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, April 30, 1968, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Ellis
Mr. Galusha
Mr. Hickman
Mr. Kimbrel
Mr. Maisel
Mr. Robertson
Mr. Sherrill

Messrs. Bopp, Clay, Coldwell, and Scanlon, Alternate Members of the Federal Open Market Committee

Messrs. Heflin, Francis, and Swan, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Axilrod, Kareken, Link, Mann, Partee, Reynolds, and Taylor, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Fauver, Assistant to the Board of Governors

Mr. Wernick, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Keir, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Bernard, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss McWhirter, Analyst, Office of the Secretary, Board of Governors

Messrs. Eisenmenger, Eastburn, Baughman, Andersen, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Chicago, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Snellings, Assistant Vice President, Federal Reserve Bank of Richmond
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee held on March 14 and April 2, 1968, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee held on March 14 and April 2, 1968, were accepted.

By unanimous vote, the action taken on April 11, 1968, under paragraph 3 of the authorization for System foreign currency operations, by the Subcommittee designated in paragraph 6 of the authorization, approving a purchase from the Netherlands Bank of $12.84 million equivalent of Dutch guilders at a rate other than the prevailing market rate, was ratified.

In connection with the preceding action, Chairman Martin noted that a memorandum from the Special Manager, entitled "Recent purchase of Dutch guilders from the Netherlands Bank at market rate plus commission," had been distributed to the Committee under date of April 25, 1968.[1/]

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 April 2 through 24, 1968, and a supplemental report covering the period April 25 through 29, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said the Treasury gold stock would be unchanged this week but a reduction, possibly in the order of $100 million, would probably be required early in May. Since the establishment of the two-price gold system a number of small central banks throughout the world had been nibbling away at the U.S. stock with repeated small orders, and he would expect that erosion of the gold stock to continue. He also thought that each new reduction of the gold

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

stock from now on would have a much stronger effect on market psychology than before--particularly as the gold stock approached the $10 billion level, which the market might regard as a possible breaking point.

In the London gold market, Mr. Coombs continued, the price had tended to hold firmly between $38 and $39. He had the impression that there were a lot of sell orders in the market at prices between $39 and $40, but also a lot of buy orders which materialized whenever the price slipped appreciably below $38. The huge mass of gold purchased for short-term speculative reasons between the devaluation of sterling and the closing of the London market was gradually shifting into longer-term investment portfolios, however, and the technical advantage currently enjoyed in the market might not last for more than a few months' time. Meanwhile, favorable developments in the Vietnam negotiations, passage of the tax surcharge, or resumption of South African sales might temporarily push the price down close to the $35 level. But he would judge that by August or September at the latest, the price would be on a rising trend, probably moving well above the $40 mark. As had been feared, the London gold price was becoming one of the most important barometers in world financial markets; it quickly reflected such developments as the recent bad news on the U.S. trade balance during March and the release yesterday of

Under Secretary of the Treasury Deming's testimony on April 12 before the Subcommittee on International Finance of the House Banking and Currency Committee. Press commentary on that testimony seemed to suggest that the Treasury might be prepared to contemplate a departure from its earlier gold policy. The price of gold in London had risen today to $39.10.

Mr. Coombs commented that most of the central banks in the swap network probably could be expected to keep their nerve even if the London gold price were to jump sharply. There was a risk, however, that speculative developments in the London gold market might from one day to another trigger very heavy flows of hot money from the dollar markets into the continental financial centers, while also stimulating even heavier gold orders from the central banks of smaller countries outside of the swap network. There was a particularly serious risk that the overseas sterling area countries might increasingly shift from sterling through dollars into gold. For the first time that he could recall a number of smaller countries, such as Singapore, Ireland, and Malaysia, had come in with orders for gold. An interest in diversifying monetary reserves seemed to be spreading among central banks of smaller countries, some of which had large reserves. For example, one of the major holders of sterling, the Kuwait Investment Office, had already inquired several times of the Bank of England as to the possibilities of acquiring gold either in London or in the United States at the official $35 price.

Mr. Brimmer remarked that after reading an account of Mr. Deming's testimony in today's New York Times he was unclear as to the strength of the commitment not to buy gold in the free market undertaken by the central bank governors who had met in Washington in mid-March. According to the Times' account, Mr. Deming had described that commitment in stronger terms than he (Mr. Brimmer) had seen used elsewhere. Secondly, the news story referred to a discussion of the possibility that the United States might use foreign exchange rather than gold in defending the dollar in the future. He had not heard that suggestion before and would be interested in comments on its significance.

Mr. Daane noted that he had accompanied Mr. Deming to the hearings in question, which were recorded in the Banking and Currency Committee print just released.[1/] He thought Mr. Deming had not described the nature of the commitments made at the Washington meeting regarding gold buying policy in terms quite as strong as the New York Times article suggested. The questions on that subject had been difficult to respond to, but he thought Mr. Deming

1/ Copies of this print, entitled "The International Monetary Fund's Special Drawing Rights Proposal and the Current International Financial Situation" have been distributed to the members of the Board and the Reserve Bank Presidents, and a copy has been placed in the Committee's files.

had formulated his answers appropriately. The possibility of using exchange operations rather than gold sales to support the dollar had been raised at the hearings by Mr. Reuss, the Chairman of the Subcommittee. Mr. Deming simply had indicated in reply that that possibility was worthy of study. He had noted that the course Mr. Reuss had outlined represented an option that had always been available to the United States under the rules of the International Monetary Fund, but had not indicated that serious thought was being given to utilizing that option.

Mr. Hayes observed that a story on the latter subject was carried on the Dow-Jones ticker yesterday under the heading, "Treasury takes more flexible stand on future international gold reforms." The text that followed treated the subject in a disturbing manner.

Mr. Daane remarked that such news stories evidently reflected efforts by reporters to dramatize the proceedings. In his judgment they gave a highly inaccurate impression of the actual discussion.

Turning to a related matter, Mr. Brimmer said he was concerned about an apparent inconsistency in U.S. international policy that arose from the fact that some countries that were buying gold from the United States were recipients of U.S. aid. He asked whether some modification of current policy might not be desirable in such cases.

Mr. Coombs replied that reasonably effective efforts had been made to discourage gold purchases by countries receiving aid from the United States. The main problem involved countries with substantial reserves that were not aid recipients, such as Kuwait. Turkey, which did receive aid, had recently bought some gold, but its case was special. Turkey had bought the gold for use in loan transactions with international institutions and had had little choice in the matter.

> By unanimous vote, the System open market transactions in foreign currencies during the period April 2 through 29, 1968, were approved, ratified, and confirmed.

Mr. Coombs noted that a $2.7 million System forward commitment in Dutch guilders, which currently had a term of two months, would mature for the first time on May 14, 1968. He recommended renewal of that commitment.

> Renewal of the forward commitment in Dutch guilders was noted without objection.

Mr. Coombs then said that his second recommendation related to a considerably more difficult situation, involving sterling. A $500 million drawing on the System by the Bank of England, having a term of three months, would mature for the second time on May 21. Unless the British drew on their $1.4 billion standby facility with the Fund to repay the drawing, he saw no alternative to agreeing to a further renewal. However, the Bank of England had been making continuous use of its swap line since June 28, 1967. As the Committee would recall, paragraph 1D of the authorization for System foreign currency operations provided that swap drawings by either party to an arrangement "shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay." Thus, extension of credit under the swap lines for a period of more than one year required specific Committee authorization, and the question to be faced concerned the position the Committee should take if the Bank of England's swap line were still in active use as of June 28, 1968.

Britain's recent progress had not been particularly encouraging, Mr. Coombs continued. March had been a bad month for sterling, although in fairness it should be noted that the difficulties then arose primarily from the gold crisis. There was much less pressure on the pound in April but the British had nevertheless incurred another deficit, of the order of $200 million. That had forced the Bank of England to draw again from the Federal Reserve the $150 million it had repaid earlier in the month, while also taking an additional $70 million in overnight credits from the U.S. Treasury. The remaining $125 million needed to cover Britain's April deficit had been secured from European sources.

Mr. Coombs remarked that he found it difficult to formulate an appropriate recommendation in the matter. In view of the importance of sterling and the undesirability of forcing the issue, it might be prudent for the Committee to allow the British to utilize the swap line for a period somewhat beyond June 28. At the same time, he thought the Committee should strongly urge the British to initiate steps that would permit them to repay their debt to the System, which now totaled $1.1 billion.

Mr. Coombs went on to say that Bank of England officials were as much concerned as the Committee was over their inability thus far to repay this debt. Several times during the last month or so they had suggested to him and to other System officials that it might be useful to consider a funding package which would involve, first, a British drawing of the entire $1.4 billion available to them in the form of a standby credit from the Fund, and, second, some increase in U.S. holdings of guaranteed sterling. Under the present terms of paragraph 1B(3) of the Committee's authorization for System foreign currency operations, the System could hold $200 million of guaranteed sterling. Of that amount, $94 million had already been used, leaving an unused balance of $106 million. The Treasury had in effect a similar authorization to acquire guaranteed sterling in the amount of $300 million, of which $188 million had been used, leaving a balance of $112 million. On the basis of existing authorizations, therefore, the Federal Reserve and the Treasury could make available $218 million in purchases of guaranteed sterling, which could be substituted for Federal Reserve short-term credits now outstanding to the Bank of England. If the British were simultaneously to approach the Fund for the full $1.4 billion standby credit available, he thought they could legitimately be asked to devote at least half of that drawing to paying off swap debt to the Federal Reserve. That would add up to total repayments of at least $918 million.

There were a number of possible variations in such a package, Mr. Coombs observed. For example, the British might draw a smaller amount from the Fund, while the Treasury and the Federal Reserve agreed to increase their guaranteed sterling holdings above the amounts presently authorized. Whatever the details, however, he thought it was urgent that some arrangement be worked out. The hallmark of the System's swap network had always been that it provided only short-term credit facilities. The Committee had traditionally considered it desirable to have individual swap drawings repaid within six months, although at the March 14 meeting it had been agreed that for the time being a more liberal view would be taken of the time period appropriate to drawings. From the inception of the network until the British devaluation about 95 per cent of all amounts drawn had, in fact, been repaid within six months. But now the System was not only faced with the necessity of a second renewal of a $500 million British drawing but was also facing the prospect that the line with the Bank of England would remain in continuous use for a period of more than a year. Such a development clearly could lead to abuse of the swap network.

There was a risk, Mr. Coombs said, that a British drawing on the Fund during the course of May might be interpreted by the market as evidence that continuing deficits in British international accounts required them to tap still another source of credit. On the other hand, if official announcements made it clear that the purpose of the British drawing on the Fund was to repay drawings on Federal Reserve swap line--hopefully, in full--as well as accumulated debts to other central banks, the adverse market effect might be fairly well neutralized. Much would depend on the timing of the announcement and the attendant market circumstances. In any event, that market risk was probably far outweighed by a different kind of risk if Britain did not draw on the Fund. The still lagging recovery of sterling, more than five months after the devaluation last November, had created a very real danger that some accidental piece of bad luck might suddenly force the British off the $2.40 parity and onto a floating exchange rate. In that case, their standby facility with the Fund might well disappear or at least be immobilized temporarily. He had the distinct impression that that was a major concern of Bank of England officials. They were most anxious to make use of the standby facility while it was still available to clear up their debt with the Federal Reserve, and in his view they deserved the System's support.

In sum, Mr. Coombs recommended that the System agree to acquire an additional $106 million of guaranteed sterling, provided that the Treasury undertook to acquire an additional $112 million, with the dollar proceeds in each case to be used to pay down the Bank of England's debt to the Federal Reserve. While those amounts struck him as quite appropriate and as involving fairly sizable contributions to Britain's ability to clear up its debt, it could be argued that the Committee's guaranteed sterling authorization should be increased from $200 million to $250 million. He would also recommend renewing the Bank of England's $500 million drawing maturing on May 21, even though to do so would raise the possibility that their line might be active for more than a year. In taking those actions, however, he thought the condition should be imposed that the British simultaneously agree to draw the $1.4 billion available to them under their Fund standby, and to commit at least $700 million of the proceeds to paying down their Federal Reserve swap debt.

