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, June 18, 1968, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Brimmer
Mr. Daane
Mr. Galusha
Mr. Hickman
Mr. Kimbrel
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Sherrill
Mr. Bopp, Alternate for Mr. Ellis
Mr. Treiber, Alternate for Mr. Hayes

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

Mr. Williams, Adviser, Division of Research and Statistics, 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
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Mr. Latham, First Vice President, Federal Reserve Bank of Boston
Messrs. Eisenmenger, Eastburn, Parthemos, Baughman, Andersen, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Richmond, Chicago, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Geng, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on May 28, 1968, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on May 28, 1968, was accepted.

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 May 28 through June 12, 1968, and a supplemental report covering the period June 13 through 17, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the Treasury gold stock would remain unchanged this week.

For value today, the Bank of France was selling $220 million of gold to the Stabilization Fund, while simultaneously selling a total of $180 million to Germany, Italy, and Switzerland. The Treasury had initially taken the position that it would be prepared to pay $35 flat for French gold delivered in New York or London. For gold delivered in Paris, however, where much of the French gold stock was concentrated, the Treasury had specified a price of $35 minus shipping costs to New York, or a net of roughly $34.93. Since the German Federal Bank and other European central banks would clearly have been prepared to pay the full price for gold delivered in Paris, that approach threatened to deprive the United States of an opportunity to get back some of the gold it had sold to France. Subsequently, however, arrangements had been made to swap gold located in Paris for gold located in New York without charge to the United States, thus enabling the United States to quote the full $35 price to the Bank of France for a very sizable amount of gold. Also, the Netherlands Bank was selling $30 million of gold to this country tomorrow. As a result, for the first time since the spring of 1961 the Stabilization Fund would have a substantial amount of gold on hand. For a time, at least, that should enable the United States to stave off the threat of a decline in the Treasury gold stock below the critical $10 billion level.

Mr. Coombs went on to say that the price of gold on the London market had fluctuated between $40 and a figure somewhat above $42. South Africa was still receiving large-scale capital inflows and consequently was under no pressure to resume sales of gold in the free market. At the recent meeting of the Bank for International Settlements, he and Mr. Hayes were visited by Governor de Jongh of the South African Reserve Bank, and he (Mr. Coombs) got the distinct impression that the Governor's main concern at the moment was the threatened buildup of inflationary pressure as a result of the heavy influx of foreign capital. The South African Reserve Bank was currently financing gold production at an annual rate of $1 billion, a large figure for a country of that size. Obviously, if that situation were to continue for long, major fiscal and monetary problems would arise. At the same time, the South African Government and Reserve Bank were clearly being pressed hard by the gold mining companies to come to some sort of a satisfactory arrangement regarding the marketing of gold, so as to give the gold-producing companies some basis for future investment planning. So far as he knew, Governor de Jongh's conversations with the European central bankers had not resulted in any promises of special deals. It seemed clear, however, that the European central bankers had been growing increasingly restive over their undertaking not to deal directly with South Africa. Now that a

number of them were receiving large amounts of gold from France--and also from the International Monetary Fund, in connection with the British drawing--their restiveness might be lessened, and it might be possible to maintain the arrangement not to buy gold from South Africa for some time to come.

Both the gold and foreign exchange markets continued to be characterized by pervasive uncertainty, Mr. Coombs observed. There were welcome indications, however, that the dollar had improved its relative standing--mainly owing, he thought, to political unsettlement in Europe. Such unsettlement, particularly in France, could represent a watershed in the exchange markets. One of the most striking aspects of the developments in those markets during the past few months had been the relatively small influx of dollars into the European central banks--despite the fact that during that period the United States had been running a heavy deficit, as had the British and, more recently, the French. The only important drawing the System had had to make under its swap lines had been one of $75 million on the Swiss National Bank. That suggested that the bulk of the dollars being poured out by the United States, Britain, and France had ended up in private hands, for placement either in the Euro-dollar market at unusually attractive rates, in overseas issues of convertible debentures by U.S. firms, or in the New York stock market. If the Congressional vote on the fiscal

package scheduled for Thursday, June 20, was affirmative, he would hope that the favorable trends for the dollar would gain further momentum.

Nevertheless, Mr. Coombs remarked, the international financial structure remained extremely fragile. Two days after the last Committee meeting--that is, on Memorial Day--a moment of extreme danger had been passed. On the preceding day General de Gaulle had disappeared from Paris, and there were widespread reports that he had decided to resign. Those rumors were given further credence on Thursday when, with the New York market closed for the holiday, the Bank of France suspended intervention through the BIS and allowed the franc to slip below the floor. Heavy selling of sterling immediately followed and nearly $100 million flowed into Switzerland. At that point, he thought, the fate of the entire international financial system had hung in balance. Later that day, however, General de Gaulle succeeded in rallying his forces, and since then the threat to the international financial system posed by the French crisis had been gradually subsiding.

Despite the improvement in the atmosphere, Mr. Coombs continued, the franc had been subject to continuing heavy pressure. The Bank of France had suffered reserves losses over the past month that now amounted to $1.1 billion; during the past week alone, it had lost $500 million. To meet those losses, the Bank of France

had had on hand $700 or $800 million when the trouble had started and it subsequently had drawn $885 million from the International Monetary Fund as well as the $100 million available under its swap line with the System. The French Government apparently intended to meet further pressures by gold sales, which had so far amounted to $492 million. At the latest BIS meeting in Basle, Bank of France officials had been unusually pessimistic about the outlook. The fact that they were taking care to stay well supplied with dollars reflected their concern over the risk of sudden large outflows.

With respect to credits under the System's swap network, Mr. Coombs said that recent developments--including the large British and French drawings on the Fund--were having substantial effects on both sides of the ledger. As of June 4, the System's outstanding drawings totaled $903 million--a large figure but only half the peak of $1.8 billion reached last December. He thought that as a result of acquisitions of currencies in transactions connected with the British and French Fund drawings, it would be possible to pay down the System's swap debts within a few days to a total of about $265 million. Discussions currently were under way with the Swiss and Italian authorities about means for funding the remaining System drawings on the central banks of those countries, and he hoped it would be possible to clear them up completely by early July.

On the other side of the ledger, Mr. Coombs continued, foreign central bank debt to the Federal Reserve had risen to $1.6 billion. The Bank of England's share of that total, which was $1.2 billion, would be completely paid off tomorrow by use of $800 million of the proceeds of Britain's drawing on the Fund, supplemented by $400 million acquired through the sale of guaranteed sterling to the System and the U.S. Treasury. The Bank of England was planning to apply about $340 million of the $1.4 billion Fund drawing to pay down debts to European central banks, retaining the remaining $260 million for current requirements. Governor Rasminsky of the Bank of Canada recently had advised that he was hopeful of repaying $100 million of the $250 million Canadian drawing shortly, and of clearing up the balance before the July 31 maturity.

One unusual feature of the recent period, Mr. Coombs observed, was the fact that three European central banks had drawn on their swap lines with the Federal Reserve for the first time. Of these, the first was the Bank of France, which on June 5 drew the full $100 million available. The French had been in a difficult position at the time of their drawing owing to the strike at the Bank of France and uncertainty as to the value date of the French drawing on the Fund. Secondly, on June 6 the National Bank of Denmark had drawn $25 million to replenish an already low cash

position that had been reduced further by the need to provide dollars in connection with the conversion of the Danish krone portion of France's drawing on the Fund. Finally, the Netherlands Bank had drawn about $25 million on June 7, to deal with a situation similar to that of the Danes. Yesterday the Netherlands Bank drew a further $30 million and--significantly--chose to accompany the drawing with the sale of gold to the United States that he had mentioned earlier.

Mr. Daane asked whether any thought had been given to an increase in the System's swap line with the Bank of France.

Mr. Coombs said that in his judgment such an increase would be useful. While the French gold sales had been helpful to the United States, in the long run it would be more helpful to have the Bank of France as a full-fledged partner in the swap network. No doubt the French position would move into surplus again at some point in the future, and it would be far better if any associated pressures on the dollar then could be accommodated by swap drawings rather than by U.S. gold sales.

Mr. Robertson asked whether it would not be better if the initiative with respect to a possible increase in the swap line were taken by the Bank of France rather than the Federal Reserve.

Mr. Coombs replied that if the experience in connection with increases in other System swap lines was a guide neither side

was likely to take a clear-cut initiative in the matter. Typically, the possibility of an increase in a particular swap line was first broached informally, and often in discussions with third parties, to avoid the risk that a direct proposal might be rebuffed. He had no specific indication as yet that the French were interested in increasing their line with the System, but officials of the central banks of other Common Market countries might be encouraging the French in that regard and some had suggested to him that an increase might well be useful at some point in the future. In his judgment, in conversations with third parties it was better to leave the door open rather than to refuse to discuss the matter while awaiting a direct proposal.

Mr. Mitchell questioned the relevance of past practice to the present situation. In light of the sensitive state of relations with the French, he thought it would be desirable for the Special Manager, in effect, to shrug his shoulders in response to any approaches by third parties regarding an increase in the swap line with the Bank of France. The Committee could, of course, authorize the Special Manager to enter into discussions, but he (Mr. Mitchell) personally would prefer to let some time elapse before an increase in the French swap line was considered. In recent years the French had attempted to undermine the whole framework of international financial cooperation, and he was dubious about the possibilities

for good-faith negotiations with them until there was evidence of a change in their attitude.

Mr. Coombs replied that some time would undoubtedly elapse in any case. He added that the System's position all along had been that it would welcome increases in the swap line with the Bank of France, paralleling those made in other lines; the resistance to such increases had been entirely on the French side. At this point, a refusal to discuss the matter at all pending a formal proposal from the Bank of France undoubtedly would be interpreted as implying that the System's position had changed. It was highly important, he thought, not to appear to be taking advantage of France's current difficulties, but rather to make it clear that the door remained open to them. The System had maintained its swap line with the Bank of France for a long period during which it had been completely inactive, in the belief that it represented a possible bridge to a future time in which France would adopt a more cooperative attitude.

