MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, July 18, 1967, at 9:30 a.m.

PRESENT: Mr. Hayes, Vice Chairman, presiding
Mr. Brimmer
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Sherrill
Mr. Swan
Mr. Wayne
Mr. Patterson, Alternate for Mr. Francis

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

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

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

Mr. Cardon, Legislative Counsel, Board of Governors
Mr. Fauver, Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors

Mr. Bernard, Economist, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss McWhirter, Analyst, Office of the Secretary, Board of Governors

Mr. Lewis, First Vice President, Federal Reserve Bank of St. Louis
Messrs. Eisenmenger, Eastburn, Mann, Brandt, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Cleveland, Atlanta, Kansas City, and Dallas, respectively
Mr. Deming, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on June 20, 1967, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on June 20, 1967, was accepted.

By unanimous vote, the action of members of the Committee on June 29, 1967, approving an amendment to paragraph 2 of the Committee's Authorization for System Foreign Currency Operations, effective June 30, 1967, to change the maximum period authorized for the reciprocal currency arrangement with the Netherlands Bank from 3 to 6 months, was ratified. The paragraph as amended read as follows:

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

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Maximum period of arrangement (months)
Austrian National Bank	100	12
National Bank of Belgium	150	12
Bank of Canada	500	12
National Bank of Denmark	100	12
Bank of England	1,350	12
Bank of France	100	3
German Federal Bank	400	6
Bank of Italy	600	12
Bank of Japan	450	12
Bank of Mexico	130	12
Netherlands Bank	150	6
Bank of Norway	100	12
Bank of Sweden	100	12
Swiss National Bank	200	6
Bank for International Settlements		
System drawings in Swiss francs	200	6
System drawings in authorized European currencies other than Swiss francs	200	6

Mr. Hayes then referred to a memorandum dated July 17, 1967, from the Secretariat proposing a further amendment to the Authorization for System Foreign Currency Operations.1/

1/ A copy of the memorandum has been placed in the files of the Committee. The recommendation presented was that paragraph 2 of the Authorization be amended by deleting therefrom the column headed "Maximum Period of Arrangement (Months)" and incorporating in the text of the paragraph provision for the New York Reserve Bank to maintain reciprocal currency arrangements with specified foreign banks for periods up to 12 months. The proposed amendment, which it was stated would permit the Special Manager to negotiate longer periods for arrangements with certain foreign banks, was regarded as consistent with the Committee's indicated interest in achieving longer maturities for swap arrangements and with action already taken approving 12-month arrangements with several foreign central banks. Adoption of the proposal would eliminate the necessity of a formal amendment to the Authorization each time a change in period was arranged. The memorandum suggested that the Committee's record of swap renewal actions could then simply reflect approval of the renewal of any swap arrangement for a further period of up to a maximum of 12 months.

Mr. Holland said that the intent of the memorandum was to suggest a simplification. It had been necessary from time to time to make changes in the column of the table in the Authorization that showed the maximum period for each swap arrangement. With the Committee now interested in moving the swap arrangements to a longer-term basis, it was thought that this might be a propitious time to amend the Authorization so as to indicate simply that a maximum period of 12 months was authorized for each swap arrangement. The memorandum also indicated how it was proposed to report, if the amendment were adopted, the Committee's action on any swap renewal in the minutes of actions taken. It had subsequently come to his attention, Mr. Holland said, that the entries in the minutes of actions taken probably could be shortened further.

Mr. Coombs said he would favor the recommendation, which contemplated a simplification of procedures, not with respect to discussion by the Committee of specific swap renewal negotiations but merely the form of the Authorization and the manner of reporting in the minutes of actions taken.

Mr. Brimmer said he would assume that the memorandum of discussion would still carry the details. He understood that the minutes of actions taken were to be an accurate index, and the question of maturity might often be a key point. Therefore, he wondered whether the Committee could appropriately dispense with a recording of maturities in the minutes of actions taken and still provide an accurate account of the actions of the Committee.

Mr. Hayes asked for Mr. Hackley's opinion, and the latter expressed the view that the minutes of actions taken need not be an abstract of the Committee's discussion. They should, of course, provide a brief summary of each action taken by the Committee. If the proposed amendment to the Authorization were adopted, there would appear to be no necessity thereafter for including reference to the maturities of swap arrangements in the minutes of actions taken, provided the maturities fell within the 12-month limitation.

Mr. Maisel suggested that the real question was whether the length of a swap arrangement was sufficiently important that it should be included in the minutes. Thus, there appeared to be two separate questions involved in considering the staff memorandum: first, the proposed amendment of the Authorization; second, whether the record of action authorizing renewal of a swap arrangement had to include reference to the length of the arrangement.

Mr. Hayes commented that he understood Mr. Hackley had said that was not necessary, within the scope of the 12-month maximum that would be provided in the Authorization.

Mr. Sherman pointed out that it had been traditional to include in the Committee's minutes reference to the maturity of any swap arrangement that was approved.

Mr. Hayes said that the question was whether it was really necessary to follow that practice, and Mr. Sherman replied that it had been customary to specify all pertinent parts of actions taken. Whether that was really essential was perhaps a matter of judgment. But a reference to maturity would appear in the memorandum of discussion, which would be prepared in the same style as the earlier minutes of the Committee.

Mr. Hayes asked Mr. Sherman whether it was his thinking that a general sentence with respect to swap renewals such as that suggested in the memorandum would be sufficient, and Mr. Sherman replied that he would be inclined to include also a reference to maturity.

Mr. Hayes noted that any renewal would necessarily be limited to 12 months, since it was proposed to amend the Authorization to include such a provision. He asked whether Mr. Sherman felt there was merit in saying the same thing in the minutes whenever renewal of a swap arrangement was approved.

Mr. Sherman replied that the memorandum of discussion would set forth the number of months for which the renewal was approved and would be a complete record. The current proposal was to state in the minutes of actions taken simply that the renewal of a swap arrangement had been approved for a period up to 12 months. If the Authorization provided a maximum 12-month period, he did not think repetition of that expression would add anything to the minutes of actions taken. If something pertinent were to be included in the minutes of actions taken, it would be the specific maturity date.

Mr. Brimmer asked at what point the actual maturity of the swap arrangements would be disclosed. Would the Committee simply say that all of the swap arrangements had a maximum maturity of 12 months, leaving the specific maturities to be recorded only in the memorandum of discussion?

Mr. Coombs said he would so construe the memorandum from the Secretariat.

Mr. Mitchell noted that the memorandum said that the proposed amendment of the Authorization would permit the Special Manager to negotiate longer periods for certain swap arrangements should the opportunity arise. He then observed that the memorandum of discussion for the June 20 Committee meeting contained a long record of comments on multilateral surveillance and the timing of maturities of swap arrangements. If the Special Manager wanted to fix all of the maturity dates on December 31 without prior approval of the Committee, the proposed amendment apparently would give him such authority. However, the decision at the June 20 meeting was to defer action on that question. He (Mr. Mitchell) would not want to see the current proposal acted upon favorably unless the Special Manager was instructed to avoid having all the swap arrangements mature on the same date.

Mr. Hayes said it was his understanding that the Committee was not dealing here with the substantive issue discussed at the June 20 meeting. On any specific proposal for renewal of a swap agreement, the Special Manager would obtain the Committee's views on the kind of maturity he would seek. The proposal now under consideration was only that the Authorization be amended to state that swap arrangements would have a maximum maturity of 12 months. That would not preclude the Committee from saying anything it wished to the Special Manager about the maturity of a particular swap arrangement.

Mr. Coombs suggested that the proposal in the staff memorandum as to language that might be used in recording action on the renewal of swap arrangements in the minutes of actions taken could be dropped from consideration without damage to the proposal for amendment of the Authorization.

Mr. Mitchell said his concern was that he wanted to have an opportunity to vote on the question whether all swap arrangements should have a common maturity date.

Mr. Swan commented that he did not see any particular objection to the proposal to amend the Authorization per se. However, if a question as to the maturity of a specific swap arrangement came before the Committee and the Committee took action on it, the language suggested in the staff memorandum for recording the matter in the minutes of actions taken would not reveal fully what the Committee had done.

Mr. Holland agreed that the suggestion for amending the Authorization could stand on its own feet. The Committee could vote for that amendment and still, if it so desired, include in the record of actions taken a reference to maturity.

Mr. Sherman asked whether he understood that Mr. Holland would like to have the maturity specified in recording each renewal of a swap arrangement in the minutes of actions taken, and Mr. Holland replied that it could be done that way.

Mr. Hayes inquired whether Mr. Holland now thought it desirable to change the second proposal in the staff memorandum, and Mr. Holland suggested the two matters discussed in the memorandum be separated.

Mr. Hayes then asked whether there was any objection to the proposed amendment of the Authorization for Foreign Currency Operations.

Mr. Wayne said he did not think it was a good procedure, in terms of general principle, to propose amendments to documents that had been worked out over a period of time unless the proposals were available in sufficient time for members of the Committee to study them. He was aware that the Secretariat thought of this particular proposal as incidental, but the result would be to amend a document that had been worked out over a period of time.

Mr. Hayes agreed that Mr. Wayne had made a good point. However, he had assumed that the proposal to amend the Authorization in the manner described in the memorandum was not controversial.

Mr. Wayne replied that he would not object to the proposal. He was not sure, however, it was not controversial.

Mr. Maisel said it was his understanding that the proposed amendment would not represent any change in policy, and Mr. Mitchell noted that one paragraph of the memorandum stated that the proposed amendment would permit the Special Manager to negotiate longer periods for swap arrangements with certain foreign banks should the opportunity arise. Therefore, it did appear that the proposed amendment would involve a change in policy.

Mr. Hayes suggested that the paragraph in question be considered stricken, and Mr. Robertson observed that the Committee then would only be approving the proposal to amend paragraph 2 of the Authorization by deleting therefrom the column headed "Maximum Period of Arrangement (Months)" and incorporating in the text of the paragraph provision for the New York Bank to maintain reciprocal currency arrangements with foreign banks for periods up to 12 months. Mr. Mitchell said he would be willing to approve the proposed amendment on that basis.

Mr. Holland commented that, if the proposed amendment were adopted, it would be with the understanding, then, that the Committee would still be afforded an opportunity to express its views to the Special Manager with regard to maturity dates of specific swap arrangements.

Mr. Hayes then suggested that the Committee vote on the recommendation to amend the Authorization and hold in abeyance the other issues raised in the memorandum until it dealt with the questions involved in the maturity dates of specific swap agreements, a matter that Mr. Coombs would discuss shortly.

By unanimous vote, paragraph 2 of the Authorization for Foreign Currency Operations was amended, effective immediately, as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	150
Bank of Canada	500
National Bank of Denmark	100
Bank of England	1,350
Bank of France	100
German Federal Bank	400
Bank of Italy	600
Bank of Japan	450

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Mexico	130
Netherlands Bank	150
Bank of Norway	100
Bank of Sweden	100
Swiss National Bank	200
Bank for International Settlements	
System drawings in Swiss francs	200
System drawings in authorized European currencies other than Swiss francs	200

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period June 20 through July 12, 1967, and a supplemental report for July 13 through 17, 1967. Copies of those reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that although the Treasury gold stock was unchanged again this week it might be necessary within the next few weeks to replenish the gold holdings of the Stabilization Fund by drawing down the gold stock, possibly by $50 or $100 million. On the London gold market, sporadic buying pressure had continued, and there had been some further depletion of the resources of the gold pool. Perhaps the most significant development was the apparent turn in the balance of payments of South Africa. South Africa had been in deficit for

9 or 10 months, and in the course of that period had probably put somewhere between $250 and $300 million of their reserves into the London market. As he had indicated before, that situation was bound to turn. The turn now seemed to be occurring, with some possibility that the flows of South African gold would drop to subnormal levels.

As of today, $380 million of the $420 million so far contributed to the gold pool had been used up, Mr. Coombs said, leaving a balance of only $40 million. At the last meeting at the Bank for International Settlements, he and Mr. Hayes had reiterated the U.S. intention to hold the London gold price regardless of the cost of intervention, but a number of the pool members were becoming increasingly apprehensive over the outlook. France had virtually dropped out, the Belgians were beginning to protest, and there were indications that the Italians were becoming fairly unhappy.

Mr. Coombs reiterated the view he had expressed on earlier occasions that the basic supply and demand trends in the gold market had turned, with gold production beginning to decline while new demand was being generated each year by rising incomes throughout the world and broadening of industrial uses for gold. As a rough guess he would say that, leaving aside speculative elements, private demand might be rising by as much as 10 per cent or more a year. The arithmetic of that had been clear for some time to the Gold

Pool, and private calculations of the outlook were now beginning to receive some publicity. A recent study by a reputable financial analyst predicted that the excess of demand over supply in the London gold market might reach the level of $1 billion by 1970. That might turn out to be a conservative estimate. The net deficit in pool operations added up to about $275 million for the first half of this year, and there was some prospect that the deficit could reach $400 million by year end. As the financial journalists began to appreciate the possibilities in this area a good many scare stories could be expected, and they would generate still further speculative buying on the London market. In his opinion, events were moving toward a "flash point"; and if a speculative outbreak did occur, widespread consequences could be expected.

On the exchange markets, Mr. Coombs said, sterling trading had been fairly well balanced during most of the period, but the Bank of England suffered fairly heavy losses on several days through intervention in the spot market. In addition, the Bank had also had sizable payments to make on maturing forward contracts. Thus far this month, through yesterday, the Bank of England had lost roughly $350 million, and another $50 million so far today; by month end the figure might easily rise to the $600 million level, and possibly beyond. He assumed that the British Government would be reluctant to show as a reserve loss more than a small fraction of the deficit, so the British presumably would be looking to the U.S. for credit assistance. He hoped that the System could limit its financing role at month end to no more than $250 or $300 million, with the U.S. Treasury and other sources providing the residual amount needed on the basis of overnight credits.

While some encouragement could be found in the fact that sterling had survived as well as it had the pressures arising out of the Middle East hostilities, Mr. Coombs characterized the British situation as extremely fragile, with little scope left for dealing with any new confidence crisis through international financial assistance over and above that already committed. He thought the British had, in effect, more than enough money on the credit side, and that solutions for their problems probably would have to be found in other directions.

