Hayes inquired whether any members of the Committee disagreed with the Manager's recommendation that no change be made at this meeting in the continuing authority directive, and no objections were heard.

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

Mr. Brill made the following statement on economic conditions:

> At this time, when the System is in the process of making a quantum jump in the intensity of monetary restraint, it is reasonable to want to assess carefully any dangers that may be inherent in such a policy course. This afternoon, Mr. Partee will be discussing the possible ramifications of recent policy changes on financial markets and institutions. For my part, I am making the assumption that policy can be implemented effectively without creating financial crisis, and will address myself to two questions: first, whether this policy is what the economy needs, and, second, how much of it is needed and how long the economy can stand it.

The proposition that the economy needs more restraint is neither as simple nor as self-evident as might seem on first blush. Current wage and price developments that tend to excite us are not necessarily leading indicators; very often these are lagged responses to economic sins committed earlier, or responses to essentially temporary supply and demand phenomena. The question that has to be answered is whether general economic circumstances will likely be such that current wage and price trends will persist, or perhaps accelerate.

In this connection, I would remind the Committee that the staff projection of GNP incorporated in the green book[1/] has real GNP expanding at less than a 4 per cent annual rate in the third and fourth quarters of this year, down from the 5-1/2 per cent rate during the first half of the year and the almost 7 per cent rise in the second half of 1965. Moreover, even this projection might turn out to be over-optimistic in two respects. First, it was completed before the July housing starts figures were in, showing a sharp drop to levels we didn't anticipate till year-end. If starts fail to bounce back--this _is_ a volatile series, but the drop in permits and the continued strain in mortgage markets do not look encouraging--this could pare three-quarters of a billion or so from the $14 billion rise in GNP projected for the third quarter and perhaps twice that from the fourth quarter.

The second area of possible over-optimism is consumption, projected as rebounding to a pace double that of the slow second quarter. This isn't an unreasonable expectation, since the reduced pace of total consumer spending in the spring seems to have been associated mainly with the slackening in disposable income plus, in some measure, the auto safety hassle. But while most attention has been focused on lagging auto sales, other consumer outlays have held up relatively well; over all, there doesn't seem to have been much change in consumers' propensity to spend. Disposable income is now slated to rise more rapidly

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

than earlier--at least there is no big tax bite scheduled--and with June and July retail sales looking good, the green book projection is persuasive.

My reservations about this consumption outlook are based more on hunch than hard evidence. Consumers have generally behaved rationally in the postwar period; when prices have risen significantly, more often than not they have decided to hold back on buying. This rational approach, along with tightened consumer credit standards, may operate to confound Detroit in a month or so, when the new models arrive in the showroom.

But, whatever reservations one may have about consumers' contribution to inflationary pressures in the months ahead, large increases in Federal and business spending are in prospect. The course of defense orders and order backlogs, and enlarged draft calls, continue to suggest a further rise in defense outlays in the months ahead. Quantifying this remains necessarily arbitrary, but the number we are using--an increase of $2-1/2 billion this quarter and the same next quarter--is not regarded as outlandish by other (equally blind) forecasters in town.

Federal nondefense spending is rising, too, and Medicare payments, after a slow start, may accelerate. Thus, we would expect total Federal outlays--defense, nondefense, and transfer payments--to rise more rapidly than tax receipts, and on a national income accounts basis the Government's net contribution to the economy to move from a $4 billion surplus in the second quarter to about a billion dollar deficit in the fourth quarter, hardly a fiscal policy appropriate to the times.

The other major expansionary force--business investment spending--seems ordained to rise over the balance of the year, and perhaps even to accelerate, since the spending increase was held down somewhat earlier this year by construction strikes and delivery delays. Shortly there will be a new reading on current and future business capital spending plans. Until then all we can say is that most of the relevant factors--the high rate of capacity utilization, the still high profit margins, the prospects of accelerating

wages, and the backlogs of machinery orders--appear to be pointing to continued rapid expansion in business spending for plant and equipment, if the funds can be found.

Business inventory accumulation could also add to the pressure on resources. Businesses have tended to accelerate buying in anticipation of price rises, and one might argue that the staff GNP projection is too conservative in expecting some moderation in inventory demands. Protective buying and stockpiling could provide a more powerful thrust to the economy than is allowed for in the projection.

Balancing the probabilities attaching to the various components of activity, I think it's a fair assessment that, over the next several months, gains in real output will be slower than the peak rates reached last winter, in part because of labor and plant capacity limitations in some key areas such as machinery, but in part also because of slackening in some demands. Nevertheless, it doesn't seem likely that activity will be slowing fast enough to head off mounting inflationary pressures. Even if our projection is shaded down a bit, it would still imply, for the balance of this year, industrial production rising rapidly enough to keep manufacturing capacity as fully utilized as ever, and unemployment still below 4 per cent.

For some time ahead, then, the greater danger is that we'll be staying in the zone of plant utilization and labor shortages where wage and price escalation is possible. Thus, the July rise in the consumer price index--four-tenths of a per cent--will bring wage increases of 2 cents an hour to over a million workers, including the auto workers, and this along with the rise in steel prices will likely provide the arguments for higher price tags on the new model cars. In turn, this will make it more difficult to argue for moderation in other wage contracts to be negotiated this fall. In the context of a still strong economy, price rise engenders price rise. Given the dim fiscal outlook, it doesn't seem to me that the System has much option now but to move aggressively toward curtailing expansion in demands, particularly in the business sector. At the same time, we will have to redouble our efforts to detect signs of any spreading

weakness in demands, in order to avoid carrying such a policy stance too far or too long.

Mr. Partee made the following statement concerning financial developments:

Events have moved so swiftly since the last meeting of the Committee that it is difficult to frame an appraisal of the situation. Interest rates have adjusted sharply upward, so that past relationships and funds flows may have little relevance for the new configurations beginning to emerge. The stock market has declined markedly further, certainly due in part to the pull of high interest rates and concern among investors about "tight money", but the financial implications are by no means clear. Uncertainty and apprehension have come to dominate the mood of both lenders and borrowers, and changes in portfolio policies and financing plans doubtless are now in process. Such is the price of escalating financial tautness in an increasingly inflationary economic environment.

The biggest question mark currently, of course, is the possible extent of a CD runoff at the major banks. These banks already are paying the ceiling rate on large-denomination CDs of most or all permissible maturities. Even so, the rise in outstandings has slowed, with banks in New York and Chicago showing no net increase since mid-year and other weekly reporters an expansion of less than $200 million. The recent further sharp rise in yields on alternative money market instruments puts the banks at a clear competitive disadvantage. Therefore, in view of the heavy schedule of CD maturities, and assuming that Regulation Q is not changed, some runoff of outstandings seems certain.

Even a fractional runoff of maturing CDs, which in September will probably total close to $5 billion, could readily involve a funds outflow of $1 to $2 billion. But there really are no past guides to provide the basis for a prediction. Perhaps the bulk of the funds will remain with the banks, even at a concession in yields, because customers will wish to remain in good standing for other purposes. This seems

to have been the experience of outlying banks, at least when yield differentials were moderate. Any substantial diversion of funds into other markets, moreover, will tend to hold down yields on the alternative instruments, though the prospects for this do not seem especially promising. Offsetting upward rate pressures in the market will probably be coming simultaneously from increased supply, bank selling, declining corporate liquidity, and investor apprehension.

Bank deposit growth generally has not been especially large over the summer. Taking daily average figures for the three months through August, we estimate that private demand deposits will show virtually no change while Government deposits will have dropped $800 million. Total time deposits will have increased by $4.8 billion, an annual growth rate of 12.5 per cent versus 16 per cent in 1965. Time deposit expansion has occurred mainly outside the money centers, however, since the big banks have not done well with their negotiable CDs and have had continuing savings deposit losses partly offsetting growth in consumer CDs.

Meanwhile, loan demand has continued very strong. Total loans at all commercial banks, on a last Wednesday basis, rose at annual rates approaching 20 per cent in both June and July, and business loans showed an almost unbelievable 30 per cent growth rate over the two-month period. Loan expansion appears to have slowed thus far in August, reflecting liquidation of both security and finance company borrowings and a marked slowing in business loan growth. But the latter development is probably temporary; the speedup in corporate payments of withheld taxes has substantially reduced August cash needs, after greatly boosting them--and probably borrowing too--in July and June.

That most big banks are expecting a strong fall loan demand emerges clearly from Federal Reserve Bank reports on their recent interviews with selected large banks. And this prospect is suggested also by the aggregate figures on corporate sources and uses of funds. We estimate that corporate investment expenditues--for plant, equipment, and inventory--in the second quarter exceeded internally generated funds by $13 billion, at annual rates, up from $10.5 billion in

the first quarter and $4.7 billion in calendar 1965. With capital expenditures continuing to rise and earnings recently leveling out, it is hard to see any appreciable diminution in this gap in the months ahead. Additional funds are being raised in the capital markets, and the new issue calendar may well rise even further in the fall, but a sizable residual demand on the banks seems certain to remain.

Assuming continued substantial business loan demand, and a sizable runoff in CDs, what can the banks do to adjust? There is a limit to continued liquidation of Government securities--especially for the large banks--because of minimum liquidity needs and pledged asset requirements. Municipal security portfolios, which had continued to expand overall until recently, provide an obvious source of funds, but at substantial cost to the banks and to market stability. Security loans and loans to finance companies can be pushed out, as seems to be going on at some large banks, but efforts by these borrowers to obtain funds elsewhere may further limit banks' ability to sell CDs.

On the liability side, a few of the largest banks have obtained substantial funds recently from their foreign branches, although prospects for maintaining inflows in that magnitude for very long seem doubtful. And almost all the big banks still have room under the rate ceilings to compete more aggressively for consumer CDs; I would not be surprised to see some do so as the September dividend-crediting date approaches.