Mr. Daane agreed with Mr. Mitchell that it would be undesirable for the System to take an immediate initiative in the matter. At the same time, it was important to recognize that the Bank of France had been sympathetic all along with the Federal Reserve's objectives in developing the swap network. If at some point they were to suggest an interest in increasing the swap line he would not want to have the System adopt a negative attitude.

Mr. Coombs remarked that the initial soundings on the matter might be made through France's partners in the Common Market rather than directly, and he would not recommend that they be rebuffed.

Mr. Robertson said that he and, he thought, Mr. Mitchell were not proposing a rebuff when they suggested that the initiative should be taken by the French. He suspected that there was not a great deal of difference between their view and that of Mr. Coombs.

Mr. Hickman commented that in his judgment there was a significant difference between responding to soundings by third parties with a shrug of the shoulders, on the one hand, and offering indications of possible System interest on the other. He would favor the latter course.

Chairman Martin asked whether the members would agree that the System should be sympathetic but not aggressive in the matter of a possible increase in the swap line with the Bank of France. No disagreement was expressed with the Chairman's statement.

> By unanimous vote, the System open market transactions in foreign currencies during the period May 28 through June 17, 1968, were approved, ratified, and confirmed.

Chairman Martin then suggested that Mr. Coombs present his recommendations.

Mr. Coombs said he would begin by reviewing recent developments in connection with sterling. Earlier selling pressure

stimulated by the French crisis had given way to moderate short covering on the basis of news reports that progress had been made at the June BIS meeting towards a new credit package designed to deal with the sterling balances. The announcement expected tomorrow that the Bank of England's $2 billion swap line with the Federal Reserve had been fully cleared should have a useful effect. Unfortunately, however, the British trade figures for May released this morning were as poor as those for April, and the balance of payments figures for the first quarter to be released later today would make very bad reading. Furthermore, the new strike threats in strategic areas of the British economy that were again appearing, and the generally increasing restiveness of the trade unions, were likely to have adverse effects on the exchange market.

At the preceding Committee meeting, Mr. Coombs recalled, there had been some discussion regarding the tenability of the present $2.40 parity for sterling. Having indicated in his memorandum to the Committee of May 20, 1968, that he was beginning to have increasing doubts on that score, he would like to explain some of the things he had in mind. First of all, it was reasonably clear that so far as exports were concerned the present parity should be more tenable than it was last November for the obvious reason that British exporters had received a competitive edge, after allowance for increased import costs, of roughly 7 per cent as a result of the November devaluation. British exports had

responded well and should prove buoyant as the year progressed. There was no argument on that score.

In Mr. Coombs' judgment the first main area of doubt regarding the tenability of the present parity lay on the import side, where devaluation had not succeeded in restraining imports. In that area, everything depended on the Government's ability to hold the wage line and to resist pressures for premature reflation. Last year, they had caved in under such pressures and, against the background of heavy Labor party losses in municipal and by-elections, the market's judgment was that there was a major risk that the Government would again fail to hold the line. Obviously, that was a value judgment, but it was one which he shared, together with a number of European central bank officials.

Continuing, Mr. Coombs said the second major threat to the tenability of the present parity lay in the capital position of the United Kingdom. Before devaluation, a number of people around this table had feared that devaluation would do more damage on the capital side than could be overcome by improvement on the trade side, and so far that apprehension had proved more than justified. To help clarify just where the British stood on capital account, he would like to give the Committee a few figures:

1. As a result of its recent $1.4 billion drawing, Britain's debt to the Fund now amounted to $3.0 billion.

2. Although the Bank of England was clearing up its swap line with the System, it still owed $550 million in swap debt to the U.S. Treasury. Adding the $387 million of guaranteed sterling held on Treasury account and the $292 million of such sterling held on Federal Reserve account, total British debt to U.S. monetary authorities was over $1.2 billion. He thought there was relatively little hope that that debt would be paid as a result of a reversal of the flow of funds.

3. Under the so-called sterling balance credit package negotiated in June 1966, British debt to the BIS and various European central banks amounted to $600 million. The British were proposing to refund that debt into a new obligation repayable over several years' time.

4. As he had mentioned earlier, the Bank of England was devoting only $340 million of the recent drawing on the Fund to repayment of its short-term debt to various European and other central banks. That would leave an outstanding balance of $700 million with a scheduled maturity date of September 1968. In addition, the British were indebted to the BIS on short-term gold swaps in the amount of $350 million, for a total of $1,050 million.

5. The Bank of England had roughly $1 billion still outstanding in market forward contracts maturing between now and next October.

6. British Government debt to Swiss commercial banks in the amount of $130 million would mature next November.

7. British Government borrowings of $250 million from the U.S. Treasury and various European central banks in November 1967 to finance a repayment to the International Monetary Fund would be amortized over a twelve-month period beginning this month.

8. The British Government currently owed $4.4 billion to the U.S. and Canadian Governments under the loan agreements of 1946.

The sum total of such debt amounted to $11.6 billion, Mr. Coombs noted. If the $4 billion of sterling balances held by central banks of the overseas sterling area, which were now in process of liquidation, were included, the total would be $15.6 billion. He had left out of account the window-dressing credits received over the end of each month by the Bank of England from the U.S. Treasury, the latest of which was for $750 million, as well as further overnight credits from other sources.

To him, Mr. Coombs said, those figures implied that the British Government was now in a hopelessly bankrupt position; they had virtually no prospect of ever being able to repay all of their accumulated debt. The main question, rather, was whether reasonably orderly procedures could be devised to deal with that massive debt structure in a way that would do minimum damage to

the functioning of the international monetary system. There was, for example, the question of what precedence should be given to Britain's various creditors. At present the Federal Reserve clearly had secured a highly favorable position; of the entire $15.6 billion debt, only about $300 million--in the form of Federal Reserve holdings of guaranteed sterling--was to the System. That favored position was unlikely to last very long, however. The British had heavy debt payments falling due between now and year-end, and unless their external accounts should suddenly shift into heavy surplus, which was improbable, they were likely to draw on the swap line to meet those payments. According to his estimates, their scheduled debt repayments between now and year-end, together with further runoffs of sterling balances and of forward contracts, would total roughly $2.4 billion. That estimated figure was comprised of the following: (1) short-term debt to central banks and the BIS, $1,050 million; (2) debt to Swiss commercial banks, $130 million; (3) scheduled repayments to the Fund, $200 million; (4) amortization of the November 1967 credits to finance a Fund repayment, $125 million; (5) year-end debt payments to U.S. and Canada, $220 million; (6) estimated attrition on forward contracts, $350 million; and (7) estimated attrition of sterling balances, $350 million.

It thus seemed to Mr. Coombs that there was a considerable prospect of massive British drawings on the swap line between now

and year-end for the purpose of repaying other creditors, quite aside from financing whatever balance of payments deficits the U.K. might suffer. If the full $2 billion available were to be drawn, total Federal Reserve and Treasury credits to the Bank of England would rise to over $3 billion, about $500 million more than the British Government had received during the entire four years of the Marshall Plan.

Mr. Coombs said he understood the views of the Committee with respect to the automaticity of the swap line. It seemed to him, however, that the Committee was now confronted with a much broader situation in which certain joint understandings should be reached by the United Kingdom and its major creditors in the interest of an equitable settlement. He would suggest that an approach be made to both the British Government and the Bank of England along the following lines:

1. Extension to 1969 of Britain's short-term debts to European central banks and the BIS would be a useful and equitable counterpart to the $1.2 billion of more or less frozen debt owed to the U.S. Treasury and Federal Reserve, and anything the Bank of England or the British Government could do to obtain such an extension would be helpful.

2. The British Government should be strongly encouraged to make some really meaningful concessions, in the form of a dollar

guarantee, to official holders of sterling. At the May meeting of the BIS in Amsterdam the British had refused to consider such concessions but there were subsequent indications that they were becoming more flexible. At the June meeting in Basle, the Bank of England had put forward a proposal under which the main burden of financing further liquidation of the sterling balances would be thrust upon the U.S. Government and foreign central banks in the form of a $2 billion, seven-year credit package. Contrary to the press reports, that British proposal had received an unfavorable reception from the central bankers at Basle. The latter urged the Bank of England instead to offer a broad guarantee to official holders of sterling balances in return for an undertaking by the sterling area countries to limit their conversions of sterling to actual balance of payments needs. The British had promised to come up with a new proposal in time for the July BIS meeting. If agreement, at least in principle, could not be reached at that time, there was a risk that liquidation of the sterling balances would accelerate.

3. The Bank of England was continuing to allow sizable discounts on forward sterling to develop, thus frustrating any inflow of funds from the Euro-dollar market into London and encouraging a runoff of maturing forward contracts. By refusing to intervene in the forward market the British in effect were

discarding a major source of short-term financing from the market which other countries, notably the United States, Canada, and Italy, had not hesitated to draw upon. To some extent the British reluctance to try to pull in short-term money from the Euro-dollar market might reflect a judgment that the competitive pull of U.S. bank bids for Euro-dollar deposits had been so strong as to leave little room for British takings. But if passage next Thursday of the tax bill were to bring about a major change in U.S. credit conditions and a much reduced recourse by U.S. banks to the Euro-dollar market, useful opportunities might open up for the British to attract Euro-dollar money into London. In any event, a return by the Bank of England to the forward market would help considerably to disprove current market judgments that the Bank of England itself did not have sufficient faith in the tenability of the $2.40 parity to operate in the forward market on a large scale.

In conclusion, Mr. Coombs said that if all three of those steps were taken--deferment wherever possible of British debt maturing between now and the year-end, development of a guarantee scheme for the sterling area countries, and resumption of strong Bank of England intervention in the forward market--there might be some hope that the British could, somehow or other, squeeze through the rest of the year. If the steps were not taken, the prospect was bleak indeed--and not only for the British.