Mr. Coombs also said that in recent weeks he had been getting some mild complaints from Bank of England officials regarding the occasional strong bidding for Euro-dollar money by U.S. banks, which tended to put some pressure on sterling. In May, for example, balances due by New York bank head offices to their foreign branches rose by nearly $200 million, and they rose by another $100 million in June. Some part of that presumably reflected itself in drains on British reserves. He hoped such bidding for Euro-dollar deposits would not reach anything resembling the intensity of last summer since, in view of the fragile British position, that could easily trigger another major crisis in sterling from which no recovery might be possible. On the other hand, he could not help but feel that the British authorities might not be responding sufficiently flexibly to pressures in the Euro-dollar market by rate increases of their own, coupled with a forceful use of forward operations. In any event, this was an area that would deserve close attention as the summer moved on.

Elsewhere in the foreign exchanges, Mr. Coombs said, there was not too much of major significance to report. The cutting of the Swiss discount rate had probably helped to check further inflows, but it had not so far brought about outflows of a magnitude requiring the sale of dollars by the Swiss National Bank. The German market had become flooded with liquidity as a result of continuing balance of payments surpluses and relaxation of credit restraint by the Bundesbank. As a consequence, outflows of short-term funds from Germany to the Euro-dollar market, partly on an uncovered basis, reached such a volume that the Bundesbank deliberately engineered a sharp decline of the spot rate somewhat below the parity level, in order to avoid sizable reserve losses and a renewed tightening of the domestic market.

Mr. Galusha asked Mr. Coombs for further comment on his reference to a "flash point," and the latter said he felt that the gold market might be approaching a flash point, which could be ignited by almost anything. With such a heavy imbalance of demand over supply developing in that market, and with exaggerated reports of a still greater imbalance likely to be publicized, the market was vulnerable to a major speculative raid which could affect the operation of the entire financial system.

Mr. Mitchell asked what kind of actions the British might now take, and Mr. Coombs replied that it was hard to say. Part of the problem lay in the fact that they had taken fairly drastic action already. The main rationale of the whole U.K. austerity program had been that time would be on their side, as the Government took steps in the meanwhile to restructure the British economy, improve productivity, and so forth. The difficulty was that there had not yet been much yield on that score, and in the meantime the U.K. had been beset by many other difficulties. There was the problem of the Middle East balances, and the slackening of economic activity in continental Europe had seriously impeded the British export drive. There was the difficulty of negotiating with the Common Market, with the French continuing to cast doubt on the role of sterling. It was one of those situations in which one simply had to hope that a solution would appear even though it was not visible at the moment.

Mr. Mitchell asked whether, in the event of devaluation, we were prepared, and Mr. Coombs replied he did not think we were fully prepared at the moment. One always had to consider the possibility of a country getting out of line and having to devalue. He personally did not think that devaluation would be of much help to the British at this particular stage. They seemed reasonably competitive in world markets, and any temporary gains in exports through devaluation would be more than offset by disruption of the sterling area and cashing in of additional sterling balances.

Mr. Hayes said he thought there was a general feeling within the British Government--at least at top level--and within the Bank of England that devaluation would not be a solution. So far as he could tell, that view continued to prevail.

Mr. Coombs said he had had no indication of any change in basic views. The trouble was that a certain amount of discouragement had developed in the past few months. Perhaps it just reflected a feeling that no country deserved such a run of continuing bad luck. Nevertheless, the situation was leading to market pressures, and another speculative attack could develop during the summer months.

Mr. Mitchell observed that the French evidently thought devaluation was appropriate. He asked whether that was their sincere evaluation or whether it reflected a view that devaluation would detract further from British prestige.

Mr. Coombs replied that in his view the French attitude reflected political considerations.

Mr. Hayes inquired whether the French would be likely to let sterling be devalued against the franc, and Mr. Coombs said he had received indications that if sterling were devalued the French would follow quickly. That issue was discussed at some length in 1964 and 1965 in various committees of the Common Market. His understanding, on the basis of confidential reports he had received, was that all of the Common Market countries except France had indicated that they could live with a 10 per cent devaluation. The French refused to go along.

Mr. Hayes inquired whether Mr. Coombs viewed the French position as a tactic of obstruction, and Mr. Coombs replied in the affirmative. He thought it reflected political policy, with finance used as a tool.

Mr. Maisel suggested that, since the gold question was so critical, the staff should look beyond the projected 10 per cent per annum increase in the demand for gold, which simply involved extrapolation of a trend. Obviously, behind the totals there were some underlying supply and demand factors. The staff should be making a major effort to learn more about those factors in terms of the world-wide use of gold, in order to find out what basic forces were at work. There had been some suggestions as to what might be done on the supply side, and apparently also on the demand side. More information should be made available, including information on alternative sources and uses of metals.

Mr. Coombs observed that a great deal of statistical work had already been done in the Treasury and at the BIS on the industrial and other demands for gold. One might perhaps speculate more on why the Indians bought gold or why people bought gold cigarette cases, but the problem was what to do about it.

Mr. Maisel remarked that he had been told that in the space program gold was used for certain purposes on a cost basis, which raised the question whether the use of substitute metals should be subsidized. There was also the whole question of encouraging gold production.

Mr. Hayes commented that he thought the point was well taken. He expressed the hope that the staffs at the Board, the New York Bank, and the Treasury would be in frequent communication and pursue the matter as extensively as possible.

Mr. Coombs said he had the feeling that quite a bit was known already about the supply and demand situation. The real problem was what to do about it.

Mr. Wayne expressed concern on that score. The Committee was unfamiliar with possible alternatives to which it might be giving thought. He recognized that publicity--even as to the fact that alternatives were being studied--would be dangerous. Nevertheless, it seemed to him foolish not to have alternative possibilities in mind--no matter how distasteful they might be--in the event a sudden panic should develop in the gold market.

Mr. Coombs brought out that it was not simply a problem of the U.S. deciding what approach would be most appropriate. There was also the necessity of persuading all the other major countries. At Basle it had thus far been impossible to open up the question, because of fear of leakages and publicity.

Mr. Wayne commented that some day the Committee might find itself faced with the question whether to support the price of gold on a massive basis or concentrate on defending the dollar. No discussion of the possible alternatives was presently available, yet the Federal Reserve might be faced with such a decision. He hoped that somewhere in the System, if such a day came, there was someone who could present the possible alternatives.

Mr. Hayes pointed out that it must be recognized that the primary responsibility in this field rested with the Treasury. He hoped there would continue to be opportunities for the Chairman to pursue this subject with the Treasury.

Mr. Brimmer said there were a few things that he thought the members should be prepared to discuss. One was the question of removing the gold cover against Federal Reserve notes. Committee members might be called upon to comment from time to time, and he did not know of any work that was under way to prepare a statement that could be used. The Chairman had made a statement earlier this year when he testified before the Joint Economic Committee. If that had not been distributed, it should be furnished to the Presidents.

Mr. Hayes noted there had been several memoranda on the subject. He suggested that the Secretary check on the extent to which they had been distributed.

Mr. Brimmer then noted that Mr. Coombs had made a cautionary comment about U.S. banks bidding for Euro-dollar money. However, in looking forward to the anticipated 1967 balance of payments deficit, on the official settlements basis, it occurred to him that this was one of the main crutches on which the U.S. might have to lean.

Mr. Coombs commented on the possibility of breaking sterling in the process, and Mr. Hayes noted that there might be some middle ground where an inflow could be helpful to the U.S. without serious effects on sterling.

Mr. Brimmer said he saw a need to look for that middle ground. It was his impression that U.S. banks were beginning to look increasingly to the Euro-dollar market as rates rose here. Left to their own devices, they might very well repeat the 1966 experience.

Mr. Hayes agreed that the matter deserved careful study, and Mr. Coombs suggested that in the process consideration should be given to what the Bank of England could do on its own to insulate itself somewhat better from Euro-dollar pressures.

Mr. Hickman remarked that it was not clear that the losses of reserves by Britain this year were caused primarily by the money market situation in this country. Instead, they were probably attributable more to the Middle East situation and other factors.

Mr. Coombs agreed that the borrowings by U.S. banks had not been a major factor thus far. However, they could grow into a major factor. The British had relaxed their rates along with the U.S., and a relatively minor shift in rate relationships could leave them in a vulnerable position.

Mr. Hayes also agreed that the problem related more to the threat of what might happen than to what had already happened. He thought the Committee might well ask the staff to keep it informed if the problem appeared likely to become acute, and perhaps to make recommendations.

Mr. Sherrill observed that an obvious next move for the British would be to reduce their military establishment and withdraw troops stationed overseas. He asked whether that would do them much good.

Mr. Coombs replied it would not help them much immediately but over a few years would add up to a substantial saving. It would involve, of course, difficult political decisions.

By unanimous vote, the System open market transactions in foreign currencies during the period June 20 through July 17, 1967, were approved, ratified, and confirmed.

Mr. Coombs then submitted recommendations for increases in certain existing swap arrangements. The swap lines in Swiss francs totaled $400 million, equally divided between the Swiss National Bank and the Bank for International Settlements. Of that $400 million, $390 million had now been drawn. When the Middle East hostilities began and the Swiss began to take in a flood of dollars, it became clear that the $400 million might be exhausted and the question of enlargement of the swap lines arose. The Swiss had done a great deal of thinking about the matter since then. He (Mr. Coombs) and Mr. Hayes had discussed the matter informally with Swiss officials at the last BIS meeting, and they would be favorable to enlarging the swap lines. This might be an appropriate time, for the situation had quieted down somewhat. There was always a danger in increasing swap lines in the midst of a crisis, but a good case could now be made for providing an additional margin of safety. He would suggest, specifically, that each of the two $200 million swap arrangements be increased by $50 million, giving a new total of $500 million. Both arrangements were on a six-month basis. Although he had had indications that both institutions would be prepared to move to a full-year basis, that question could be folded into the Committee's discussion of the more general question of moving toward a common maturity date for the entire swap network.

> By unanimous vote, increases of \$50 million each, from \$200 million to \$250 million, in the swap arrangements with the Swiss National Bank and the Bank for International Settlements (System drawings in Swiss francs) were approved.

Mr. Coombs' second recommendation related to the swap arrangement of \$200 million with the Bank for International Settlements involving System drawings in authorized European currencies other than Swiss francs. That facility would permit the System, in the event it exhausted its lines with any of the European central banks, to fall back upon a supplementary source. So far, that had not been necessary. The BIS, however, had drawn against the facility on several occasions. It had drawn in the latter part of last year in order to deal with pressures in the Euro-dollar market. That operation was useful, coming as it did at a time of general movement toward credit ease, since it assisted that movement. Again in June, on the occasion of the outbreak of war in the Middle East, the BIS drew against the swap line. If the hostilities had continued, for even another day or two, he felt sure they would have drawn the full amount available. Thus, there seemed to be a case for providing an additional margin of safety by increasing that swap arrangement from \$200 million to \$300 million. He had informally discussed the possibility with the management of the BIS, and they would welcome such action.

Mr. Sherrill asked whether the Germans and Italians would be likely to regard such an increase favorably, and whether the French might attack it.

Mr. Coombs replied that Bank of France officials had so far refrained from criticizing the System swap arrangements with other central banks. The German and Italian views, he thought, would be sympathetic toward this move. The Italians in particular were clearly anxious to protect the smooth functioning of the Euro-dollar market.

Mr. Hickman inquired how the announcement would be effected, and Mr. Coombs said the practice had been, whenever it seemed advisable to minimize the impact of any such announcement, simply to include it in the regular Thursday press briefing at the New York Bank, with a simultaneous routine release from the Board's offices. A similar procedure could be followed in this case. Whether it would be possible to complete the negotiations by this Thursday, he did not know, but in any event he would hope that the announcement could be ready by the following Thursday.

> By unanimous vote, an increase from $200 million to $300 million in the swap arrangement with the Bank for International Settlements involving System drawings in authorized European currencies other than Swiss francs was approved.

Secretary's Note: On July 20, 1967, the increases in the swap arrangements with the Swiss National Bank and the Bank for International Settlements were announced.

In consequence of the foregoing actions authorizing increases in the swap arrangements with the Swiss National Bank and the Bank for International Settlements, there was also approved by unanimous vote, effective immediately, the necessary amendment to paragraph 2 of the Authorization for System Foreign Currency Operations. With this amendment the paragraph read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
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National Bank of Denmark	100
Bank of England	1,350
Bank of France	100
German Federal Bank	400
Bank of Italy	600
Bank of Japan	450
Bank of Mexico	130
Netherlands Bank	150
Bank of Norway	100
Bank of Sweden	100
Swiss National Bank	250
Bank for International Settlements	
System drawings in Swiss francs	250
System drawings in authorized European currencies other than Swiss francs	300

There remained, Mr. Coombs pointed out, the question of what to do about the maturity dates of the swap arrangements that were coming up for renewal within the near future. These included the following:

Foreign bank	Amount of arrangement (millions of dollars)	Period of arrangement (months)	Maturity of latest authorized renewal
Bank of Sweden	100	12	July 19, 1967
Swiss National Bank	200 1/	6	July 20, 1967
Bank for International Settlements:			
System drawings in Swiss francs	200 1/	6	July 20, 1967
System drawings in authorized European currencies other than Swiss francs	200 1/	6	July 20, 1967
Austrian National Bank	100	12	July 26, 1967
Bank of Japan	450	12	July 28, 1967
German Federal Bank	400	6	August 9, 1967
Bank of France	100	3	August 10, 1967

At the Committee meeting on May 2, Mr. Coombs recalled, he reported that the central banks of the Common Market countries had apparently entered into a binding agreement under which the maturities of their swap arrangements would be moved to end-of-quarter dates. His recommendation at the time was to deal firmly with the problem, even to the extent of allowing the French swap arrangement to terminate if that was necessary in order to undo the agreement. That recommendation was disapproved by the Committee, with concern expressed about the

1/ Increase in arrangement over this amount authorized earlier during today's meeting.

consequences of terminating the French arrangement, and he and Mr. Hayes were asked to negotiate some compromise. Therefore, they went to the next BIS meeting with the objective of keeping the French swap arrangement intact and yet, at the same time undoing the agreement by the Common Market countries to move their swap maturities to quarter-end dates. There emerged a proposition, which seemed to him reasonable and relatively harmless, to move the entire swap arrangements to a one-year basis, with maturities at year end, at which time renewal of the arrangements would come up for discussion and negotiation. It developed in the course of the Basle discussions that the pressures for special surveillance were not widespread. Governors Carli and Blessing were not sympathetic, and even Governor Brunet was rather neutral. The proposed compromise solution provided something of a face-saving device and, as he had said, it seemed to him relatively harmless. He assumed that the Common Market countries would continue to push certain common policy measures, but he hoped that those would focus elsewhere and that the Federal Reserve swap network would be left out of the picture.