In the end, however, it seems likely that more banks--including major money market banks hard pressed by CD losses and prime customer credit demands--will have to come to the Federal Reserve for assistance. Increased borrowing, whether on a regular basis or under a special assistance program, will pose problems for open market operations and for interpreting money market statistics. Greater accommodation of the major banks at the window will not necessarily be offset by lesser borrowing by the smaller banks, given the pattern of reserve distribution, but it will provide the base for increased credit expansion by the banking system as a whole. Hence, it will be important for open market operations to mop up any excess reserves

> provided to the system through assistance operations involving individual banks. Such excesses are likely to show up initially in the very short-term money markets, and to be reflected in such things as Federal funds rates and flows, availability and rates on dealer loans, and yields on the shortest-dated Treasury bills.
>
> It is for these reasons that the draft directive language provided by the staff[1/] places more emphasis than usual on money market rates and conditions and less on net borrowed reserves. We feel that close attention to the money market will provide a better indication of any developing ease than will net borrowed reserves, which may become a less meaningful--and perhaps even a perverse--indicator of pressures on aggregate reserves in the period ahead.
>
> The "no change" directive specifies that money market rates and conditions be held about where they are today, which should be accompanied by some CD runoff in the weeks ahead. In this event, member bank deposits in September should increase less than the 8 per cent we would have projected in the absence of the developing CD problem; perhaps a figure around 6 per cent would be a reasonable expectation. The "tightening" directive specifies a gradual firming in money market rates and conditions. This should result in a sizable and growing CD runoff, and consequently in only a modest growth in the bank credit proxy for September--perhaps 2 or 3 per cent. In either alternative, we feel that the Account Manager will need an unusually large degree of discretion to deal with potentially destabilizing developments; the possibility that such may occur is greater now than it has been for a long time past.

Asked whether the projection for increase in member bank deposits in September was seasonally adjusted, Mr. Partee said that it was, although he warned that there was a certain amount of variation in the seasonal adjustment. He went on to say that the projections were very speculative and that they were included

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1/ Appended to these minutes as Attachment A.

for purposes of illustration as much as anything else. It was quite early to be having any firm view of September projections. A principal factor, however, was the delivery of $3 billion of tax bills late in August, which would give a large impetus to average bank credit for the month of September. The 8 per cent projection included substantial demand deposit expansion, in recognition of what had occurred in every last-of-quarter month for the past several quarters. It also allowed for a lesser rise in time deposits than had been occurring recently, including nothing but a seasonal change in CD's. The 6 per cent projection assumed a modest CD runoff; credit growth would be lower--perhaps in the 3 per cent range--in the event of a large CD runoff.

Mr. Hayes said he understood that the 6 per cent figure was a rough estimate in event of the kind of CD runoff that might be expected from the maintenance of existing credit conditions, and Mr. Partee agreed, emphasizing that it was a very rough estimate.

Mr. Brimmer noted that the inflow of funds to certain U.S. banks from their foreign branches did not show up in member bank deposits (the credit proxy). Therefore, if the inflow continued, there could be some credit expansion beyond that indicated by the credit proxy. Mr. Partee agreed, but added that the current inflow might well be less than the high figure of

around $700 million in July. If that rate of inflow continued, he estimated that it would represent the equivalent of an increase in the credit proxy figure by two or three points for the month, on an annual rate basis. For the year as a whole, the influence would not be so great because the inflow was not too significant during the first half of the year. Mr. Hayes agreed that the inflow was not likely to continue at the high July rate.

Mr. Hickman asked Mr. Partee about the degree of confidence he attached to the projection of an easing of short-term money market rates. It would seem that the pressure of strong loan demands would tend to mop up available funds. If the System maintained the current state of conditions in the money market, would it not, in effect, be supplying more reserves than needed?

Mr. Partee replied that in the blue book the staff had projected perhaps a moderate easing of short-term rates. The System would be buying a considerable amount of securities and current changes in private investors' portfolio composition should favor short-term instruments against intermediate- and long-term securities. There could be more easing if, in fact, a considerable amount of credit was provided through the discount window. For the period immediately ahead, maintaining money market rates about where they were would probably not mean easing but absorbing any sloppiness that might develop.

Mr. Hickman said he was wondering if one could not get to the same place by maintaining required reserves about where they were. He did not like to place reliance on money market conditions if there was some better policy guide.

Mr. Partee replied that the staff was very reluctant to specify the reserve aggregates at this time because the relationships were so uncertain in view of the deposit shifts that were taking place.

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

> As Charlie Walker observed recently, the "mix" between Federal monetary and fiscal restraint today "is very much like an extra dry martini--about 6 parts monetary to only one part fiscal." Mr. Brill has suggested that the mixture is now becoming even drier than that.
>
> It has sometimes been argued that this sort of recipe ought to be well suited to the U.S. balance of payments situation, because monetary restraint particularly restrains capital outflows. But the 1966 experience to date exposes the flaws in this line of analysis. The sharp tightening of credit conditions has indeed reduced net outflows of capital significantly. But because monetary restraint has so far operated very selectively on domestic demand, it has not prevented excessive aggregate demand pressures from sharply worsening the external balance on goods and services.
>
> The effect of tight credit on capital flows is clearly visible for flows of U.S. bank credit and of foreign liquid funds. In July there was a reflow of about $140 million of bank credit covered by the VFCR reports; only about one-third of this was seasonal. In view of the developing squeeze on large U.S. banks, it now seems reasonable to take the July movement as a portent for the near-term future, and to regard the second-quarter outflows as only a temporary interruption of the reflow that had

developed earlier. Japanese and Italian borrowers in particular have been repaying debt to U.S. banks, and the Japanese would be repaying even faster if the authorities there were not trying to slow them down.

The second capital flow that clearly reflects tight money and high interest rates in this country also comes through U.S. banks. I refer to the inflow of foreign private liquid funds through the foreign branches of U.S. banks. Such inflows were exceptionally large in July and early August, totalling about $900 million, and were also sizable--about $1/2 billion--during the first half year. The huge surge in July was related to the run on sterling and should be viewed as temporary. But funds are also being attracted out of other currencies by the very high Euro-dollar rates that U.S. bank branches are now prepared to pay.

Other capital flows have been less clearly affected. It may be that the falling off in new Canadian security issues in this country since April owes something to the high cost and relative scarcity of U.S. funds. We know very little so far about this year's direct investments.

Against the known improvements on private capital account must be set a disturbingly large deterioration on current account. From the fourth quarter of 1965 to the second quarter of 1966, the annual rate of current account surplus declined by about $1-1/2 billion. Merchandise imports increased as rapidly as before, despite large releases from domestic stockpiles, while merchandise exports leveled off. The balance on military transactions plus services apparently did not change much over this particular period, but has worsened by comparison with the year 1965 as a whole.

The net result of all these changes, and of others that we cannot yet measure, has been to widen the payments deficit on the liquidity basis of calculation to an annual rate of roughly $3 billion in July and early August.

The alternative payments measure, based on official reserve transactions, has developed very differently, and shows a seasonally adjusted surplus during July and early August. The difference results mainly from that fact that the huge inflows of foreign private liquid funds in that period improve this balance but do not affect the liquidity calculation. Since a large part of the exceptional July inflows should be regarded as temporary, we should expect to see a renewed deficit on the official

settlements basis later in the year, although that deficit might be held well below the liquidity deficit by some continuing inflow of foreign liquid funds.

To answer more broadly the questions of where we now stand and where we are heading, one needs to take account of longer-run trends and of likely business cycle swings. I would be prepared to concede that we may not yet have seen much trend deterioration in the payments position this year. The increase in the liquidity deficit from a rate of $2 billion a year in 1964-65 to $3 billion now may be largely explainable in terms of temporarily or cyclically excessive demand pressures whose adverse effects have outweighed the cyclically favorable effects of unusually tight credit. Similarly, the official settlements deficit might still have been at about the $1-1/2 billion rate of 1964-65 if it had not been for cyclical boom developments here and the recent run on sterling. These rough impressions of trend cannot, of course, be closely appraised until long after the event.

The worrisome thing is that the earlier trend of slow improvement in the balance of payments appears to have been stopped in its tracks. Moreover, it is in danger of being reversed if, as the green book suggests, the upward pressure of rising labor costs is now to be added to the existing pull of demand on prices of manufactured materials and products. It seems to me that the fiscal-monetary policy martini that we have concocted this year is likely to produce a much worse hangover in the balance of payments (and also in the domestic economy) than would a mixture containing a forthright dose of general fiscal restraint. The tightening of credit that has helped our capital account can be reversed a lot more quickly in some future recession than can a price-cost spiral that will have impaired our international competitiveness.

My remarks are in no way intended to question the recent trend of monetary policy--quite the contrary. The point is that unless restraint of some kind can be pushed to the point where it significantly dampens aggregate demand and heads off the inflationary spiral, the long-run prognosis for the balance of payments is very bleak.

Mr. Hayes suggested that, since Mr. Robertson might have to leave before the meeting was finished, he start the go-around of comments and views on economic conditions and monetary policy.

Mr. Robertson said that first he would like to suggest, in view of the discussion earlier today, that the staff be asked to update last year's contingency planning on how to handle the securities market in the event of a sterling crisis.

It was agreed that that should be done.

Mr. Robertson then made the following statement:

> Beyond question, the current economic situation is so fraught with inflationary pressures that we need to be applying all the restraint upon the availability of credit that we can reasonably bring to bear. The main issue that should concern us today is how best to achieve that policy posture (with perhaps a secondary issue being: "How can we recognize that position when we get there?").
>
> Already there is a good deal of monetary restraint present in our financial system. Interest rates have been rising sharply, securities markets are tight, and both bank and nonbank credit extensions to private borrowers as a group seem to have slowed somewhat.
>
> Even so, when we see the kinds of excess demand still apparent in most markets, the accelerated rates of advance in prices and wages that are taking place, and the overlay of inflationary expectations apparent in many quarters, we simply cannot sit back and assume that monetary policy has done enough.
>
> There is one major problem that we must take account of, of course, in contemplating any further firming by monetary action. That is the subject--already discussed this morning--of the highly uneven impact of the credit restraint already achieved, and the likelihood that still more uneven effects could follow from further credit-tightening action. These uneven credit effects need to concern us--not just because they are inequitable, or because they give rise to political hostility, but because the kinds of credit being least affected are those financing some of the most inflationary and unsustainable types of private expenditures, most particularly business plant, equipment, and inventory spending.