Chairman Martin suggested that the Committee plan on holding a full discussion of the sterling situation at its next meeting, by which time the July meeting of the BIS would have been held. In the interim the members would have the opportunity to give careful thought to the comments Mr. Coombs had made today.

The Chairman then noted that Mr. Maisel had just returned from a European trip and invited him to comment.

Mr. Maisel observed that he had spent a good deal of time in London discussing the sterling situation. While he had been exposed to substantially the same set of facts as Mr. Coombs, his interpretation of those facts was somewhat different from the latter's.

There was general agreement among the ten or fifteen experts from banks, the government, and the universities with whom he had talked, Mr. Maisel said, that the outlook for Britain's current account would depend primarily on the course of imports, as Mr. Coombs had suggested. The majority, however, were more optimistic than Mr. Coombs; they were of the view that the recent high level of imports was a temporary phenomenon. Exports would now grow faster than imports and as a result the current account would be moving into balance and then into surplus in coming months. If that judgment was correct the critical area for Britain was that of their capital accounts and particularly that of the overseas sterling balances.

Secondly, Mr. Maisel continued, the view appeared to be widely held in London that the government would fall if any change was made in the present $2.40 parity for sterling. Thus, while there might be some question of the government's ability to hold the rate, there was little question that it would take all measures in its power in the effort to do so.

Mr. Maisel agreed that the three steps Mr. Coombs had suggested that the British should be encouraged to take were critical, although he (Mr. Maisel) would have placed the stress somewhat differently. From his conversations with European central bankers he gathered that they would be willing, if not particularly happy, to help underwrite the over-hang of sterling balances if Britain took some measures (particularly by granting exchange value guarantees) to deal with them. It was their view, on the basis of the experience when sterling was devalued last November, that the dangers that would be posed for the whole international monetary system if there were another sterling crisis outweighed the risks to them of sharing some of Britain's current illiquidity. While they would not be happy to risk holding frozen sterling, they felt it necessary to take such a risk in order to attempt to avoid the danger of sterling's collapsing and pulling with it the entire international monetary structure.

As to possible forward operations by the Bank of England, Mr. Maisel continued, both in London and Brussels he had encountered

the view that the pressure on sterling through the Euro-dollar market was as much one of availability of funds as of price. Great emphasis was placed on the willingness of U.S. banks to acquire Euro-dollars even at considerable price differentials. As a result granting cover would not solve the problem. In any case, Bank of England officials thought that renewed intervention in the forward market would be interpreted by traders as a sign of weakness and thus might damage confidence and do more harm than good.

Mr. Coombs then said he had one further recommendation, relating to a System drawing of $175 million on the Bank of Italy that would mature on July 26, 1968. The System had had drawings outstanding on that swap line since September 19, 1967, so that if the drawing in question was renewed for a further period of three months and not repaid before maturity the line would be in active use for more than one year. He recommended renewal of the drawing if necessary. However, he hoped it would not be necessary; as he had indicated earlier, discussions were now under way regarding funding arrangements that should permit clearing up the Italian swap line by early July.

By unanimous vote, renewal for a further period of three months of the System drawing on Bank of Italy, maturing July 26, 1968, was authorized.

Chairman Martin then asked Mr. Solomon to report on the recent meetings of the Group of Ten Deputies and Working Party 3 that he had attended.

Mr. Solomon said he would limit his report on the two meetings--both of which had been held in The Hague because of the uncertainty of the situation in Paris--to the developments of particular interest to the Committee. Of the three items on the G-10 agenda, the first related to improvements in the procedure for use of the General Arrangements to Borrow for financing gold tranche drawings on the Fund. As the Committee knew, the gold tranche position was regarded as a reserve asset automatically available for use of the member countries. However, if a large drawing was made at a time when the Fund's holdings of currencies were low, the Fund itself had to borrow currencies from the G-10 countries. Existing procedures had involved consultations and were rather cumbersome, and there was a need to reconcile the formal automaticity of gold tranche drawings with the actual availability of funds. It was agreed that the IMF should prefinance gold tranche drawings--assuming it had the currencies needed--and subsequently come to the G-10 countries to replenish its currency stocks, on the understanding that those countries would give sympathetic consideration to the use of the GAB for such ex post settlement. That in fact was the procedure followed

in the recent French drawing. In his judgment the agreement was an important development in the use of the GAB, and it strengthened the Fund itself.

Other actions at the meeting, Mr. Solomon continued, were approval of the use of the GAB for France's drawing on the Fund and a redistribution, to eliminate France's share, of the contributions under the GAB in connection with tomorrow's drawing by Britain.

Finally, Mr. Solomon said, he might mention one other development at the meeting. In connection with an earlier British drawing on the Fund, France had lent the Fund $140 million through the GAB, and it now wanted to use that claim as a reserve asset. It was agreed that the French claim would be transferred to other European countries--namely, Germany, Italy, Belgium, and the Netherlands. That transfer, which was the first of its kind, confirmed that such claims could now be viewed as another type of reserve asset, similar to the gold tranche.

Mr. Solomon then turned to the WP-3 meeting, noting that it had focused mainly on prospects for the U.S. balance of payments on the assumption that Congress would promptly enact the pending fiscal restraint measures. Rather careful preparation had been made for the discussion. In particular, the Chairman and the Chief Economist of the Organization for Economic Cooperation and Development, after visiting the United States several weeks ago,

had developed a fairly satisfactory statement on U.S. balance of payments prospects. The OECD Secretariat projected a distinct slowdown in the rate of expansion of the U.S. economy over the next year, more or less in line with the projections now being made in Washington. Their analysis led to the expectation that there would be a deceleration of the wage-price spiral and a sharp improvement in the U.S. trade balance, with a resulting strengthening of confidence in the dollar and in present international monetary arrangements. The general picture of improvement over the next year in the U.S. trade balance and over-all payments balance was accepted by the WP-3. Even the representatives of countries that were likely to be most affected by a slowdown in the U.S. economy, such as Britain and Japan, accepted the need for it.

With respect to monetary policy, Mr. Solomon continued, in his own presentation at the meeting he had stressed the need for maintaining flexibility in the period ahead, given the uncertainty as to how hard the contemplated fiscal package would bite. He had also emphasized the lag in the workings of monetary policy. The consensus at the meeting was to caution against too prompt and too substantial an easing of U.S. monetary policy. At the same time, it was suggested that selective measures be used as far as possible to shield the housing industry against the effects of tight money

and high interest rates. The members of WP-3 thought that both domestic and balance of payments considerations justified the caution against undue monetary easing. That view was based not on detailed projections of GNP and its components over the year, but rather on the experience of WP-3 with other countries undertaking stabilization programs, where the tendencies had been toward underkill rather than overkill. It also reflected a concern that undue monetary ease might result in a deterioration in the capital account that would offset the improvement expected in the trade balance. The only other recommendation WP-3 had for the United States was that an incomes policy should be reinstituted once fiscal restraint began to take hold.

Mr. Solomon noted that the French representatives made no contribution at all to the discussion of the U.S. situation. With respect to developments in France itself, some reports were made but it was clear that the situation was still too unsettled for any definitive analysis. The immediate problem was one of confidence; current capital outflows from France involved funds of nonresidents not affected by the new exchange controls and an adverse movement of "leads and lags." For the longer run, assuming that political stability was restored and that effective government continued, one major question was how large the increases in French wages and other costs would be. Other questions concerned the extent to

which the higher costs would be passed through in the form of higher prices, and the effect that price advances would have on France's international competitive position. Meanwhile, aggregate demands certainly would be increased in France as a result of the recent developments. There was some spare capacity in the French economy which should permit absorption of some of the demand increases, but there no doubt would be income as well as price effects on French imports. The term "total transformation" had been used by one of the French representatives to describe the current situation. In any case, there was a great deal of uncertainty, and some concern by France's neighbors that recent developments there might spread across the French borders and possibly across the English channel.

The British situation was the final item on the WP-3 agenda, Mr. Solomon said. Everyone was still waiting for the effects of the devaluation, particularly on imports, to appear. As Mr. Coombs had indicated, exports had been doing reasonably well and the prospects were favorable. While there was some anxiety about the absence to date of any significant decline in imports, the general expectation of WP-3 and the OECD Secretariat was that imports would fall off--although no one could pinpoint the timing. No specific policy proposals were made to the British at the meeting.

Mr. Solomon said he might mention two other matters, although they were not formally discussed at the meetings. On the sterling balance prospects, it was his impression from talking informally with various people in attendance at the meetings that the British were prepared to go ahead with a scheme that would offer maintenance of value guarantees of official holders of sterling in exchange for commitments by the latter that they would run down their sterling balances only to meet balance of payments needs, and not for such purposes as diversifying their reserve assets. The British hoped to combine such a scheme with the $2 billion credit package mentioned by Mr. Coombs to finance unavoidable reductions in sterling balances. It was his understanding that a letter to that effect would be sent toward the end of this week or early next week to the central banks that were expected to provide the "umbrella" of credits, and that the British hoped to move ahead on both prongs at the July Basle meeting.

Finally, Mr. Solomon remarked, he shared Mr. Coombs' favorable view as to the situation at the moment in the gold market and the prospect for maintaining the arrangement under which European central banks would not purchase South African gold. However, a new complication had arisen in the form of an application by South Africa to sell some gold to the Fund under the Articles of Agreement, at a price of $35 per ounce. The Fund

would be considering the matter next week. The legal question of whether the Fund was obligated to buy gold from a member country was a complicated one; and if that question was decided in the negative there would remain a policy question regarding the proposed transaction. The U.S. position on the matter had not been worked out as yet and he suspected the same was true for other countries. The fact that South Africa had made the application was not publicly known.

Chairman Martin noted that on June 3, 1968, a staff memorandum entitled "Treasury views concerning backstopping facilities for Federal Reserve swap arrangements" had been distributed to the Committee, and that on June 7 a draft of a possible letter from the Secretary of the Treasury to the Federal Reserve had been sent to Under Secretary Deming for review.1/ Since Mr. Deming had not yet had an opportunity to respond, the Chairman suggested that the Committee postpone consideration of the subject of backstopping facilities until its next meeting. Meanwhile, copies of the draft letter would be distributed to the members.