Mr. Coombs urged that the Committee adopt a policy decision to move the entire swap network to a full-year basis, maturing at year end. On the question whether something would be gained by changing the arrangements with the non-Common Market countries to that basis, he thought there would be an advantage. An argument could be made for fragmenting the dates, but the Federal Reserve had good friends among the non-Common Market group, and he could see an advantage in having the maturities of those swap arrangements coincide with those of the arrangements with the Common Market group. He had checked with the Treasury on that point, and the Treasury shared the view that if changes in maturities were to be made it would be better to have the non-Common Market group synchronized with the Common Market group. The Treasury felt that the year-end maturity date proposal was a reasonable compromise.

Mr. Mitchell said he did not understand why Mr. Coombs referred to a compromise. The issue at stake was multilateral surveillance. Under the proposed plan, there would be a review of the entire swap network at the same time each year.

Mr. Coombs replied that the Federal Reserve had been presented with a binding agreement on the part of the Common Market countries to move their swap arrangements to end-of-quarter maturity dates. That was broken up; they consented to give up that agreement.

Mr. Mitchell asked what had been gained. Now all of the swap arrangements would mature on the same date. This would put the System in the worst possible bargaining position because it would have to negotiate with all of the other countries at the same time.

Mr. Coombs replied he would take the opposite position. There were no problems except vis-a-vis the Common Market countries. The

Federal Reserve would go through the same procedure it had always followed; toward the end of the year, renewal of each swap arrangement for another year would be proposed to the bank concerned. There would be no multilateral discussion except if by any chance the Common Market countries used the occasion to try to bargain. At that point the situation would be greatly aided by having all of the other countries drawn into the discussion.

Mr. Brimmer observed that he thought the basic issue had been settled in May when Mr. Coombs presented to the Committee the possibility of terminating the swap arrangement with the Bank of France. The Committee did not want to do that, and instead instructed Messrs. Hayes and Coombs to negotiate. Having taken that course of action, the Committee now had to decide whether it wanted to live with the results of the negotiation. It seemed to him that the Committee ought to go along with the diplomatic settlement that had been negotiated.

Mr. Hayes agreed. He commented that the assignment of persuading the Common Market countries to break up their agreement had been a difficult one. The basis on which they had agreed to abandon the agreement--although it was not a binding condition--was the possibility of working toward a year-end maturity date, which appealed to them as a face-saving device. He believed it was indeed a compromise, and he saw little likelihood of the Common Market countries successfully caucusing against the System on an annual basis, particularly at year end when many of them found the swap lines valuable. In his opinion, the plan should not unduly embarrass the System, and having the other swap arrangements on the same maturity basis would strengthen the System's hand because any concerted action by the Six, if it developed, could be better resisted.

Mr. Scanlon asked whether any of the non-Common Market countries had a contrary view on the matter.

Mr. Coombs replied that he thought all of them would be prepared to move to a full-year basis and that they had no particular concern about the maturity date. The Swiss, for example, had indicated that they would be willing to do whatever the Federal Reserve suggested.

Mr. Coombs then pointed out that if the Committee was favorable to a move toward synchronization of maturities on a 12-month, year-end basis, that might involve a somewhat varied interim pattern, since the periods of the maturing arrangements differed. Certain banks, if confronted with the prospect of switching to a new maturity basis, might prefer initially to renew the existing arrangement until the end of this year. Others might want to renew for a year at this time and change to the year-end maturity pattern later. He hoped the Committee would permit flexibility in working out such matters.

Mr. Hayes noted that, since several of the swap arrangements would mature in the near future, the Committee should reach a decision on how to handle them. He suggested that the Committee approve renewal of the maturing swap arrangements mentioned by the Special Manager on their existing maturity basis. He also suggested that the Committee authorize the Special Manager to conduct negotiations looking toward the conversion of the entire swap network to a 12-month, year-end maturity basis, with the understanding that if such negotiations led to proposals for some change in the maturity basis of any maturing swap arrangements, those could be submitted to the Committee for approval.

> By unanimous vote, the renewal, on the existing maturity basis, of the swap arrangements that were to mature within the next month was approved.

> With Mr. Mitchell dissenting, the Special Manager was authorized to begin negotiations looking toward placing all of the System's swap arrangements on a 12-month basis, with maturities at year end.

Mr. Coombs inquired whether, if the negotiations that had been authorized resulted in a proposal in a given case to renew a swap arrangement for a lesser period than six months in order to reach the year-end maturity pattern, that would be recorded in the minutes of actions taken, which would be accessible to the public upon request.

In discussion of that question, Mr. Holland suggested that it would not appear that the minutes of actions taken would have to reflect the fact that the Special Manager had been authorized to negotiate. On the other hand, if the result of negotiations and report thereon to the Committee by the Special Manager led to a decision by the Committee to approve the renewal of a swap arrangement with a different maturity, such action on the part of the Committee would have to be noted in the Committee's records. The question of the content of the minutes of actions taken, in terms of maturities, went back to the matter that had been discussed by the Committee earlier during this meeting on the basis of the memorandum from the Secretariat dated July 17, 1967.

Mr. Hayes suggested that the matter be studied further by the Secretariat during the period until the next Committee meeting. Comments by other members of the Committee indicated general agreement with the view that a distinction should be made between an authorization for the Special Manager to conduct negotiations and an action taken by the Committee based upon a recommendation by the Special Manager as a result of the negotiations.

Mr. Wayne expressed the hope that the Special Manager might be able to negotiate with the German Federal Bank for a renewal of the swap arrangement with that institution for a period of at least six months. If it became known that the arrangement with the German Federal Bank had been renewed for a lesser period, he felt that that might be misinterpreted.

Mr. Coombs commented that much the same kind of problem was involved in the case of the arrangement with the Bank of France, since renewal of that arrangement for a rather short period would apparently be necessary at some point in moving to a year-end maturity basis.

Mr. Wayne suggested that a change in the maturity of the French swap arrangement would not be of as much concern as a renewal of the arrangements with other central banks, such as the German Federal Bank, for a shortened time period, and Mr. Hayes suggested that the Special Manager keep these comments in mind in conducting his negotiations.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period June 20 through July 12, 1967, and a supplemental report for July 13 through 17, 1967. Copies of both reports have been placed in the files of the Committee.

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

> The dramatic rise in Treasury bill rates since the Committee last met has been amply described in the written reports from the Trading Desk and in the blue book.[1/] Part of the rise reflected the fact that bill rates--partly for seasonal reasons--had been running well below other short-term rates; these other rates--on bankers' acceptances, commercial and finance paper--experienced a much more moderate adjustment. Mainly, however, the adjustment in bill rates stemmed from the onset of the Treasury's cash financing program, which will inevitably weigh heavily on the short-term area of the Government

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

market. A much better atmosphere has prevailed in the bill market for the past ten days, with average rates on three- and six-month bills set at about 4.25 and 4.75 per cent, respectively, in yesterday's regular auction. At these levels, rates were 11 and 3 basis points, respectively, under their interim high points, but nearly a full per cent above the lows reached a few days after the last Committee meeting.

The longer-term securities markets are now also in far better shape than in June. In the market's view, prospects for a meaningful tax increase have improved and the possibility of a massive buildup of forces in Vietnam seems to have diminished. Government securities dealers were able to reduce their holdings of coupon issues maturing in more than 1 year from nearly $500 million to about $130 million over the past four weeks, with the bulk of the reduction taking place before the end of June. After a fairly strong price rally towards the close of the period, prices of Treasury notes and bonds maturing within ten years were generally unchanged to 3/8 of a point lower over the period as a whole, while for long-term issues there were gains ranging from 1/8 to around 2-1/2 points. The recent improvement in the Government bond market was in large part a reflection of the better performance of the corporate bond market after yields on new corporate issues had reached new peaks in late June. The sellout of a large triple A industrial issue on July 11 at 5-3/4 per cent, 1/4 per cent below the offering price of a similarly-rated telephone issue two weeks earlier, marked something of a turning point in that market. The tax-exempt market was slower to respond, but at the higher yields now prevailing a better atmosphere exists there also.

While the securities markets are now in a relatively good technical position, their sensitivity to changes in expectations was again amply demonstrated by the rapid rise in Treasury bill rates following the earlier increase in long-term rates. A sustained period in which dealer and investor confidence in markets and rate levels can be regained is badly needed, and it can only be hoped that the Treasury can have something constructive to say about fiscal policy and the financing outlook by the time it meets with its American Bankers Association and Investment Bankers Association borrowing committees next week.

Open market operations over the period included all the tools of the trade--outright purchases and sales of

Governments, repurchase agreements, matched sale-purchase agreements, and operations in bankers' acceptances--to meet shifting patterns of reserve availability. They were directed at maintaining a steady money market, and the Federal funds rate--with a few aberrations--hovered around the discount rate. The stability of the Federal funds rate and dealer lending rates provided some limitation on the rise of short-term rates, as the absence of financing problems and the emergence of a positive carry on Treasury bills for the first time in many months lent some heart to the dealers.

Since the last meeting, open market operations supplied a net of about $750 million in reserves. Operations on several occasions were complicated by heavy selling of Treasury bills by foreign accounts during the period of heaviest pressure in the bill market, and over $600 million of such bills were purchased for the Open Market Account. In addition, market purchases of bills amounted to just over $900 million while outright sales (including some to foreign accounts) and redemptions of maturing bills amounted to about $930 million. Some use of repurchase agreements was made in the first half of the period, and yesterday the System temporarily absorbed reserves by selling $295 million of Treasury bills and simultaneously repurchasing them for delivery on Thursday, July 20. Purchases of coupon issues during the period amounted to $133.5 million. As the blue book notes, the market availability of Treasury notes and bonds has been sharply reduced. I think as a general rule we can continue to make some purchases of coupon issues as reserve needs and market conditions permit, but I would agree with the staff comments on the proposed directive[1/] that now is a good time to drop the specific reference to such operations in the directive.

Free reserves fluctuated widely over the period, reflecting first the difficulty that banks had in managing their reserve positions over the mid-year statement date and the Fourth of July Holiday, and then, in the statement week ended July 12, the usual rise in that week of country bank excess reserves to abnormally high levels. New York City banks had a difficult time in managing their reserve positions, winding up each of the

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1/ Appended to this memorandum as Attachment A.

last two weeks with cumulative excesses of \$400 - \$800 million, a sharp contrast to their typical near zero position. And our own projectionists, as well, have had their problems in estimating bank reserve positions. The high \$597 million free reserve figure published for the week of July 12 caused a few raised eyebrows, but had little lasting market impact.

The market is in a more receptive mood for the Treasury's August refunding than appeared likely two weeks ago. Not only is the general atmosphere better, but dealers have substantially cut back their positions in coupon issues, and they even have relatively light bill positions, as banks have not been pressing the tax bills won in the auction of July 5 on the market. But the Treasury has a delicate job to do and the market is not yet in a position to have firm convictions about the future nor is it in a mood to take great risks. In general it would appear advisable for the Treasury to keep ahead on its cash needs to the extent it can and to minimize the number of trips to the market.

In addition to the refunding of \$9.6 billion in notes and certificates maturing on August 15 (of which \$3.6 billion are held by the public), it appears that the Treasury will need about \$2 billion in cash before the end of August and perhaps somewhat more by mid-September. If market conditions are satisfactory, the Treasury might incorporate a new cash offering with its August refunding, offering two, or possibly three, notes maturing in 15 months to as long as 6 - 7 years. A major financing of this type would of course require a substantial amount of dealer and bank underwriting and could involve a fairly extensive even-keel period. Treasury financing plans are of course complicated by uncertainties as to the nature and the timing of any action on fiscal policy. Final determination of terms and amounts will depend not only on the state of a market that is highly dependent on psychology and expectations but also on fundamental economic and political decisions on taxes and fiscal policy. With an announcement on the refunding set for Wednesday, July 26, time is indeed short.

Mr. Maisel noted that the Manager and other members of the Committee staff had suggested that the specific reference to operations in coupon issues be omitted from the directive. He inquired as to the rationale according to which such operations would be conducted in that event.

Mr. Holmes replied that when the System was supplying reserves and there was an availability of coupon issues in the market, when even-keel considerations were not present, and when the market was not undergoing fundamental price readjustments, the Desk would be prepared to buy coupon issues in some modest amount relative to reserve injections. That held true before the Committee recently decided to include the specific reference to coupon issue operations in its directives.

Mr. Maisel inquired whether the Desk would differentiate according to maturities, and Mr. Holmes said operations would depend on availability. The Desk would ask the dealers to show their offerings, and would look at them relative to the market at the time.

Mr. Maisel asked whether, if dealers decided to go short, that would rule the System out of the market. If so, this meant to him that when the System ought to be in, it would get out. The attitude seemed to be that the System should reinforce dealer expectations instead of going against them.

Mr. Holmes commented that the Desk did not normally use a rate objective. Its operations rested on availability in the market and the need to inject reserves. If the Committee wanted to establish a rate objective, which is a legitimate central bank concern, then he thought special Committee action was called for. Otherwise, the Desk would buy without a rate objective on the basis of availability in the market.

Mr. Maisel said he understood, then, that if dealers went short a rate objective would be required for the purchase of coupon issues. That, he thought, was not a good policy, and it suggested to him that a specific reference to operations in coupon issues should be included in the directive. It seemed logical that the Committee should have a policy objective, independent of dealer expectations, on managing its portfolio.

Mr. Wayne commented that the fact that dealers might have short positions would not prevent offerings from being shown to the Desk on a go-around. The Desk could still get offerings on coupon issues somewhere in the market.

Mr. Hickman agreed with Mr. Maisel that the dealers would back away and that not many offerings were likely to be shown.

Mr. Hayes observed that over a period of years System operations in coupon issues had generally been conducted on a somewhat marginal basis, on the theory that the System did not want to be the primary factor setting rates in the market. As the Manager had said, the Committee could depart from that policy if it wished. But under that policy there had been a willingness to buy in reasonable amounts in relation to availability and the size of the market at a given time, while trying to avoid becoming the dominant element in the market. The Committee could, of course, always make a conscious departure from that policy.