The kind of discount administration program we have talked about this morning seems to me to offer us one possibility of doing something--not everything, but something--to redress this lack of balance in credit restraint. In my judgment, some such program--adjusted and qualified as seems wise in the light of the best thought of everyone in the System--has to be an essential part of our future monetary policy. To fall short on this score will be to stop monetary policy from making its fullest contribution to the very difficult task of economic stabilization that this country faces today.

I am going to assume, therefore, that we will take steps in the direction outlined that will make further tightening via open market operations feasible and desirable. To be specific, I would like to see net borrowed reserves running deeper by at least $100 million--one-fourth of the reserve effect of the reserve requirement increase--by the time that action becomes effective in early September. Beyond that, I recognize that member bank borrowings might mount considerably higher as banks seek discount window assistance in meeting the September squeeze. I would urge the Manager not to engage in open market purchases to reduce such borrowing, but to instead be prepared to conduct operations to keep such injections of borrowed reserves from in any way easing the climate of firmer money market conditions that I hope we will have achieved by then.

Finally, let me say a few words about the desirability of keeping the "proviso" clause in the directive. It is important in our instructions to the Manager to keep in mind the need for providing him with sufficient flexibility to moderate unexpected and undesired surges or contractions in credit demand. Generally, he should be able to make the net position of banks and the money market less comfortable if credit demands prove very strong and more comfortable if such demands become weak. As strong demands converge on banks, the Manager in his operations should force the banks to meet some part of their resulting reserve needs through the discount window; in that way, the discipline of the window can be added to the discipline of the market place. On the other hand, if demands prove weak, it would not be amiss if banks as a whole were in a position to reduce some of their indebtedness to us.

However, in as inflationary a situation as we face today, we should be more wary of letting the indebtedness

of banks to the Federal Reserve become too low than about forcing it to high levels. In the current circumstances, this means that the Manager should see to it that net borrowed reserves deepen further, and more rapidly if credit demands prove strong and threaten to bring about a rapid aggregate reserve expansion. Only if it is crystal clear that demands are weakening, or if in the unlikely event that financial markets become patently disorderly, should he let up in any significant way on the pressure on banks.

I believe the following wording for the second paragraph of the directive would accomplish the objectives I have in mind:

> To implement this policy, while taking account of possible unusual liquidity pressures on banks, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining further firming of money market and reserve conditions, with the firming to be greater if bank credit tends to expand more than expected.

Mr. Hayes then made the following statement:

The pace of the business expansion appears to be increasing in the current quarter, and there are signs that inflationary pressures in the economy are accelerating. As has been true for many months, the outlook is for continuing strength in the economy over the remainder of the year and well into 1967. Price developments in July were very discouraging, as wholesale food and farm prices once again rose sharply; and earlier hopes for lower prices in this area later in the year seem to have vanished. Consumer prices continue to rise at a rate of about 3.5 per cent. The airline wage settlement seems likely to set an excessive wage pattern for upcoming contract demands; and emergence of cost-push pressures is further indicated by the recent steel price increase.

There is no basis for encouragement as to our balance of payments position, despite some recent official and press comments in that direction. A preliminary deficit figure of $437 million for July is very unfavorable even after allowance for seasonal factors. For several months we have observed a serious deterioration in our trade surplus, and apart from special transactions our liquidity deficit would have increased from a $2.0

billion rate in the first quarter to a $2.5 billion rate in the second quarter. For the time being, pressure on the dollar in foreign exchange markets has been significantly reduced by heavy borrowings in the Euro-dollar market by overseas branches of American banks. Incidentally, this was not reflected in the required reserves of the banks involved and has provided a partial alternative to enlarged Federal fund purchases and borrowings at the discount window.

Bank credit statistics are as usual highly confusing, but the growth so far in 1966 has been only a little below last year's excessive rate. There has been some uncertain indication of a more significant slowing in the last few weeks, even after allowance for the estimated growth of U.S. bank liabilities to overseas branches. However, New York bankers are projecting a further substantial loan increase for the third quarter and are again tightening their lending policies. The prime rate boost was of course intended to facilitate this process of rationing. Current loan demand is no doubt swollen by fears that credit may become still harder to obtain some months from now. Meanwhile the big city banks are faced with the prospect of a considerable loss of negotiable CDs over the coming weeks and months, in the light of the recent sharp upward movement of nearly all market interest rates.

Coming to matters of policy, I am impressed anew by the urgent need for development of a concerted System approach in view of the very difficult economic and financial conditions we face and the lack of clear understanding of these problems in many quarters outside the System. In the first place, the need for general Governmental policies of restraint seems to be obvious; yet there is still no evidence of a likely near-term assist from fiscal policy in the form of a tax rise. With the burden on monetary policy therefore excessively heavy, we must be even more than usually alert to the risk of causing undue financial strains or disorderly markets, without losing sight of our basic goal of slowing the rate of bank credit growth.

In connection with recent increases in reserve requirements, I think it worth emphasizing the inevitably intimate connection between reserve requirement changes and open market operations. Inasmuch as open market operations are inherently capable of supporting, reinforcing, or nullifying the reserve effect of a

requirement change, it would have been useful to have a prior general discussion of possible future reserve requirement changes at a meeting of the Committee, just as it has been our general practice to use this forum for a general exchange of views on the desirability of a discount rate change.

My second observation on the latest change in requirements has to do with my concern that the System may be playing into the hand of those who maintain that a very sharp distinction may be made between cost of credit and its availability. More concretely, it seems illusory, for example, to refrain from approving a discount rate rise on the ground that it may lead to an escalation of market rates, while raising reserve requirements in the hope that this may lead to slower credit expansion without appreciable rate effects. There seems to be little doubt that the two recent increases in reserve requirements have been a significant contributing cause of the sharp upward move in market rates. I might add that our directors wish to be associated with these comments on the necessarily close tie between cost and availability of credit.

Turning to open market policy, I would hope we can maintain a firm rein on bank credit expansion. Further tightening should be closely geared to the pace of growth of bank credit as that can best be measured in the short run. In this connection, it is worth noting that the bank credit proxy for August, after allowing for re-lending of funds obtained from foreign branches, appears to be running at or below the lower end of the 4-6 per cent range mentioned at our last meeting. I will be pleased if this is the way the August figures finally come out. Looking ahead, I would continue to feel that a rise in the proxy at a rate significantly above 6 per cent would be reason for greater restraint, provided that market conditions permit such action by the Manager. In general, I believe we should be paying close attention to the uncertainty that has prevailed in financial markets. In terms of net borrowed reserves, I have in mind a level of around $500 million, with higher levels if credit expansion is excessive.

A higher net borrowed reserve figure of course implies forcing the banks to acquire more of their reserves through the discount window; and this in turn would automatically give the System additional leverage over the banks' credit

policies. As I said earlier, all of this can be accomplished in the period immediately ahead without any essential change in the method of administering the Reserve Banks' discount windows. I think all of us agree that we should try to force more banks into the window; but, as I have already suggested, this is the automatic effect of any tightening through our tested instrument of open market operations.

The discount rate is even more glaringly out of line with market rates than it was about six weeks ago, when the directors of a number of Reserve Banks voted to increase it. Our own directors feel quite strongly that the rate should be raised now that the Treasury financing is out of the way. I very much hope that the Board of Governors will see fit to go along with an increase some time in the next two weeks or so, as I think it would be most unfortunate if the impression were to gain ground that the rate is "frozen" at its present level until the banks become much tighter than they are now. The discount rate has traditionally been a "member of the team" of credit policy instruments. At the very least it has been moved from time to time to bring it in line with the realities of market conditions, even when it was not used as a dramatic advance signal. It is so far behind the parade now that it may cause unnecessary public confusion as to our basic policy objectives, besides rendering administration of the window more difficult than it would otherwise be. I am not sure in my own mind whether the rise at this time should be by 1/2 per cent or by 1 per cent.

As far as the first paragraph of the directive is concerned, I would suggest adding to the phrase "and interest rates have risen substantially" the words "in an atmosphere of great uncertainty." Alternative A of the second paragraph would best express my policy conclusions, but with all the provisos involved I would not object to alternative B if the majority prefers it.

Mr. Francis observed that there were some similarities between the economic problems of the British for the past three or four years and the economic problems of the United States during the past year. In both cases public policies had fostered excessive total demand

for goods and services resulting in inflation. Total demand in excess of ability to produce leads not only to current price inflation but also to bottlenecks and other inefficiencies of production, which, as time passes, may cause the margin between demand and available supply to become even larger. The British might have had greater real production in the recent past if they had not followed excessive total demand policies which led to inflationary wage settlements and "hoarding" of labor.

In the United States, Mr. Francis said, prices had been rising during the past year, and output was not being hampered by shortages of key items. Current wage demands, the breakdown of the administration's price guidelines, and talk of wage and price controls pointed up the seriousness of the problem of excessive total demand. The problems of wage negotiations and of commodity pricing would be greatly simplified if there were public confidence that total spending was being kept within limits which would foster general price stability. The longer total demand outpaced real output the greater the economic problem became, as evidenced by the British situation.

But the economy continued to operate under the pressures of excessive total demand, Mr. Francis remarked. Although total spending slowed in the second quarter, the last half of the year apparently would resume a rapid pace similar to that which spending

had followed since the end of 1964. It was highly unlikely that the productive capacity of the economy could accommodate that level of demand without further and sharper price increases, and as one looked towards next year's wage bargaining, the inflationary prospects seemed even more dismal.

It became increasingly clear, Mr. Francis said, that fiscal policy had been far too expansionary and had been the primary contributor to excessive total demand during the past twelve months. Moreover it would apparently continue in the same direction over the last half of this year. But he did not think a withholding of appropriate monetary measures was justified because of lack of a more enlightened fiscal policy. Rather, the Committee should view fiscal policy as part of the given total demand picture and adapt monetary policies accordingly.