There was no objection to the Chairman's suggestion.

1/ Copies of the memorandum and the communication to Mr. Deming have been placed in the Committee's files.

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 May 28 through June 12, 1968, and a supplemental report covering June 13 through 17, 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:

> During the period since the Committee last met, a basic tone of optimism about the prospects for the tax bill blossomed in the financial markets. And with this better feeling, there was a corresponding waning of concern that monetary policy might be tightened further. In this atmosphere, interest rates moved substantially lower, and there was a noticeable absence of the tension that prevailed just a month ago. Favorable action on fiscal policy by the House this Thursday would probably result in a further consolidation of the gains made recently, particularly in the longer end of the market; unfavorable action would lead to financial market conditions that no one really wants to contemplate.
>
> Interest rate declines were most prevalent in the Government securities market. Both the corporate and municipal markets are laboring under a heavy calendar of new issues, and investors were generally highly selective in their approach to new issues that were priced to yield less than the recent highs. Even in these areas congestion seemed to be breaking up in the past few days. In the Government securities market, yields on longer bills were particularly affected, and declined by 20-30 basis points over the period. Yields on longer-term Treasury issues moved significantly lower--generally by 1/8 to 1/4 per cent or more. In yesterday's Treasury bill auction average rates of 5.58 and 5.63 per cent were set for 3- and 6-month bills, down 12 and 24 basis points from the rates established in the auction just before the Committee last met.

With market rates declining, the financial institutions appear to be faring rather better than had been anticipated earlier as they moved into the June tax date and the mid-year interest crediting period. As the blue book[1] notes, the decline in commercial bank CD's now appears to be only little more than seasonal, partly reflecting the willingness of dealers to build up their portfolios of CD's, presumably in the hope of short-term capital gains. The thrift institutions did not fare badly in May, and with the recent decline in rates the current outlook is better than had been anticipated earlier. The more comfortable position of the banking system appears to be reflected in the credit proxy, which has moved to the plus side from the declines anticipated three weeks ago.

Assuming favorable action on fiscal policy, interest rates--particularly longer rates--should be subject to further downward expectational pressure. This pressure will be tempered--and could at times be offset--by Treasury cash borrowing in July (with an announcement probable late this month) and by corporate preparations for retroactive tax payments. Unfavorable international developments could also become a major factor influencing domestic rates, particularly if they affect Euro-dollar flows which have been so important in helping the large banks face the current tax period with relative equanimity.

Open market operations over the period supplied about $211 million reserves on balance. Early in the period a sizable amount of matched sale-purchase agreements were made to counteract some temporary easing in the money market. The June 5 statement week saw a puzzling combination of very deep net borrowed reserves and a generally comfortable money market. The net borrowed reserve figure of $590 million originally published for that week (subsequently revised back to $542 million) was the deepest in nine years, but it caused little or no concern to the market. In the statement week ended last Wednesday, a substantial volume of repurchase agreements was made in order to keep the money market on an even keel, while awaiting the precise timing of the British drawing on the International

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

Monetary Fund. That drawing, now scheduled for tomorrow as Mr. Coombs indicated, and the simultaneous pay off of the British swap drawing from the Federal Reserve, will, of course, have a major impact on bank reserves. The swap repayment will in itself absorb $1-1/4 billion reserves, although there will be a $400 million offset from the System's purchase of guaranteed sterling and from the System's warehousing of the Treasury purchase of guaranteed sterling. In addition, there will be substantial sales--perhaps $400 million or so--of Treasury bills by foreign central banks who are asked to convert the currencies drawn by the British into dollars; we will, of course, have the opportunity to take these bills into the System Account as a partial offset to the reserve drain. Finally, there will be a drain on the Treasury's balance stemming from the U.S. share of the British drawing and from the redemption of special Treasury certificates of indebtedness issued by the Treasury to Belgium and Italy who will need the funds in connection with the repayment of the System's swap drawing on them.

In addition, the French transaction discussed by Mr. Coombs will create some complications involving the Treasury bill market and, depending on whether any portion of the U.S. gold purchase from France is monetized, for the Treasury's cash position.

Given the volume of activity on the international side and the uncertainties about future developments, it is difficult to be precise about the apparent need for the System to supply reserves in the period ahead. On our current estimates it would seem that we would have to inject over $2 billion in reserves by the week of July 10 in order to keep net borrowed reserves within the recent range of experience. While there may be a sizable availability of Treasury bills from various foreign central banks, it appears likely that we shall have to do a substantial amount of outright buying in the market, perhaps including some coupon issues. This should, of course, exert some downward pressure on short-term rates.

As the blue book notes, the uncertainties on both the domestic and international side make it particularly difficult to predict the constellation of money market conditions and reserve variables that will be compatible with alternative policies over the period ahead. The Committee has before it three alternative draft versions

of the directive[1] for its consideration. While the interpretation to be given any of these directives depends, as usual, on the outcome of the Committee's discussion this morning, it might be useful to set out the essential differences among them as I would presently understand them from the blue book discussion.

Alternative A is essentially a no-change directive. There would be room for a significant decline in bill rates--if the Committee so desired--but only if expectational and other market forces tended to bring them about. If bill rates first declined, and then rose under the impact of the Treasury's cash borrowing, the Desk would not make any special effort to prevent this from occurring, other than the normal sort of trade-offs undertaken when the money market variables with which we are concerned are moving in different directions.

Alternative B suggests that any early decline in Treasury bill rates--if it occurs--should be accommodated and confirmed by resisting any tendency for rates to rise again. The resistance would take the form of providing reserves to keep the Federal funds rate below 6 per cent and by a reduction in pressure on banks' net reserve positions. In essence this alternative suggests a change in policy if the bill rate, after having declined, comes under upward pressure during the period.

Alternative C is a straightforward easing of policy designed to lead market rates of interest down. The money market variables associated with this approach are not far different from those associated with alternative B, but they are to be attained even if the bill rate is moving lower independently. A prompt move to the lower levels of the Federal funds rate and net borrowed reserves would probably be taken by the market as a confirmed shift in Federal Reserve policy.

It should be noted that all three versions of the directive contain language that would be useful in fending off disorderly markets if anything went badly awry with the tax bill. Given the strength of optimism about passage of the bill, and the heavy discounting by the market of that eventuality, I hope that these veiled references to unfavorable Congressional action will remain a matter of academic interest.

I should also note that under any of the directives there would probably have to be wide swings in net borrowed

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1/ Appended to this memorandum as Attachment A.

> reserves on a week-to-week basis to accommodate the large fluctuations in country bank excess reserves that typically take place in July--particularly between the second and third weeks of the month. In the absence of such swings in net borrowed reserves other money market conditions could alternate between extreme tightness and extreme ease.

Mr. Mitchell asked whether the Manager would expect any significant change in the flows of funds to financial intermediaries--either disintermediation or a significant reduction from the rate of inflows of a year ago--if the Committee adopted alternative A of the draft directives.

Mr. Holmes replied that it was hard to say because it was not clear how much downward pressure there would be on interest rates. He assumed there would be some; on the other hand, there would also be upward pressures arising from retroactive corporate tax payments and from the cash financing the Treasury would be announcing in late June for payment probably around July 10 or 12. The Treasury presumably would choose an instrument designed to have a minimum impact on the market--most likely tax anticipation bills--but the pattern of interest rate changes that would emerge from the various conflicting pressures was uncertain.

Mr. Mitchell remarked that it was clear in any case that adoption of alternative A for the directive would entail a greater risk of disintermediation than would alternatives B or C. He then asked what Mr. Holmes anticipated with respect to pressures on the Regulation Q ceilings.

Mr. Holmes replied that the position of banks had been helped considerably by the recent declines in secondary market rates on CD's. On the whole, the CD situation looked much better now than had seemed possible a few weeks ago.

Mr. Daane said he gathered that despite various uncertainties the Manager's best guess was that bill rates would decline following fiscal action but subsequently would be subject to upward pressure. He asked when that upward pressure was likely to occur, and whether his understanding was correct that it would be resisted if the Committee adopted alternative B but not if it adopted alternative A.

Mr. Holmes replied that in his judgment upward pressures were most likely late in the period before the tentative date--July 16--for the Committee's next meeting; perhaps in the second week of July. In general, he would interpret the directives as Mr. Daane had suggested, although the Desk's specific response to upward bill rate pressures under alternative B would depend on the Committee's intentions. For example, the bill rate might fall to a relatively low level in the next few weeks--perhaps as low as 5-1/4 per cent. If it then rose only part way back to current levels--say, to 5-1/2 per cent--he would rely on the Committee's instructions in deciding whether to resist the rise.

By unanimous vote, the open market transactions in Government securities, agency obligations,

and bankers' acceptances during the period May 28 through June 17, 1968, were approved, ratified, and confirmed.

Chairman Martin then noted that a memorandum from the Manager entitled "System Subscriptions in Treasury Cash Refundings" had been distributed to the Committee on June 6, 1968, and a memorandum from the General Counsel entitled "Legal considerations regarding Federal Reserve participation in Treasury refunding operations" had been distributed on June 12, 1968.[1] He asked Mr. Holmes to comment.