Chairman Martin invited Mr. Daane to comment, noting that the latter had visited with the Governor of the Bank of England last week.

Mr. Daane remarked that Governor O'Brien had seemed quite favorably disposed toward drawing the full $1.4 billion available to Britain from the Fund and using it in part to clear up their debt to the Federal Reserve. However, he (Mr. Daane) sensed that there was concern among British officials, particularly at the Treasury, about the possible market consequences of announcing such a drawing, as well as questions regarding timing. Also, there was some hope on their part of a partial funding of their indebtedness by means involving U.S. support, although some of the particular funding methods the Chancellor of the Exchequer originally had in mind did not appear feasible from the point of view of the United States.

Personally, Mr. Daane continued, he agreed with Mr. Coombs that the U.S. monetary authorities should encourage the British to make the Fund drawing in order to reconstitute their credit lines and that the United States should provide whatever assistance was feasible. In the latter connection, he thought it would be desirable for the System and the Treasury to offer to increase their holdings of guaranteed sterling, and he would favor raising the System's authorization for such holdings from $200 million to $250 million. He also thought the Committee should be prepared to see British use of their swap line with the System extend beyond a year if necessary, as unfortunate as that might be. In short, he considered Mr. Coombs' recommendations to be reasonable.

Chairman Martin noted that with $218 million of existing System and Treasury authorizations of guaranteed sterling holdings unused, an increase of $50 million in the System's authorization would mean that a total of $268 million was available. While that was not a large figure relative to the amount of Britain's short-term debt, it was not insignificant. Perhaps that was about as far as the Committee should be prepared to go at present.

Mr. Maisel remarked that in his judgment the most important question before the Committee at the moment was whether it was prepared to have Britain's swap line with the System continue in active use for a period longer than a year.

Mr. Daane observed that he understood the British were close to the decision point with respect to a drawing on the Fund. At the moment they were waiting to learn what the U.S. monetary authorities were prepared to do in helping them to fund part of their debts.

Mr. Brimmer said he thought the System should encourage the British to draw on the Fund--and the larger their drawing the better--in order to reconstitute their credit line with the System. By going to the Fund the British would in large measure be utilizing European sources of funds, which was desirable under current circumstances. He also would favor increasing the authorization for System holdings of guaranteed sterling to $250 million, and permitting British drawings on the System swap line to extend beyond June 28 if necessary.

Mr. Hickman noted that if the British had $268 million available for repayment of debt to the System through increased U.S. holdings of guaranteed sterling and if, as Mr. Coombs suggested, they applied $700 million of their Fund drawing to that purpose, the total would still be insufficient to reconstitute the swap line in full, since their drawings currently were $1.1 billion. He would consider it desirable for them to clear up their debt in full if they were going to draw on the Fund.

Mr. Coombs remarked that repayments of $968 million would bring the British within striking distance of clearing up the swap line completely. In his judgment it would not be difficult for them to raise the remaining funds necessary.

Chairman Martin then suggested that the Committee approve an increase from $200 million to $250 million in the limit on

System holdings of guaranteed sterling and authorize the renewal of the $500 million Bank of England drawing that matured on May 21 for a further period of three months. Those actions would be taken on the understanding that consultations would be held with the U.S. Treasury looking toward encouraging the British to draw on the Fund in order to liquidate their swap debt to the System at the earliest time feasible, in light of the fact that if debt was still outstanding on June 28 the line would have been in continuous use for a year.

Mr. Ellis asked whether it might not be desirable to authorize renewal of the $500 million drawing until June 28, rather than for a full three months.

Mr. Coombs commented that he thought there were grounds for preserving the customary three-month term for swap drawings, while hoping that the British debt would in fact be repaid before June 28.

Chairman Martin concurred, noting that to renew the drawing for a period of less than three months would be putting a great deal of pressure on the British under circumstances that were extremely difficult for them. Mr. Hickman expressed a similar view.

Mr. Hayes said he thought the actions proposed by the Chairman were highly appropriate.

Mr. Robertson observed that further discussions with the U.S. Treasury and with the British authorities obviously would be required before detailed arrangements could be worked out, and such negotiations could best be conducted by one individual. He thought the Committee should act today to approve a $50 million increase in the limit on guaranteed sterling holdings and to authorize renewal of the $500 million British drawing, but it should leave to the Chairman the matter of negotiating regarding the use of those authorizations and the related question of a British Fund drawing.

Chairman Martin remarked that that was essentially the approach he had in mind.

Mr. Robertson added that the Chairman should be armed with the specific authority to agree to permit the British to continue active use of their swap line with the System for a period of more than one year if necessary

Mr. Hickman noted that the Committee would in effect be taking that position if it authorized renewal of the British drawing that matured on May 21 for a further period of three months.

Mr. Daane said he would favor granting such authority but with the expectation that by June 28 the British would repay as much as possible of their swap debt to the System.

By unanimous vote, paragraph 1B(3) of the authorization for System foreign currency operations was amended, effective immediately, to read as follows:

1B(3). Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $250 million equivalent.

By unanimous vote, renewal for a further period of three months of the drawing by the Bank of England maturing on May 21, 1968, was authorized.

Mr. Coombs then noted that the System was approaching a full year's use of several swap lines in connection with its own drawings. In the case of the Belgian swap lines, a $4.5 million drawing would mature for the first time on May 14 and a $5 million drawing would mature for the second time on May 28. In themselves, those two drawings should not present any particular difficulties; the amounts were small and it might be possible to acquire enough Belgian francs to pay them off. But the standby portion of the Belgian line had been in active use since drawings were initiated on July 26, 1967, and currently $55 million remained outstanding.

He had been hopeful, Mr. Coombs continued, that a reversal of hot money flows after the central bank meeting in Washington in March, together with the subsequent tightening of System credit policy, would permit greater progress than in fact had been made in paying off the swap debt to the Belgians. Furthermore, there had been under negotiation a Treasury issue of still another Belgian franc bond to the National Bank of Belgium as an offset to U.S. spending for NATO purposes in Belgium. It now appeared, however, that the Belgian franc bond involved might not amount to more than $25 to $35 million, which would still leave a balance of $20 to $30 million to be paid off.

Mr. Coombs said he could not give the Committee any assurances that it would be possible to pay off the System's debt to the Belgians before July 26; indeed, the System might have to make further drawings in that period. In particular, if the Committee authorized renewal for three months of the two Belgian franc drawings that matured in May and those drawings were allowed to run on for their full term, the standby facility with the Belgians would have remained in active use for more than one year.

Mr. Coombs thought the Committee would be well advised to grant such approval only as a last resort, and that it might legitimately urge the Treasury to proceed with arrangements to draw on the Fund or otherwise provide the System with the Belgian francs required to clear up the account as soon as possible.

Mr. Coldwell noted that the agenda for today's meeting included consideration of a proposed letter to the Secretary of the Treasury relating to backstop facilities for System swap drawings. He asked whether Mr. Coombs' proposal might not best be discussed in connection with that agenda item.

Chairman Martin commented that he had planned to suggest that consideration of the letter in question be deferred until the next meeting of the Committee. In the course of a discussion he and Mr. Robertson had held yesterday with Treasury officials, the latter had offered to prepare a memorandum of understanding on the subject which the Committee presumably would want to have before making a decision regarding the letter. It was planned to distribute copies of the Treasury's memorandum to the members before the next meeting.

Mr. Ellis then asked whether it was necessary to authorize renewal of the Belgian franc drawings for a full three months. The case was different from that of the British drawing, since drawings by the System itself were involved. The disinclination to see swap lines remain in active use for more than one year involved a matter of principle which in his judgment should be held to as firmly as possible.

Mr. Coombs remarked that even if renewal of the drawings in question for three months was authorized, there was a safeguard in the fact that they could be repaid with uncovered dollars at any time the System chose. The Treasury, of course, would then face an immediate problem of dealing with the dollars thus placed in the hands of the Belgians. In light of the safeguard, he recommended renewal of the drawings for three months--which would implicitly authorize active use of the standby facility with the Belgian National Bank for more than a year if necessary--while undertaking to urge the Treasury to take the kind of actions required to permit repayment of the drawings as soon as possible.

By unanimous vote, renewal for further periods of three months of the two System drawings on the Belgian National Bank maturing on May 14 and May 28, 1968, respectively, was authorized.

Mr. Coombs noted that the System's swap line with the Bank of Italy was another that had been in active use for an extended period. A $200 million System drawing on the Italian line would mature for the second time on May 29, and he recommended renewal for a further period of three months. Drawings on the swap line with the Bank of Italy had been initiated on September 19, 1967, so that even if the $200 million drawing remained outstanding for its full term the one-year limit would not be exceeded. However, he saw little prospect of payoffs during the summer months. Accordingly, he thought the Committee would be well advised to urge the Treasury to plan for an early drawing of lire from the IMF, or alternatively for an issue of lire bonds, to enable the System to clear up the Italian line before drawings on it reached the threshold of a one-year period.

Renewal of the drawing on the Bank of Italy was noted without objection.

Finally, Mr. Coombs said, he should mention the System's two Swiss franc swap lines--with the Swiss National Bank and the Bank for International Settlements--although the maturity dates of outstanding drawings did not occur soon enough to raise the question of renewals at this meeting. The Swiss franc lines had been in continuous use since June 2, 1967, and System debts of $132 million were still outstanding under them. It might be possible for the Federal Reserve to acquire a sizable amount of Swiss francs during May, and it was barely conceivable that the balance remaining could be completely liquidated during the course of that month, before the lines had been in use for a full year. If not, the chances were that the Swiss franc would begin to strengthen in June when the semi-annual window dressing operations began, thus further delaying liquidation of the debt. Here also, he thought the Committee might legitimately express the view that the Treasury should initiate negotiations as soon as possible with the Swiss National Bank with a view to providing a take-out for the System through issuance of Swiss franc bonds or a sale of gold to the Swiss National Bank.

Mr. Daane commented that while he supported the Special Manager's recommendations he would note a question that had been raised in the course of discussions in Europe last week. For some time, but particularly lately, the Europeans had felt that the

United States should arrange for a large standby facility with the Fund to make it absolutely clear that this country did not intend to make protracted use of the System's swap lines or undue use of the Roosa bond technique to finance the U.S. balance of payments deficit they foresaw for 1968. In their judgment a single large Fund drawing at some point would be preferable to a sequence of smaller drawings. When such questions had been raised he had replied that the Federal Reserve was quite conscious of the fact that the swap network was intended to offer only short-term credit facilities. He had noted, however, that a large Fund drawing by the United States might prove counterproductive if it were made before a program of fiscal restraint was in effect.

Mr. Coombs remarked that arranging for a large U.S. standby facility in the Fund would also require a forecast of requirements in terms of individual currencies, and any such forecast would necessarily be highly uncertain.

Mr. Daane observed that he had made a similar point in his conversations with the Europeans, stressing the undesirability of borrowing in advance of need, but they had nevertheless thought there would be important psychological advantages in a large Fund drawing by the United States. Their suggestion might also pose a problem in connection with the Fund's resources of particular currencies, in view of the large standby facility that had already been arranged for the British.

Mr. Hayes remarked that a large British drawing probably would enable the Federal Reserve to repay some of its swap debt with currencies obtained from the Fund by the British. However, the amount of debt that would remain to be settled could not be predicted at this point.

Mr. Coombs then said that he would like to make one final observation. Recent major difficulties in the international financial arena had necessitated a certain amount of flexibility and adaptation of procedures on the part of the System. But the Committee was now faced with a basic question of principle in deciding how long it should permit individual swap lines to remain active. The principle that the swap arrangements provided only short-term credit facilities had been the foundation stone on which the network had been constructed, and any deviations from it could, in his judgment, have highly undesirable consequences for the whole network.

Chairman Martin remarked that Mr. Coombs' point was well taken. The problem was a serious one and warranted continuing study by all members of the Committee.

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 April 2 through 24, 1968, and a supplemental report covering April 25 through 29, 1968. Copies of both reports have been placed in the files of the Committee.