During the past year financial intermediaries had been slow to increase their rates on both loans and savings, Mr. Francis noted. That reluctance to adjust to market conditions had resulted from their own conservatism and short-run profit considerations, pressures from the administration and the supervisory agencies, and restrictive laws and regulations. As a result, the flows of funds through banks, savings and loan associations, and other financial intermediaries had declined, and, surprisingly, the smaller flows had been characterized as a rate war for funds among financial institutions. The

reduced role of the financial intermediaries had been induced by an expansion of direct lending and borrowing in the capital and money markets and by an intensified use by corporations of their own liquid funds. Most funds raised in the open market went to governments and the larger well-known businesses. Small borrowers who relied chiefly on financial intermediaries for credit were those mainly affected by these changing credit flows.

It had been suggested, Mr. Francis added, that supervisory agencies should further limit rates paid by financial intermediaries at a time when most other rates had been working up. It seemed to him that that would be the wrong thing to do. To the extent that the limitation held back adjustments in particular areas, it misallocated resources. Such actions would tend to reduce further the role of financial intermediaries and would make it still more difficult for those small borrowers that relied on financial institutions to get an appropriate share of the credit. Also, there was a risk that diverting funds from banks and other intermediaries might be interpreted as monetary restraint (i.e., a slower growth in deposits, bank credit, and measurable liquid assets) when in fact total liquid assets might continue to rise unabated via other avenues. It was becoming increasingly evident that over the past four months the firmer stance of the Committee had brought about a leveling off in the rate of growth of total reserves and money.

While the rate of growth of productive capacity might be a reasonable first approximation of a norm for the growth of the money supply, Mr. Francis remarked, there were times when a lesser rate was appropriate, just as there were times when growth should be more rapid than normal. In this period of easy fiscal policy and higher interest rates, when the rate of growth of demand for money holdings was exceptionally low and there was an excessive total demand, now, if ever, was the time when the money stock should not be increased so rapidly as the demand.

The recent moderation of monetary expansion was most encouraging, and he would like to see restraint applied with increasing pressure until there was evidence that spending plans and inflationary expectations had been moderated. He thought that maintaining the same degree, or somewhat less, of total reserve availability than had prevailed over the past few months was in order. Shortly, he would expect that the banking system would be increasingly unable to accommodate further spectacular increases in business lending such as had occurred since April.

There had been some talk of an autumn "liquidity crisis" both for banks and for nonfinancial corporations, Mr. Francis noted; but that should not deter the Committee from its quest for long-run stability. If anything like a liquidity crisis should show itself, it seemed to him that the necessary short-run adjustments could and should be made through the discount window.

The discount rate continued to be increasingly out of step with market realities and almost any economic reasoning argued for its realignment, Mr. Francis said. He was aware, however, that other telling arguments existed for continuing the rate without change. So long as those arguments remained dominant, he was confident that borrowing could be controlled by proper discount window administration as a tighter over-all policy was pursued.

Mr. Patterson reported that the Sixth District economy continued to be exuberant. About the only soft spots were in southern Florida, where the airline strike seriously cut the summer tourist business, and in some agricultural areas where production of cotton and corn was expected to be down because of drought and reduced planted acreage. Construction employment held at very high levels in most areas of the District, and construction contracts through June remained strong despite disruption in the mortgage markets. There was a strong advance in manufacturing employment in June that helped pull up total nonfarm employment, although the July figure would probably show less strength because of strikes. However, the strongest growth industry was Government employment, which had experienced a seasonally adjusted increase of 8.7 per cent since the first of the year.

Sixth District bankers, especially those in the larger cities, continued to complain about difficulties in meeting the

credit demands stemming from the exuberant behavior of the economy even though many of the District banks had apparently experienced less pressure than banks in other parts of the country. Many District banks had been able to hold on to their investments despite the loan expansion. The larger city banks were in the tightest positions. In Mississippi, where the seasonal loan peak generally came in August and September, some banks had been hard put to meet loan demands and, judging from the applications at the discount window from an increasing number of small country banks, the pressures were extending outward from the larger cities. For the District as a whole, the major seasonal pressures were yet to come although the normal seasonal increase from now to December of about 2.5 per cent was small compared with the current seasonally adjusted growth in loans of 1 per cent a month. Pressures were greatest at the Atlanta banks, and last Wednesday all the Atlanta banks raised their prime rates to 6 per cent.

Mr. Patterson said that, after looking at economic conditions in his own area and concluding that they were fairly typical of what was going on throughout the nation, it would be easy to fall into the temptation of considering that the policy the Committee had been following had had no effect at all on slowing down the pace of the economy. However, he did not think that was so. Undoubtedly, expansion would have been much greater

had policy provided a higher reserve base for the growth of bank credit. More importantly, the way rates were behaving and funds were being sought out suggested that the economy was tightening itself and that that tightening was going to have an increasing effect on limiting total demand.

One of the men at the Atlanta Bank had suggested that this was the time for the System to punt. Although he was not an expert quarterback, Mr. Patterson believed a football team decided to punt when it was in such a position that an offensive act was too risky to make and giving the ball back to the other team might eventually create a better offensive position.

On the basis of similar reasoning, Mr. Patterson concluded that an increase in the discount rate now seemed to be too risky a move to make. He feared that the psychological impact would not result in merely a technical adjustment of catching up with market rates but rather in pushing the whole rate structure up, intensifying the illiquidity of the banks, and ultimately forcing the System into supplying large quantities of reserves in order to avoid a liquidity crisis.

Under those circumstances, it seemed to Mr. Patterson that the banking system and the financial markets should be allowed to handle the ball for a while with the System maintaining a strong defense. In other words, it should allow market adjustments with

minimum interference. The recent rise in the prime rate suggested that that was already occurring. A strong defense implied that the System should not prevent further market adjustements by raising permissible rates under Regulation Q nor offset the effects of the Board's recent action raising reserve requirements against time deposits. If, as a result, more banks were forced to resort temporarily to the discount window, a gradual deepening in the net borrowed reserve figure should be allowed. He favored alternative A of the draft directives, with the change suggested by Mr. Hayes.

Mr. Bopp remarked that with the business advance showing clear signs of accelerating in the current quarter, financial markets had continued under considerable strain. Bankers in the Third District expected more intense loan demand in the fall, with seasonal growth added to the cyclical thrust responsible for the intensity expected. The demand for business loans had been especially strong since midyear. Though old customers and large borrowers continued to be accommodated, new borrowers had in many cases been turned down. All of the Philadelphia reserve city banks followed the increase in the prime rate. There had been few changes in terms of mortgage loans in the past several weeks. Most Philadelphia banks were making mortgage loans only in exceptional cases and to fulfill previous commitments. Only a minority of the banks, however, had attempted to cut back instalment loans.

As for sources of funds to meet the anticipated fall loan demand, Mr. Bopp said that two Philadelphia banks expected consumer-type savings certificates to provide the bulk of the funds needed. Two other banks thought they could attract some CD funds in the near term; however, all expected CD's to decline in the fall. Two large Philadelphia banks believed they might be forced to reduce loans in the fall as a result of shortages of funds.

In the nation as a whole, Mr. Bopp continued, it also seemed likely that the banking system would come under increasing strain in coming months as loan demand intensified under seasonal pressures and as banks found it more difficult to replace maturing CD's. Indeed, $7.7 billion (about 43 per cent) of the negotiable CD's of $100,000 and over outstanding July 27 would mature in August and September. That raised the question of market reaction to a runoff, possibly one of sizable proportions. Since a market confronted with the unexpected was more likely to be buffeted by severe pressures, the Philadelphia Bank had tried to get some further idea this past week of bank expectations regarding the Regulation Q ceiling. The question had been discussed with high-ranking officers at each of the five major Philadelphia banks. Those individuals expected no change in the Q ceiling, and all expected some pressures to develop from CD runoffs as rates on other instruments rose. Two respondents cited public statements by System officials as the basis for their belief.

One banker believed political considerations prevented any change in Regulation Q. Another said that the Federal Reserve System had performed two "operations of relief" in behalf of banks previously, and that he felt bankers were on their own this time. He also stated that he believed "monetary policy has done all it can do."

Turning to policy, it seemed to Mr. Bopp that the proper course was to allow pressures to build slowly and to exert further restraint on growth rates in reserves and bank credit. Accordingly, he would coordinate open market operations with the Board's action on reserve requirements to achieve a gradual move toward further restraint. He would use the discount window if necessary to ease severe pressures on individual banks. In view of the intense pressures currently prevailing in money and capital markets, however, he suggested that any move toward further restraint should be gradual and should be implemented with great caution. On economic grounds, he still favored an increase in the discount rate. On balance, he favored alternative B for the directive, but he did not feel strongly.

Mr. Hickman expressed the view that business activity should continue to move forward for the rest of the year, sparked by increasing demands for equipment and materials. Defense spending had already far exceeded expectations and, as pointed out in the green book, "there appears to be no abatement in the pace of the increase." Plant and equipment spending was exceptionally strong. As an illustration,

one of the Cleveland Reserve Bank directors, the chief executive officer of a leading machine tool producer, stated at the last Board meeting that present order backlogs were sufficient to maintain production at full capacity for the next 14 months, even without any new orders, although he warned that some of the backlog would be cancelled in the event of a business recession. Production of 1967 autos would soon be moving into full swing and, as now planned, the auto component would provide more than seasonal stimulus to the production index in coming months. However, with expected end-of-August inventories of approximately 1.1 million cars, equivalent to a 48-day supply, planned production might be too optimistic.

Steel output turned up in July on a seasonally adjusted basis, Mr. Hickman noted, but it was expected to decline in August and should contribute little to the production index, plus or minus, for the balance of the year. Steel companies reporting to the Cleveland Bank on a confidential basis indicated that new orders in August were not rising as much as usual, and that defense orders thus far had been easily absorbed by the industry.

On the price front, Mr. Hickman said, the public seemed to be catching up with the fact that inflation was a clear and present danger. Actual price behavior, however, had been mixed, with prices of sensitive industrial materials declining recently. While that might imply a temporary lessening of inflationary pressures on

industrial prices, the resumption of rising farm and food prices and disquieting wage negotiations--both present and future--left little room for complacency.