Mr. Wayne said a departure would mean that the System would inevitably become the market. He would not want to go along with such a policy.

Mr. Mitchell asked whether, with the corporate calendar as it was, it seemed appropriate to be as tranquil as the Manager had indicated. Two weeks of extremely heavy corporate offerings were indicated, with more in prospect for August. That could easily upset the long-term market. There was a good deal of restraint flowing out of the present level of long-term rates, and that could bite deeply almost any time. That factor could become worrisome on the mortgage side. Operations in coupon issues would represent an attempt to deal somewhat selectively with the problem.

Mr. Maisel suggested that they should tend to minimize the flow of funds from deposits to market investments.

Mr. Brimmer asked the Manager what he thought the positive gain would be from dropping the reference to coupon issues at this time. The memorandum attached to the draft directive said that if the Committee wanted to drop that reference, this would seem to be a good time. He wondered, however, whether it was advisable to throw away the insurance policy simply because little need was seen for coupon issue operations in the forthcoming period.

Mr. Holmes referred to the factors mentioned in the memorandum attached to the draft directive.[1/] He noted that the availability of coupon issues in the market had decreased substantially and that small net reserve needs were projected for the coming period. Further, the Committee was moving into an even-keel period, during which the Desk normally tried to avoid exerting any market effect, through its operations, that might make the Treasury's problem more difficult. Finally, there still would be an opportunity to buy coupon issues if market conditions, availability, and reserve objectives were such as to indicate the desirability of such operations.

Mr. Brimmer said he would like to modify the reference to coupon issues in the directive rather than to drop it, and that he would submit suggested language during the go-around.

1/ The pertinent paragraph read as follows: Deletion of the reference to operations in coupon issues is proposed in line with some Committee members' suggestion at the last meeting that this instruction might well be subsumed under the more general instructions given to the Manager. Should the Committee desire to follow such a procedure, the current meeting would be a propitious time to do so, since the occasions for coupon issue purchases will probably be considerably reduced by the forthcoming August refunding, the projected small net reserve needs between now and the next meeting, low or net short dealer positions in intermediate and longer-term Governments, and the more settled conditions in the bond market.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period June 20 through July 17, 1967, were approved, ratified, and confirmed.

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. Koch presented the following statement on economic conditions:

The pace of aggregate economic activity has quickened moderately in recent months, and a further rise in spending is in prospect, barring a wave of protracted strikes.

The just available, preliminary Commerce GNP estimates for the second quarter indicate about a 2-1/2 per cent annual rate of increase in real terms, and our staff projections call for about a 4-1/4 per cent rate of rise in the third quarter. The recent over-all expansion has occurred despite a modest further decline in industrial production and a slight rise in the unemployment rate. Total nonfarm employment, however, showed a good increase in June despite the downdrag of strikes.

But there are still bears as well as bulls on the economic outlook. The bears stress the relatively sluggish economy while the bulls stress the likelihood of a future rapid pickup in the rate of expansion.

To my mind, the bulls have the better of the argument. The relatively weak first half was due mainly to a huge inventory adjustment. Total final sales have expanded rapidly, rising approximately $15 billion in each of the first and second quarters. Most forecasters of more vigorous economic expansion in the third and fourth quarters and beyond foresee an early end to the inventory adjustment and continuing high final sales. This, it seems to me, is still the most likely prospect.

At our last meeting the staff presented a longer-run projection of the economy covering the next four quarters. What new information has become available since that time, and how has it made us change our assessment of the likely future course of the economy? In brief, the answer to this question is that the new information has not made us change our outlook of the future significantly, although the advance in activity may be less prompt and less vigorous than we had anticipated earlier.

One expansionary item of economic news that has become available recently has been the pickup in auto sales. Unit sales of domestic cars were at about an 8-1/2 million annual rate in June and even higher during the first ten days of July, as compared with a 7-1/2 million rate in April and May. In part because of this rise in auto sales, aggregate personal consumption in the second quarter rose more than in the first. Consumption is likely to be a continuing, fairly strong expansionary force in the third quarter because of expected favorable car sales and higher expenditures on food. This consumption projection is backed by more buoyant recent consumer surveys of intentions to buy.

Unfortunately, we again have little new information with which to check our earlier projections of likely Federal Government spending over the quarters ahead. Our current best guess still is that the rise in defense spending in fiscal 1968 will be much less than in 1967, assuming only a relatively modest further build-up of troops in Vietnam. There is beginning to be more public assurance that an increase in income taxes will be enacted. Also, word around Washington is that the rise may well be more than 6 per cent, perhaps 8 per cent. The best guess still is that the President will request the increase, along with a renewed appeal to cut nonessential spending to the bone, later this month or at least by early August prior to Budget Director Schultze's scheduled presentation of an interim budget to the Joint Economic Committee.

As for the remaining items of final demand, our earlier projected rise in residential construction in the third quarter seems consistent with most recent data on housing starts, building permits, and mortgage commitments. Revised Census data, however, show a lower level of outlays on residential construction both in 1966 and in the first half of this year. Higher new car purchases--in part for business purposes--and recent increases in new orders for machinery and equipment tend to support our earlier estimates of a modest rise from here on in business spending on plant and equipment.

The case for an early end to the inventory adjustment strikes me as persuasive. Additions to manufacturers' stocks have recently been small, and they have been mainly in defense items and goods in process. In the case of distributors, auto inventories have declined, with shortages of cars reported in some areas. Retail trade sources indicate that stocks of household durables have been substantially reduced, and some outlets are stepping up new orders.

Excessive stock/sales ratios by historical standards are concentrated in durable goods manufacturing lines. But in some of these lines expanding orders and sales should begin to whittle ratios down wherever they may still be considered too high. Current stock/sales ratios do not seem out of line among most nondurable goods manufacturers and distributors. The inventory drag on GNP was over $11 billion in the first quarter, $5 billion in the second, and should be further reduced in the third.

The recently revised Commerce data on GNP also show a smaller over-all price rise in 1966 and in the first half of this year than had been estimated earlier. Nevertheless, our staff is projecting some rise in the GNP deflator in the third quarter, partly due to higher food prices, which reflect mainly past supply rather than current demand conditions. In the industrial sector of the economy, average prices were again little changed in May, as continuing selective rises in finished goods were offset by further declines in some materials.

But the character of current collective bargaining activity bodes ill for future business costs and industrial prices. Labor demands seem more and more to be centered above rather than below 5 per cent annual wage increases, including fringe adjustments, and these demands appear to have firmed, due in part to the recent resumption of more rapid increases in the cost of living. It is unlikely that increases of this magnitude can be offset in many industries by equivalent increases in productivity. As a result, rising unit labor costs and upward pressures on industrial prices will no doubt pose an increasingly severe problem in the months ahead. Once markets strengthen, it will be difficult to hold businesses back from attempting to pass higher labor costs on to their customers in the form of higher prices.

But, on balance, the domestic nonfinancial economic situation still seems to me to call for watchful waiting on the monetary front, even if such a position were not called for by the imminence of Treasury financing. Resurgence in economic activity is just getting started; there is still a moderate amount of unutilized labor and plant capacity available; and many uncertainties in the outlook remain, including the possibility that strikes will unsettle things--for a time at least. This "steady in the boat" policy prescription also seems called for when one recognizes the dampening influence on economic activity already set in train by the prevailing, historically high level of long-term interest rates and even when one takes into account the lagged effects of monetary variables on activity.

Mr. Mitchell drew attention to the following sentence in the first paragraph of the draft of current economic policy directive that had been submitted by the staff: "Output is still being retarded by adjustments of excessive inventories, but growth in final demands continues strong, reflecting substantial further increases in Government outlays and also some strengthening in consumer expenditures for durable goods and housing." He pointed out that although Government outlays had increased from the first quarter to the second quarter, the rate of increase had dropped back. Therefore, he questioned whether the sentence conveyed the right impression as to what actually took place in the second quarter, as compared with the first quarter, and what was now taking place.

After some discussion, Mr. Hayes suggested reversing the order of the last two parts of the sentence and leaving out the word "substantial" in describing the trend of Government outlays. Mr. Mitchell agreed.

Mr. Swan raised a question about the part of the first sentence of the proposed directive that stated that ". . . prospects for further expansion have strengthened."

After discussion of this point, Mr. Mitchell suggested saying that ". . . prospects are for further expansion."

Mr. Hayes commented that this was getting close to the area usually covered in the go-around. He believed that in the minds of most businessmen the prospects had strengthened somewhat, but others might feel differently. The question could be discussed further as the meeting proceeded.

Mr. Partee then made the following statement concerning financial developments:

> Developments since the last meeting of the Committee demonstrate again the great potential of expectations and investor psychology for influencing security market conditions. Thus, before dropping back a bit in recent days, the 3-month Treasury bill yield had jumped nearly 100 basis points, mainly on the news of Treasury financing and growing apprehension about the size of the second-half deficit. This unprecedented rise took place even though the first round of financing--the $4 billion in tax bills--was taken up entirely by the banking system, supported by ample reserve availability. Conversely, the long-term bond market has rallied recently, even though the summer corporate calendar remains as heavy--or heavier--than in the spring. And considerable speculative interest appears to have developed in the stock market--particularly in smaller and more volatile issues--despite a continuation of relatively poor current earnings reports.
>
> Expectations are unlikely to have significant lasting influence, however, unless borne out by future events.

Thus, the sustainability of current yield levels and relationships will depend on whether market expectations are correct. By and large, I think that they are, and that the upward rate move that has occurred is, in practical terms, virtually irreversible. But I see little justification for still higher yields any time soon, given the still largely prospective character of the business resurgence, and I believe that we should guard against that possibility if special pressures in particular credit sectors should develop.

With regard to short and intermediate markets, Treasury financing requirements clearly will be the dominant influence in the months ahead. Our current estimate is that, even assuming a 6 per cent surtax effective October 1, and retroactive to July 1 for corporations, net Treasury and Federal agency credit needs in the second half will total about $18-1/2 billion. This is far more than in the second half of any other year since the War, and is 2-1/2 times the comparable 1966 financing volume. The bond rate ceiling, if not market realities, dictate that virtually all of this financing be done in the short and intermediate area. Though much of it doubtless will be taken up initially by the banks on reserves supplied by the System, subsequent distribution is likely to keep retail markets under more or less continuous pressure.

Rates on short-term Treasuries now appear relatively attractive, given the 4 per cent discount rate and the present posture of policy, and such instruments are likely to continue in good demand at around current levels. But intermediate rates could well come under further upward pressure, especially if the Treasury takes advantage of its new authority to issue notes of up to 7 years. The interest rate curve already reflects this, sloping moderately downward from 6 years on out, but of course the downward slope has frequently been much more extreme. It is in the short and intermediate maturity area--ranging from about 1 to 6 years--that market instruments seem to provide the most competition for deposit-type savings. Both banks and the specialized depositary institutions appears to have negotiated the mid-year interest and dividend crediting period quite well, despite the better returns recently available in the market. But the story could be different this fall if intermediate yields were to rise appreciably further.

In long-term bond markets, a technical rally was probably about due in view of the substantial yield rise of recent months. But firmer expectations of Administration action on taxes and the reductions in supply stemming from System purchases of coupon issues probably assisted in bringing it about. Positive fiscal proposals in the next few weeks could extend and broaden the yield decline, especially if a larger tax increase is requested than the 6 per cent surtax originally proposed. Most long-term markets are in a fairly strong technical position, with dealer inventories generally reduced--virtually non-existent in the case of long Governments--and investor views as to the near-term rate outlook more closely balanced between bulls and bears.

Major assistance to the long-term market would be provided, of course, by a drop in corporate financing demands. The calendar for July and August still looks extremely large, but I think that the chances for some decline later on have improved recently. Interest rates are now quite high by historical standards, and the market atmosphere has shifted to the point where the outlook for still higher rates no longer seems the "sure thing" that it was. In addition, aggregate corporate needs for private external financing probably dropped abruptly at mid-year. Accrued corporate tax liabilities--a source of funds--declined very sharply in the second quarter as a result of the speedup in tax payments, and that is now behind us.

As has been pointed out before, the characteristics of the corporate bond market tend to produce marked unevenness in new issue volume. The financing decisions of a relatively few corporations dominate the size of the calendar, and corporate treasurers naturally want to fund their debt at the most propitious times possible. Thus the exceptional new issue volume this year has partly reflected a desire to take advantage of the cyclical low-point in rates, and probably was speeded up and compressed as it became evident that the cyclical decline would be weak and short-lived.

It is interesting to recall that in the spring of 1961 too--at the cyclical low--there was a wave of corporate financing that put new issue yields up 40 basis points between March and July. Subsequently, new issue volume waned and yields dropped back to about their previous lows. The current situation differs in important respects from 1961, of course. Treasury financing requirements are much larger, business capital spending--and hence the need for external funds--has remained high, and the threat of intensified inflationary pressure is much closer to being a clear and present danger, given factory utilization and unemployment rates. But the absolute level of interest rates is also markedly higher than in 1961. A tendency toward reduced bond financing, now that the advantage of timing is lost and as business resurgence produces improved internal funds flows, seems to me a good bet to recur.

The staff draft directive provided for this meeting suggests deletion of the reference to System purchases of coupon issues. The change is proposed partly on the grounds that provision of needed reserves in this way, among others, has become an established procedure and partly because technical considerations, including the forthcoming Treasury refunding, suggest that there will be less occasion for making such purchases over the next few weeks. But I would hope that the Manager would continue to give active consideration to the possibility of providing reserves through purchases at any point in the maturity range indicated by market developments, Treasury financing considerations permitting. In particular, I think that it is important that the System do whatever it can to relieve market pressures--particularly in the intermediate area--if and when they tend to develop. As for general monetary policy, the Treasury refunding obviously calls for an even-keel posture until the next meeting.

Mr. Hersey presented the following statement on the balance of payments and related matters:

A good deal of water has flowed under the bridge since the time, last March, when this Committee altered the key sentence of its policy directive, describing the current objectives of policy, in such a way as to mute its concern about the balance of payments. In March, and for that matter as early as the first overt move toward easing last November, the Committee was concerned above all that the U.S. economy not slip into a recession. With time passing, and conditions changing, I should remind the Committee again that sooner or later it may wish to reconsider the question of whether Federal Reserve policy ought to be taking more account of the balance of payments problem. It is unfortunately true that, as the policy directive has been saying since April, "the balance of payments deficit has remained substantial despite some improvement in the foreign trade surplus."