Mr. Holmes noted that his memorandum dealt with a complicated problem, and he would not attempt to review all of the technical details orally today. Briefly, the problem arose as a result of new debt management techniques the Treasury had used in both its February and May 1968 refundings, in which an exchange offering for the maturing issues was combined with a cash offering. In a straight cash offering with optional new issues, the System traditionally had converted its entire holdings of the maturing issue into the shorter of the new issues, in order to avoid market uncertainty as to how much of the longer issue would have to be taken up by the public. For technical reasons, however, in the combined cash-exchange offerings of February and May the System

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1/ Copies of both memoranda have been placed in the files of the Committee.

had had to convert its entire holdings into the longer issue offered in exchange, and none into the shorter issue sold for cash. The result was that the nature of the System's subscriptions now depended on the particular refunding technique the Treasury employed. It was desirable, in his judgment, to devise new procedures that would give the System flexibility in deciding which new issues to acquire in refundings, while preserving its arms-length relationship with the Treasury. The procedures recommended in the memorandum would permit the Treasury to announce simultaneously the specific amounts of the new issues offered to the public and that additional amounts would be fully allotted to the System and the Government Trust Accounts. The memorandum also suggested that the Treasury might want to discontinue the past practice of making full allotments to other "bedfellows", such as State and local governments, foreign central banks, and publicly administered pension funds. Finally, when--as in the February refunding--the cash offering was later in time than the exchange offering, it was proposed that the new issues offered for cash be dated as of the maturity date of the maturing securities, so that the System would not lose interest if it exchanged its holding of maturing securities for the issues sold for cash.

In response to the Chairman's request for comment, Mr. Hackley said he had found no legal objections to Mr. Holmes'

proposals. As noted in his memorandum, the only legal question raised by the proposals was whether the new securities acquired by the System would fall within the purview of Section 14(b) of the Federal Reserve Act, which provided that direct and fully guaranteed obligations of the United States may be bought and sold either in the open market or directly from or to the United States, and that the aggregate amount of such obligations acquired directly from the United States that were held at any one time by the Federal Reserve Banks shall not exceed $5 billion. In his judgment the securities would not fall within the purview of Section 14(b). He noted that for more than 30 years Committee Counsel had consistently held that U.S. obligations acquired from the Treasury in exchange for maturing securities acquired by the System in the open market were not covered by the provisions of Section 14(b).

In the course of the ensuing discussion Mr. Daane indicated that he was not wholly persuaded of the desirability of all aspects of Mr. Holmes' proposals. At the end of the discussion it was agreed that the Manager should be authorized to explore the matter informally with the Treasury without undertaking commitments for any change in present procedures, and that the Committee would plan on pursuing the question at its next meeting.

Chairman Martin observed that the Committee had planned to discuss today the memoranda before it on issues involved in setting

interest rates on System repurchase agreements. In the interest of time, however, he suggested that general discussion be postponed until the next meeting, with the members remaining free to make any comments they chose regarding the current level of the RP rate in the course of the go-around later in today's meeting.

No objection was raised to that suggestion.

The Chairman then noted that certain materials[1/] had been distributed to the Committee on June 13, 1968, relating to the so-called "Proxmire amendment" to S. 3133, the temporary interest rate legislation. The amendment, which had recently been approved by the Senate Banking and Currency Committee, would authorize the System to deal in agency issues in the open market and directly with the issuing agency, and would express the sense of Congress that the authority should be used "when alternative means cannot effectively be employed to permit financial institutions to continue to supply reasonable amounts of funds to the mortgage market during periods of monetary stringency and rapidly rising interest rates." In his judgment enactment of that amendment would create serious problems for the System. Yesterday Mr. Robertson and he had discussed the matter with Secretary Fowler and Chairman Sparkman of the Senate Banking and Currency Committee, and a letter to the Senator was now being prepared.

1/ Copies of these materials have been placed in the Committee's files.

In response to the Chairman's request for comment, Mr. Robertson said that the amendment would be reconsidered by the Senate Committee within a day or two. It was the Board's hope that it would be eliminated from the bill at that time on the grounds that it represented an undesirable departure from traditional central banking principles. In effect, it would utilize the Federal Reserve System to subsidize the housing industry. It also would create problems for the System and the Treasury, since any System purchases of agency issues for purposes of the bill would have to be offset by sales of an equivalent amount of direct Treasury obligations, raising interest rates on the latter.

Mr. Robertson added that similar legislation was likely to be introduced in the House next week. Even if the Senate should approve the amendment it was not a foregone conclusion that the House would also do so.

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:

> With the crucial vote on the fiscal restraint package just two days away, we are faced with unusual hazards today in projecting the short-run outlook. The

problem is greatest in the financial area, where failure to vote the tax bill would be greeted with deepest gloom, producing shock waves both domestically and internationally. But the outcome for fiscal restraint, of course, will also have a marked impact on the outlook for the economy generally. We would expect increased tax withholdings to have a prompt and sizable dampening effect on consumption, and for restraint on Federal expenditures to have a gradual but progressively larger impact as the fiscal year progresses. Taken together, and including also the secondary effects on other sources of spending, we believe that the prospect would be for a sharp reduction in real growth in the economy over the year ahead.

That pattern of events was presented to you in some detail at the last meeting of the Committee, and the outlook does not seem to me to have changed in any important respect in the intervening three weeks. What I would like to emphasize today is the high probability of some slowing in economic expansion in the period immediately ahead, even in the absence of enactment of the fiscal restraint package. The configuration of major strike threats, the apparent stabilization of the size of the war effort in Vietnam, the cumulating lagged effects of monetary restraint, the slowing in exogenous injections of personal income resulting from Government programs, and the continued conservatism of consumers in their spending behavior--all point to a near-term slowing in the growth of final sales. With less frenetic expansion in markets, and with the existence of ample production capacity, moreover, there seems to me little prospect that business would greatly increase its capital spending plans or engage in any extended accumulation of inventories on a substantial scale.

The upsurge in final sales already appears to have slowed substantially from the extraordinary 13 per cent annual rate of the first quarter. Our current estimate, as contained in the green book,1/ is for a rise of less than $19 billion in the current quarter, down from $26 billion in the first quarter. But this estimate may prove to be too high, unless there is a sizable further gain in retail sales this month. Initial reports are

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

not promising. The sales rate for domestic new cars dropped sharply in the first 10 days partly because of the different timing of dealer sales contests, and other retail sales were noticeably weaker in the first week of the month, perhaps reflecting the Kennedy assassination. Private nonresidential construction also appears to have been running weaker than implied by our business fixed investment projection, judging from the April and May reports.

Looking ahead, the prospect is for a slowing in the growth of personal incomes, even without the fiscal package. The Federal pay raise at mid-year will provide a significant addition, of course, but the effects of other Federal programs--the increase in social security benefits and in the minimum wage--are already largely reflected in the second-quarter totals and will not add appreciably to third-quarter flows. Moreover, a temporary slowdown in income payments next quarter seems likely in automobiles and steel, where inventories have been accumulating sharply, and perhaps in related industries. Assuming that consumers would continue their high rate of saving in the absence of a tax increase, which they appear to have been doing again in the current quarter, slower growth in income would be directly reflected in the consumption figures.

In other sectors too, there seems to me little prospect of a marked near-term strengthening in spending. The latest Commerce-SEC survey of business plant and equipment investment intentions, though a shade higher for the year than the previous survey, indicates little increase in the pattern of expansion. The second half is now projected to rise 3 per cent from the first half, much of which probably reflects higher prices in the heavy construction and capital goods fields. Residential construction expenditures still seem likely to decline in the months immediately ahead whether or not there is a tax increase. Earlier declines in the flow of mortgage commitments and the relatively bleak outlook for thrift institutions point to at least a temporary interruption in what otherwise appears to be an exceptionally strong demand situation. Federal spending probably will be limited also whether or not there is a tax increase, reflecting earlier uncertainties in program planning and restrictive appropriations policies. Finally, with military force levels apparently stabilized in Vietnam,

at least for the time being, the sizable increases in defense spending witnessed in the first half seem likely now to taper off.

Given these prospects for moderation in the sources of economic expansion, it might be questioned whether a tax increase is really necessary. I continue to think it is, for domestic as well as international reasons. The self-generated moderation which I foresee could prove largely temporary, and there is virtually no room for error on the upside. Should consumer demand become more ebullient and the saving rate decline from its recent very high level, or should further acceleration in the war effort suddenly prove necessary, we would be right back in a situation of excessive over-all expansion such as has prevailed in the early part of this year.

The most important domestic consideration arguing for a firm posture of restraint in public economic policy, however, is that the underlying inflationary pressures in the economy continue unabated and are likely to persist for some time to come. In order to brake the pervasive tendencies toward excessive wage increases, excessive price adjustments, and excessive spending and investment anticipations based in part on the psychology of inflation, it may well be necessary to go through a period of reduced growth and less receptive markets. These tendencies probably will continue to be a major concern in the formulation of monetary policy, as they have been for some time past. Nevertheless, if the fiscal package is enacted, the substantially more restrictive mix of economic policy that results would appear to leave some room for an easing off in monetary restraint. A policy that deliberately courts a business recession seems to me of dubious merit, either in terms of the immediate objective of reestablishing more stable economic conditions or as a viable solution to the longer-run problem of bringing the inflationary uptrend to an end.

Mr. Brill made the following statement regarding financial developments:

The Committee must by now be understandably weary of the staff's repeated laments about the difficulty of projecting constellations of market and monetary variables for short periods ahead. This time we mean it. The variety of possible events on the immediate horizon make

short-term forecasting, particularly of financial markets, nigh impossible. The blue book distributed for this meeting deserves an award for bravado, if not for clarity or accuracy.

In recent meetings, the staff has addressed itself to the problems of the longer-run strategy of monetary policy in the event of failure, or alternatively, of success in achieving fiscal restraint. I think the basic themes of these analyses still hold: if the burden of restraint remains on the shoulders of monetary policy, financial conditions will have to be made somewhat tighter. But the degree of additional monetary restraint needed to achieve reasonably prompt and adequate economic cooling-off is not very large, taking into account the restraint already cranked into the system. Alternatively, if the fiscal program is enacted, I still think we need prompt but moderate easing of financial conditions, to guard against too abrupt a slowing in activity next winter, a slowing which would be much more severe, in our judgment, than is suggested in the overly-optimistic outlook of the OECD document to which Mr. Solomon referred.