Nor could one be complacent about the financial situation, Mr. Hickman continued, in view of the serious stringencies developing in financial markets. The depressed states of the mortgage and stock markets were well known. Beyond that, more selective lending policies of banks were pushing corporations increasingly into the capital market. Private placements were drying up as a source of funds; insurance companies were overcommitted and were themselves contemplating use of the capital market. In the municipal market, lower prices and rising yields, in part caused by bank selling, had resulted in cancellations of new municipal financings. Thus, intended policy effects had apparently been achieved throughout all sectors of the money and capital markets.

Moreover, mounting evidence suggested that further pressures would build up in the weeks immediately ahead, as strong demands for credit pressed on a growing scarcity of funds. Although prediction in that area was always hazardous, Mr. Hickman believed the Committee could look for sharply higher yields in the corporate and municipal markets in the next few months, caused by further bank liquidation of municipals, the drying up of CD's, and the withdrawal of insurance companies from the mortgage and capital markets. All that had led

and would lead to a desired reduction in aggregate demand. The problem was to achieve just the amount of reduction that was needed to relieve price pressures without destabilizing the economy. His own view was that the Committee should wait to see how the economy responded to the steps already taken.

Mr. Hickman therefore recommended that policy be kept about the same until the next meeting, with bank reserves provided only to satisfy seasonal needs. If bank credit increased more than projected, under the moderate CD runoff assumption, net borrowed reserves should be allowed to rise perhaps to as high as $600 million. On the other hand, if bank credit increased less than projected, then net borrowed reserves might be allowed to remain about where they were, that is, around $400 million.

Mr. Hickman said he had been on the call since the last meeting, and would like to commend the Manager for his handling of a very difficult situation. The refunding was touch-and-go all the way, with considerable attrition, and with the new issues drifting off in the after-market. The Manager was hampered during and after the refunding by major revisions in the reserve statistics, particularly by a shortfall in required reserves below expectations. That caused net borrowed reserves for one week to fall below $400 million. On the other hand, smaller net borrowed reserves were accompanied by lower total reserves, nonborrowed reserves, and bank

credit (proxy) than had been adjudged appropriate by the Committee. Yet the money market was extremely tight and uncertain. In the words of one observer, the market was characterized by "solid erosion." Despite all of that, the Desk was able to steer a middle course that avoided the extremes of tightness and ease.

Mr. Hickman repeated that he favored keeping policy about the same until the next meeting. He found the first paragraph of the draft directives acceptable, with Mr. Hayes' suggested amendment. He would suggest a second paragraph reading "To implement this policy, while taking account of potential liquidity pressures within the banking system, 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; provided, however, that if required reserves expand more rapidly than expected, operations shall be conducted with a view to requiring greater reliance on borrowed reserves."[1/]

Mr. Brimmer pointed out that there was a minor inconsistency between objectives with respect to the balance of payments and on the domestic side. While the inflow of funds from foreign branches of U.S. banks apparently was helpful from the balance of payments standpoint, it undercut to some extent the efforts of the Committee to achieve further gradual credit restraint at home. That was

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1/ Later during the go-around, Mr. Hickman indicated that a directive along the lines suggested by Mr. Mitchell would be acceptable to him.

particularly important because so few U.S. banks had foreign branches and benefited from the inflow. He hoped that before too long the Board would review the situation and reach a judgment about the appropriate steps to take, if any, with regard to the inflow.

With respect to the domestic scene, Mr. Brimmer commented that the question was being raised increasingly whether the System had gone far enough with monetary policy. That was enhanced because of the uncertainty and doubts on the part of some observers about the differential impact of credit restraint. His own feeling was that the System had not gone far enough. Despite the lack of additional assistance from the fiscal side--and today's paper quoted a high official as giving assurance that there would be no tax increase at this time--he thought it was vital that the System push on with the use of monetary instruments. The recent informal survey of current lending practices, conducted by the Reserve Banks at the request of the Board, provided mixed evidence. The responses describing the activities of some of the banks were less comforting than he had hoped. While there were substantial variations, even within Districts, on balance the evidence indicated that the banks were in fact rather close to being prisoners of their large customers. While he would not say that in public--only within the Committee--he thought he detected such a high degree of value on customer relations

that the banks, in fact, had difficulty in saying "no." He repeated that he thought the System should push on.

During the past couple of weeks, Mr. Brimmer said, he became concerned about the way the Desk was carrying out the directive of the Committee. He agreed with Mr. Hickman that it was a difficult period, complicated by the Treasury financing and the serious problem of how to maintain an even keel, but he had asked a staff member to review the operations of the Desk during this period because it was possible to see some slippage and he wanted to know why that had occurred. The staff appraisal was shared with the Manager, who thought it was worthwhile to undertake a review of that kind from time to time. The evidence suggested that the Manager had decided to accept net borrowed reserves in the lower part of the indicated range. The reasons for that decision were convincing to the Manager and were accepted by him (Mr. Brimmer). That meant, however, that the Committee was starting off with net borrowed reserves not quite as it had hoped they would be when the Committee met a month ago. How to quantify that was difficult, but he felt that the Committee was slightly behind and that it should make up some lost ground. As a minimum, he hoped that the effect of the Board's reserve requirement action would not be completely offset. Roughly one-fourth could be passed through to net borrowed reserves, in his opinion.

In summary, Mr. Brimmer thought the Committee ought to come out with net borrowed reserves somewhat higher than at present. The Manager had suggested a figure in the high $400 millions, but he (Mr. Brimmer) was hopeful they would end up in the high $500 millions. On the discount rate, he would say simply that he had heard the comments around the table this morning.

All of this suggested to him, Mr. Brimmer said, that the Committee ought to come out with alternative B, phrased as suggested by Mr. Robertson, because it would permit the Committee to make up some of the ground that had been lost.

Mr. Maisel said that from all the documents received for this meeting it seemed to him that two critical facts stood out. First, it appeared that aggregate demand was going to expand less than aggregate supply for the next half year. Second, the credit variables, with the exception of business loans, had finally reached the point where they were expanding less than normally. Most had now reached a level of expansion only about one-half to two-thirds of the expansion rate of last year. Those were the two critical bases against which the Committee was going to have to operate.

Accordingly, Mr. Maisel said, it seemed to him the Committee had now reached the point where it must consider what impact monetary policy was expected to have on the situation with respect to aggregage supply and demand. How would the monetary variables react, and would the reactions be desirable for the economy? As to action the System

was taking now, when would it be expected to be effective? He did not think the answers to those questions were critical at this meeting, but he believed they would grow increasingly important over the next few months, and he would hope the Committee could have specific estimates of the expected impact and the lags involved.

Mr. Maisel disagreed with the view that there had been any undue slippage. Rather, he would want to hold the credit proxy at an annual expansion rate close to the average thus far this year. It seemed to him that the Committee should start allowing the market to react against a rather constant growth rate rather than to determine the market, with one basic exception. Business loan expansion was far out of line with all other credit variables, and he would favor a policy of trying to indicate to the banks, through the discount window, that a substitution of business loans for securities was not aiding monetary policy in the fight against inflation. It should be made clear that if credit was going to be curtailed, the place where the curtailment would do the most good was in business loans.

With those provisos, Mr. Maisel said, he would favor continuing to follow a credit proxy variable as a basis for Desk operations. He would be well satisfied with a 6 per cent expansion rate in the credit proxy, and he would support alternative A for the directive on the assumption that that was its goal. He would not be concerned

if net borrowed reserves fell below current levels, or if money market conditions relaxed somewhat or tightened, provided the credit variables continued to expand at about the rates that had prevailed recently.

Mr. Daane made the following statement:

> At the outset Mr. Chairman, I would like to address myself to the Board's action of last Wednesday, not in a spirit of recrimination or of crying over spilled milk but rather because, as indicated in your statement as well, I think the considerations surrounding that action are highly revelant to the problems and decisions we confront today. Perhaps I can most simply summarize my views with respect to that action and where it leaves us and leads us by reading into the record my memorandum to the Board of August 11, 1966. That memorandum read as follows:
>
> > I have reviewed carefully Governor Robertson's memorandum of August 9, 1966, proposing a further increase in reserve requirements on large holdings of time deposits, and the related staff memoranda. I have also discussed the possible market impact with the Manager of the System Open Market Account. On the basis of this review and discussion, and despite my feeling that the System should, in the absence of sufficient fiscal restraint, move further in the direction of credit tightening, I am strongly opposed to the suggested reserve requirement action at this time for the following reasons:
> >
> > (1) The announcement effect, in the present market, would in my judgment have severe repercussions, going well beyond what would be desired and well beyond the repercussions of a modest discount rate change. If it resulted, as it well might, in a substantial forced sale of assets by one or more of the largest banks this could bring us close to a disorderly market and necessitate Account operations and resultant reserve expansion contrary to present System objectives. Present market sensitivity is amply demonstrated in the reception accorded this

week's issue of Public Housing Authority notes and in the current behavior of the new 5-1/4s, which are selling below par despite substantial Treasury purchases during the past two days.

(2) The action would intensify the problem the banks face in September of replacing existing CDs without, in my judgment, achieving the differential impact on bank credit expansion intended and desired. As I review the staff documents, and from my own discussions with several bankers whose judgment I respect, it seems to me that the real problem confronting us is one of avoiding too abrupt a runoff of CDs rather than aggravating a squeeze by our actions. And I am skeptical, as apparently so is staff, that the desired differential effects would ensue. I think banks would simply cut back further in the credit areas where they are now cutting--hitting much harder on other loan and investment areas than on business loans, and least of all on the demands from their best business loan customers.

(3) The action most assuredly will be used by the banks as the peg upon which to hang a further increase in the prime rate. This unnecessarily exposes the System to the escalation of interest rates attack and I would not be at all surprised to see some of this come from administration as well as Congressional sources. On the other hand, it would expose us to attack from the larger banks--and one difficult to gainsay--to raise Q ceilings, once more in order to avoid a drastic blockage of fund flows.