Just how substantial the underlying deficit has been during the past year has not been fully revealed by the official statistics of the liquidity deficit--as you are fully aware. At the middle of August the first press release on the second-quarter balance of payments will once again announce a liquidity deficit of the order of magnitude of half a billion dollars. But before counting the effects of foreign official and international acquisitions of over-one-year time deposits and international institutions' acquisitions of over-one-year U.S. Agency securities--not to mention various other transactions that may or may not be thought of as "special"--the deficit on the liquidity basis exceeded one billion in the second quarter, after approaching a billion in each of the two quarters before. A deficit of four billion dollars a year on this basis cannot be regarded lightly, since this is the amount that has to be financed either by drains on U.S. reserves or by increases in the claims on the United States of one kind or another of foreign official institutions, except to the extent that commercial banks abroad, other private residents of foreign countries, or international institutions add to their liquid and near-liquid claims on the United States.

The problem of financing the deficit has not been as acute during these last three quarters as it may become if the deficit continues on this scale. Before seasonal adjustment, the deficit since September 30 of last year on the basis I have described has been about $2-1/2 billion. Drains on our gold reserves and IMF position have totalled less than $200 million. Since the net increase in liquid and near-liquid liabilities to others than monetary authorities was quite small over this period, there was about $2 billion to be added to our net liabilities, liquid and near-liquid, to foreign monetary authorities. Over half of this was taken, in one form or another, by central banks in Asia and Latin America. The largest single chunk of the total went to reduce our official holdings of sterling and raise Britain's official dollar holdings. The Continental central banks, despite large current account surpluses in Germany and Italy, took almost nothing from us in the way of near-liquid assets and did not have much change in their net liquid claims on the United States. Several reasons for that result can be cited. For Italy, the period in question did not include the summer months in which Italian reserve gains are largest, and also there were sizable outflows of nonbank investors' funds from Italy. Germany made sizable prepayments both on government debt and on military purchase account. Also, with a push from the increasingly easy money market conditions in Germany, the German commercial banks built up foreign assets and paid off external liabilities by a total of over three-quarters of a billion dollars in the eight months through May.

It is open to question whether reserve gains in Asia and Latin America, to say nothing of British reserve gains, will continue on any such scale as they attained in the past three quarters. Equally, it is difficult to foresee continuing large outflows of commercial bank funds from Germany. If our deficit continues large, the financing problem is bound to become more difficult.

What is happening with the deficit? As I mentioned, the deficit on the "liquidity and near-liquidity" basis in the quarter just ended was somewhat larger than in either of the two preceding quarters. But neither the difference, nor--so far as we can see at this moment--the causes of the increase, look important enough to be described as a significant worsening of a situation that was already bad enough. A major factor in the apparent worsening was a rather large outflow of U.S. short-term bank credit, much of it to Japan. It is questionable whether this bank credit outflow will be continuing on so large a scale. Also, in the second quarter new foreign and international capital issues in the United States remained fairly large, with rather heavy concentration of offerings in April, and this flow may diminish. Possibly, though we have no evidence on this, U.S. direct investment outflows may have been abnormally large, after having been unexpectedly small in the first quarter. In general, we do not expect the outflows of private capital in these various forms to be as large in the months ahead as in the months just past, though the total is likely to exceed the average of the first and second quarters.

The picture for trade is a mixed one. It is true that exports, as well as imports, fell off in the month of May. But it appears that during the second quarter exports financed by economic aid may have been appreciably smaller than in the first quarter and commercial exports larger.

Looking ahead, I would expect the decline in imports which started in the second quarter to continue a few months more. Clearly one of the biggest question marks for the rest of the year applies to U.S. exports. People both inside and outside the Government look for some further expansion.

It is safe to say, however, that growth of U.S. exports is likely to be slow at best until a clear upturn in demand occurs in Germany, and spreads from there to other countries. The state of business pessimism in Germany, and now in France too, is pretty dark.

Probably what we have to expect for the over-all balance of payments is further large quarterly deficits ahead, in the half billion to one billion per quarter range.

With such an outlook, with U.S. labor market demand comfortably strong, and with the dangers of cumulative recession in the United States now pretty clearly past, the Committee will need to be considering, if not at this meeting then not long from now, whether U.S. monetary policy ought again to be tinged with a bias of caution imposed by the international payments problem. There is no need, and no possibility, of producing a quick solution through monetary policy action alone. To restore equilibrium may take years yet. What we can aim for is noninflationary growth with a minimum expansion of liquidity in the economy consistent with steady growth.

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

The outlook for a strong resurgence of business activity in the second half of the year continues to brighten, and the danger of a recession has by now virtually disappeared. Inventory spending, which has recently dominated the behavior of

GNP, remains an important factor in the pattern of output growth throughout the year. Whereas the abrupt decline in inventory spending in the first quarter provided an $11 billion drag on total output, the drag was appreciably smaller in the second quarter, should be smaller yet in the third, and may well be replaced by a positive stimulus in the fourth. When this factor is combined with a probable accelerating growth in final spending, the resulting projections show an almost explosive expansion of GNP in the absence of a tax increase. And even with a sizable tax rise, effective October 1, the economy should continue to pick up speed through the yearend. Naturally this type of projection is subject to important uncertainties, including those connected with the Vietnam war and those which result from serious strike prospects, particularly in the auto industry.

It is interesting to note that the over-all inventory-sales ratio, even after a decline in May, remains substantially above the range that prevailed from the beginning of 1964 through mid-1966, and expansion of GNP along the lines in question would go far toward bringing this ratio down close to the earlier level.

There is serious cause for concern on the price and cost front, despite the continuing stability to date of the industrial wholesale price index. With higher food prices in prospect, both the wholesale and consumer price indexes are likely to rise further, and with a prospect of excessive wage settlements in the coming months, the recent stability in unit labor costs will probably be short-lived. Thus we find a growing threat of stepped-up pressure on prices from both the demand and the cost side.

Although it is possible that the published liquidity deficit in the balance of payments may drop slightly in the second quarter because of an increase in special transactions, the underlying deficit apparently increased substantially. A gain in the trade surplus was more than offset by an increase in bank credit (especially Japanese acceptance financing) and a net deterioration in other capital flows. Moreover, there seems to be no prospect of any major improvement in the second half of the year, so that we may reasonably expect a liquidity deficit for the full year of $2-1/2 to $3 billion, and an underlying deficit of close to $4-1/2 billion. On my recent trip to

Europe I found a great deal of uneasiness among central bankers on the subject of our balance of payments, with the tendency to feel that we are "drifting" and failing to take necessary decisive action to reduce the deficit. There is also some uneasiness with respect to the outlook for sterling, particularly as it may be affected by higher oil costs and rising interest rates in this country.

I continue to feel some concern over the persistent rapid expansion of bank credit, even though the pace in the second quarter was more moderate than in the first. I would not like to see anything like the 12 per cent rate of growth of the credit proxy during the first half of 1967 continue for very long in the future. The recent data on money supply and related liquidity indicators suggest a similar view. At the same time, we have obviously been faced with an unusually abrupt advance in market interest rates, especially when we view the short-term rate movements at the end of June and in early July. As for long-term rates, they are uncomfortably close to last summer's peak level, despite the recent improvement in the capital markets. So far the rise in market rates does not seem to pose a serious threat to the savings inflows into depositary institutions. And although the level of corporate bond yields has reduced the relative attractiveness of mortgages as compared with bond purchases for some major institutional lenders, the volume of new mortgage commitments remains very satisfactory and points to a good level of housing construction over the coming months. Of course, further large rises in market interest rates could create a significant threat of disintermediation, with various ramifications throughout the economy.

All of these considerations point strongly to the pressing need for a sizable tax increase. By this I mean an increase of at least 6 per cent--probably more--to be effective at the earliest practicable date, perhaps October 1. Fortunately there seem to be strong indications that the Administration will request Congressional action along these general lines. If there ever was a time when monetary policy needed a strong assist from fiscal policy, that time is the present; and I believe that there is growing public recognition of this state of affairs.

As for monetary policy, it seems to me that no change in policy is the wise choice for the immediate future--despite the strong underlying case for some firming of policy in the light of inflationary risks, the balance of payments situation, and the need to moderate the growth of bank credit and deposits. A number of factors are enforcing this conclusion: First, the projected excessive growth in demand is as yet only a forecast rather than a present reality; second, the sensitive state of the financial markets suggests that even a modest firming of policy would run the risk of a dangerous overreaction; third, and of great importance, nothing should be done to disturb the prospects for quick action on taxes; and, finally, with the Treasury's refunding announcement due on July 26, possibly involving substantial cash financing, there would be insufficient time to change policy in any case before "even-keel" considerations became a factor.

I find the staff's draft directive quite satisfactory, except that the reference to the balance of payments situation should be strengthened to point up the recent further deterioration in the underlying payments position. I would favor inclusion of the proviso clause as drafted. I would also concur with the staff in their suggestion that we drop the specific reference to coupon issues at this time.

Mr. Lewis noted that final demand had been rising at about an 8 per cent annual rate since the fourth quarter, little changed from last year. That was above the growth rate consistent with reasonable price stability if the economic potential of the country grew at about 4 per cent a year. Indications of excessive demand could be found in price behavior; over-all prices had apparently risen at an undesirably high 3 per cent annual rate since late 1966. In addition, public policies were now intensifying the likely demands for goods and services in the near future. The high-employment budget deficit was estimated at about a $9 billion annual rate in the second and third quarters, or some $10 billion more expansionary than in the corresponding two quarters of 1966.

Bank credit had risen at an 11 per cent rate since December, Mr. Lewis pointed out, a significantly greater rate than during the expansive period of late 1965 and early 1966. Money supply had increased at a 7 per cent rate since December, also somewhat greater than the extremely rapid rate of the 12 months ending with April 1966.

Since expansion in bank credit and money generally operates with a lag, Mr. Lewis said, the present rates of increase were adding to future potential demands for goods and services. Even if a tax increase lessened fiscal stimulus, he thought it would be desirable for the expansion of bank credit and money to be moderated, and he would like to see monetary policy so adjusted. He believed that the cost, in terms of higher interest rates now, would be offset by the benefits from more sustainable economic growth, less price acceleration, and some progress toward reducing the U.S. balance of payments deficit. Furthermore, he thought that monetary restriction now, which would limit total demands and reduce the rate of inflation, was more likely to be accompanied by lower average interest rates over the next year than a current policy of attempting to slow upward movement in rates.

Mr. Lewis said, in conclusion, that he would prefer to permit some firming of the money market if possible, even during the Treasury financings.

Mr. Patterson said that at the last meeting, and in reviewing the memorandum of that discussion, he was impressed by the emphasis on economic prospects rather than on what was happening, whereas attention used to be directed almost entirely to current developments. To see if the economy was really going in the direction it was expected to follow, he had taken a closer look at the statistics that had become available, especially for the Sixth District. He had noticed a sharp increase in lending by the District's large banks in recent weeks, and a significant increase in District automobile sales in June. Savings flows to savings and loan associations and residential contracts were also continuing to show good gains. In short, he noted some improvement in general economic activity.

On the national scene, Mr. Patterson found evidence that the stage had been set for an end to the economic adjustments that were worrisome earlier. Accordingly, the relevant policy question today, as he saw it, was whether monetary policy should now become less expansionary. Here, it seemed to him, the answer was becoming gradually clearer irrespective of what weight one might give to current or future developments, although he believed that the exact degree of the response should be determined by unfolding economic conditions.

The Committee's task was not made easier by the frequent intervals the Treasury could be expected to be in the market, Mr. Patterson continued. He hoped that that likelihood would not delay any decisive monetary action by the Committee as needed. He also hoped that if even-keel consideration made it incumbent on the Committee to maintain present money market conditions, that would not involve additions to reserves of a magnitude inconsistent with longer-run domestic and balance of payments trends. Reserves supplied during the course of a Treasury financing sometimes had a way of developing into permanent additions to reserves, credit, and bank liquidity. Although that possibility was more germane to cash financings than to the kind of refunding operation ahead, he would prefer, if possible, to keep a slightly tighter lid on reserve expansion over the next 4 weeks.

Mr. Patterson favored the draft directive, amended to include the changes suggested by Mr. Mitchell. He also favored deleting the reference to coupon issues.

Mr. Bopp noted that although some new signs of economic pickup had appeared recently a number of other indicators had been disappointing. Information about the Third District economy followed a similar pattern. Manufacturing output in May increased a little, but employment declined. Other indicators were mixed. That kind of behavior probably was to be expected in the transition from a slow first half to a more vigorous second half.

Because of the importance of housing activity in the expected economic pickup, Mr. Bopp continued, and particularly because of its sensitivity to interest rates and the availability of funds, the Philadelphia Bank had been trying to keep in close touch with developments in that sector of the economy. In a survey of mortgage lenders, builders, and realtors last week, a change in attitude was found. A couple of months ago lenders were concerned about the effects on rates of a possible over-supply of funds available for mortgages. They were increasing their liquidity and looking for declines in mortgage rates during the summer. Accordingly, they were cutting or dropping fees, service charges, and other special expenses, and were reducing interest rates.

Now, Mr. Bopp said, attitudes had been transformed by the combination of a plentiful flow of savings, a relatively slow demand for mortgages, and especially by attractive rates on market instruments. Lenders felt quite good about their positions. Their liquidity had improved, higher market rates had had no adverse effect as yet on the flow of savings, and attractive rates on bonds were beckoning. The result was that there was no pressure to lower mortgage rates below 6 per cent. Within the past several weeks, there had been increasing pressure to raise fees and to tighten other terms. The prevailing belief was that bond yields would stay high for the balance of the year at least. That attitude was reflected in commitments for the rest of 1967, which were below the second half of 1965 for most of the institutions surveyed.

Lenders were not actively seeking mortgages now, Mr. Bopp continued, but if housing activity should pick up markedly they would be in a position to liquidate recently-acquired corporates and divert incoming savings to mortgages. How much effect such a development might have on market rates was difficult to say. The fact, however, that lenders had been diverting funds into corporates that ordinarily would have gone into mortgages must have helped restrain the increase in rates on corporates; a reversal of that flow would tend to raise them.

Mr. Bopp thought that an even-keel policy, with the Treasury in the market, should include an effort to hold market rates fairly steady. Given a continuing heavy volume of new issues, that might be difficult to accomplish, particularly in view of the reduced scope for System operations in coupon issues. Hopefully, the Administration's reassessment of the fiscal outlook would produce an announcement of firm intent to seek higher taxes promptly. That should have a beneficial effect on the market.