The question is, how do we get there from here, under either fiscal alternative? The principal difficulty in answering this question is the extent to which financial markets, domestic and international, take the initiative out of our hands. Consider, for example, the possibility that the fiscal package fails of passage--a possibility the staff found too horrible to contemplate and therefore assumed away in the green and blue books. Recent financial market developments suggest that the market is betting, albeit somewhat nervously, against this possibility. But looking back at recent periods when market expectations were suddenly jolted--in March, at the time of the gold crisis, and in mid-May, when the tax hike was postponed--the result was some quick unloading, particularly of longer-term issues in dealer hands. A repetition on a larger scale might be expected in the event of an adverse vote next Thursday.

The usual procedures for dealing with the emergence of disorderly markets--clearing out dealer inventories at progressively lower prices, until the market shows signs of functioning on its own--would probably need to be called into play, as would the procedures developed in 1966 for emergency aid to other financial institutions.

Since we would want to come out of such a transition period with more monetary restraint than at present, the objective of interim action would not be that of trying to forestall tightening of credit markets, but rather that of keeping adjustments orderly and within bounds, encouraging the market to find levels at which borrowers and investors are willing to do business with one another.

I am not too sanguine about the ease with which these objectives could be achieved. My fears are based not so much on domestic financial grounds as on the possibility of major international financial repercussions. Perhaps we are trapped by our own efforts, which have made the tax increase the sine qua non of fiscal integrity. The international consequences of failure to get fiscal restraint could swamp the purely domestic impacts, and put us into a different ball-park for monetary policy.

Let me now turn to the more probable and happier, but not necessarily easier, set of problems for monetary policy in the case of fiscal success. As the staff indicated in the chart show at the last Committee meeting, the longer-term monetary requirements in this case involve establishing a financial environment in which thrift institutions are encouraged to expand their commitment activity promptly, in order to insure an expansion in building activity next winter. Strength in housing activity is essential, not only to insure a reasonable amount of aggregate demand next year, but also to meet the particular problem of a developing housing shortage.

To achieve this will require maintenance of the inflow of funds to thrift institutions, and removal of the threat of massive outflows. Recent experience in this regard has been surprisingly good. Net savings inflows have been maintained at a much better pace than might have been expected in light of the widening spread in favor of rates on competitive market instruments. Preliminary data for May, for example, indicate a rebound in net inflows to mutual savings banks and savings and loan associations comparable to that following the year-end interest and dividend crediting period. But the initial impact of the tax increase may well fall heavily on such savings flows, particularly when higher tax withholdings start.

Moreover, the rate relationships emerging subsequent to passage of the fiscal restraint program may not automatically provide the needed encouragement to thrift institutions to stimulate a rise in commitments now in the confidence that adequate savings inflows will be available later. The market has to some extent already discounted the tax increase. Given the Treasury's near-term financing needs, and given investor attempts to switch from short- to long-term investments, we may experience a version of "Operation Twist" which would tend to keep rates relatively high on those market instruments most competitive with thrift institutions.

Thus, any further decline in short-term rates is likely to be modest, and would likely be short-lived if monetary actions are such as to maintain key money market indicators--the funds rate and net borrowed reserves--at or near recent levels, as would be the case should the Committee adopt directive alternative A. The danger I see in this course is that we run the risk of repeating the mistakes of early 1960, when a sustained high discount rate induced banks to make portfolio adjustments and pay off borrowings at the Fed, rather than expanding credit for an economy already beginning to slow up and head for a recession.

The staff has suggested another policy alternative, one which still leaves the initiative to the market but would avoid giving a misleading signal as to the longer-run intent of policy. In this alternative--B--no initiative would be taken by the System to push rates down. But if short-term market rates did decline further following enactment of the fiscal package, and then gave signs of reversing trend--because of Treasury financing demands, because of investor portfolio switches, or because of apprehension about the intent of monetary policy--then alternative B would require offsetting Desk operations to reduce the funds rate. The precise level of the funds rate needed to offset a reversing market tendency is conjectural; a drop to the 5-3/4 - 5-7/8 per cent range might do the trick, but the rate might have to be even lower.

Another policy strategy is specified in alternative C, which would have the System taking the initiative in encouraging a downward movement in short-term rates, by easing bank reserve positions sufficiently to get the funds rate down below 6 per cent.

As the policy options are now cast in the draft directives distributed to the Committee, alternative B looks superficially attractive. It relieves us of any obligation to make the first move, and it brings System initiative into play only if market expectations and market forces do not sustain a downward adjustment in market interest rates. Yesterday's market developments suggest that such an adjustment is under way. But once the initial euphoria induced by improved prospects for fiscal legislation is dissipated, the market will become increasingly sensitive to indicators of the stance of monetary policy. Maintenance of the funds rate at 6 per cent or more, with a discount rate remaining at 5-1/2 per cent, are not signals conducive to market expectations for even a moderate easing in our policy posture, and a snap-back in market rates would become more likely. I don't see the point of letting misimpressions as to policy becoming embedded in the market and then trying to turn them around.

In view of the still high level of credit costs, and the lag with which monetary actions have their impact on the economy, it seems to me appropriate for the System to take some modest initiative in moving interest rates to levels more appropriate to the longer-run needs of an economy operating under strong fiscal restraint. Let me emphasize that I am not recommending offsetting fiscal restraint by massive monetary easing. A bill rate hovering below 5-1/2 per cent does not strike me as cheap money, nor does bank credit expansion at a 6-8 per cent annual rate seem excessively generous, particularly in a period of heavy Treasury borrowing and unexpected corporate tax liabilities. But I do think the market needs some signal that, with the enactment of the tax and expenditure program, we are going to step back a bit from the current degree of monetary restraint. A deliberate but relatively small step in open market operations may forestall the need for a more overt signal to the market through discount rate action, at least for a while.

Mr. Mitchell said he had thought that the major thrust of the argument in favor of alternatives B or C for the directive was the need to avoid any further deterioration in the flow of funds

to thrift institutions. But the evidence seemed to indicate that those flows had been at a satisfactory level recently and that the interest rate structure suggested they would continue to be satisfactory throughout the dividend-crediting period. Accordingly, he was somewhat puzzled by Mr. Brill's policy recommendation.

Mr. Brill replied that he was perhaps less confident than Mr. Mitchell that inflows to thrift institutions would be sustained at recent levels even in the event of fiscal action. One factor that might operate to reduce such inflows was the reduction in the saving rate that was likely to accompany the tax increase, as consumers adjusted to the increase initially by reducing savings in order to maintain their spending plans. Moreover, to achieve even the low 1-1/2 per cent rate of real growth the staff projected for the first half of 1969, it would be necessary to have inflows to thrift institutions of a size sufficient to induce those institutions to expand their mortgage commitments--not simply sustain them at recent levels.

Mr. Mitchell commented that consumers might react to the tax increase by reducing either their spending or saving. To the extent they reduced spending the objectives of fiscal restraint would be achieved and flows to thrift institutions would be maintained. But if the bulk of the tax increase was reflected in lower saving, greater monetary restraint than otherwise would seem to be required.

Mr. Brill replied that the staff was projecting a decline in the dollar flow of personal saving as a result not only of a reduction in the saving rate but also because, as Mr. Partee had indicated, growth in income was expected to slow as a result of the fiscal package and other factors. Accordingly, in the absence of a change in monetary policy, inflows to thrift institutions could weaken.

Mr. Mitchell then said he questioned the desirability of making a monetary policy decision today on the basis of guesses as to the probable course of events following enactment of the fiscal package. In his judgment it would be better for the Committee to plan on holding another meeting after Congress had acted and there had been an opportunity to observe the market reaction.

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

> This Committee meets today at a time when substantial changes in the economic situation, both at home and abroad, are either under way or about to occur. We all have very much in mind the changes that may follow Congressional action--either way--on the fiscal program.
>
> At the same time, at least two major changes seem to be under way abroad. First, the convulsions in France have thrown that country's balance of payments into deficit and have forced France to draw from the IMF and sell gold for the first time since 1958. Secondly, the position of sterling has improved somewhat, or so it seems to me. The massive U.K. reserve losses of May have given way to modest reserve gains so far in June, thanks mainly to reports of funding and guaranty

arrangements for the sterling balances; as already noted, the U.K. foreign trade figures in May were unchanged from April, but we would still expect improvement in the months ahead in lagged response to last November's devaluation and the March budget, which have already been reflected in a sharp drop off in retail sales at home and in rising export orders.

Two of these changes--enactment of the U.S. fiscal restraint package and a turn of the tide for sterling--had already been assumed in the balance of payments projections given to the Committee at its last meeting. It will be gratifying, of course, to see these favorable developments actually occur--if they do occur--because without them the prospects would be for a very uneasy and crisis-ridden summer. But their occurrence may still leave the United States with a payments deficit that is large and only slowly diminishing. As Mr. Hersey suggested last time, the official settlements deficit could be of the order of $2-1/2 billion over the coming fiscal year, assuming that the recent flood of liquid funds from abroad will subside, as it must. Although we would hope that some part of that deficit would have its counterpart in a U.K. surplus and could be readily financed by U.K. repayment of debt, the remainder would be likely to involve renewed U.S. gold losses, IMF drawings, and provision of exchange rate guarantees.

The third development that I have mentioned, however--the set of changes that is resulting from recent events in France--does represent a new element that can be helpful to our balance of payments, and to the adjustment process world-wide, provided that it goes far enough in some directions and not too far in others. For France alone, a modest swing toward more expansionary domestic economic policies, a moderate once-for-all dose of wage inflation (of the sort absorbed on occasion in the past by the Netherlands and Italy), and even a short-lived burst of capital flight, can be useful from the point of view of international payments adjustment. But I think we should hope that the French Government can reestablish its authority very soon and that further capital flight can be limited. French drawings on the IMF and on swaps plus French gold sales already scheduled total nearly $1-1/2 billion. That is a lot even for a country that had $7 billion of reserves when the trouble began. It would be no help at all to anyone for the

drain to persist to the point at which a new French devaluation had to be considered. The present French Government will certainly do everything in its power to avoid that outcome. But the danger exists, nonetheless. With French foreign trade totaling about $25 billion a year, a mere shift of one month in average leads and lags can cost more than $2 billion of French reserves.