(4) Cushioning operations at a time when we are normally supplying reserves will necessitate much larger open market operations and there would be technical difficulties involved in such an action.

In summary, I think the timing of the action would be unwise in the light of current market developments, of an impending prime rate increase (and without an FOMC meeting providing a forum for full discussion of the integration of our instruments). I question whether the desired differential effect will be accomplished and think

> there is a real risk that it will necessitate System action either to expand reserves or to raise Q ceilings to avoid undue blockage. And, finally, it seems to me that further credit tightening could better be achieved with a further gradual tightening of open market operations, subject to a full review by the FOMC on August 23, 1966.

Subsequent to my memorandum the Board rejected the proposal to increase reserve requirements, the prime rate was then raised, Secretary Fowler publicly rebuked the banks, and the Board majority then went ahead with an increase in reserve requirements--an action which I did not share and would not have shared had I been present. Following last Wednesday's action we have, of course, had, as I see it, the worst of all possible worlds--a resultant sharp runup in interest rates, with serious talk of another prime rate increase, and weakness in the pound sterling also not unrelated to our recent action.

In evaluating where all of these developments leave us and lead us today, I am impressed by the views expressed by members of the Dillon Committee at their meeting last Friday. This committee, comprising some of the top minds in the country on international and national financial matters, did not discuss the Federal Reserve's latest action in their joint session with Government officials which I attended. Apparently, however, they did review it thoroughly in their own deliberations prior to meeting with Government officials. And one member of the Dillon Committee told me that they were all extremely critical of the action, using fairly strong language in the process. Only one member of the group (which, of course, includes Messrs. Dillon, Heller, Gordon, Rockefeller, Roosa, Kindleberger, Mayer, Wilde, and Bernstein) defended the action and then only if it was aimed solely at raising slightly the cost of CD money and assuming the reserve impact would be completely offset by open market operations. Some of the reasoning of those critical of the Fed's move did appear in the joint discussions and I think is worth noting. The view generally seemed to be that we were closer to precipitating a financial crisis than anyone in Washington realized; that while monetary policy should not "lose its nerve" it was indeed biting and biting hard--now--even on business loans; that if it had been left alone the market and credit situation would

have tightened itself more than sufficiently; but that the further stress induced by our action could serve to provoke a crisis or, at best, be self-defeating because of our efforts to prevent such a crisis. There was an unequivocal statement of the Dillon Committee addressed to the Secretary of the Treasury that what was lacking on the Washington side was a clear voice and sense of purposeful direction and guidance. I might mention also that one of the factors cited as contributing to the over-taut market situation was the continuing stream of agency issues and question was raised as to whether there might be any way to defer agency efforts to raise new money.

As I have thought about all of these matters in terms of today's decisions, I am convinced that we can allow very little, if any, of the increased reserve requirement at this juncture to find its way into the net borrowed reserve target. Absent that Board action, I think we might very well have directed the Manager of the Account to permit the credit markets to further tighten themselves somewhat, or even to probe cautiously toward a further reduction of availability as market conditions permitted, against the background of a slower pace of loan expansion, even of business loans as indicated by weekly reporting banks, of the inroads on bank liquid asset portfolios that have taken place, of the significant volume of CDs maturing soon--all leading to existing strong pressures and even stronger pressures in September. Next month's likely larger CD attritions can only serve to add to the pressures on banks facing heavy loan demands with reduced liquidity. Thus, I now conclude that we cannot utilize the most recent action to produce further tightening but must instead think about whether we should try to accelerate our seasonal provision of reserves through open market operations and similarly provide more of a cushion through the discount window than is contemplated in the draft memorandum on discount administration. Otherwise, I think there is the danger of really disruptive interest rate developments--disruptive to the financial markets and the economy--and that risk is too great to run. Unlike Mr. Robertson's view, expressed this morning, that he is not bothered by interest rates, I am bothered, and especially by their implications in terms of market

pressures. Last Friday in our regular Board staff discussion of these matters, I raised the question of the possibility of a financial crisis. Privately a staff member slipped me a not altogether facetious note that the probability was ranked by one staff member at 25 per cent, one member at 33-1/3 per cent, and one member at 49.9 per cent (almost a 50-50 chance). While I myself do not see the percentages really that high, the fact that they exist at all in the judgment of informed observers should, I think, give us cause for concern. Frankly I still do not believe that the kind of further interest rate escalation we see emerging--escalation that held the Board back from approving a discount rate change, yet was an inevitable result of last week's action--should be welcomed by us or by the administration. I am puzzled by the seeming naivete of the view that cost and availability of credit can be neatly separated and central bank credit so channeled as to determine which loan demands will be satisfied, all without putting severe pressure on interest rates. All of whatever experience I have myself had with financial markets suggests that this cannot be done. To the extent that banks do not meet commitments or satisfy borrowers' demands and these demands turn elsewhere, the price of money inevitably will go on up. The prime rate change undoubtedly reflected the fact that large corporate issues required more than 5-3/4 per cent and, without the prime rate increase, bank corporate customers would have come in for their total lines.

All I am saying is that monetary policy may have produced about as tight a credit situation as we usefully can. While it is important not to let up on the restraint we have achieved, I think that we have pushed about as far as we can at the moment, without the buttress of adequate fiscal restraint, and are now achieving all that we can hope for from monetary policy alone. In saying, as we all have said, I believe, at one time or another, that monetary policy cannot do it all alone, I am anxious that we now not try to disprove ourselves and bring about a financial disorder either at home or abroad. I would not attempt a firming of market conditions as per alternative B and would perhaps provide reserves more willingly than indicated in alternative A. I would eliminate the

> reference to supplying minimum reserves and suggest simply maintaining about the current state of money market conditions--accepting the Partee definition meaning no relaxation--giving full flexibility to the Manager of the Account and, as I have already indicated, relying on the continuing good sense and efforts of our discount officers without elaborate new rules and arrangements. I am not as confidently certain as Mr. Robertson that there is no case now for some realignment of the discount rate.

Mr. Mitchell said that if he understood Mr. Maisel correctly, the latter was implying that the time might be close for a turn around. As he (Mr. Mitchell) looked at the pertinent table in the green book, it showed total loans and investments rising in July at an annual rate of 10.9 per cent with increases of 8.7 per cent in June, 10.2 per cent in 1965, and 8.7 per cent for 1966 to date. While the rate of increase was down in August, that was just like touching down an airplane that might bounce and take off again. There had not been nearly so much of a touching down as to accomplish the objectives the Committee had been striving for for a long time. It seemed to him the rate of expansion had to be down to the hoped-for August level for a while before the Committee had achieved its goals. He thought monetary policy was biting, and had been, but he thought it could bite a little more. That was why he thought some further tightening was desirable.

Mr. Mitchell preferred alternative B of the draft directives, although he could live with alternative A. However, he had a change to propose, recognizing that it would give the Manager a considerable amount of leeway, probably more than he could use. His suggestion

was that the second paragraph of the directive read: "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying the minimum amount of reserves consistent with maintaining orderly money market conditions and the moderation of unusual liquidity pressures within the banking system; provided, however, that if bank credit expands more rapidly than expected, operations shall be conducted with a view to requiring still greater reliance on borrowed reserves." It would then be up to the Manager to judge what it took to maintain orderly money market conditions and what it took to moderate unusual liquidity pressures. He thought the Manager actually had been operating close to that standard for the past couple of weeks. He regarded it as an adequate standard and thought it indicated where the Committee should stand in the next few weeks.

Mr. Shepardson noted that several comments had been made about the naive idea that credit availability could be affected without a rate effect. He did not know of anyone who had that idea. The thing he was concerned about was that at times there had been more emphasis on rate than availability. The emphasis needed now was on reducing credit availability. While recognizing that there would be a rate effect, he would look for the guideline at availability, rather than rate. He thought there had been rate

adjustments in recent weeks and months that were not entirely compatible with the amount of reduction in availability that had been achieved. He did not believe anyone at the table failed to recognize that the degree of credit availability had an effect on the rate, but the question was one of where the emphasis should be placed in the economy of today.

Mr. Shepardson aligned himself with those who felt the Committee should be pushing for some further gradual tightening. He would accept alternative B as originally proposed, since the philosophy embodied in that language reflected his thinking.

Mr. Wayne reported that although economic activity continued strong in the Fifth District, the latest business survey of the Richmond Reserve Bank contained a few indications of a slowing trend. In addition to a weaker trend in residential construction, a variety of nondurable goods manufacturers now reported some decline in new orders and backlogs. Unemployment remained at very low levels, however, and wages were continuing upward.

Nationally, Mr. Wayne added, the dominant question was whether the economy was regaining in the third quarter some of the momentum lost in the second. The incomplete data now available for July and early August were not sufficient, in his view, to provide a conclusive answer.

In the policy area, it seemed to Mr. Wayne that a combination of pronouncements and actions by the System was conveying to

the banks and the financial markets the message of restraint. If high interest rates could be effective in curbing excess demand, the present general level of rates should do the job, given time. The critical factor now was to impose a firm restraint on the availability of credit. If that should produce still higher interest rates, they would have to be accepted. There was no question as to the need for continuing restraint; the only question was how it should be applied. An increase in the discount rate would be felt mainly through its announcement effects and would probably drive up interest rates with little effect on reserve availability. It was true that the discount rate was far out of line, but the market seemed to be accepting the new relationship. Through firm administration of the discount window, borrowing had been held to moderate levels and it was doubtful that any feasible increase in the discount rate would change the demand for discounts greatly. Consequently, he believed an increase in the discount rate would produce several undesirable effects without accomplishing anything constructive. In the current delicate situation, a sudden move of the wrong kind could cause real trouble.

Mr. Wayne favored keeping the pressure about as it was and as it had been for the past month, which meant that reserves would have to be supplied, either through the discount window or in the open market, to offset most of the additional reserves that would

be required next month. Alternative A of the draft directives expressed his views adequately.