At present, Mr. Bopp pointed out, the economy was still operating well under capacity, and continuation of expansion in money and credit at the rates projected by the Board's staff seemed appropriate. How rapid the expansion had been was highlighted by the fact that in the first 6 months of this year the rate of growth of the money supply was greater than in the first 6 months of any of the cyclical downturns of the 1950's. As the economy accelerated, a less rapid rate of monetary expansion might be called for.

Mr. Hickman commented that although the business situation today was sluggish, it should improve later this year, due largely to expansionary public policy. The contrast between the current situation and the longer-term outlook posed a dilemma for monetary policy. The Committee, in effect, had a choice between two alternatives. The first was to maintain a policy of aggressive ease such as there had been in the first quarter and again in July, according to the staff's projections. The second alternative was to seek a more moderate rate of monetary expansion, such as there had been in the second quarter, give or take a percentage point or two. He rejected, out of hand, a third alternative--actual tightening--because of weaknesses in the economy and uncertainties about the fiscal outlook, work stoppages, Vietnam, and a host of other imponderables.

Mr. Hickman suggested that the case for the first alternative--aggressive ease--rested mainly on three factors: (1) the need to promote, and not abort, a genuine recovery in the private sector of the economy; (2) concern about the adverse effects of higher interest rates on construction and capital spending decisions; and (3) the continuing heavy Treasury financing. While there was merit to that alternative earlier this year, the countervailing risks now seemed to be excessive. Continued aggressive ease now would be inflationary later on when the private sector resumed its normal rate of growth. The Committee must, of course, accommodate the Treasury's second-half financing operations. But it should avoid excessive credit availability in so doing, since that might promote a false sense of well-being on the part of Congress and the Administration, and delay a tax increase indefinitely. If the Committee knew for sure that there would be a tax increase--and if it knew the speed, timing, and magnitude of the increase--aggressive monetary ease might perhaps be justified, but the future in that murky area was more than usually cloudy. Also, of course, there was the problem of the continuing U.S. balance of payments deficit, which might deteriorate further in the event of continued aggressive ease.

The policy alternative that appealed to Mr. Hickman was that of moderate monetary expansion. If the high July rates continued, the Committee faced the possibility of an abrupt shift in policy later this year when the private sector recovered. That could give rise again to wide swings in monetary variables such as occurred in 1966, which were incompatible with balanced and sustainable economic growth, and which might threaten the continued existence of an independent monetary authority. Moderation should be achieved by reducing the rates of growth in aggregate reserve measures and in bank credit to the 6 to 8 per cent range that he had recommended at the last two meetings. Reduced rates of growth might result in higher interest rates, but that would not necessarily be undesirable if such rates served to expedite appropriate fiscal policy.

The effects of moderate slackening in rates of growth of bank reserves at this time, Mr. Hickman continued, would not be felt immediately in the real sector; hopefully, the effects would not be felt until the expected acceleration of economic activity became a reality later this year. There would, of course, be the usual political problems associated with moderation of monetary expansion, but the Committee could not continue to inject massive volumes of reserves without buying serious economic problems in the period ahead. If the "consensus" economic forecast proved not to be correct (and the record in that regard had not been exactly perfect), the Committee would still have sufficient time to adjust policy in moderate steps to the altered circumstances. While higher interest rates in financial markets might cause some disintermediation, the costs to the economy would not be nearly so great as the costs of aggressive ease and price inflation.

Mr. Hickman thought the staff directive was quite good as drafted. In view of his concern about continued aggressive ease, he would include a one-way proviso clause reading: "but operations shall be modified insofar as the Treasury financing permits to prevent bank credit growth from exceeding current expectations." Also, in the first sentence of the first paragraph he had some trouble with the reference to a modest rise in economic activity, in view of the decline in industrial production and the increase in unemployment. It seemed to him that the staff was referring to GNP, and he would spell that out, somewhat along the following lines: ". . . .GNP rose moderately in the second quarter and that prospects for more rapid expansion have strengthened." Another alternative would be Mr. Mitchell's suggested wording.

Mr. Sherrill expressed agreement with the draft of current economic policy directive, with the reference to coupon issues omitted. He believed that the economy was presently in delicate balance and that continuation of the current monetary policy was the best available alternative. In his opinion, continuation of growth in the economy was very much dependent on recovery in the housing sector, and any moves that might drain funds from the mortgage market could have an adverse effect on the growth trend. Even-keel considerations were paramount at this particular time, and he would prefer not to include a proviso clause in the directive.

Mr. Brimmer commented that, as he had indicated previously, he had been counting on the ability of U.S. commercial banks to pull in Euro-dollars later this year as one of the principal sources of assistance in keeping the official settlements deficit somewhat lower than now seemed likely. Therefore, he thought it would be unfortunate if concern for the British led the System to advocate reducing substantially this source of support to the balance of payments. While he agreed that some middle ground should be sought, he did not see any other significant source of improvement in the balance of payments at this time. On the other hand, he was disturbed about Mr. Hayes' suggested modification of the directive in reference to the balance of payments. Actually, the Committee had no way of quantifying the "underlying deficit" in the balance of payments, which was not a commonly accepted definition. The Committee had to be guided by the liquidity and official settlements bases of calculation, neither of which had really demonstrated deterioration so far. Further, it must be remembered that the directive issued today would be published in October. The only official statement issued up to that time presumably would be the Treasury's statement issued in August. That might set up the appearance of conflict in the appraisals of the situation by the respective sources. He did not think the Committee should do that inadvertently. Thus, he would be in favor of leaving the pertinent part of the directive as it stood.

More fundamentally, Mr. Brimmer said, Mr. Hersey's presentation portrayed a basic ideological difference in the way the balance of payments problem should be approached. It was his (Mr. Brimmer's) understanding that the Administration had decided, under present circumstances, with the Vietnam war a major source of drag on the balance of payments, and in view of the political opposition that would be encountered in an attempt to adopt other balance of payments measures such as taxes on direct investments, to look for means of financing the deficit. He thought it appropriate, if one accepted the Administration's position that the principal source of the deficit was short run, to look for means, on an ad hoc basis, to finance the deficit. He would be reluctant to see the quarrel whether certain special transactions were legitimate or not publicly debated.

Mr. Brimmer went on to say that he favored keeping the reference to coupon issues in the directive. He had developed suggested language, as follows, to modify the reference instead of discarding it: ". . . using operations in coupon issues as appropriate in supplying part of reserve needs." It might turn out that, given even-keel considerations and other factors referred to by the staff, it would be inappropriate, in the judgment of the Manager, to buy coupon issues at all. But he (Mr. Brimmer) would like to see the reference to coupon issues kept in the directive as a hedge.

Mr. Brimmer said he would not be inclined to include a proviso clause in the directive. For reasons such as Mr. Sherrill suggested, this was no time to shift gears. If Mr. Hickman's suggestion were accepted, he felt that that would amount to shifting gears, at too early a stage. The Committee's concern should not be simply with the Treasury financing as a technical matter. Instead, the Committee should wait out the next month, by which time there would probably have been some Administration statement on taxes. He thought it would be unfortunate to shift gears ahead of that statement. The risks were not so great that the Committee should not wait for a month.

Mr. Maisel said he had felt last time, and still felt, that the equilibrium of demand and supply in the economy, as projected by the staff for the next year, would make a logical goal and that the Committee should adopt whatever policies it believed would best achieve that equilibrium. The projection may have been optimistic as to when a tax increase would become effective and also on the degree of expansion in private demand this year. Since those would be two offsetting errors, they required no change in the staff projection.

Today, Mr. Maisel noted, the Committee faced two decisions with respect to the directive. On coupon issues, he hoped the Committee would simply retain the same clause as last time; i.e., retain the words that had been crossed out in the draft directive. He thought it particularly important to retain that provision in the directive since he interpreted the Manager's answer to his (Mr. Maisel's) earlier question as expressing a view that dropping the clause would be more than technical; that it would really be a policy change. The System's willingness to buy coupon issues had had a marked effect. Present rates were the result of expectations and the supply and demand for long-term issues. The Committee's operations in coupon issues had increased the supply of intermediate and long-term funds. At the same time, by moderating expectations, they had decreased the demand for funds, and perhaps also, therefore, the flow of credit. Policies to increase supply and decrease demand were both logical objectives for the current period. Whenever the Committee could in current circumstances, it ought to adopt policies that had a maximum rate effect with minimum impacts on the flow of added money and credit.

With respect to the second problem, that of the proviso clause, Mr. Maisel had no strong feelings. He would hope, however, that the Committee could maintain the credit flows which the staff projected as needed for a stable economy. Major questions arose on the degree of firmness the Committee could hold regarding the current period's projections and goals as shown in the blue book. He would prefer to trade rates for flows insofar as that could be done through meeting expectational forces directly. He would like falling rates of interest and a slower rate of increase for the credit proxy.

The blue book and the Manager did not seem to agree as to when the Treasury would borrow and, therefore, when credit could be expected to expand, Mr. Maisel commented. That raised major problems regarding the proviso. He would assume that if the Committee used the proviso it was not fixing a definite goal as shown in the blue book. Instead, the projections upon which action was to be taken would be altered as facts replaced assumptions. Such a shift was very important. If projections were made based on assumptions, and if the assumptions turned out to be incorrect, the projections should be amended as new information became available. Action should be taken in accordance with the amended projections when applying the proviso.

Mr. Mitchell said he felt there should be some subtle changes in the directive to reflect the concern that had been expressed that the rate of monetary expansion was a little greater than desirable. He also felt that something should be done about the reference in the directive to the balance of payments. An objection had been raised to Mr. Hayes' suggested language, but he did not see anything really wrong with an expression to the effect that the underlying deficit remained substantial despite some improvement in the trade surplus. Also, he would use "sustainable" in place of "renewed" in reference to fostering conditions conducive to economic expansion. He had criticized that word many times, but he thought the concern at this point was more about sustainability than renewal.

As to the second paragraph of the directive, Mr. Mitchell said he would retain a reference to coupon issues more or less in the form Mr. Brimmer had suggested. He would also include a clause as follows: "but operations shall be conducted insofar as the Treasury financing permits to moderate any apparent tendency for bank credit and the money supply to expand more rapidly than 10 and 5 per cent, respectively." He would put in those figures arbitrarily to eliminate ambiguity, realizing that conditions would be changing.

What he had suggested, Mr. Mitchell said, were changes designed to indicate concern about the recent very generous rates of expansion of bank credit and money supply. Considering what the Committee was likely to be facing later in the year, he thought it appropriate to inject such a note of concern at this point.

Mr. Wayne reported that business activity in the Fifth District showed no decisive trend. In the national economy there were scattered signs that the renewed expansion which had been widely predicted for the second half might be getting under way. In addition to growing private demands, defense expenditures would probably increase, as noted in the green book.[1/]

In view of the lags involved in the effectiveness of monetary policy, Mr. Wayne noted that a move toward a slightly firmer posture might be in order. On the other hand, in addition to the fact that the upcoming Treasury financing argued against tightening at this time, he believed there were several other cogent reasons for delay. First, the turnaround in the economy, if it had occurred, was still in its very early stages, and the Committee could afford to wait for some additional confirming evidence. Second, insofar as interest rates were concerned, a somewhat firmer posture had already been achieved as a result of the huge demands converging on the capital markets. Long-term rates were near the highs of last summer, and prospective Treasury demands were likely to cause further upward pressure on short-term rates. He would not like to see rate relationships produce financial and economic distortions of the kind experienced last year. Finally, the Administration now seemed disposed to press for fiscal restraint. Since that was the kind of restraint that was really needed, he would defer, at least for a while, any monetary

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

action that would place additional upward pressure on interest rates.

The draft directive was acceptable to him, Mr. Wayne said, although he would not object to changes in wording in the first paragraph such as suggested by Mr. Mitchell. While he would like to see the proviso clause added to the second paragraph, he would accept the directive with or without such a clause. However, he would object strenuously to including precisely-stated rates of growth in the directive in expressing Committee objectives.

Mr. Clay observed that the striking developments of recent weeks had been in the credit markets rather than in the nonfinancial sector of the domestic economy. The flow of information in the latter area continued to be indicative of future growth at an increasing rate. That outlook was closely associated with the growing volume of Government expenditures, although the size of Government spending remained unclear. In line with the expected expansion in both the private and public sectors of the economy, it was probable that growing pressure on costs and prices would become of increasing concern over the coming months.

Mr. Clay thought the importance of fiscal policy action had been underscored by the behavior of the money and capital markets in recent weeks. Unless the course of economic activity during the balance of the year turned out to be quite different than appeared probable at this time, the economy would require a measure of public policy restraint that would be difficult to apply by monetary policy in view of the recent level of interest rates.

For the period ahead, Mr. Clay said, it would appear appropriate to continue essentially the monetary policy that the Committee had been pursuing, although there might be some problem in stating the guidelines for such a policy. In addition to the volatility that appeared to exist in the credit markets at this time, there were several other factors, including the uncertainties of Treasury financing, the Federal budgetary projections, and the proposed tax increase. It seemed in order, nevertheless, to take the maintenance of essentially the prevailing money market conditions as the goal of policy during the forthcoming period. The projected slowdown in bank credit growth in August as compared with July should by no means be a matter of concern. Rather, bank underwriting of Treasury financing had produced too high a rate of bank credit growth for July and a slower pace of expansion would be desirable.

The draft economic policy directive seemed satisfactory, Mr. Clay concluded, for the interval until the next meeting. Deletion of the specific reference to operations in coupon issues from the directive was appropriate at this time, in his opinion, and he would also omit the proviso clause.