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

> Money market conditions firmed substantially further over the four weeks since the Committee meeting on April 2 and a fair amount of flexibility was required of open market operations. In the first part of the period, the move towards slightly firmer money market conditions threatened for a moment to push the bill rate higher than the Committee had desired, and this rise had to be mitigated. Later, fairly aggressive operations had to be undertaken to confirm the still greater firmness called for by the increase in the discount rate and in Regulation Q ceilings. Over the period, the changing prospects for fiscal action by Congress and for peace talks in Vietnam exerted their usual influence on the markets, particularly the capital markets, and there were minor complications resulting from the last-minute banking holiday in New York following the assassination of Dr. King.
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> As the written reports indicate, interest rates moved higher over the period in an orderly reaction to the discount rate increase. While Treasury bill rates were roughly 3/8 per cent higher by the close of the period, the rise was tempered from time to time by seasonal demand for bills from public funds and by relatively low dealer positions. In yesterday's regular Treasury bill auction average rates of 5.50 and 5.61 per cent were established for three- and six-month bills, up 35 and 34 basis points respectively from the auction just preceding the April 2 meeting of the Committee.
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> In the capital markets yields on Government bonds in the under 7-year maturity category were generally 20-25 basis points higher, reflecting in part the imminence of Treasury financing, while yields on longer-term issues showed mixed changes. Yields on corporate and municipal issues rose--following an irregular pattern--although at the end of the period there was some hope that the increase in Regulation Q ceilings would enable commercial banks to continue purchases of municipals despite increased monetary restraint.

I think it is fair to say that the banking system and the markets are still in the process of adjusting to the new degree of firmness that has emerged since the discount rate change. So far, commercial banks--despite sizeable CD losses in March and through mid-April--have not been overly aggressive in competing for CD money, but 6 per cent has become a fairly common rate on 3-month maturities. Once the seasonal demand for Treasury bills is over, perhaps by late May or early June, short-term rates should come under substantial upward pressure as the Treasury moves into a period of heavy cash needs--even with little or no change from the present level of Federal funds rates or bank reserve positions. A sharp upward adjustment of the bill rate would quickly eat up the slack in CD ceilings and bring the commercial banks under greater pressure. Longer-term rates--and to a lesser extent short rates as well--will continue to be heavily influenced by Congressional action on taxes and spending and by peace prospects in Vietnam. As a result there are mixed views in the capital market about the likely course of interest rates, and little willingness on the part of participants to be either very long or very short in the longer end of the market.

As far as open market operations are concerned, a fair amount of flexibility--as noted earlier--was required to achieve money market conditions in line with the Committee's instructions, with alternating periods of reserve supply and absorption. Early in the period there was a tendency for conditions to firm up more than we felt the Committee desired as major money market banks moved into a heavy basic reserve deficit. This was countered by a substantial supply of reserves through repurchase agreements and outright purchases of both Treasury bills and coupon issues, followed by reserve absorption when the actual supply of reserves--in part reflecting a bulge of float stemming from the unexpected banking holiday in New York on April 9--turned out to be greater than anticipated and the money market eased. Again--on April 15--outright purchases of bills were undertaken to help ward off a move in the Treasury bill rate above the level desired by the Committee.

Later in the period, when because of the large volume of excess reserves carried by country banks into the second week of their settlement period, the Federal funds market was slow to respond to the greater over-all firmness of policy signalled by the discount rate increase, fairly aggressive use was made of matched sale-purchase agreements to absorb redundant reserves. We felt it particularly important to get an early response in the Federal funds rate in order to make clear the degree of restraint desired by the Committee before the Treasury had to set terms for the forthcoming May refunding. The funds rate finally moved to 6 per cent and above late last Wednesday, but, as you know, it took net borrowed reserves of $536 million to do it. On Thursday--although the projection showed no need to absorb reserves for the week as a whole, and indeed we were buying bills from a foreign account for delivery on Friday--matched sale-purchase agreements were again undertaken to push the Federal funds rate higher.

Looking to the period immediately ahead, we expect a need to supply reserves through the statement week ending May 8. It would be desirable to avoid exerting any downward pressure on bill rates through heavy outright purchases, and we may be lucky enough to have some substantial sales from foreign accounts that will limit our market demand. Repurchase agreements would also be a useful device, given the reserve outlook which indicates a need to reverse operations after the May 8 statement week, and I would like to return to that subject in just a minute.

First, however, it should be noted--as described in some detail in the blue book[1/]-- that the credit proxy in April turned out at the lower end of the range anticipated at the April 2 meeting, and that no strength is anticipated for May--the projection is for growth at an annual rate in a ±2 per cent range--despite the fact that bank CD rates are now more competitive with market rates. If the Committee decides to include a two-way proviso in the directive--as the staff draft[2/] provides--it would be most helpful to define as clearly as possible what the Committee has in mind as being a significant deviation from current expectations. Personally, I would think that a fairly wide deviation from the zero midpoint would be quite tolerable on either side, and that due allowance should be made if the Treasury decides to raise more cash

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

2/ Appended to this memorandum as Attachment A.

in May than has been assumed in arriving at the proxy estimates.

As you know, the Treasury is meeting today and tomorrow with its market advisory committees and will announce the terms of its May refunding of $8 billion maturing issues--of which $4 billion are held by the public--at the close of business tomorrow. This is perhaps not the easiest time to set terms of a refunding, given the recent shift of monetary policy and the possibility that some sense of direction will emanate from the Congressional conference committee on fiscal policy today or in a few days' time. Market views have been all over the lot. Some participants recommend that the Treasury stay short with a single 15- or 18-month issue; some would recommend an optional offering of a 5 to 7 year maturity. Some would raise a substantial amount of cash now; others would wait until later. And while most seem to favor a cash refunding, there are adherents to a rights offering as well. But there is virtual unanimity that the Treasury cannot afford to rely heavily on the possibility of good news on fiscal policy in establishing the terms.

The System holds $3.6 billion of maturing issues and as usual we would expect to exchange the entire amount for the new issue or issues that may be offered.

To return to the matter of the rate on RP's, members of the Committee have received a memorandum on our limited experiment to date with a flexible repurchase agreement rate.1/ The memorandum sets forth the rationale--as we see it--for a continuation of the experiment and describes the objective criteria that we would propose to follow in any continuing experiment. In summary, the memorandum proposes that the experiment continue, using a rate of about 1/4 per cent below the Federal funds rate as an appropriate rate for System RP's--at least until a wider spread develops between the Federal funds rate and the discount rate. I should note that on Friday and again yesterday--when it appeared that money market tightness might require a temporary reserve injection--we indicated at the morning call that we would be prepared to make repurchase agreements if

1/ A copy of this memorandum, dated April 25, 1968, and entitled "A flexible Rate for Repurchase Agreements", has been placed in the Committee's files.

the situation demanded and would do so at a rate of 5-3/4 per cent--1/4 per cent above the discount rate. Federal funds traded as high as 6-1/4 per cent on both days, but most trades were at 6-1/8 per cent and no operations were undertaken.

I should make it clear that in recommending that we set the repurchase rate about 1/4 per cent below the Federal funds rate, I believe we should avoid using either a statistical average of the recent effective rate on Federal funds over, say, the last five business days or the Federal funds rate actually prevailing at the time operations are undertaken. I would avoid such a mechanical formula since a single day's aberration, such as often occurs at the end of a statement week, can affect the average more than would be warranted. And I would avoid necessarily using the rate of the moment since it too could well be a deviation that our repurchase agreements were designed to correct. I believe that the base rate might be best described as a rough average of the recently prevailing Federal funds rates, leaving out rates on any given day that deviated significantly from the norm. Such a procedure would be clear-cut enough for the market to understand the objective nature of the RP rate and still give the System sufficient flexibility. As the memorandum notes, the current environment would, in our view, call for an RP rate of about 5-3/4 per cent--a level that might help to maintain some moderate upward pressure on the 3-month Treasury bill rate.

As the memorandum notes, if the Committee agreed with the rationale and criteria described therein, we would propose to continue the experiment with a flexible RP rate, on the understanding that a further evaluation will be undertaken by the Committee staff, and that we would not depart from an RP rate about 1/4 per cent below the Federal funds rate--as described above--without further consultation with the Committee.

Mr. Hickman said he favored continuing to experiment with higher rates on System RP's. He was not sure, however, that the RP rate should be related to the Federal funds rate since, as the Manager had noted, the latter fluctuated widely. He asked whether the possibility had been considered of tying the RP rate to bank lending rates to Government securities dealers. Such a procedure would appear logical because, at times when the System was making RP's, dealers had the alternatives of securing financing from banks or from the System.

Mr. Holmes said the Account Management had considered using the dealer loan rates set each morning by major New York banks as a basis for the RP rate but had decided that they were not appropriate for the purpose. Ordinarily, major New York banks acted as lenders of last resort to dealers, and their rates on such loans tended to be substantially higher than those at which dealers could borrow elsewhere. Since the Account Management made RP's only at its own initiative it had to set a rate that was competitive with the general level of rates at which dealers could borrow.

Mr. Hickman remarked that it might be possible to meet that problem by setting the RP rate at a level, say, one-half of a percentage point below the dealer loan rate at New York banks. In any event, use of dealer loan rates as a basis for System RP rates seemed to him to be worthy of further study, in view of the volatility of the Federal funds rate.

Mr. Holmes said the staff would study the question further. It was his impression, however, that dealer loan rates were more volatile than the Federal funds rate.

Mr. Robertson then made the following statement:

I would like to say a very few words on the subject of the rate of interest on repurchase agreements. First, let me note that the discount rate established by the System represents the ultimate cost of liquidity to the economy, and in that sense is the anchor rate in the market. If an anchor rate is to be changed, it should be changed only by those in the System given authority by law to make such changes. If repurchase agreements are entered into at a rate different from the discount rate, that is tantamount to changing the anchor rate in the market and the ultimate cost of liquidity for the nation--even though it is changing a rate applicable only to nonbank dealers.

Both nonbank dealers and banks are ultimate sources of liquidity in the private economy--dealers because they are the residual buyers of Government securities sold by those seeking funds, and banks because they are the last resort for loans. And both banks and nonbank dealers on occasion have access to the Federal Reserve for marginal financing of their own positions. Thus, a change in the repurchase agreement rate inevitably reflects a change in the System's evaluation of what the cost of liquidity should be in the country--a determination which is more properly left to the discount rate.

I realize that the Account Management in part wants to bring the repurchase rate more in line with existing dealer financing costs. But again if there is reason to bring the financing cost of ultimate liquidity into line with market rates, this should be done through the discount rate so that it is applicable equally to banks and to nonbank dealers.

There is a way, however, of making funds available to nonbank dealers on a temporary basis without bringing into question the cost of such funds as it might relate to the discount rate. This could be done if the Manager were to undertake matched purchase-sale transactions, instead of repurchase agreements, in just the same way that he makes matched sale-purchase transactions instead of reverse repurchase agreements. One might say that this is simply further masking of a loan transaction. But there is one difference. The rate of interest on matched purchase-sale transactions would be divorced from the discount rate and would be whatever rate the

> market sees fit to bid (and the Manager sees fit to accept).
>
> Irrespective of whether the Federal Open Market Committee wishes to accept this proposal, I think all action on the Manager's own proposals should be deferred pending staff evaluation of all related proposals in this area.

Mr. Brimmer observed that, as the members knew, he had expressed reservations about the use of a higher RP rate in the course of recent Committee meetings. While the Board's staff had not yet had an opportunity to make an independent evaluation of the matter, the Manager's memorandum had answered many of the questions that he (Mr. Brimmer) had had. In his judgment it reflected progress in working out a rationale for flexible rates on RP's. Nevertheless, to a considerable extent he shared Mr. Robertson's view that responsibility for determining basic rates at which the System would lend should not be delegated to the Manager. To date, at least, insufficient evidence had been accumulated to indicate that it was either necessary or desirable for the Committee to do so. Moreover, the underlying circumstances might well be altered if, as a result of the reappraisal of the discount rate mechanism now under way, the discount rate itself became subject to more frequent change. He hoped the Committee would retain responsibility for setting the RP rate for the time being, while continuing to study the matter. In any case, under no circumstances would he favor tying the RP rate to the dealer loan rates of a small group of New York banks.