Mr. Clay commented that the basic problem with which the national economy was faced continued to be one of overexuberance, despite the variation among sectors of the economy. Accordingly, appropriate public policy required further measures of restraint, including further restraint through monetary policy. The Board of Governors recently had taken a step in that direction through an increase in reserve requirements on time deposits effective in September. Open market operations should be coordinated with that action so that the added restraint involved in the reserve requirement increase was made effective.

The Committee was faced with a number of uncertainties that would have to be taken into account in implementing monetary policy through open market operations, Mr. Clay pointed out. Those included the various impacts upon the commercial banks and the financial markets deriving from the demand for loans, tax and dividend payments, CD liquidation, and the higher member bank reserve requirements. Recognition had to be given to the convergence of a number of those important financial developments as mid-September approached and the unknown magnitude of their impact upon the financial system. Consequently, allowance had to be

provided in the implementation of monetary policy to meet those potentialities. Alternative B of the draft directives appeared satisfactory to him.

Mr. Scanlon reported that the trend of economic activity in the Seventh District remained essentially unchanged in July and early August. With the exception of the automobile industry, there had been no moderation of production gains by District manufacturing firms. Upward price pressures remained strong. While unemployment increases had occurred in automobile centers, other major District areas reported strong labor demand and continuation of labor shortages. Help-wanted advertising in Chicago area newspapers in July increased 16 per cent, significantly more than the 3 per cent gain posted last year.

According to a representative of a local steel firm, Mr. Scanlon said, customers did not react adversely to the recent steel price increase. Although notice of the price hike was given several days prior to the effective date of the increase, customers did not take advantage of the opportunity to obtain supplies then available at the lower prices.

As a result of unfavorable weather during July, crop prospects in the Seventh District had been revised downward. Corn production was now expected to be below last year's level in Illinois and Indiana. Farmers might defer the marketing of 1966

grain crops since the outlook was for strong prices. Bankers had noted that the seasonal deposit increase related to the harvest might be somewhat less than originally expected.

Mortgage terms had continued to firm in the Seventh District. Bank loan figures continued to reflect heavy credit demands by business, and bankers' statements in connection with the recent prime rate boost indicated that they anticipated even stronger demands through the fall. Since midyear the growth in business loans had been well above the experience in other recent years, with the Seventh District relatively stronger than the nation as a whole. The major Chicago banks reported that they were following restrictive loan policies; few commitments for term loans were being made. To a considerable extent, the higher volume of business loans had been offset by liquidation of other types of loans, probably reflecting tighter loan policies. In addition, there had been a marked decline in holdings of both U.S. and municipal securities in the past few weeks. While those developments had reduced the rate of growth in over-all bank credit, they had also reduced liquidity further.

The major Chicago banks showed an improved basic reserve position compared with a month ago. That was partly due to sales of securities but also reflected their acquisition of a sizable amount of CD money earlier this month and an even larger increase

in other borrowings. Nevertheless, those funds were short-term and there was considerable apprehension as to how the banks would meet CD maturities as well as meet the customer loan demand they expected.

Mr. Scanlon noted that preliminary estimates indicated some recent slowing in the growth of most monetary and credit measures after sharp increases in July. It appeared to him that it would be appropriate to maintain the more moderate rate of monetary and credit expansion in coming weeks. The settling of the airline strike and the increase in reserve requirements effective mid-September should help to curb any tendency for more than seasonal expansion in adjusted required reserves. If those conditions could be achieved within the existing degree of reserve pressure, he would recommend such a course. However, if continued slower reserve expansion required greater reserve pressure, he would favor moves to bring about that condition.

Mr. Scanlon felt that for economic reasons the discount rate should be raised. If the discount rate were brought more in line with market rates, the System would be in a position to obtain the announcement effect of large and prompt rate reductions if and when they should prove desirable. That did not mean that he foresaw a downturn--quite the opposite. He believed the longer one operated with a rate disparity and the wider it developed, the

more difficult it would become to find the "right time" for a change. He favored alternative B of the draft directives.

Mr. Galusha submitted the following statement for inclusion in the record:

Ninth District conditions fairly well parallel those set forth in the green book, with these exceptions:

In the main, the District's experience in the second quarter, and continuing into the third, is somewhat more bullish than that of the nation. Retail sales, for example, rose strongly in the District during the second quarter, while there was a distinct slow-down at the national level.

Data for June and July indicate a strong comeback in the industrial sector from the April-May pause. Impressive gains were recorded in the mining industry, including metal mining and petroleum, and continued expansion of taconite production. Of the 15,950,000 gross tons of annual taconite capacity under construction on June 21, all but 750,000 tons were located in the Ninth District, primarily in Minnesota, with one large development in the Upper Peninsula of Michigan.

Agricultural conditions continue generally good in the District, with the exception of southwestern Montana, which is suffering from a severe drought, and areas of North Dakota which are suffering from too much rain during the critical period of wheat harvest. There is little expectation that livestock prices will depart from 1965 levels to any greater extent than presently prevail. Grain marketings are uncertain at this point, partly for the reason mentioned earlier, and partly because of an indicated tendency on the part of farmers to hold grain for continued strengthening of price. Because of this strengthening of price, however, there is reason for the banking community to expect pressure if there is a reversal of current farmer attitudes, whether caused by a change in market expectations or crop damage, which would affect its storage ability.

The general picture is one of high cash farm receipts, which in turn will mean a continued high level of consumer demand.

The need for an increase in monetary restraint continues on balance. Wage settlements being made this summer, and

the outcome of negotiations which will continue through the next twelve months, are of a pattern. What evidence of easing has occurred in some areas of the economy is at least offset by continued exuberance in other parts. The Vietnam requirements are certain to continue to accelerate, particularly in the light of the most recent developments in China. It might be argued that while monetary policy has not been particularly effective in curbing the present inflation--the current issue of the Economist having likened it in terms of influence to sun spots--it still is the only weapon being used. Protestations of the banking industry notwithstanding, one is left with a feeling that banks are meeting most reasonable credit requests, and the term "reasonable" is liberally construed.

The most compelling reason for a further increase in monetary restraint, including an increase in the discount rate in the near future, would be to free the System from the position of technical imbalance with market rates.

These arguments have been advanced with full knowledge that there are political constraints which may be thought persuasive against such an action now, plus the industry pressure that would result from a further increase in open market rates if Requlation Q is not changed. There is the further argument advanced by one of my colleagues that the current degree of monetary restraint is so far from the average experience of the last decade and a half that our quantitative estimates of its impact may be quite poor. It may be that under these circumstances the rate of inflation, which at present is still of a modest order by world standards, is a price that may have to be paid. However, I am not persuaded that the case for greater monetary restraint has been adequately defeated.

Mr. Galusha said he could accept either of the alternative draft directives. This was a period when flexibility of operations would be needed, but at least the present degree of tautness should be preserved. It seemed to him the discount rate was in a ridiculous position and there would have to be a technical adjustment. There

was little reason to believe that market rates were going to come down very fast, and the longer the disparity existed the more difficult it was going to be to change the discount rate.

Mr. Swan commented that although Twelfth District aerospace firms reported vigorous expansion in employment for the second month in a row, total nonagricultural employment in the Pacific Coast States remained about the same in July as in June. With a decline in farm employment, the rate of unemployment rose in July to 4.8 per cent, from 4.6 per cent in June.

On the financial side, Mr. Swan said that in the four weeks ended August 10, total credit at weekly reporting banks declined more than a year earlier, but by about the same relative amount as elsewhere. The decline in business loans was much greater than a year earlier, and contrasted with an increase in the same period this year at weekly reporting banks elsewhere in the U.S. Large negotiable CD's rose 6 per cent in the period, in contrast to a decline of .6 per cent at weekly reporting banks outside the District. However, time deposits of States and political subdivisions declined; that was the one area where there was considerable feeling at major banks that rate increases would be necessary to hold the deposits. The prime competition was from the Treasury bill market rather than agency obligations. There was still room to raise the rates on that sort of time deposits, and presumably that would be done.

Looking back over the last four weeks, Mr. Swan was struck by the fact that the Committee's directive a month ago referred to "maintaining about the current state of net reserve availability and related money market conditions." Maybe net reserve availability was at the lower end of the range in subsequent weeks, but certainly not related money market conditions. From the August figures, it appeared that the changes in total reserves, required reserves, and bank credit were somewhat less liberal than had been expected. In view of those developments, the substantially increased rate structure, and the market uncertainties that existed, it seemed to him the Committee should not take further action to tighten irrespective of market forces. Instead, he would consider it desirable to maintain about the present market conditions, recognizing that they were tighter now than a month ago. If credit demands were stronger than expected, which he translated into the 6 per cent figure mentioned by Mr. Partee, then the Committee should permit further tightening. Otherwise, he would neither ease nor tighten. In trying to find some measure to relate that to, he had somewhat the same feeling he assumed was in the minds of the staff when they dropped the reference to net reserve availability; namely, that the latter could not be used very well in view of the prospect of substantially increased borrowing. If this occurred, he would

expect some increase in net borrowed reserves, but that would be hard to interpret in terms of money market conditions.

While he had been thinking in terms of alternative A of the draft directives, Mr. Swan welcomed Mr. Mitchell's language. He thought it was an improvement over either of the draft alternatives, so he would support that sort of directive if the reference to bank credit expanding more rapidly than expected tied into the 6 per cent projection. He believed that a decision on the question of a discount rate increase could not be delayed much longer. He would hope it would not be necessary to wait until substantial borrowings were already on the books. The executive committee of the Board of Directors of the San Francisco Bank took no action to increase the rate at its last meeting, but expressed much the same kind of concern that had been mentioned by Mr. Hayes.

Mr. Irons said conditions in the Eleventh District were very strong, probably reflecting some of the same factors being reflected nationally. Nationally the situation was one of strong inflationary pressures, in his judgment, and called for no lessening in the degree of restraint that the Committee had been attempting to achieve. It seemed to him that monetary policy had been effective recently in influencing the attitude of banks. As to the uncertainties associated with the anticipated mid-September

runoff of CD's, that might be something like the situation that was feared with respect to savings deposits a month or so ago; the situation might turn out to be not as bad as expected, even though significant strains might affect banks and markets.