Assuming that the capital flight can be stopped, there will remain some more lasting adverse shift in the basic French balance of payments. Much of this shift will be reflected in larger surpluses for other Common Market countries, and only a small part may show up as an improvement for the United States and United Kingdom. Against this background, it would be helpful if just a little of the French malaise could spread to Italy and Germany. It may well spread to Italy; also, the recent elections there seem to open the way for more expansionary fiscal policies, in line with promises made by the Moro government on which delivery has yet to be made. But whether inflation will spread to Germany seems much more doubtful. Hence, unless the German Government takes a strong lead in formulating more expansionary policies, new strains may develop within the Common Market, and also between that area as a whole and the rest of the world. France will have a payments deficit, but Germany and the EEC as a whole may continue to have a large surplus. I might note, and of course one would not say this publicly, that in that situation a German revaluation could provide a helpful way out--for France, for Germany, and for the Common Market versus the rest of the world. But it would be very difficult to sell this idea to a German Government.

My tentative conclusion about the French disturbances of recent weeks is that, provided their inflationary and capital flight effects can be brought under control well short of a French devaluation, they have bought the United States and the United Kingdom a little more time. They tilt the basic payments position a little in our favor, compared with what it would otherwise have been. And they have had a useful confidence effect, reminding people that political and economic stability are not the exclusive property of continental European countries. It has been interesting to observe, as Mr. Coombs has noted, that most of the capital fleeing from France seems to have gone into dollar assets, rather than into other European currencies.

On the other hand, whatever time we have been granted was badly needed. The urgency of our making a balance of payments adjustment is in no way diminished, just because the odds that we can make it in time have improved slightly.

Let me say a word now about the specific question that is before the Committee today--the question of how soon and how much to ease monetary policy if the Congress adopts the fiscal restraint package. I think there can be very little difference of view about the course that we all want the domestic economy to take; it is the same from both the domestic and international points of view. We need a temporary but decisive slowdown in the real growth rate in order to remove excess demand pressures and slow down inflation. On the other hand, we want to avoid--if it can be avoided--a recession that would be likely to breed another too rapid expansion.

The problem comes in specifying the monetary conditions and actions that will lead to this desirable result. Here I defer in large measure to my colleagues on the domestic side. They have persuaded me that there is some measure of over-kill in the combination of the fiscal package plus the present degree of monetary tightness, so that some degree of easing will be in order when the fiscal legislation is enacted. On the other hand, as a balance of payments specialist I hope that any easing can initially be modest, so that we can get at home a rather early disinflationary impact from the tax action, and so that its confidence effects can make themselves strongly felt in foreign exchange markets for a time.

Mr. Galusha noted that there was a report in the New York Times this morning about attempts by the French to secure protectionist relief from some of the Kennedy Round tariff reductions that were scheduled to take effect July 1. It would be unfortunate, he thought, if such relief was granted and resulted in damage to the foreign trade of the United States and Britain, both of which

were counting heavily on the scheduled tariff reductions. He asked about the implications of the French effort and the prospects that it would succeed.

Mr. Maisel remarked that a debate was under way at present among the Common Market countries as to the extent to which cost increases in France would have to be passed through to higher prices. The other members were arguing that French manufacturers should be able to absorb the bulk of the cost increases, and pointed to the recent experience in Italy and Holland by way of example. The French felt that the analogy did not apply since their manufacturers had been operating with smaller profit margins than those in Italy and Holland. While France's request was being resisted currently, the Common Market probably would accede to it in the end. In any case, the matter at issue was internal to the Common Market, with no implications for external tariffs.

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

> There has been little change in the domestic business situation. Available statistics show renewed strength in May following hesitation in April when civil disorder was widespread. The unemployment rate remains at a low 3-1/2 per cent.
>
> Consumer prices continue to rise at a rate of about 4 per cent per annum, the highest rate for any sustained period since the Korean war. The recent slowdown in the rate of advance in wholesale prices

appears to be due to special factors. The underlying pressures for price increases remain very strong.

Our balance of payments picture has improved somewhat in recent weeks, due principally to continued heavy long-term borrowing by American corporations in the Euro-bond market through convertible debentures, and to large purchases by foreigners of stocks of American corporations. There is also some prospect for improvement in the U.S. trade balance but this will depend on our ability to restrain inflation at home.

Despite the improvement, the prospective underlying deficit for 1968 is in the $3 - $4 billion range. The hopes expressed at the beginning of 1968 for an improvement in our trade surplus in 1968 have foundered on the rocks of inflation.

Interest rates have receded in recent weeks with the improved prospects of a tax increase. If these prospects are realized, it would appear that the thrift institutions are not likely to experience large withdrawals at the time of the mid-year interest and dividend crediting period. The growth in bank credit continues to be modest. In view of current rate levels and the availability of funds in the Euro-dollar market, the New York City banks do not appear to be overly concerned about the possibility of a further runoff in large-denomination certificates of deposit.

At long last it now appears that the House of Representatives will vote this week on the tax bill recommended by the Conference Committee. I trust that there may be prompt enactment of this vital and long overdue legislation. Even with the passage of the bill--with its 10 per cent surcharge and its $6 billion spending cuts--the over-all Federal budget is likely to show a substantial deficit in the coming fiscal year. Vietnam spending estimates have already been upped substantially from last January's estimates. Some of the other spending categories specifically exempted from the cutback provisions are also likely to exceed earlier estimates. At the same time, it is very doubtful that the full cutback of $6 billion will be realized; later relaxation of spending restraint is more likely than not.

The Treasury will have a heavy borrowing program in the last six months of 1968. Indeed, it may be expected to announce late this month an offering early in July of perhaps $4 billion of new issues for cash.

In my opinion, Federal Reserve open market policy should continue unchanged. Impending Congressional action on the tax bill, the marginal competitive position of the thrift institutions, and prospective Treasury financing all counsel against a further increase in Federal Reserve restraint at this time. On the other hand, prompt enactment of the tax bill would not, in my view, warrant an immediate easing of credit policy. I have already mentioned the improbability of a reduction in spending to the extent specified in the tax bill. I think that we should await the enactment of the legislation and seek to assess the effect of its enactment before taking any steps to ease credit policy. The inflationary pressures on our domestic economy require more restraint than is now being provided by monetary policy and our balance of payments remains poor, necessitating the maintenance of relatively high interest rates.

Money market conditions are, of course, measured by a variety of factors which at times may move in different directions. During the period immediately ahead, these measures could be especially sensitive to uncertainties, both domestic and foreign. With this caveat, it would appear that a Federal funds rate fluctuating around 6 - 6-1/4 per cent, net borrowed reserves in a $350 - $450 million range, and member bank borrowings in the $650 - $750 million range would be appropriate. If enactment of the tax bill produces a downward effect on Treasury bill rates and other rates, it would not seem necessary to counter this development by open market operations. I think the System could afford to accommodate an expansion of bank credit next month brought about by the cash borrowing of the Treasury and corporate borrowing to meet stepped-up tax payments.

If the tax bill is not enacted, there could, of course, be serious repercussions in the domestic financial markets and the foreign exchange markets. Under such circumstances it may become necessary for open market operations to focus on the maintenance of orderly conditions, especially in view of the impending large Treasury financing.

I have no suggestions with respect to the first paragraph of the draft directive provided by the staff. For the second paragraph, I favor alternative A.

Mr. Latham reported that although there was some evidence of a slowing down in the rate of advance, the New England economy as a whole continued to show an upward trend which had now been under way since mid-1967. The New England labor market was tight in practically all categories with demand continuing very strong. Unemployment continued in the 3.8 to 3.9 per cent range which had prevailed since last July. Initial unemployment claims after the communications strike influence were again running 5.2 per cent below year ago levels. Manufacturing output had had an erratic course upward since the low of last July, with the gain in nondurable goods. Construction contract awards through April still showed an upward trend since the low of late 1966, with the level above the peak of 1966. Residential contracts were sharply upward for both single- and multi-unit housing, with single-unit contracts exceeding the peak level of early 1966 in each of the past three months. Nonresidential building had shown little change since last September.

After a first-quarter advance, Mr. Latham said, there appeared to be some slackening in the second quarter in the rate of inventory accumulation. The exception seemed to be in raw materials. Prime defense contracts in the first quarter were one-fourth above the corresponding period of a year ago. Consumer prices in the Boston area were up 1.6 per cent from January to

April of this year, with the April index figure 4 per cent above a year earlier. That was the largest April-to-April advance since the 1950-51 period.

Mutual savings banks outside of Boston were doing remarkably well with respect to deposits, Mr. Latham continued. Boston banks were showing a growing decrease in net savings flows--deposits less withdrawals--during the first five months of 1968. Boston mutual savings banks had been slow to join the rate race.

Mr. Latham noted that mortgage interest rates in the District continued to rise in May, with 34 of 80 mutuals reporting increases. Seven per cent was the more common rate, but a number of the country mutuals were still making mortgage loans at 6-1/2 and 6-3/4 per cent. For the first time in recorded history the average Boston rate was above the outside rate.

Mr. Latham commented that preliminary reports for May indicated a tightening trend for life insurance companies. Policy loans continued to rise but as yet there was no evidence of any decline in mortgage loan repayments. Insurance companies were exercising more caution in both loans and investments. Large commercial banks were evidencing concern over their heavy loan positions; they anticipated increased demands with or without fiscal action. CD rates were at the ceilings. Outstanding CD's were declining but there were no present evidences of disintermediation.

While most bankers and businessmen reported business as good to excellent, Mr. Latham said, there was growing evidence in their comments that perhaps things had been too good for too long and that what was needed was a further period of enforced belt tightening, hopefully through fiscal action.