Mr. Hickman commented that he found Mr. Robertson's proposal for matched purchase-sale transactions in lieu of RP's attractive, particularly because the bidding procedure involved would avoid the need for delegating to the Manager the authority to set specific RP rates.

Mr. Daane remarked that in the past the Committee had not treated the relation between the RP rate and the discount rate as sacrosanct; on occasion during periods of easy money the RP rate had been below the discount rate. The question was one of setting realistic rates on RP's in given market circumstances. In the current instance the Committee was still feeling its way. It was not making a permanent delegation of authority, but was simply experimenting with a technique that the Manager thought would prove useful in implementing Committee objectives. Accordingly, he favored continuing the experiment while maintaining close surveillance to see whether or not the intended results were achieved. He also welcomed Mr. Robertson's suggestion, which he thought merited study as a possible alternative or supplementary technique to RP's.

In reply to a question by Chairman Martin, Mr. Holmes said the question of whether the experiment with a higher RP rate was to be continued was likely to be a practical one almost immediately. There was a possible need to make repurchase agreements today, and if the Committee agreed he would propose to set the rate on them at 5-3/4 per cent.

Mr. Hayes said he would like to associate himself with Mr. Daane's views. It would be desirable to avoid giving the impression that System RP rates were, as a practical matter, frozen to the discount rate. He recalled the difficulties experienced in the summer of 1966 when dealer loan rates were so far above the discount rate that it had seemed better not to make RP's at all than to make them at the discount rate. By continuing the experiment now the Committee would be in a better position to choose among alternatives later. He agreed that Mr. Robertson's proposal for matched purchase-sale transactions was an interesting one that should be explored further.

Mr. Brimmer suggested that during the period of experimentation the RP rate be set one-quarter of a percentage point above the discount rate. Under such a procedure the RP rate would be tied to a rate under the System's control rather than to the Federal funds rate, but at the moment, at least, it would be at the same level as under the Manager's proposal.

Mr. Holmes said there might be a problem in explaining such a procedure to the market. Dealers had been told that the

System was experimenting with flexible RP rates somewhat closer to market rates, but under the suggested course the RP rate would be fixed in relation to the discount rate.

In reply to a question by Mr. Brimmer, Mr. Holmes said that no specific method of establishing the RP rate had been mentioned in the discussions with the dealers.

Mr. Daane remarked that the objective might be accomplished by agreeing that the Manager should have the discretion to set the RP rate anywhere in the range from the discount rate to a level one-quarter of a percentage point higher.

Mr. Holmes commented that while there might be some minor problem in explaining such an approach to the market he thought it would be feasible, and it would permit the RP rate to be set closer to market rates.

Mr. Ellis then asked whether the Manager was prepared to comment at this time on Mr. Robertson's proposal for matched purchase-sales contracts.

Mr. Holmes replied that he believed there would be some difficulties associated with the proposal but that it certainly deserved study. He would prefer to give the Committee his reactions at a later time, after there had been an opportunity to review the proposal carefully.

Chairman Martin suggested that the Committee authorize the Manager to continue experimenting with flexible RP rates in the manner he had outlined, while making clear that it was still an experimental operation; that a study of Mr. Robertson's proposal be undertaken; and that the Committee plan on reviewing the subject of rates on RP's at its next meeting.

No disagreement was expressed with the Chairman's suggestions.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period April 2 through 29, 1968, were approved, ratified, and confirmed.

Chairman Martin 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. Partee made the following statement on economic conditions:

> The domestic economic situation continues to look exceptionally strong. Employment, incomes, spending, and real output all are rising rapidly and seem certain to continue doing so in the months immediately ahead. The $20 billion first-quarter GNP increase published by the Commerce Department, though a little smaller than we had estimated a month ago, featured an extraordinary $25 billion increase in final sales--the largest relative advance since the Korean War period. Inventory accumulation, on the other hand, was quite modest, particularly in view of the buildup in steel stocks. If the small inventory number reflected in part miscalculations as to the strength of final sales, which seems probable, then a compensating step-up in output is the next logical expectation.

With the strengthening in demand, inflationary pressures remain great and may well be intensifying. Nonfarm employment rose 800,000 from the fourth to the first quarter--far more than the normal labor force growth expectation--and the unemployment rate dropped to 3.6 per cent in March, with adult male unemployment the lowest since the Korean War. Hourly compensation advanced especially sharply in the first quarter, partly reflecting the increase in Federal minimum wage rates but also the acceleration in wage increases associated with a very tight labor market situation. The year-to-year gain in manufacturing compensation substantially exceeds that in productivity, though output per manhour recently has been increasing at a more satisfactory rate.

Business, moreover, appears to be passing cost increases along quite fully through higher prices, despite continuing moderate rates of industrial capacity utilization. This is suggested by the sharp rise in corporate profits indicated for the fourth and first quarters--a rise that greatly exceeded the relative expansion in current dollar GNP. It is also reflected in the behavior of the price indexes themselves. The goods component of the consumer price index has risen at a 5 per cent annual rate over the past two quarters, compared with a 1-1/2 per cent rate in the spring and summer quarters last year. And the quarter-to-quarter advance in wholesale industrial commodity prices also has accelerated, with the first quarter average up 4.2 per cent, at annual rates, from the final quarter last year. The rise in industrial commodity prices moderated in March and April, mainly reflecting supply developments in sensitive materials. But the proportion of product classes showing price increases remained large--nearly one-half in both months--and it seems clear that the basic trend is still strongly upward.

This view is supported by the prospect of another overly large GNP increase in the current quarter. It seems to me difficult to fault the staff projection of a $21.5 billion rise as being unduly alarmist. The projection incorporates a leveling off in housing, virtually no rise in plant and equipment spending, and a relatively moderate pick-up in inventory investment, considering both the low first-quarter rate and the fact that this will be the period of maximum steel accumulation. Military outlays are projected to continue rising only at the first-quarter rate, and personal saving is assumed to remain at the 6.8 per cent rate indicated for the first quarter.

Consumer spending is seen as rising less rapidly than in the first quarter, though still at a very substantial 10 per cent annual rate. This might be questioned as too optimistic, on the grounds that the unusual burst in spending last quarter represented a bunching in demands from which some retrenchment may now be expected. Indeed, new car sales in the first 20 days of April fell well below the first-quarter rate. But the increase in spending over recent months was broadly based, extending to furniture and appliances, apparel, and the general merchandise lines as well as autos. Consumption had lagged appreciably during 1967--especially toward year-end when the Ford workers were on strike--and it seems to me more reasonable to interpret what has happened as a catching up from the past rather than as borrowing from the future.

The point that impresses me most is that the recent surge in consumption reflects mainly the rapidity of the step-up in disposable incomes, which rose at a 10 per cent annual rate in the first quarter. And the income rise is set firmly in train, reflecting as it does the strong uptrend in employment and overly large wage increases. Wage demands in turn are fueled by the tight labor market and by sharply rising consumer prices, which workers want to offset by higher wages, and it is hard to see how these demands can be strongly resisted so long as both conditions persist. Therefore, the urgent and exceedingly tricky problem is to achieve and maintain just enough restraint on aggregate demand to reduce gradually the receptivity of markets to price increases and induce some slack in the labor force, but without bringing on a full-fledged recession.

The areas of demand most immediately subject to monetary restraint, for the time being at least, are not the areas of excessive spending. Housing starts have leveled out over the winter, and now seem about to turn downward. Plant and equipment expenditures have not yet shown signs of disproportionate expansion; order backlogs in the machinery industries have in fact declined over recent months. Inventory investment has not even been up to normal--much less excessive--rates, though this as noted may be partly a function of the strength in final sales.

And public construction is very little higher than a year ago, with financial markets particularly unreceptive to larger tax-exempt offerings.

A further dampening of demand in these areas, of course, would help to free resources for use in other sectors, and this may well prove to be necessary. But it seems to me that the economy's main problem at present is with excessive increases in consumption. For the most part, monetary policy appears to influence this sector mainly through indirect effects on incomes, and then only with a sizable time lag. Fiscal policy, on the other hand, can have a direct and immediate impact on disposable income and hence on consumer spending.

Thus, as for some time past, a tax increase seems the best medicine for what ails us, and hopefully one is now about to be enacted. Financial markets must be kept taut to guard against any developing excesses in credit-financed private demands. But I for one welcome the chance today for a pause in monetary tightening. This gives us needed time to assess what real effects recent tightening moves may be having and to see what develops on the tax front in the month ahead.

Mr. Brill made the following statement regarding financial developments:

Treasury financings are often unwelcome impediments to the execution of monetary policy. The even keel dictated by the forthcoming financing, however, provides a welcome opportunity for us to catch our breath in order to assess the implications for the economy of the restraint that has already been set in train, and to weigh again the possible outcomes of the major determinants of future policy--the prospects for fiscal restraint and for peace negotiations. The staff is really not in a position to contribute any useful insights on the latter points, but it may be helpful to review what has been accomplished in the past five months of progressive monetary restraint.

The blue book table summarizes the impact of System actions since November on key monetary flows.[1/] The rate at which total reserves have expanded has been cut in half, compared with the pace during the spring and summer of 1967. Increasingly, banks have been forced to obtain the reserves they have needed from the discount window, rather than having them supplied through open market operations. Borrowings are up $550 million since November and now account for almost 3 per cent of total reserves, compared with less than 0.5 per cent in November. Moreover, the cost of obtaining reserves from this source has increased considerably--by over a third.

It is not surprising, therefore, that bank willingness and ability to expand loans and investments has been curtailed. The pace of bank credit expansion since November is down sharply from the May-November rate, a drop of two-thirds in terms of the credit proxy, and about one-half even if one adds in the nondeposit sources of bank credit such as Euro-dollar inflows and borrowing from the System.

The sharp decline in bank credit expansion did not generate as widespread financial pressure as might have been expected, since the high volume of financial saving and reduced business demands for external funds moderated the market impact of System actions, particularly in longer-term markets. Corporate security issue volume remained well below the frantic pace of last summer and fall, and banks continued to add to their portfolios of municipals and of longer-term Treasury issues, while running off large amounts of short- and intermediate-term Treasuries.

1/ The table showed the following annual growth rates, with dates inclusive:

	May '67 - Nov. '67	Dec. '67 - Apr. '68
Total reserves	9.6	4.6
Nonborrowed reserves	10.0	-1.2
Bank credit proxy	11.3	3.7
Money supply	8.4	5.6
Time and savings deposits at banks	14.7	5.5
Savings accounts at thrift institutions	9.1	6.1 (Dec. '67- Mar. '68)

Thus, despite a sequence of System actions that included tightening of open market operations, an increase in reserve requirements, and three discount rate actions, all of which boosted the cost of day-to-day money by about 2 percentage points and raised the cost of 3-month money to the Treasury by close to a full percentage point since mid-November, most long-term rates are now only slightly higher--10 to 15 basis points--than they were just before the British devaluation. Upward pressures on short-term rates have threatened inflows to nonbank intermediaries, but these institutions managed to squeak by the most recent dividend-crediting period with a loss experience, over all, that was not as bad as that experienced at the beginning of the crunch in 1966, although clearly not as favorable as in the spring of 1967. With respect to financial conditions, then, our bark has been loud, but--as yet--we really haven't seen much evidence of the bite in financial markets most relevant to spending decisions.

Let me underscore the "as yet", for maintenance of the present stance of policy is likely to bite quite deeply before many weeks pass. We expect business financing needs to be growing significantly, since there is likely to be an increase in inventory investment this quarter--as contrasted to the reduction during the first quarter--and also because tax payments are scheduled to rise sharply relative to tax accruals. While business loans have been moderate until recently, they have been accelerating--growing at a 3 per cent annual rate in January, 7 per cent in February, 11 per cent in March, and 18 per cent in April. True, the April figures were swollen by a large take-over loan, but even after taking this into account the remainder represented a further pick-up in the expansion rate of business loans.

Capital market financing by corporations is picking up, too, with the calendar rising in May, although the volume scheduled is still far below last fall's hectic pace. Consumer demand for short-term credit has also been accelerating this year, and should continue to rise--and press on bank resources--if the projected auto sales volume is realized.