In view of the illiquidity of banks and the effect of the change in reserve requirements, Mr. Irons felt that a reason was indicated for trying to maintain for a time about the same degree of tightness that had been experienced in the market up to this point. He had had in mind that he would favor alternative A of the draft directives for the period ahead, but he liked the modification offered by Mr. Mitchell because it seemed to reflect what the Committee was really trying to do. The Committee was trying to get all the restraint it could in the market, but at the same time to maintain orderly conditions. Mr. Mitchell's modification pointed that up clearly. If what the Committee was trying to achieve could be achieved, well and good. If not, then the Committee should not force matters, with money market conditions as they were and with the uncertainties that loomed ahead around mid-September.

Mr. Robertson withdrew from the meeting at this point.

Mr. Ellis said that within the framework of generally high and rising economic activity in New England, three aspects might be highlighted. First, District mutual savings banks reported

downward changes in July deposit balances for the first time in many years. Even though new July deposits were up 24 per cent and interest credits were up 19 per cent compared with July 1965, withdrawals were up an even greater 47 per cent. The net change was a .06 per cent decline. Second, the District's member banks continued to gain savings and other time deposits at rates substantially above the national average. Third, the region was not experiencing a slow-down in construction, not even residential construction. New England total construction contracts in June rose 45 per cent above June 1965. For the first six months the total stood 34 per cent above the same six months in 1965. Residential contracts in June exceeded June 1965 by 6 per cent, and the first six months showed a 9 per cent year-to-year gain. June building permits in Massachusetts were up 20 per cent from last year, for a six-month cumulative gain of 19 per cent.

Turning to monetary policy, Mr. Ellis said it was fairly evident that the economy remained tilted toward inflation. Demand pressures of Government expenditures, capital outlays, and probable expansion in consumer spending indicated the likelihood of a further trend in that direction in the fall. To the cost pressures of wage settlements in excess of productivity gains were added the escalation of wages to match cost of living increases. Credit creation continued excessive, especially after the long period of expansion. The

objective as long ago as last December was to slow credit creation, but the record showed acceleration in business loans, total loans, total credit, and reserves. There had been three weeks now in which the rate of growth seemed less than expected, but, as Mr. Mitchell had said, one touchdown does not make a safe landing. He expected that demands ahead in the fall were going to produce another take-off in the loan category.

Mr. Ellis agreed with Mr. Brimmer's analysis that the Committee's posture should be one of gradual tightening. It was simply a question of the next step, and his answer to that question rested on two convictions. First, he felt that the September "crisis" would turn out to be quite manageable without special programs to soften the impact of expected developments. He recalled the special efforts to soften the July "crisis" that was supposed to occur at savings and loan associations and mutual savings banks. Actually, the period passed without great strain. When banks could foresee and plan ahead, they did so. The principal potential problems were faced by large sophisticated banks. CD deposits were not going to disappear altogether, although they might shift in form and location. The existing mechanism of the discount window would provide whatever cushion was needed. His second conviction was that the Committee should continue to focus its attention on aggregate reserve availability, and its cost, rather than attempt

to tailor a program that sought to allocate credit by categories, at some risk of lessened attention to changes in the aggregates.

Mr. Ellis said those convictions led him to suggest, as a first point, that the Committee should tighten the net borrowed reserve target another notch, by perhaps $50 or $100 million. Net borrowed reserves had averaged $400 million the past three weeks, and he would suggest that the target be moved to $500 million, plus or minus $50 million. He suggested this target knowing that the Committee would meet again only a few business days after the effective date of the reserve requirement change. It could well postpone until that time an appraisal of how much the effect on reserves should be offset. If borrowings at the discount window rose substantially above the $800 million average of the past several periods, he would add the excess to the net borrowed reserve target. That would provide a cushioning reserve to those banks that needed it, while not losing the effect of some general tightening on other banks. Banks had already been advised that the window would be available for distress cases.

If that course were followed, Mr. Ellis said, he would expect market rates to rise if credit demands turned out to be as excessive as projected by bankers to whom he had talked. Having permitted the rate of bank credit expansion that it had since December, the Committee could hardly expect to accelerate

credit growth enough to forestall further rate increases this fall if the demand continued to expand as much as he had been told it was going to expand. Even the 6 per cent projected rate of credit growth associated with the "no change" alternative directive would not insure rate stability.

If action such as he had described were taken, Mr. Ellis continued, he would reinforce it by lifting the discount rate from 4-1/2 per cent to 5-1/2 per cent when practicable. Internationally, that would confirm the System's intention to fight inflation, and it would confirm that the discount rate was still a tool of monetary policy. It would buttress reliance on the window without attracting less urgent borrowing seeking to take advantage of the present bargain rate. It would clear the air of uncertainty as to whether or when the discount rate would be changed. Further, the longer the System waited to move the more difficult it would be to change the rate.

Mr. Ellis said he welcomed the Manager's advice that he proposed to make repurchase agreements at rates above the discount rate. The Manager knew, of course, that the nonbank dealers were going to protest and charge discrimination.

As to the directive, Mr. Ellis said that alternative B was his choice. While he could support Mr. Mitchell's intent, he

rejected his language as really constituting a "no change" directive. He preferred a directive that called for gradual firming.

Mr. Hayes said it was his impression that the differences expressed in the go-around were not enormous. While he would not want to minimize them too much, they appeared to represent primarily differences in shading, both in interpreting where things had been going on the credit side recently and in interpreting the degree of danger that might be faced in financial markets and the risk for the near-term of rising rates. But the differences seemed rather marginal, as exemplified by the fact that several persons had said that either of the alternative draft directives was acceptable to them. It appeared to him from his tally that the preferences were very close, with possibly a little shading toward alternative B. Perhaps, however, Mr. Mitchell's proposal represented a compromise solution that would be generally satisfactory.

Mr. Sherman said Mr. Robertson had stated before he left the meeting that Mr. Mitchell's proposed language would be acceptable to him.

After the Secretary had read Mr. Mitchell's proposed language, Mr. Hayes said he was not quite clear as to what the proviso clause meant in view of the preceding language to the effect that a minimum of reserves was to be provided consistent with maintaining orderly conditions and avoiding unusual liquidity pressures.

Mr. Mitchell said it was his thinking that the Manager would be expected to "skate close to the edge" if the credit proxy seemed to be going up faster than expected. He thought that in the light of today's discussion the Manager knew that the Committee wanted to achieve a little firming if it could do so.

Mr. Holmes said he assumed that what was wanted was as much restraint as could be achieved without leading to a financial crisis. It was his understanding that a 6 per cent rate of growth in the credit proxy would be acceptable to those at the table. That was what was presently expected for September, but it might turn out to be far different. If it did turn out different and the expansion was greater than 6 per cent, then he would move toward deeper net borrowed reserves and tighter money market conditions, to the extent, however, that there were no liquidity pressures such as to require attention.

Mr. Hayes commented that the Manager evidently felt that the proviso clause would not prevent his paying adequate attention to orderly market conditions and Mr. Holmes replied that he thought it would not. As he understood it, the reference to liquidity pressures carried through the whole flavor of the directive. He added that he would "skate a little closer to the edge" if credit expansion rose sharply.

Mr. Ellis said he did not want it on record that everyone around the table accepted a 6 per cent rate of credit growth for September. Such a rate was not acceptable to him. Mr. Shepardson agreed.

Mr. Hayes said he felt sure there were differences of opinion on the exact figure, but something on that order was what he thought people had in mind as the consensus.

Mr. Bopp suggested that the policy record entry for today's meeting should make clear that that did not mean that the Committee was prepared to tolerate disorderly conditions if bank credit expanded more than anticipated.

Mr. Brimmer recalled that he had expressed a rather strong preference for alternative B. He hesitated to dissent from the consensus, but he would like the record to show that he was not happy about the prospect of a 6 per cent increase. If the increase fell short of that figure, he would feel better, and he would encourage the Manager to "skate a little closer to the edge." He was unhappy that the word "firming" had been lost from the directive.

Mr. Daane said he preferred alternative A to alternative B, even in the amended version, but he would not record a dissent from the directive.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise

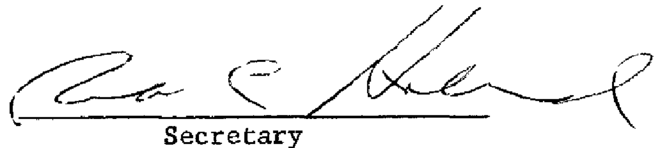
directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding more rapidly than in the second quarter, despite further weakening in residential construction. Recent wage and price developments suggest that inflationary pressures are becoming more intense. Credit demands continue strong, financial markets have tightened further, and interest rates have risen substantially in an atmosphere of great uncertainty. The balance of payments 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, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying the minimum amount of reserves consistent with the maintenance of orderly money market conditions and the moderation of unusual liquidity pressures; provided, however, that if bank credit expands more rapidly than expected, operations shall be conducted with a view to seeking still greater reliance on borrowed reserves.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 13, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

CONFIDENTIAL (FR) August 22, 1966.

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on August 23, 1966.

First paragraph

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding more rapidly than in the second quarter, despite further weakening in residential construction. Recent wage and price developments suggest that inflationary pressures are becoming more intense. Credit demands continue strong, financial markets have tightened further, and interest rates have risen substantially. The balance of payments 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.

Second paragraph

Alternative A (no change, with qualification)

To implement this policy, while taking account of potential liquidity pressures within the banking system, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying the minimum amount of reserves consistent with maintenance of the current state of money market conditions; provided, however, that if bank credit expands more rapidly than expected, operations shall be conducted with a view to requiring greater reliance on borrowed reserves.

Alternative B (firming, with qualification)

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying the minimum amount of reserves consistent with attaining a gradual firming of money market conditions, except as changes may be needed to moderate unusual liquidity pressures within the banking system; provided, however, that if bank credit expands more rapidly than expected, operations shall be conducted with a view to requiring still greater reliance on borrowed reserves.