Mr. Scanlon summarized the following statement, which he submitted for the record:

> The "flavor" of economic activity in the Seventh District remains essentially the same as I have reported at recent meetings of this Committee. Most firms are operating at relatively high levels. There is widespread expectation that the general measures of activity will rise during the second half of 1967. However, the major companies in our major industries do not have a firm basis at this time for projecting significant increases in their own business. This situation has been reported repeatedly in recent monthly meetings of Midwest business economists at our Bank.
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> At the most recent meeting, last week, there was a consensus that expenditures for new plant and equipment would do well to hold at current levels during the remainder of 1967, that the inventory adjustment was substantially completed (except for machinery manufacturers and for TV at retail), that the auto industry would show a large swing in output as production of 1968 models is pushed vigorously in the expectation that the plants soon would be shut down by strikes, that retail sales and residential construction probably will rise gradually, that capital issues will continue in unusually large volume through September at least, and that business loan demand at banks this fall may show no more than a seasonal rise. Widespread upward pressures on costs and downward pressures on profits have been resulting in efforts to boost prices, some successful and some not successful.
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> Steel production has weakened further in the Chicago area, with the operating rate in June down about 10 per cent from the March level.
>
> Labor markets are not so tight as earlier, although there is not much evidence of slack. Salary and wage rates of white collar workers employed by major Chicago firms are reported in May to be 5.5 per cent above a year ago. In the two preceding annual

surveys the increases were 3.5 per cent and 2.6 per cent, respectively. Prior to that, annual increases were about 1.5 per cent.

Insofar as agriculture is concerned, current crop prospects are favorable in the District and will help to maintain farm income and farmers' expenditures at high levels.

The banking sector shows some evidence of developing pressures. Business loan growth in the past month looks modest only by comparison with the very rapid expansion that was taking place a year ago. Although much of the borrowing by businesses in June may be attributed to unusually heavy tax liabilities, business loans at weekly reporting banks have risen further since the tax date and the rise appears to be fairly widely distributed among most of the industry groups. Demand for other loans continues to be moderate. In the District, acceleration in auto sales so far has not noticeably affected bank instalment loan activity. Total loans of smaller member banks in June showed about the same increase as in the past two years.

Despite somewhat lower basic deficit positions, the major Chicago banks appear not to be very comfortable about the prospects for the second half. Reliance on the money market is heavy and occasionally may give rise to rather heavy borrowing at the window. Prior to the latest financing, holdings of Governments were reduced rather sharply and these banks have made very small net purchases of municipals in recent weeks. They have raised rates on short-term CD's, and appear reluctant to place funds in relatively low-yield Governments. They see little prospect for improvement in bond prices in the months ahead.

The business and financial trends in our District suggest that monetary policy probably is confronted with the same type of problem it faced last summer. Most estimates of the expected thrust of economic activity and appraisals of the prevailing financial scene indicate the need for a policy of additional restraint. On the other hand, the level of interest rates that might be consistent with such a policy would bear heavily on a few important sectors, such as residential construction and certain financial institutions. The lessons of last year indicate that public officials are unwilling to permit these sectors to bear the major brunt of anti-inflationary policy, yet are almost equally unwilling to ease the burden through adequate and timely fiscal measures. Monetary policy, therefore, is faced with the task of achieving the maximum restraint consistent with continued viability of financial intermediaries and the housing industry, and maintenance of flexible and adaptive financial markets.

There is a related problem for the Board of Governors, of course, and that has to do with the ceiling rates that commercial banks are permitted to pay on time deposits. I appreciate the many problems involved in this area but, based on our experience last year, I would hope that if the situation requires it, ceiling rates on accounts other than passbook type savings accounts would be raised for both banks and nonbank financial institutions.

Policywise, over the next few weeks I would favor provision of reserves at a rate closer to that of the second quarter of this year than the first--about 4 per cent annual rate. I would expect this to result in money supply growth of about 5 per cent, bank credit growth of about 10 per cent, some further increases in short-term rates, and probably a mild increase in long-term rates. Short-term rates would be expected to approach long-term rates and, in the absence of adjustment of current ceiling rates on time deposits, come close to a level that would have substantial effects on nonbank intermediaries and residential construction. Unfortunately, such rates probably would not produce the needed degree of restraint. If ceilings on time deposits are raised, a somewhat smaller provision of reserves probably would serve to maintain viable markets while achieving somewhat greater restraint on inflationary forces.

This kind of posture is not greatly different from that set forth in the draft directive, except that within the context of this directive I would prefer to resolve any differences on the side of a more moderate degree of expansion. I would tend to aim for the lower end of the several ranges given in the blue book. I favor the proviso clause as amended by Mr. Mitchell. I concur with the staff suggestion

> to drop the reference to coupon issues, not because I am not in favor of such operations but because such operations were conducted prior to the inclusion of that reference in the directive and I do not see that its absence restricts us.

Mr. Galusha reported that crop estimates and the Minneapolis Reserve Bank's most recent survey of country bankers indicated that this year's harvest would exceed last year's and that, even with further declines in grain prices, crop receipts would be unchanged from a year ago. Livestock receipts could also be unchanged, but he was not entirely sure that cattle and hog prices were going to increase through the remaining months of 1967. Farmers were still unhappy, but the survey suggested they were becoming ready buyers again. He was now looking for a significant further increase in country bank loan demand and, more important, a significant increase in demand for farm machinery.

Mr. Galusha said he did not as yet have any firm estimates of June and early July share account and deposit flows for the District's one savings bank and the savings and loans. However, scattered reports, mostly from the Reserve Bank's directors, indicated that those institutions did very well over the mid-year dividend period. There was evidence, too, that residential construction was picking up sharply.

Turning to monetary policy, Mr. Galusha commented that with the Budget Director going before Congress in the near future the

Committee should soon have reliable estimates of Federal tax receipts and expenditures for fiscal 1968. Even if the Treasury were not about to announce refunding terms, he would therefore be inclined to hold steady for a while--to wait, that is, for those estimates. At the moment, then, he did not see the Treasury's being in the market as effectively constraining the Committee. Come August, of course, the situation might be different.

Mr. Galusha hoped that the Budget Director's Congressional appearance would result in lower interest rates. It would seem inappropriate for the Desk to intervene in an attempt to prevent any decline in rates touched off by what the Budget Director had to say. There was, though, some probability that rates would rise, not decline, if the Desk did not intervene, and he would like to see the Desk instructed to intervene should bearish pressures develop. Possibly such an instruction would be implicit in an even-keel directive.

If the Administration did not come through with the outline of a tax increase, Mr. Galusha said, the Committee would have to make a hard decision. But it could do that after the Treasury had borrowed what new money it was going to need. In sum, he would favor holding free reserves at the average of recent weeks, unless what the Budget Director had to say about fiscal 1968 was poorly received in credit markets. In the face of bearish pressures, he would like to see free reserves increased. But business opinion he had solicited confirmed Mr. Hayes' assessment.

Mr. Galusha urged again that something be done about the reserve requirements of the smallest member banks. Whatever some Reserve Bank economists might think, the membership problem was very serious indeed, and in his judgment a revision of reserve requirements should have a high priority. Even though the limits within which the System could alter the reserve relationships of banks might be narrow, the fact that the System would be demonstrating its awareness of the problem presented by an archaic reserve structure could ultimately enhance the possibility of legislative action to enlarge the System's operational authority.

Mr. Swan reported that in California aerospace employment declined a little in June, for the first month-to-month decline in over a year. Even though the gain in Washington more than offset that decline, the projections for the next few months indicated that gains in aerospace employment for the area as a whole were likely to be slight. Actions on the part of just a few major employers could change the situation abruptly, but at present the prospect for substantial gains ahead did not seem very bright.

On the other hand, Mr. Swan said, since mid-June there had been quite an extension and deepening of confidence on the West Coast that the increase in housing construction was likely to be both sustained and significant. That area had been somewhat more pessimistic than others during the first half of the year about the kind of pickup that was going to occur, but there now seemed to have been some change in attitude. Two banks that were major factors in the mortgage market in California indicated that the kinds of inquiries they were getting about financing of both new construction and existing houses tended to support that position.

As to the flow of funds into savings and loans during the first part of July, Mr. Swan said that while he did not have any final figures, some of the major associations indicated that they had come through the period in good shape. Those views were supported by the behavior of outstanding Federal Home Loan Bank loans, which rose a little in the first few days of July and then dropped below end-of-June levels. Meanwhile, District banks were showing increased interest in time and savings deposits. Most of them had raised their rates on large negotiable CD's, principally as a defensive measure in response to rate increases elsewhere throughout the country, but some of them also had been renewing their advertising for the so-called consumer-type certificates. Whether that was motivated by their own positions or by the fact that they felt this was a basis for increased competition with the 5 per cent maximum rate on savings and loan certificates, he was not sure, but a number of banks had again been advertising a

5 per cent certificate. They were extending the guarantee of that rate up to one year, and in some cases up to 5 years.

In terms of policy, Mr. Swan said it seemed to him that if the Committee accepted the projections of rising activity at the rates anticipated for the third and fourth quarters, it must be concerned about the high current rate of expansion of bank reserves and credit. In view of the present state of the capital markets, the Treasury financing ahead, and the fact that economic expansion was not yet picking up rapidly, the Committee probably should accept a no-change policy at this time, basically in terms of the draft directive. But he agreed strongly with Mr. Mitchell that the directive should express, more than it did, concern about the kind of monetary expansion that had been occurring relative to what was seen ahead. He also had a question about use of the phrase "renewed economic expansion" in the last sentence of the first paragraph of the directive without some qualification. He would accept "sustainable," but all things considered would suggest in preference ". . .conducive to continued economic expansion, while recognizing the need for reasonable price stability for both domestic and balance of payments purposes." He thought some explicit expression of that kind would be desirable at this time.

Turning to the second paragraph, Mr. Swan said he would eliminate the reference to coupon issue operations. Although he saw no particular objection to the wording Mr. Brimmer proposed, he did not see any difference between that and the position expressed by the Manager that he (the Manager) would in any event continue operations in coupon issues to the extent appropriate. Therefore, he saw no strong reason to retain the reference to coupon issues in the directive. He would prefer the inclusion of a one-way proviso clause, and did not feel that the addition of such a clause would amount to shifting gears. In order to avoid arguments about quantification, he would use phrasing such as "any apparent tendency to expand more than currently expected."

Mr. Irons commented that in the Eleventh District there had been a rise in the production index of 2 or 3 points, almost entirely attributable to an increase in petroleum production as a result of Middle East developments. The allowable had been increased to 48 per cent, the highest in about 10 years. The month-to-month gain in production was about 7 per cent.

Mr. Irons also reported that there had been some active selling of consumer-type CD's. The large city banks were pushing those CD's hard, with complaints from some of the smaller country banks that the rates being offered were forcing them into adverse positions. Recently a couple of officers of large banks had indicated to him that there were rather clear signs of an increase in housing demand, with requests for financing coming to the banks in increasing amounts. A sampling of the general attitudes of a few businessmen and bankers revealed a bit of disappointment about the rate of expansion that was allegedly taking place. The actual figures were not as exuberant as some of the projections they saw. However, they were not pessimistic; they simply had not seen the figures to substantiate the projections.

Mr. Irons thought the economy was still in an adjustment process, one that had been taking place with a minimum of adverse effect in several areas such as inventories, retail trade, and housing. He felt that those adjustments had about bottomed out and that the next series of movements would be expansionary. But he also felt that for a time such movements might be moderate rather than strong and surging. There were still major factors about which uncertainty existed, such as Vietnam and a tax increase. Perhaps one could now be reasonably sure of a tax increase, but there were still questions of how soon and how much. This all put the System in the position of having to determine and administer policy without full or reasonably good knowledge of the factors that would influence policy.

For some time, Mr. Irons said, monetary policy had resulted in large injections of funds into the market. He had a feeling that the Committee should be moving toward less ease rather than to continue the degree of ease that had been experienced over the past several months, realizing that it probably could not do much along that line for the present in view of the Treasury financing and the need for even keel, along with the major factors to which he had alluded on which information was lacking. Nevertheless, within the limitations imposed by Treasury financing, he would like to see a movement toward somewhat less ease, with advantage taken of whatever opportunities might present themselves. He would provide essential seasonal requirements but beyond that be restrictive, with a view to maintaining conditions in the market that, while perhaps not too much different from what had been experienced, hopefully would not be easier. He would think in terms of free reserves of $250 million, plus or minus $50 million, member bank borrowings below $100 million, loans to dealers at 4-3/8 per cent, and a Federal funds rate around 4 per cent. In sum, he would hope that whenever possible the Manager would take advantage of any opportunities to snug up a bit on the degree of ease.

Mr. Irons favored dropping the reference to coupon issues from the directive. With regard to the proviso, while he had long been critical of the use of such a clause, on this occasion he would go along with the type of proviso suggested by Messrs. Mitchell and Swan to point up that, while the Committee was not changing policy basically, if it should be possible to move in the direction of less ease to dampen excessive credit expansion, the Manager was so authorized. Such a proviso might be useful. With that qualification, he would accept the directive as drafted.

Mr. Ellis said available statistics confirmed that the existing level of rates did not seem to have launched a pattern of disintermediation in New England.

Turning to the draft directive, Mr. Ellis expressed agreement with the statement in the opening lines that there had been a strengthening of economic prospects as portrayed by the staff in its bullish projections at the last meeting of the Committee. In that connection, he quoted part of the concluding summary Mr. Brill had then presented, as follows: "The analysis suggests that the postulated restraint package--a 6 per cent tax increase and continued high cost of borrowed funds--would not be adequate to counteract all inflationary pressures in an economy spurred by re-emerging strength in private demands plus further military demands on resources. Given the lags in monetary policy effects, if we were convinced that the net fiscal stimulus in the model were the most probable development, we should be cranking up to a greater degree of monetary restraint than has been built into the projection." The fiscal package Mr. Brill was discussing then was a 6 per cent surtax, effective for corporations July 1 and for individuals September 1. With current discussions pointing more toward taxes possibly effective September 1 or January 1968, the fiscal package upon which the model was relying now seemed remote.

Mr. Brill had proceeded, Mr. Ellis recalled, to warn of a replay of the 1966 credit "crunch" if substantial reserves were not provided to "accommodate the soaring credit demands from the Treasury." What Mr. Ellis feared was undue concentration on the "lessons of 1966," as Mr. Brill called them, to an extent that obscured earlier, and in the long run, even more important lessons. By failing to enact tax increases earlier (while expanding outlays) the Administration had in effect already chosen to accept the resultant excessive demand and rising prices now projected for the fall of the year. By accommodating the Treasury and choosing to "wait and see" the impact of acknowledged unsustainable rates of credit expansion, the System would become a partner in that policy.

Mr. Ellis urged more seeing and less waiting. He would point policy toward lessened ease, accepting the higher rates that would eventually result, accepting the resultant restraint on debt expansion--and expecting some slower growth in outlays by those sectors most dependent on credit creation--until a combined package of fiscal and monetary measures provided some assurance that the problems being built were not greater than those being solved.