All in all, banks are likely to come under increased demand pressure from the private sectors of the economy--if not in May, then certainly in June. This pressure will be intensified by the larger-than-expected volume of Treasury financing that will be necessary. Back in January, we were estimating Treasury cash flows as permitting some small net retirement of debt over the first half of the year. Now it looks as if there will be net borrowing of about $3 billion for the period, with much of the difference in estimates still to be made up in the two months remaining in the fiscal year. Market pressure will be even stronger if the Treasury tries, in June, to get a leg up on its second-half financing needs.

On the supply of funds side, some leeway exists for banks to bid for large CD's--in the process driving market rates up further. While banks have quickly gotten up to the new ceilings on 3 to 4-month maturities, they still have some elbow room in the longer maturity range--if they and their customers are willing to go out that far. On the other hand, savings funds from consumers are likely to be harder to get. Inflows of consumer-type time and savings deposits rebounded in February and March, after January losses, but the outflow in April has been exceptionally sharp and recovery will be limited by the higher level of rates available on competitive market instruments. Nonbank thrift institutions are also likely to be affected by the latest round of market rate increases in the shorter maturities. Indeed, while thrift institutions scraped by the recent dividend-crediting period, the experience in the last days of the period was poorer than in the earlier days, presaging a diminishing flow in coming weeks even before the next crediting period. An attractive coupon and maturity on the forthcoming Treasury financing could accelerate the process.

Thus, as business and Federal credit demands accelerate, the bite on financial markets of the present posture of policy should become increasingly evident. And if we go into June with no tax action or no progress on peace negotiations, we may find the pressures developing in financial markets to be intense. We are not out of the woods, by far, in avoiding the possibility of a financial crunch.

Mr. Heflin noted that both Mr. Partee and Mr. Brill had suggested a pause in monetary tightening which they had related in part to the need for even keel. It was likely that monetary policy would be under even keel constraints for most of the remainder of the year, and if no fiscal action was forthcoming the Committee might well be asking itself at each meeting how much further tightening could be accomplished within such constraints. He was concerned about possible differences of opinion among the members, and between the System and the Treasury, as to the restrictions on policy imposed by Treasury financings. There might even be differences of view on the implications of even keel for the short run, in view of the Manager's observation that the markets were still adjusting to the recent firming of policy. While some staff memoranda on the subject of even keel had been distributed in November, he thought a Committee discussion of the matter would now be helpful.

In response to the Chairman's request for comment, Mr. Brill said his recollection was that the memoranda on even keel of last November were confined to the thinking of System staff and did not discuss the Treasury's views. Nor did they reflect any essential differences of opinion among the staff on general principles. As to the immediate situation, the blue book described specific money market conditions that the staff believed would be consistent with maintenance of an even keel posture in the period until the next meeting.[1]

Mr. Partee commented that even keel constraints might well be absent at the time of the next meeting of the Committee, although the Treasury's financing schedule was still uncertain at the moment.

Chairman Martin then remarked that a Committee discussion of the type Mr. Heflin had suggested undoubtedly would be useful. He did not think that time would permit such a discussion today, but the Secretary might be asked to consider when it could be scheduled.

Mr. Reynolds then made the following statement on the balance of payments and related matters:

1/ The blue book passage referred to read as follows: "As best can be gauged at this point, the maintenance of prevailing firmer conditions in the money market during the next four weeks may involve a Federal funds rate fluctuating around 6 per cent, member bank borrowings around $750 million and net borrowed reserves in a $350-$500 million range. Both borrowings and net borrowed reserves might possibly be deeper depending in part on the extent of reserve pressure that develops at central money market banks and on the inclination of banks to borrow from the discount window rather than in the funds market. Persistence of this degree of tautness in such money market indicators may serve to drive the 3-month bill rate up in a 5-1/2 -- 5-3/4 per cent range, partly because of the associated high dealer financing costs (with costs of new money in New York often 6-1/2 per cent or a little above) and also because of the effect on attitudes of market participants who may not have yet fully appreciated the extent of monetary tightness that is in train."

The story I have to tell today makes three main points: (1) the payments deficit was smaller in the first quarter than we expected, despite abysmal trade figures; (2) the deficit is likely to increase later in the year, despite some expected improvement in trade; and (3) there is growing awareness that the payments deficit will be large again this year, and this awareness is itself creating new uncertainties.

On the first point, the over-all balance of payments deficit in the first quarter of 1968 turns out to have been smaller than we expected a month ago. On all bases of calculation, it was running about $1-1/2 billion lower at an annual rate than during the year 1967. The detailed figures have been provided to you in the supplement to the green book.[1/]

The rate of deficit still was larger than in 1965 and 1966. But the over-all improvement from 1967 is remarkable in view of the fact that on merchandise trade alone there was a very large deterioration. The trade surplus was running at an annual rate of only $1/2 billion in the first quarter, worse by $3 billion than for the full year 1967. Thus, there was a net improvement on all non-trade items of more than $4 billion, annual rate, between the year 1967 and the first quarter of 1968.

The largest improvement occurred in flows of U.S. capital reported by banks, consisting mainly of items covered by the Federal Reserve restraint program. These shifted from an outflow of about $1/2 billion in the year 1967 to an inflow at an annual rate of roughly $1-1/2 billion in the first quarter of 1968--a favorable shift of $2 billion, annual rate.

Other items that have moved favorably probably include the travel account (since the ending of EXPO 67) and personal remittances and bond purchases for Israel (which had bulged as a result of last year's crisis in the Middle East). Also, we were helped in the first quarter by an unusual foreign direct investment in the U.S. Shell Oil Company of about $200 million. Against these favorable elements, however, we know of some that were unfavorable. Military spending abroad was running higher in early 1968 than in the year 1967. And U.S.

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

purchases of new Canadian security issues were larger. Inflows of foreign liquid funds, including inflows from foreign branches of U.S. banks, were again substantial in the first quarter, at about the same $1-1/4 billion annual rate after seasonal adjustment as during the year 1967.

All the non-trade items so far mentioned may together account for an improvement from the year 1967 to early 1968 of roughly $3 billion, annual rate. We still have another $1 billion of non-trade improvement to explain. The most likely candidate for this is direct investment, net of foreign borrowings. We know that the new mandatory Commerce Department program induced a flood of U.S. corporate borrowing in the Euro-bond market during the first quarter. It may also have interrupted actual expenditures abroad; it would not be surprising if the imposition of new regulations with criminal penalties had had some temporarily paralyzing effects.

So much for the recent past. We turn now to prospects and my second main point. If you reflect on the elements in the payments situation that have improved, you will see that almost all of the improvements are temporary. None of them is likely to go further, and some of them will be reversed. The end of EXPO 67 and of abnormal remittances to Israel, for instance, are events that cannot be repeated; we shall not get any further mileage out of these. If it is true that we have had as much as a $1 billion annual rate improvement in the net flow of U.S. direct investment capital, that, too, is all we are likely to get. It is all that the program was designed to achieve, and there seems to be very little danger that the goals will be over-fulfilled.

The huge improvement in flows of U.S. bank-reported credits--from outflow to reflow--will not only go no further, but is likely to be reversed. The inflow covered by the Federal Reserve program was as large during the first quarter as had been intended for the full year. Thus the net flow for the remainder of the year may be zero, and the shift from massive inflow to zero inflow will be a sizable adverse shift. Similarly the shift from an exceptional inflow of foreign direct investment capital to none will be an adverse shift.

Thus the prospect for the rest of the year is for a substantial deterioration on capital account, even if inflows of foreign liquid funds continue. I would guess that there will be little net further change for services transactions, and also for military transactions, since Vietnam negotiations are not likely to begin reducing our foreign exchange costs until troops can actually be brought home. Is is possible that the prospective worsening on capital account will be more than offset by a strong recovery in merchandise trade?

I and most other Government analysts are not inclined to think so. We do expect some recovery in the trade surplus. An inter-governmental group recently projected a merchandise trade surplus of about $2-1/2 billion for the year 1968--given tax action or equivalent monetary restraint--and that implies a significant recovery from the first-quarter rate of only $1/2 billion. The first quarter figure was unusually low because of a longshoremen's strike in New York, and also because of heavy strike-induced imports of copper. Exports should now rise fairly rapidly as a result of the business expansion in Europe, which will also boost the earnings and purchasing power of third countries. But the trade improvement over the rest of the year seems unlikely to outmatch the capital account deterioration. I would be inclined to project an over-all deficit for the year at least equal to the first-quarter rate and perhaps somewhat above it. Thus the liquidity deficit before special transactions is likely to be above $3 billion, and the official settlements deficit is likely to be above $2 billion.

These guesses of mine are not only fairly typical of those made by Government forecasters. They are also the sort of guesses being arrived at by other observers, including foreign government officials and writers for the financial press. Indeed, the OECD Secretariat in Paris took an even gloomier view in their documentation for last week's meeting of Working Party 3. They foresaw an official settlements deficit even larger this year than in 1967, perhaps of as much as $4 billion. Not only was their view of merchandise trade a little gloomier than ours, but also they expected that the recent inflows of foreign liquid funds might be reversed, partly because of growing uneasiness about the stability of the dollar, so that there might be no net growth in private foreign dollar holdings for the year as a whole. Similar calculations, or at least similar apprehensions, probably lie behind the recent purchases of gold from us by foreign central banks of a large number of countries in recent weeks, which were described in the green book and mentioned by Mr. Coombs.

Given the prospects for another large U.S. payments deficit this year, and the likelihood that awareness of these prospects will be disturbing foreign exchange markets as the year unfolds, there is much force in the contention of the OECD Secretariat and Working Party 3 that the need for a cooling-off of the U.S. inflation is becoming increasingly urgent if the international adjustment process is to remain an orderly one. Also the OECD urges, as Governor Daane has mentioned, that we had better plan rather carefully how we are going to finance our continuing deficit.

Chairman Martin then called for the go-around of comments and views on economic conditions and monetary policy, beginning with Mr. Hayes, who made the following statement:

Most recent statistics suggest a further strengthening of the economic expansion. While consumption outlays are unlikely to repeat their extraordinary first-quarter gains in the current period, they are nevertheless likely to move up substantially, especially if favorable developments in Vietnam should lead to more exuberant consumer buying. On balance, an excessively rapid pace of business advance in the second quarter seems quite probable. The outlook for Congressional action on tax and expenditure restraint, while perhaps a bit improved, is still clouded by uncertainties arising from Vietnam, urban problems, and election-year politics. In the absence of a tax increase, the chances for a near-term reduction in the recent rate of price increases of roughly 4 per cent appear dim, while a further acceleration remains a distinct possibility.

It is interesting to note that manufacturing production has been playing a smaller role in gains in GNP over the last year or two than in many past periods. Since the last quarter of 1966 such production has been rising at an annual rate of only about one-half per cent, while real GNP has grown at about three-and-one-half per cent. This goes far to explain the existing combination of some slack in plant capacity utilization and a very tight labor market.

Our balance of payments deficit continues at an unsustainably high level--although the size of the underlying deficit is on occasion obscured by special transactions. For example, the reported deficit for the first quarter was a little less adverse than had been expected. But the sharp deterioration of the trade balance is highly disturbing, particularly since the benefits from the President's January program now seem likely to be a good deal smaller than originally hoped. With an underlying liquidity deficit of $4 billion now officially estimated for the full year 1968, the possibility of another international financial crisis in the near future cannot be ruled out.

The bank credit indicators seem to be giving conflicting signals for April. While the credit proxy projections indicate a slight decline in bank credit, the weekly reporting bank data suggest a picture of considerable strength. More rapid gains in business loans since mid-March have been especially notable. With substantial Treasury financing due later in the year, a strong pickup in loan demand could generate major pressures on the banking system. The credit proxy for May is particularly hard to evaluate, since allowance must be made for the effects on time deposit growth of the increased Regulation Q ceilings, and the possibility of a Treasury cash borrowing, either in conjunction with or immediately following the refunding operation.

As for monetary policy, the imminence of the refunding will require an even keel from now through mid-May--and a cash offering later in the month could mean an extension of this even keel period. In any case, I would doubt that we should seek a tighter policy at this time even in the absence of this even keel constraint. The series of moves taken recently have constituted strong monetary restraint, the ultimate effects of which will take some time to be fully felt. Lagged responses can be expected in the financial markets and at the thrift institutions, followed by restraint on real activity and prices; but the force of these influences cannot be accurately measured at this point.

The relations between various segments of the money market have been a bit unpredictable of late, with the Treasury bill rate still showing signs of seasonal demand pressures. But with that possible exception, I believe we have now achieved the firming adjustments that were suitable under the directive adopted at the April 19 telephone meeting of the Committee. Thus, I would urge a policy of no change--with the understanding that doubts would be resolved on the side of firmness. A Federal funds rate around 6 per cent would seem appropriate. Net borrowed reserves ranging from $350 to $450 million and borrowings of $700 to $800 million might be consistent with this rate, although these figures could be higher if the banks should choose to make greater use of the discount window.

The directive as drafted seems to me highly appropriate. As far as the proviso clause is concerned, I believe that against the background of the recent performance of the proxy, and the uncertainties as to the timing of Treasury cash borrowing, we could stand a fairly substantial deviation, say 5 to 6 percentage points, from the zero mid-point before considering the proviso applicable.

Mr. Ellis reported that the New England economy continued the advance it had resumed in the middle of last year. The trends in construction, production, and employment showed stability or growth at high levels. Consumer spending remained especially high considering the post-Easter period. Manufacturers predicted sales gains and reported that investment outlays would rise 3 per cent from last year's peak, according to final tabulations for firms accounting for 28 per cent of the region's factory employment.

Reported statistics did not confirm any incidence of disintermediation at the District savings banks, Mr. Ellis said, but in discussions District bankers indicated their expectations of such a development given present levels and trends in interest rates. Policy loan figures covering the first-quarter experience of New England life insurance companies showed an increase 40 per cent faster than in the fourth quarter of 1967 and 25 per cent faster than in the first quarter of 1966.

Mr. Ellis remarked that the weeks since the Committee's April 2 meeting had brought confirmation of projections for an economy with rising demand pressures from the consumer, business, and government sectors. Expectations of labor shortages and of wage gains in excess of productivity advances had likewise been validated. And the Committee's fears of inaction on fiscal restraint had been realized. In short, the basic economic analysis had been confirmed and the outlook for inflation remained largely unchanged, including discouraging weakness in the U.S. international balance on trade account.

Looking ahead, Mr. Ellis continued, the Committee faced successive periods of heavy Treasury financing to meet scheduled deficits. Fortunately, the System had been able to assume a stiffened posture in monetary policy, with higher interest rates, and the Committee could now validate that posture gradually by appropriate open market operations. His own sensing of prospective credit demands suggested that banks would be under increasing pressure as corporations responded to expanding consumer outlays with both inventory building and efforts to expand output.

Experience also supported the view that bank credit expansion was positively correlated with large Treasury financing efforts. If banks were faced with swelling credit demands, the restraining effect of monetary policy moves already taken would become more evident. That "working out" of the effects of restraint as initiated from the demand side should be allowed to proceed without further overt monetary policy moves, thus permitting the Committee to appraise more effectively just how much restraint had been created. He would describe such a pause as "the pause that tightens."

For intermediate policy goals, Mr. Ellis would look for Federal funds rates regularly around 6 per cent, borrowings in the $600 to $700 million range, and net borrowed reserves in the $400 to $500 million range. He thought the proposed directive was appropriate in view of the prospective Treasury financing. He agreed that in interpreting the two-way proviso clause allowance should be made if Treasury cash financing was greater than presently expected, as suggested in the notes attached to the draft directive.[1/]

1/ The passage referred to read as follows: "As noted on page 7 of the blue book, the May projection for the proxy is premised on the assumption that the Treasury will raise only about $400 million of new cash in the May refunding. If the Treasury in fact were to raise more new cash, the proxy projection would be increased(as a rough estimate, by about 1 percentage point for every $500 million of additional new cash raised). The Committee presumably would wish to have the Account Management take that fact into account in interpreting the proviso."

However, he saw no reason to provide in advance for any easing of policy should bank credit fail to grow in the one month. He would accept the range of deviation suggested by Mr. Hayes of around 5 percentage points from the zero mid-point of the projection.

Mr. Coldwell reported that over-all economic conditions in the Eleventh District were still strong and expanding, with mounting evidence of speculation in land, stocks, and credit. The Texas industrial production index had held steady at a level 9 per cent above a year ago, despite the fact that crude oil production, which was weighted heavily in the index, was being cut back from its recent year-over-year gains of about 13 per cent. Activity was strong in the defense and transportation equipment industries and was leveling off at a peak in the ordnance industry. Production of primary metals was up partly as a result of the settlement of the copper strike.

District labor markets were very tight, Mr. Coldwell said. The unemployment rate was 2.5 per cent in Texas and below 1.5 per cent in Dallas and Houston. There were only nine thousand unemployed persons in the city of Dallas, and estimates indicated that between five and seven thousand of those persons were simply between jobs. Major strikes were under way at present in the construction industry, and there were hints that the settlement would involve an increase in wages and fringe benefits of perhaps

16 per cent. Businessmen's attitudes on capital spending reflected an inflationary bias; the impact of rising costs of credit was nominal if costs of construction were advancing at 10 to 15 per cent rates. Retail sales in the District were very strong.

With respect to District financial developments, Mr. Coldwell continued, banking aggregates were moving up strongly, including business and real estate loans and demand deposits. With some banks locked into heavy holdings of long-term Governments, borrowings from the Reserve Bank had risen sharply. He was impressed by the rising volume of loans criticized by bank examiners. Bankers were expressing increasing concern about a possible crunch in financial markets or ultimate credit controls, but they were more concerned about inflation, deficits, and lack of fiscal action.

Mr. Coldwell said he had little to add to the discussion of the national and international situation. It seemed to him that the economy was nearing a peak of activity, with limits imposed by the availability of labor, the diversion of capacity to defense production, and the availability of credit. The economy could surge to a super boom unless restraint was strong. The wage-cost problem was pervasive; wages were 7 to 9 per cent above a year ago. Credit demands were rising as borrowers sought insurance against a crunch or controls, and the threat of disintermediation was considered strong. On the international side, the poor first-quarter trade figures and over-all payments deficit could bring new pressures. The gold market was in a tenuous state and subject to rumors, unrest, or any sudden military flare-up such as in the Mid-East.

Mr. Coldwell observed that the Treasury financing would dominate market conditions and influence the flexibility of monetary policy in the near term. However, he thought it would be desirable in any case for the Committee to allow time for assessment of the actions already taken while continuing to hope for fiscal action. He would prefer to maintain the taut tone and feel of the market and to avoid relaxing the current degree of pressure. For targets, he favored net borrowed reserves in a $350 to $500 million range, the Federal funds rate near 6 per cent, and the Treasury bill rate in a 5.50 to 5.75 per cent range. He would prefer no growth or even a decline in the bank credit proxy in May. The draft directive was acceptable to him.

Mr. Swan reported that unemployment in the Pacific Coast States had edged up in March by 0.1 per cent to 4.5 per cent, as payroll employment in those States--as well as in the other District States--had declined slightly. Such employment had changed relatively little for the second month in a row, rising by 0.1 per cent in February and declining by the same amount in March. As in February, employment declines in March were concentrated in manufacturing and construction activity. Also, aerospace employment declined in March in both California and Washington.

Other available data for the District seemed to suggest a somewhat livelier pace of activity than did the employment figures, Mr. Swan continued. Housing starts in the West did not decline in March, as they had elsewhere in the country, and the volume of residential building permits rose in contrast to a decrease in the nation as a whole. Conditions in lumber markets were strong in both March and April and the increase in steel production in the West far surpassed the gain nationally. The settlement of the copper strike, of course, had a favorable effect on District activity. Cash receipts of District farmers were 5 per cent larger than last year, which also was greater than the rise in the nation.

The financial situation in the District, however, was not greatly different from that in the country as a whole, Mr. Swan said. For the four weeks ending April 17, loans at District weekly reporting banks had increased more than in the corresponding periods of 1966 and 1967. In the single week ending April 17, District banks experienced a substantial decline in both savings deposits and large CD's outstanding. As a result major banks, which in the preceding three weeks had been net sellers of Federal funds, shifted to the buying side and also increased their borrowings from the Reserve Bank. Those banks, however, continued to supply a considerable volume of funds to securities dealers. California savings and loan associations had experienced substantial deposit outflows through the April 15 tax date. Although those outflows subsequently had leveled off, the usual seasonal increase in the latter part of April apparently was not developing. The associations probably would do well to hold their deposits at the level to which they had declined in mid-April, or even at a slightly lower level.

As to policy, Mr. Swan agreed that both the Treasury financing and the desirability of pausing to assess the effects of the System's recent tightening moves called for no change at this point. The draft directive was acceptable to him. He recognized that in interpreting the proviso clause allowance should be made for some deviation from the bank credit projection for May because some of the effects of the recent policy actions remained to be worked out. He would be reluctant, however, to accept an upward deviation of as much as 5 percentage points from the zero midpoint of the projection unless it was associated with additional cash being raised in the forthcoming Treasury financing. If the Treasury did not raise a substantial volume of new cash in May it was likely to do so in June, and that suggested the desirability of avoiding an unduly large growth of bank credit in May. Accordingly, he would favor accepting an upward deviation of only about two or three percentage points in May before implementing the proviso clause.

Mr. Galusha remarked that in the Ninth District output increased sharply in the first quarter, perhaps at more than a 6 per cent annual rate, and employment increased impressively, at an annual rate of about 3 per cent. Furthermore, there were indications that output and employment would continue to increase at the rates of the immediate past. The Reserve Bank's most recent survey of District manufacturers indicated that they were still expecting substantial increases, year-over-year, in sales. According to preliminary results, it was expected that sales would be up 7 per cent from last year in the second quarter and 9 per cent in both the third and fourth quarters. Not all the respondents had yet been heard from; and since some of the missing respondents were companies that lately had enjoyed sharp increases in sales, the final results might well show greater expected increases than the preliminary figures.

Even construction output might continue to increase, at least for a while, Mr. Galusha commented. Total liabilities of savings and loan associations rose much less in March 1968 than in March 1967, but mortgage commitments increased about as much as in March of last year. Also, the Federal Home Loan Bank in Des Moines reported that so far in April savings inflow had been about normal.

Mr. Galusha observed that the situation of District farmers and ranchers had improved and their prospects seemed relatively favorable. He expected that the over-all index of prices received would continue above its 1967 level, and that cash farm receipts this year would be higher.

Turning to open market policy, Mr. Galusha said that in view of the fact that the System had increased discount rates twice and decreased free reserves rather sharply--all in a quite short interval--he would have favored keeping policy unchanged even if the Treasury were not about to announce the terms of its May refunding. The targets indicated in the blue book were acceptable to him. Again, however, he would urge the Manager to concentrate on maintaining the bill rate within the appropriate range--from 5-1/2 to 5-3/4 per cent.

Mr. Scanlon commented that total spending and prices apparently continued to rise at excessively rapid rates, although recent monetary actions, hopefully, would gradually provide greater restraint. The slower rate of inventory increase in the first quarter reflected the rise in final demand and implied a rise in new orders for a variety of goods. Generally, price increases on manufactured goods appeared to be as frequent as at any time in the past six months, and appreciably more numerous than a year ago. Prospects that farm prices would increase this year had been strengthened by reductions in the potential supply of beef.

There were some signs of a revival in capital goods spending, Mr. Scanlon noted. Orders for a variety of industrial controls and components had surged in the past two months. District firms that had reduced their work forces through layoffs and/or attrition now reported great difficulty in hiring adequate staffs.

Mr. Scanlon remarked that savings institutions in the District apparently experienced slower growth or net outflows of savings in April. However, even that experience was more favorable than had been anticipated by many of the industry forecasters. As a result, there still was hope that housing activity would decline only moderately in the second half of 1968. At this time in 1966 the cut-back in commitments to residential builders had made the subsequent decline in starts all but inevitable.

Large savings and loan associations recently had raised rates charged on new mortgages to 7 per cent in Chicago and to 7.5 per cent in Milwaukee, Mr. Scanlon continued. Demand for housing was so strong, as evidenced by low vacancy rates and rising prices of existing homes, that those higher mortgage rates probably would not deter many prospective purchasers. Shortages of skilled building trades workers in most District centers were tending to place a ceiling on construction activity.