Mr. Ellis noted that there seemed to be rather general concern around the table about the rates of growth of the money supply and bank credit in light of the projected course of the economy in the second half of the year. He agreed with Mr. Mitchell that this concern should be reflected in the directive, not only in the proviso clause but in the basic content of the directive. In particular, he favored the language for the first paragraph of the directive that had been suggested by Mr. Swan. He thought the thrust of a proper policy was embodied in Mr. Mitchell's attempt to deal with the language of the proviso clause, but he would prefer to phrase the clause in terms of indicating that operations should be modified, insofar as the Treasury financing permitted, if bank credit tended to expand more rapidly than in recent months. Within the general concept of even keel, the Manager would be instructed to proceed, as best he was able, to avoid any increase in the rate of growth of bank credit over that of recent months, in recognition of the concern that had been expressed about the present growth rate.

Mr. Robertson said that he thought there could be little dispute about near-term policy. Obviously this was a time for even keel. He would go along with a directive of the kind proposed by Mr. Swan, utilizing also suggestions made by Mr. Mitchell and others. He submitted the following statement for the record:

> The evidence put before us seems to me to support the judgment that the economic adjustment is well along and is proceeding constructively. A stronger--perhaps

too strong--rate of advance may lie ahead of us, but this ought to be dealt with most appropriately through a reduction of the current extraordinary rate of fiscal stimulus.

In this environment, as I see it, the best course for monetary policy would be to continue just about as it is--comfortable and amply accommodative without being aggressively easy. Thus, I would favor essentially an "even-keel" policy, whether or not a Treasury financing was imminent, but, of course, the fact of the August refunding will have to be taken into account by the Manager.

Within this general policy framework, I would like to say a few words more about two operating issues--purchases of coupon issues, and the proviso clause.

Now is probably as good a time as we shall be presented with for disengaging from our market-influencing operations in coupon issues. Bond markets are quite settled--thanks, it should be remembered, to the shift in underlying expectations concerning fiscal actions and not basically because of Federal Reserve support through coupon issue purchases. Net reserve needs between this and the next meeting of the Committee are modest, removing one other rationale for System buying. "Even-keel" considerations also call for a "hands off" attitude on the part of the System, at least in the maturity sectors involved in the refunding. Finally, market holdings of longer-term coupon issues are very scarce. Our last buying operation moved a good many dealers into net short positions, and no stabilizing purpose would be served if we were to drive them deeper into short positions by keeping up our buying. By any reasonable calculation, therefore, I submit that it is time for the System to "cease and desist" in this operation and thus avoid the inevitable erosion of market independence. At the moment we have a chance to bow out gracefully, and I think we should seize the opportunity.

Therefore, I am all in favor of deleting the pertinent clause in the directive containing the general instructions to the Manager. I would not tell the Manager never to buy coupon issues at all. On occasions when any sector of the coupon market has sufficient supplies of securities available to permit their purchase with less impact on market rates than an equivalent purchase of bills, Federal Reserve purchases of such issues--properly explained--might be justified. But those occasions will be infrequent. In addition, I want never to omit mention of the case of market emergency, when excessive inventories or generally disorderly conditions are choking the market's ability to function. In that kind of instance, aggressive System coupon purchases can be a vital "unblocking" action, and I think we generally recognize this fact. Apart from these two special kinds of circumstance, however, I advocate depending as much as possible on market actions to smooth supply-demand imbalances and restructure yields; in the long run, I think such market functioning will promote the course of effective monetary policy more than it will hinder it.

Having talked about something I would like dropped from the Manager's tool chest, let me now turn to something that I would like to see put back into it. I mean, of course, the proviso clause, which would call for altering slightly his targets for money market conditions if banking aggregates deviate excessively from projected patterns. I recognize that an "even-keel" period is not a particularly apt time to reinsert the proviso, but I want to say a few words about it anyway, if only in the nature of a prelude to the next meeting, by which time the Treasury refunding ought to be out of the road.

It is important to keep clear in our minds what function the proviso serves. It is not, as I see it, a reiteration, for emphasis, of one of our intermediate objectives. To be sure, it could be used this way--and we almost did so last winter in considering a proviso clause that would have called for still easier money market conditions if long-term rates had kept rising. But I think such intermediate objectives are usually more appropriate subjects for the last sentence of the first paragraph, where we describe the kind of over-all money and credit conditions we are seeking to promote.

It is also not simply an error-correcting device--a phrase for bringing the Manager back on the proper track if the Committee misguesses the course of bank credit (or whatever other factor might be cited in the proviso clause).

Its basic purpose, I submit, is to produce a more timely adjustment of open market operations to changes in credit demands than would be likely to happen if we were operating without it. In the world of finance, the Federal Reserve has substantial control over the single most important supply element, namely, bank reserves. But interest rates and credit flows are affected not only by supply but also by demand--which the Federal Reserve may be able to influence but cannot control.

When we tell the Manager to maintain the same money market conditions, we are giving him essentially an interest rate target. If money market rates subsequently start to go down, he cannot tell by that alone whether credit demand is weakening or he is overshooting in his supplying of reserves. But, in the former case, aggregate banking and credit variables will probably be weakening, and in the latter case they will be strengthening. Hence, by looking at the aggregates to adjust his reading of money market variables--as the proviso clause tells him to do--he can be quicker and more accurate in interpreting money market developments and responding to them appropriately.

Let me hasten to admit that there are a number of shortcomings in the current state of the proviso art. For one thing, our measurement techniques, especially seasonal adjustment, are far from perfect, and that argues for not reacting to each wiggle in the aggregate series but rather to the emergence of sizable and persisting movements. This, you might say, could as well--or better--be done at the Committee meeting every four weeks. On the other hand, there is no law that says that the clouds obscuring our vision should only lift on every fourth Tuesday, and having the Manager geared to act whenever an underlying deviation does become perceptible is a matter of prudence.

Second, there is no unanimity on just what banking or credit aggregate is the correct variable to be cited in the proviso clause. Aggregates that seem ideal to some are not yet susceptible of frequent or precise measurement; others are afflicted with a special sensitivity to the degree of intermediation or disintermediation, or to the current tilt in the never-ending seesaw of Treasury and private demand deposits. But it bears emphasizing that which aggregate is chosen is less important than that some aggregate be chosen for the proviso. (Squabbling too much over the former can get the baby thrown out with the bath.) After all, if the staff is doing its job in allowing for foreseeable seasonal and technical influences in its projections of all these variables, then a strong shift toward stronger credit demands will usually tend to pull all these variables out of pattern. Stronger credit demands will typically be accompanied by more demand for money balances; and banks and other intermediaries will typically try to respond to greater credit demand by increasing their fund-flow, i.e., increasing intermediation, so long as regulations permit. There may be some differences in the rapidity and breadth of response these intermediaries can achieve, but since the quickest of all are the bank CD adjustments, a proviso clause that is usually tied to bank credit as the action variable is not unreasonable.

A final factor to be borne in mind is the positive public relations value that the proviso clause has demonstrated, especially with journalists and academic scholars. The cry of "money market myopia" has faded, and some of our erstwhile more vocal critics now see the proviso clause as providing the first graphic demonstration of how we can adapt our money market operations to underlying supply-demand changes. Having achieved some good "P.R." with the proviso, this is not an achievement to be lightly cast aside.

The proviso clause represents, in the last analysis, an extension of Committee reflexes, and it gives the Manager a greater degree of controlled flexibility in adjusting to developing events.

By the harsh test of hindsight, the proviso clause has served us well this past year. I hope we can vote it back into the directive.

Mr. Hayes commented that the consensus today seemed quite clear: in all the circumstances there should be no basic change in policy at this time. However, there was some preoccupation with the rates of growth of bank credit and the money supply.

Mr. Brimmer said that he had lost track, as the discussion proceeded around the table, of the opinions of Committee members (voting members) as to whether this was in fact the time for any change in policy, basic or otherwise. He agreed with Mr. Hayes' summarization that there had been no suggestion for a basic change, but there had been some recommendations for an implicit change along with some explicit recommendations.

Mr. Hayes replied that he felt the question to which Mr. Brimmer referred would be resolved when consideration was given to the second paragraph of the current economic policy directive. He had not yet come to that paragraph; instead, he proposed to take up in order the suggestions that had been made with respect to the directive, beginning with the suggestions that related to the first paragraph.

Mr. Hayes then reviewed the suggestions that had been made with respect to the first paragraph of the directive, and in each case a consensus was obtained.

Turning to the second paragraph of the draft directive, Mr. Hayes noted that there appeared to have been a fairly heavy preponderance of opinion in favor of including a proviso clause, with quite a few expressions in favor of a one-way proviso. He then called upon the Secretary, who read the following suggested language: ". . . but operations shall be modified insofar as the Treasury financing permits to moderate any tendency for bank credit to expand more than currently expected." A consensus developed in favor of the use of "currently expected" rather than "in recent months."

Mr. Brimmer asked, in this connection, for a specification of "currently expected." The answer given was that the blue book projected, assuming no change in prevailing money market conditions, a 10 - 12 per cent annual rate of increase in bank credit for July and August together, with money supply expected to rise in a 5 - 7 per cent range on average in July, though leveling off in early July and into August as banks slowly reduced their holdings of the new tax bills and as loan repayments liquidated some private demand deposits. The projections assumed that the payment date for the next new Treasury cash financing would not occur prior to the end of August.

Mr. Brimmer said he would understand that, with the kind of ceilings indicated, the adoption of the proposed language for the directive would not amount to any change in policy.

Mr. Hayes replied that it would certainly not contemplate any basic change in policy. As to whether the inclusion of the proposed proviso clause might be called a kind of shading of policy, he supposed that that was a matter of semantics. It was clear that no one wanted any significant, visible change in policy.

On the question of retaining in the directive a reference to operations in coupon issues, Mr. Hayes said the Secretary's record indicated quite a heavy preponderance of opinion in favor of omitting such a reference.

Mr. Brimmer commented that there had been suggestions to retain the existing reference in the directive, to drop it, and also to modify it. He proposed taking a vote on the suggested modification.

Other members expressed the view that the first question to be decided was whether the directive should contain any reference to coupon issue operations. In line with those comments, Mr. Hayes proposed voting initially on whether to drop from the directive any reference to operations in coupon issues.

A vote was taken on that basis, and Messrs. Hayes, Robertson, Scanlon, Sherrill, Swan, Wayne, and Patterson voted to drop the reference to coupon issues from the directive. Messrs. Brimmer, Maisel, and Mitchell voted to retain such a reference.

Mr. Hayes then suggested that a vote be taken next on the proposed current economic policy directive in the form in which that directive had evolved from the Committee's discussion. He noted that in voting on the directive members could either register a dissent or vote in favor of the directive as a whole, but with indication, if desired, that they wanted to record a dissent from the decision to omit the reference to operations in coupon issues.

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 economic activity has been rising modestly and that prospects are for further expansion. Output is still being retarded by adjustments of excessive inventories, but growth in final demands continues strong, reflecting some strengthening in consumer expenditures for durable goods and housing, and also further increases in Government outlays. The over-all indexes of both wholesale and retail prices have risen further, although wholesale prices of industrial commodities have remained stable. Bank credit expansion has been large in recent weeks. Most short- and long-term interest rates, after reaching advanced levels under the influence of heavy public and private securities market financing, have declined somewhat recently. The balance of payments deficit has remained substantial despite some improvement in the foreign trade surplus. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to continuing economic expansion, while recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

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

Messrs. Brimmer, Maisel, and Mitchell, in voting favorably on the directive, stated that they would have preferred to retain in the second paragraph of the directive a reference to the utilization of operations in coupon issues in supplying part of reserve needs.

Mr. Hayes noted that there had been distributed to the Committee by the Steering Committee for U.S. Government Securities Market Study certain policy papers relating to matters affecting Desk procedures. The Steering Committee's memorandum of July 11, 1967, which transmitted the most recent group of papers, indicated that it was anticipated that several additional policy papers would be forthcoming.

The policy paper concerning System lending of securities to Government securities dealers had been scheduled for discussion at this meeting, but Mr. Hayes proposed that consideration of the paper be deferred, and no disagreement was indicated.

Mr. Hayes referred next to a memorandum from the Secretariat dated July 13, 1967, relating generally to procedures for dealing with requests for information regarding actions of the Open Market Committee.

The memorandum, a copy of which has been placed in the files of the Committee, submitted a set of "records of actions" of the Committee covering its meetings during the year 1962. It indicated that similar records had been prepared for the period from the beginning of 1963 through May 23, 1967, and that they would be distributed as soon as reproduced. The "records of actions," together with the minutes of actions taken that would be prepared for each Committee meeting from June 20, 1967, onward, would provide a complete listing of all actions taken at Committee meetings subsequent to those meetings for which the full minutes had been made public. Committee approval of the "records of actions" was not being requested, on the presumption that the Committee would feel that the responsibility for the completeness and accuracy of this historical record should properly rest on the Secretariat.

The memorandum noted that preparation of the "records of actions" had been undertaken in order to facilitate compliance with the terms of the Public Information Act and the Committee's revised Rules Regarding Availability of Information. The staff proposed to make available upon request any part of the "records of actions" up through the meeting of April 4, 1967.

The memorandum also outlined procedures proposed to be followed by the staff in dealing with requests for access to the "records of actions" and "minutes of actions" for Committee meetings subsequent to April 4, 1967.

The proposed procedures were noted without objection.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 15, 1967.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) July 17, 1967

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on July 18, 1967

The economic and financial developments reviewed at this meeting indicate that economic activity has been rising modestly, and that prospects for further expansion have strengthened. Output is still being retarded by adjustments of excessive inventories, but growth in final demands continues strong, reflecting substantial further increases in Government outlays and also some strengthening in consumer expenditures for durable goods and housing. The over-all indexes of both wholesale and retail prices have risen further, although wholesale prices of industrial commodities have remained stable. Bank credit expansion has been large in recent weeks. Most short- and long-term interest rates, after reaching advanced levels under the influence of heavy public and private securities market financing, have declined somewhat recently. The balance of payments deficit has remained substantial despite some improvement in the foreign trade surplus. In this situation, it is the Federal Open Market Committee's policy to foster money and credit conditions, including bank credit growth, conducive to renewed economic expansion, while recognizing the need for progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of forthcoming Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market (; but operations shall be modified insofar as the Treasury financing permits to moderate any apparently significant deviations of bank credit from current expectations).