Credit demands associated with rising activity in the past month appeared to have by-passed District banks, Mr. Scanlon observed. It was possible that the greatly deepened basic deficit position of the large Chicago banks might have made them reluctant lenders. Most of them had been buying Federal funds in substantial amounts and some had borrowed more at the discount window. They had reduced their holdings of both Governments and agency issues. With the CD ceilings higher, they had been able to restore some of their recent deposit losses, although there were some complaints that Regulation Q ceilings did not permit banks to be competitive for short-term funds in the 60-day maturity area. The drain of savings and smaller certificates had accelerated.

Mr. Scanlon said he was pleased with the slowing in the rates of expansion of most aggregate measures of money and credit, and he trusted that the abrupt acceleration in money supply growth in April reflected nothing more than a faster than usual run-down of Treasury balances. In light of the continued substantial upward pressures on both wages and commodity prices and the deterioration in the balance of payments, he would like to see a continuation of those moderated rates of growth.

May could be a trying month for the Committee, Mr. Scanlon remarked. The Treasury was confronted with a major refinancing and also might raise some new money. At such times in the past the Committee had tended to be relatively generous in providing reserves. He hoped that the terms of the pending financing would not cause the Committee to provide reserves just for that purpose, and that the Treasury understood that was the Committee's view. On the other hand, he would not like to see an actual contraction in reserves and credit. The undesirable price rises experienced were past history and there was not much the Committee could do about them now. Rather, it had to be concerned with efforts to moderate price pressures in the future.

Consequently, Mr. Scanlon favored a policy designed to achieve an expansion in total reserves at an annual rate of no more than 3 per cent. With the recent changes in Regulation Q providing a little leeway for banks to bid for longer-term CD's, that should be consistent with a modest growth in bank credit. The draft directive was acceptable to him.

Mr. Clay remarked that the Federal Reserve System had executed marked changes in monetary policy since the April 2 meeting of the Committee. Also, striking new economic information had become available during that period. A combination of developments, both domestic and international, had given further evidence of the need for public economic policy of increasing restraint.

The domestic economy had experienced accelerating demand for goods and services pressing upon available resources, notably manpower, with upward pressure on costs and prices, Mr. Clay continued. The pace of advance was well beyond what could be accommodated and sustained, and evidence pointed to further intensification of pressures in the months ahead. Meanwhile, the country's international trade had put on its worst performance in several years. In view of the increasing need for economic restraint and the continuing lack of fiscal policy action, the added monetary measures taken recently had been singularly appropriate.

Quite apart from Treasury financing operations, Mr. Clay thought it would be in order at this time to hold monetary policy in its present posture for the period immediately ahead. Some time was needed to permit adjustments in the money and capital markets and in the various financial institutions to work themselves out. Time also was needed to further assess the unfolding economic situation. In addition, the Treasury would soon be involved in a major financing operation. That put an added premium on avoiding any overt monetary policy actions in the near term. However, it was of the utmost importance that monetary policy should not be relaxed, and that ground already gained should not be lost during the Treasury financing period.

In Mr. Clay's view, the appropriate monetary policy decision today was that of maintaining the prevailing firmer conditions in the money market. That might be construed in terms of the probable financial conditions specified in the blue book. He recognized, of course, that those specifications were tenuous in view of many uncertainties, including possible fiscal policy action, Vietnam peace negotiations, and the Treasury financing details.

The draft economic policy directive was satisfactory to Mr. Clay.

Mr. Heflin said that in the interest of time he would submit for inclusion in the record the statement he had prepared on economic conditions in the Fifth District and on his policy views, which paralleled those of Messrs. Hayes and Ellis. He would make just two observations. First, the data now in hand clearly supported and validated the System's recent policy actions and made it perfectly clear that those actions had come none too soon. Secondly, monetary policy might be of maximum effectiveness at present if the firmer conditions in the money market were maintained and none of the present degree of restraint was traded off in the interest of a liberal definition of even keel.

Mr. Heflin's prepared statement read as follows:

Fifth District business continues to parallel closely the national trends noted in the green book, with some evidence of further acceleration of demand in April. Respondents in our latest survey report strong demand and rising prices in virtually all areas of activity. This is apparently the case even in construction, despite the rising cost of money. Consumer spending is reported as continuing to register large gains, especially in automobiles, nondurables, and services. According to a spot telephone survey we made last week, our large banks expect a further slowdown in the rate of growth of their time and savings deposits over the summer months, but only a few express any concern over disintermediation. The consensus is that the demand for homes is strong and that mortgage money is currently available, although at high and rising rates.

The latest data on the national economy and on our balance of payments accentuate the urgency we all feel for fiscal restraint, and I am hopeful that they may have produced a similar effect in other quarters. I am especially concerned over the suddenly more buoyant outlook for the current quarter, the prospect for renewed acceleration in inventory building, and the discouraging trade figures. It is clear that our latest tightening moves came none too soon. It also strikes me as unlikely that they will prove an adequate substitute for fiscal restraint in contributing to a slowdown in domestic inflation and improvement in our external accounts. Thus in the absence of fiscal action it seems to me that we will continue to confront the question of whether credit policy has done all it can to help restore domestic and international stability. On the other hand, an early tax increase coupled with expenditure cutbacks would raise questions of the appropriateness of the new fiscal policy-credit policy mix. In any case, press reports suggest that the fiscal policy issue may come to a head soon and, whatever the outcome, it seems to me that we must stand prepared over the next few months to adjust credit policy in either direction.

As for current policy, I believe we have moved about as far as we can for the present. The market appears to have reacted well to the latest discount rate action, although I am not sure that market rates have yet adjusted fully. Over the next four weeks, we have the May refunding to contend with and, moreover, the Treasury will likely be in the market again shortly after our next meeting. Thus we will be encountering even keel constraints for perhaps the next six to seven weeks.

I would hope that we could move through this period without trading off any of the present degree of market restraint in the interest of a liberal definition of even keel. Similarly, I would hope that bank credit growth will remain within the range projected in the blue book. It seems to me that until the next meeting we should be guided primarily by rate targets, keeping in mind the possibility that market rates may not have fully adjusted to the latest discount rate increase. Under the circumstances I would be inclined to accept, as consistent with even keel, 90-day bill rates as high as 5-3/4 per cent and Federal funds rates occasionally above 6 per cent. If bank credit growth exceeds significantly the blue book projections, I believe these market rates should be at about the upper levels I mentioned. I recognize that in the kind of markets we face today the Manager must have considerable latitude for discretion, but I also think that he should be instructed to resolve doubts on the side of restraint. Specifically, bill rates below the discount rate would strike me as inconsistent with the policy posture implied in our latest actions, especially if they are accompanied by member bank borrowings lower than the average for the past three weeks.

Mr. Daane said that for reasons others had already given he favored no change in policy at this time, which he would define as meaning no relaxation in the Committee's present posture of restraint. He agreed with Mr. Hayes that the Manager should be instructed to resolve doubts on the side of firmness.

Mr. Daane added that he found it difficult to respond to the Manager's question concerning the appropriate interpretation of the two-way proviso clause because of the great uncertainty existing at present regarding the relations that were likely to prevail among financial variables in the coming period. In light of that uncertainty, he would prefer to delete the proviso clause entirely.

Mr. Maisel said he would accept even keel as the prescription for policy at this time. He thought, however, that the Committee should consider what response would be appropriate if money market variables began to reflect rising market expectations of the passage of a tax bill or of an end to the hostilities in Vietnam. Even though the probability of such developments in the near term might not be very high, it probably was high enough to warrant some contingency planning. If the market came to believe that either fiscal restraint or peace was likely, he would expect demands for liquidity to become less urgent and some planned borrowings to be postponed. As a result, interest rates probably would tend to decline somewhat and even at those lower interest rates flows of money and credit probably would be smaller than now expected. Under such circumstances it would seem to him to be undesirable to attempt to offset the downward adjustment of interest rates. At the same time, the proviso clause in the directive would become more critical. He would therefore want to retain the clause in the directive, and to have it implemented if bank credit growth in May appeared to be outside the narrow range of the projection given in the blue book. As suggested in the notes to the draft directive, the projection should be adjusted if the Treasury raised more new cash than had been assumed.

Mr. Brimmer said he had received some information from the Department of Commerce this morning that supplemented Mr. Reynolds' useful report on the U.S. trade balance. It appeared from a special analysis just completed that the copper strike had resulted in a deterioration of $328 million in the trade surplus from the fourth quarter of 1967 to the first quarter of 1968, and that the dock strike had produced a deterioration of $150 to $200 million. A geographical breakdown revealed deterioration in the balance with all areas except the Near East and Oceania, with neither of which was U.S. trade large. The reduction between the two quarters in the trade balance with Canada and Western Europe was $680 million. Those figures indicated just how serious the deterioration in U.S. trade had been.

Moreover, Mr. Brimmer said, it was probable that the 1968 balance of payments target the President had given in his New Year's Day message would be missed by a substantial margin; the liquidity deficit in 1968 was quite likely to be above $3 billion, as Mr. Reynolds had suggested. He (Mr. Brimmer) was particularly disturbed by the loss of momentum he thought had occurred in the Government's program to improve the U.S. balance of payments.

There seemed to be a lack of enthusiasm among the agencies concerned for the effort to get on with the job of reducing the deficit.

Mr. Brimmer said the draft directive was acceptable to him as written. He agreed with Mr. Maisel that, if the market reacted to enhanced prospects for a tax increase or for peace in Vietnam, it would be unwise to resist the resulting easing tendencies. Indeed, if a tax bill were actually enacted well before the Committee meeting tentatively scheduled for May 28, he thought the Committee should meet before that date to reconsider its policy. The kind of fiscal package now being discussed--involving a $10 billion tax increase and expenditure cuts on the order of $5 or $6 billion--together with the existing degree of monetary restraint might well add up to too much restraint. In any case, it was clear that fiscal action would represent a watershed requiring a new examination of the posture of monetary policy.

Chairman Martin commented that the Committee should not overlook the fact that the Treasury would be engaged in a financing operation during the coming period.

Mr. Sherrill observed that the Committee had already built a great deal of restraint into the economy, the effects of which were still in train. He agreed that it would be desirable to maintain the present degree of restraint in the coming period. He thought the focus of operations should be on keeping the 90-day bill rate within a 5-1/2 to 5-3/4 per cent range and maintaining as much stability as possible in money market conditions in general. The draft directive, including the two-way proviso clause, was acceptable to him, and he was prepared to see a relatively wide deviation of bank credit from the projection--five or six percentage points--if necessary to keep the money market stable.

Mr. Hickman commented that the excessive pace of aggregate demand in the current quarter would maintain pressure on prices and would continue to affect the U.S. trade balance adversely. If consumer spending remained strong and prevented inventory building in the near term, inventory investment in the second half of the year could contribute strongly to aggregate demand and thus further aggravate price inflation.

On the financial front, Mr. Hickman continued, the major event since the April 2 meeting of the Committee was the increase in the discount rate and in Regulation Q ceilings. Insufficient time had elapsed to assess fully the responses to those actions. Interest rates had adjusted upward, but not so much as he considered desirable, nor so much as seemed to him consistent with the consensus of the Committee at its telephone meeting on April 19. He had in mind in particular the three-month bill rate, which was now somewhat below its level--around 5.55 per cent--at the time of the telephone meeting.

As he understood the intent of current policy, Mr. Hickman said, it was to validate the increase in the discount rate. In his opinion, that would imply the following targets: a Federal funds rate of 6 to 6-1/4 per cent most of the time; a bill rate moving upward toward 5-7/8 per cent; and member bank borrowing around $700 million. Except for the borrowing target, the Committee failed to achieve those objectives in the short period since the telephone meeting, although the Federal funds rate had moved up recently. Special circumstances--specifically, low dealer inventories and strong investment demand--had made it difficult to attain the bill rate objective.

Of course, Mr. Hickman remarked, very little could be done during the forthcoming Treasury financing. Nevertheless, he felt that the Desk should do what it could--when it could--to achieve the firmer conditions that had been specified in the April 19 directive. The basic goal should be to prevent a too rapid expansion of bank credit, by keeping the 91-day bill rate close to the relevant new Q ceiling. That would, of course, be difficult to achieve during the period of the Treasury refunding; but the System should maintain pressure on the money market during the financing, and press forward towards further tightening as soon as the refunding was out of the way. The staff's draft directive and the associated conditions spelled out in the blue book might or might not provide the tautness in money market conditions that he thought appropriate. Again he would mention the three-month bill rate, which was presently below the lower end of the 5-1/2 to 5-3/4 per cent range specified in the blue book. Because of the risk that the draft directive would be misinterpreted in a way that resulted in ground being lost, he thought the directive should be revised to call for tighter money market conditions as soon as the Treasury financing permitted.

Mr. Hickman concluded by noting that he agreed the Committee should plan on meeting before May 28 if a tax increase was enacted, provided that the staff would have had an opportunity to develop revised projections for GNP and other variables.

Mr. Bopp remarked that the unabated cost pressures and continuing price rises confirmed the appropriateness of the direction of monetary policy during the past several months. Unfortunately, it was more difficult to judge the appropriateness of the degree of restraint. For example, special factors during the first quarter swelled consumer incomes and might also explain the increase in their expenditures. But the decline in the saving rate might be an indication that consumers were beginning to move away from the caution that characterized their spending last year. In any case, it was likely that there would be secondary effects of the recent increases in consumer expenditures. In the face of recent declines in stock-to-sales ratios stemming from the record consumer spending, business inventory investment over the year probably would be more of a stimulant than was thought earlier. Businessmen might even raise their sights on capital spending.

In the Third District, Mr. Bopp said, all of the evidence of March and scattered preliminary data for April confirmed the conclusion of growing strength. Also, conversations with commercial bankers in Philadelphia pointed to growing pressures. All of the bankers reported that loan demand was now running ahead of projections for the first time since late in 1966. In addition, one banker reported anticipatory borrowing stimulated by the recent increases in the discount and prime rates. Many of them, expecting that loan demand would continue strong, were beginning to apply controls to their lending officers. Partly as a result of seasonal loan expansion, Philadelphia bankers were liquidating Government securities and most of them were out of the municipals market. All of the bankers indicated that they were beginning to feel more pressure on their liquidity positions.

Thrift institutions said that savings inflows were below normal for this time of year but no worse than they had expected, Mr. Bopp continued. Insofar as they could tell, competition for funds by commercial banks was not hurting them even though some banks were offering competitive rates plus guaranteed maturities of ten years or more. The thrift institutions reported that they either were making no new mortgage commitments or were making new commitments only on a highly selective basis.

It now seemed certain to Mr. Bopp that the economy was in for more trouble in the months immediately ahead with cost-push pressures on prices supported by a pull from demand. Nevertheless, in spite of the over-ebullience of the economy and in spite of the latest discouraging news on the trade balance, he thought it was appropriate to pause and hold to the existing degree of restraint.

Mr. Bopp said he arrived at that conclusion for several reasons. Most important, the recent discount rate increase had not yet been digested and much of its impact was still to be felt. Second, although the growth rates of financial aggregates had been more erratic than usual, looked at since the end of the year they were approaching levels he would consider acceptable. Third, if a tax increase was voted it might be possible to minimize the risks of disintermediation and a credit crunch which every move to further monetary restraint now entailed. Also, further tightening now might jeopardize whatever chances remained for passage of a tax surcharge. Thus, he favored no policy change for the next four weeks, even abstracting from the even keel considerations associated with the mid-May Treasury refunding. The proposed directive appeared appropriate.

Mr. Kimbrel remarked that the experience of large Sixth District banks in the CD crisis period had been somewhat different from that suggested by the total U.S. figures. District banks had lost some large-denomination CD's, but the decline was by no means of such major proportions as at New York banks. Moreover, so far this year a moderate fall at District banks in privately-held large-denomination CD's had been more than offset by a significant rise in such CD's issued to State and local governments.

However, Mr. Kimbrel said, loan behavior at the large District banks had been very similar to the national experience. The long-predicted upturn in corporate loan demand seemed to have materialized. Four of the five District banks whose business lending was heaviest had substantial increases in the four weeks ending April 17. Only one of the top five, a bank in New Orleans, reported a drop.

Concentrating on the behavior of business loans at the large banks could, of course, be misleading with respect to the total picture, Mr. Kimbrel continued. District country banks had consistently expanded their loans this year, and that expansion had been great enough to more than offset any weakness at the larger banks. Loans were up significantly on a seasonally adjusted basis in each of the District States since the first of the year. Moreover, District member banks as a group had been able to expand their loans without any over-all reduction in their investments. That loan pattern was not unique to the Sixth District. The Board's staff estimated that all commercial bank loans rose at a seasonally adjusted annual rate of 6.1 per cent in the first quarter.

If there was to be any bite to Federal Reserve policy, Mr. Kimbrel said, it would have to include cutting down on the pace of economic activity closely dependent on bank lending. Since it was hard to find evidence that that had occurred, a continued move toward a more restrictive policy seemed in order. However, with the Treasury conducting financing operations between now and the next meeting, the Committee might be forestalled from doing anything toward moving toward a firmer policy. At the same time, he hoped it would be possible to avoid inadvertently easing or giving the impressing of easing. He also hoped to avoid giving the impression that, should short-term rates rise further, an increase in the Regulation Q ceilings would be inevitable or that the System would conduct operations so as to avoid a penetration of the ceilings.

Mr. Kimbrel had no suggestions for improving the draft directive.

Mr. Francis remarked that demands for goods and services continued to rise sharply and that upward pressures on prices were becoming progressively more intense month by month. At the present time most price measures were indicating a 4 per cent annual rate of inflation. Even if the excessive demands for goods and services were eliminated today, the imbalances and past increases in certain key prices would continue to exert strong upward cost-push forces on some prices for a prolonged period.

Mr. Francis continued to be pessimistic about getting help in resisting inflation from either a tax increase or a cut in Government expenditures. Recently, the System had taken a series of actions designed to reduce the rate of monetary expansion. Money, which had grown 7 per cent last year, had gone up at an annual rate of about 5 per cent in the last three months. In the current inflationary situation with continued expansionary fiscal developments, he preferred to have money go up at about a 2 or 3 per cent rate.

The firming that occurred in the money market following the most recent increase in the discount rate might not be sufficient to slow monetary growth to that target range, Mr. Francis said. If demand for credit was strong enough to cause a continued rapid growth in money at existing interest rates, he felt the System should quickly take another step toward restraint.

Mr. Francis went on to say that another long period of Treasury financing had started, and some believed it was desirable to avoid changing policy during such periods. However, it seemed to him that even keel considerations should not stand in the way of the System's resisting excesses and inflation. In the past, during periods of rapid economic expansion, alternating periods of even keel and non-even keel had acted as a ratchet, tending to expand monetary aggregates in successive jumps. Under even keel, demands for credit at going market interest rates were accommodated, so that System actions caused the monetary aggregates to expand rapidly. In other periods, hesitancy to permit wide movements in money market conditions had prevented actions offsetting the rapid growth in monetary aggregates that had occurred in the even keel periods.

Recent experience presented a striking example of that ratchet effect, Mr. Francis continued. During the last nine months of 1967, total demands for goods and services and for credit were expanding rapidly. In the weeks when the Manager was operating under an even keel directive, weekly changes in money averaged a 12 per cent annual rate of increase. At other times, weekly changes in money averaged a 4 per cent rate of increase. Altogether during the nine-month period, the annual rate of increase in money averaged 7 per cent, despite general recognition of an excessively stimulative fiscal policy and full evidence of strong upward movement in prices. It seemed to him that during the last year adherence to the even keel concept caused monetary policy to make a substantial contribution to an enduring impairment of the domestic price structure and to a further deterioration in this country's balance of payments with other nations. That was an excessive price to pay for any temporary advantage to the Treasury in its destabilizing access to the capital markets.

Mr. Francis believed that the Desk should permit wider fluctuations in money market conditions during the forthcoming even keel periods in order to assure that monetary aggregates would rise at only moderate rates. That was particularly important in view of the experience in the past two weeks, when most monetary aggregates expanded at excessively high rates.

Mr. Robertson made the following statement:

> It is easy to be brief in my comments this morning. Monetary policy from now until our next meeting should stay right where it is--holding tight to the firmer money market conditions that have been achieved, while watching developments, especially the rate of bank credit expansion, closely.
>
> All the key considerations that I can see argue for this course--the need to maintain an even keel during the Treasury financing; the need to observe the effects of our latest round of overt actions to raise discount rates and the Q ceilings on large CD's; and the possibility of some more concrete action on the fiscal front. Our job is not necessarily done, but I do think a month's holding action at the existing level of restraint is appropriate for now.
>
> I would emphasize, however, that the Manager should avoid any slippage back into an easier stance. If a key variable like the bill rate stays more comfortable than we intend, he should seek to create commensurably greater firmness in other elements of money market

> conditions more subject to his control. With this caveat, I would be prepared to vote in favor of the draft directive as submitted by the staff, two-way proviso and all--interpreting the word "significantly" therein along the line suggested by the Manager earlier this morning.

Chairman Martin said he had nothing to add to the Committee's discussion. With the possible exception of Mr. Hickman, the members appeared to be in agreement on policy.

Mr. Hickman said he could vote for the proposed directive if the Committee agreed that it was to be interpreted in the way he considered desirable, but otherwise he would find it necessary to dissent. In itself the draft was not sufficiently specific in calling for the policy course he thought was appropriate. As he had indicated, he favored maintaining the current degree of restraint, correcting any slippages that might occur, and tightening further when the refunding was over.

Mr. Daane remarked that he subscribed to the spirit of Mr. Robertson's suggestion for policy but he saw problems in attempting to spell out specific targets--for the bill rate, for example--in light of the great uncertainty about the relationships that would prevail in the coming period.

Chairman Martin said he did not think it would be useful for the Committee to try to interpret the directive language any further than had already been done in the course of the go-around.

Mr. Hayes said that as he understood Mr. Hickman's remarks the latter favored revising the draft directive to call for tightening as soon as the Treasury financing was completed. He (Mr. Hayes) had always been reluctant to issue that type of directive.

Mr. Hickman observed that he recognized the need to take account of the after-market. He favored moving toward firmer conditions after the redistribution process was completed, not the day after the settlement date for the financing.

Mr. Robertson commented that he perhaps was more confident than other members of the Committee that a tax increase would be enacted and that that would happen before the next meeting of the Committee. If his optimism was warranted there would be no need for a further firming of monetary policy.

Mr. Hickman remarked that he would be prepared to consider changing the direction of monetary policy if fiscal action were taken.

Mr. Hayes said nothing would please him more than to be able to slacken monetary restraint in the event of passage of a tax bill, but he did not fully share the confidence Mr. Brimmer had expressed earlier that fiscal restraint would make an immediate easing of monetary policy feasible. And, of course, it was not certain that a tax increase would be enacted.

With Mr. Hickman dissenting, 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 information reviewed at this meeting indicates that over-all economic activity has expanded at a very rapid pace thus far in 1968, with prices rising substantially, and that prospects are for a continuing rapid advance in activity and persisting inflationary pressures in the period ahead. Since late fall, growth rates of bank credit, the money supply, and time and savings accounts at financial institutions have on balance moderated considerably. Market interest rates have risen in recent weeks, partly in reaction to the firming of monetary policy including the further increase in Federal Reserve discount rates. The U.S. foreign trade balance has worsened further, and the international payments position of the United States continues to be a matter of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of Treasury financing activity, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the firmer conditions prevailing in the money market; provided, however, that operations shall be modified to the extent permitted by Treasury financing, if bank credit appears to be deviating significantly from current projections.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 28, 1968, at 9:30 a.m. Chairman Martin noted that, as discussed earlier, it might prove desirable to call a meeting at an earlier date.

At this point, all members of the staff withdrew from the meeting except Messrs. Holmes, Holland, Hackley, Sherman, Molony, Kenyon, and Broida. The Committee heard a report from the Manager regarding the recent follow-up with market participants in connection with the leak of information on the Treasury financing of August 1967.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) April 29, 1968

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on April 30, 1968

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