Mr. Coldwell reported that economic conditions in the Eleventh District were still generally at a high level, with further pressures developing on the employment market and unemployment at minimal levels. Some weakness had developed in the construction area, but it was not clear how long it would persist. Retail trade remained very strong. There were continuing indications of speculative activities, including substantial financing demands for mergers and takeovers. Reports from banks reflected unevenness in their positions and in the impact of reserve pressures on them. Bankers were expressing deep concern over possible disintermediation and also over potentially strong loan demands, especially in connection with the retroactive corporate tax payments involved in the pending fiscal legislation. They were also concerned about probable wage-cost increases in the period ahead.

Mr. Coldwell observed that there had been little respite from inflationary pressures nationally or from the problems in the international financial arena. He doubted that final sales

would decline substantially as a result of the expected fiscal legislation, since he suspected that consumers would be more inclined to reduce saving than spending in response to a tax increase.

Mr. Coldwell thought there were two broad policy questions facing the Committee today. First, was the Committee certain enough of the future restraining effect of fiscal action to relax monetary restraint? Secondly, should monetary restraint be relaxed at a time when near-term Treasury financing meant there would be little chance for reversal if that should prove desirable? His own position was that the Committee could not afford to relax monetary restraint until there was evidence that fiscal restraint was having an impact on the current economic situation, and that it could afford to wait until July before deciding whether there was a need for relaxation.

Accordingly, Mr. Coldwell said, he would suggest maintaining the status quo with respect to firmness, with a caveat on the need to preserve orderly market conditions. Alternative A of the directive drafts was acceptable to him, although it might be worthwhile to add a reference to Congressional action on fiscal legislation in view of the importance of such action. He did not favor alternatives B or C because both implied a precommitment to easing. However, he would give more than the usual degree of

leeway to the Manager and have doubts resolved on the side of ease. Certainly, interest rates should be permitted to move without resistance.

Mr. Swan observed that economic conditions in general continued good in the Twelfth District, although in May the unemployment rate in Pacific Coast States rose by 0.2 of a percentage point to 4.6 per cent. The rise in unemployment was accompanied by the fifth consecutive monthly decline in California aerospace employment from the peak of December 1967. Loan demand was continuing to hold up well in the District and borrowings from the Reserve Bank remained at high levels. In fact, in the three weeks ending June 12, District bank borrowings averaged $140 million, about 20 per cent of the national total. There seemed to be less concern than earlier, however, about possible disintermediation. The latest available figures for share holdings at California savings and loan associations--relating to the experience through the first two weeks of June at five associations which accounted for about 18 per cent of the State total--showed some rise. The associations considered the increase quite satisfactory under existing circumstances.

As to policy, Mr. Swan said he shared what seemed to be the general view that some definite slowing of the rate of economic growth was needed. In his judgment the Committee should not be

too hasty in moving toward ease if the tax bill were passed. He recognized the possibility that some degree of overkill might be involved in the combination of the proposed fiscal restraint and the existing monetary restraint, and he also recognized that if that should prove to be the case prompt action to ease monetary policy would be required. But that did not necessarily argue for an immediate move toward easing. In terms of market psychology it would be better for the System not to appear to be attempting to move immediately to offset the tightening effect of the tax increase. In other words, the danger of appearing to move too far too fast in the direction of easing seemed to him to be greater at the moment than the danger of overstaying a policy of restraint.

Having said that, Mr. Swan continued, he had to admit that he had hesitated between alternatives A and B for the directive because he thought the System certainly should not offset any decreases in short-term interest rates that might occur following passage of the tax bill. On balance, he favored alternative B, despite the fact that the Manager had indicated he would interpret A as not calling for efforts to resist such rate declines. He would, however, want to add a proviso regarding bank credit growth to the staff's draft of B. He was concerned about the possibility that unduly rapid bank credit growth might result from the Desk's

efforts to resist subsequent upward pressures on short-term rates, as called for by B, and from other factors, such as Treasury financing. Accordingly, after the statement reading "provided, however, that operations shall accommodate tendencies for short-term interest rates to decline in connection with affirmative Congressional action on fiscal legislation," he would add "so long as bank credit expansion does not exceed current projections." For purposes of that proviso, he would specify the annual rate of bank credit growth projected for both June and July as in the range of 3 to 6 per cent, the range given in the blue book for June.

Mr. Swan added that he would also suggest a change in the final clause of the staff's draft of the first paragraph, which read "while taking account of the potential impact on financial markets of developments with respect to fiscal legislation." He would prefer to delete the words "financial markets," since the Committee obviously was concerned with the effects of fiscal legislation on the economy as a whole.

Mr. Galusha remarked that System policy seemed to be having an effect, at least in the construction industry. He had had reports, particularly from life insurance companies, that inquiries from would-be borrowers had become much less numerous than they had been. No wonder, what with lenders getting interest rates of 8 or 9 per cent or more on commercial construction loans,

along with various kinds of "participations." The word "participations" should be in quotes for they had been of a nature that in another era in his old home State of Montana would have aroused the vigilantes. Apparently many of those who had previously taken options had been willing to pay very high rates--so as not to lose their options. But in reaction to such high rates, would-be borrowers were not now taking further options.

Turning to Committee policy, Mr. Galusha expressed the view that even if the House passed the tax bill tomorrow, the Committee should not immediately make an overt change in policy. It seemed to him important not to give the rest of the world the impression of having acted with indecent haste. But he would not want to see the Manager resisting further declines in interest rates unless, of course, the House did not pass the tax bill.

He came out, then, for alternative B of the staff directive drafts, Mr. Galusha said. While it put something of a burden on the Manager, it seemed nevertheless to be the best possible directive in the present awkward circumstances. It allowed for an overt change in policy, if necessary, but sometime in the future, and not immediately. That, as he had said, seemed to him important.

Mr. Scanlon reported that the economic picture in the Seventh District had not changed appreciably in the past month.

Price increases continued to outnumber decreases by a wide margin, and labor markets remained very tight. Price reductions continued for products containing substantial amounts of copper, for certain chemicals, and for some types of steel. On the other hand, prices of a wide variety of machinery and equipment, consumer hard goods, and certain other chemicals had increased. In agriculture, he believed the prospect was for higher prices for pork, beef, and poultry.

Mr. Scanlon noted that an informal survey of District employers and reports from local Employment Service Offices indicated continued shortages of readily usable workers, both trained and inexperienced. In fact, labor markets in some smaller centers appeared to have tightened recently, and resembled the larger centers more closely. Steel ingot output was beginning to drift lower following the earlier decline in orders. But most finishing mills in the area would continue to operate at practical capacity through July. Shipments also would be at a very high rate in June and July, followed by an abrupt decline even if a strike was averted.

Orders for equipment and equipment components had varied greatly from product to product, Mr. Scanlon continued. Over all, there was little reason to anticipate more than a very gradual uptrend for total equipment output in physical terms through the

end of 1968. Nevertheless, prices on the average were expected to continue to rise at a 3 - 4 per cent annual rate. District residential construction continued at a high level, except in Michigan where most building trades workers had been on strike since early May. Prices of existing homes offered for sale appeared to be rising rapidly; the increase in the past year was estimated at about 10 per cent.

Despite greater demands, the large District banks did not appear to Mr. Scanlon to be unduly tight. They had done very little borrowing at the discount window and had reduced net purchases of Federal funds, but Euro-dollar borrowings had risen to new highs. Negotiable CD's outstanding had declined about 15 per cent in the past three months but rates offered appeared competitive in the current market.

Mr. Scanlon said he would like to see monetary policy aimed in the direction of attainment of a modest growth in total reserves. However, he would be hesitant to change policy until action had been taken with respect to the tax increase and reduction in Government expenditures and the Committee had had an opportunity to appraise the results. For today, he favored adoption of alternative A for the directive and he urged the Committee to watch developments closely--either in the event of fiscal action or in the event the bill failed to pass. He believed

it would be wrong for the record to show that the Committee had tried to formulate monetary policy by speculating on the effects of a bill whose passage was so uncertain. If that required a meeting in the interim before the next scheduled meeting, the Committee should have one.

Mr. Clay remarked that the basic factors affecting the economy domestically and internationally, and the problems with which monetary policy was faced, remained essentially the same as earlier. The more immediate factor that might alter the role that monetary policy would play in the weeks and months ahead was the probable disposition of the Federal tax bill. While that issue was being decided--whether for part or all of the period until the next meeting--the Committee should continue its restrictive monetary policy, including the maintenance of firm monetary conditions. There now appeared to be a distinct possibility, however, that the fate of the tax bill would be determined prior to the next meeting of the Committee. Thus, the System would need to formulate monetary policy with the realization that the fiscal measure probably would be either enacted or defeated in that interval.

Assuming passage of the tax bill, Mr. Clay said, it could be expected that interest rates in the money and capital markets would respond by moving downward. Considering that uncertainty

concerning the tax bill had focused principally on the House of Representatives, it might be that the reaction to the tax bill passage would begin with a favorable vote in that chamber. The preferable approach on the part of the Committee would appear to be that of awaiting developments in the money and capital markets and of avoiding any overt move by the System to lead interest rates downward. However, an orderly decline in interest rates should not be resisted. That System policy stance would seem to be appropriate until the next meeting of the Committee, at which time a new assessment of the situation could be made.

There was, of course, the other possible contingency--namely, defeat of the tax bill, Mr. Clay remarked. That contingency might be the more difficult one for which to formulate policy ahead of time, granting the necessity of continuing a policy of strong monetary restraint under those circumstances. In fact, it might become necessary to convene a special meeting of the Committee if the tax bill was defeated.

Mr. Clay thought the targets of policy could be considered to be within the general range of money market conditions specified in the two paragraphs beginning on page 5 of the blue book.1/

1/ The paragraphs referred to read as follows:
"Current money market conditions would appear to encompass a Federal funds rate generally in a 6 -- 6-1/4 per cent range, net borrowed reserves in a $300 - $450 million range, and member
(Footnote continues at bottom of following page.)

However, special factors caused an abnormal degree of uncertainty as to the variations that monetary variables might experience in the period ahead.

Either alternative A or B of the directive drafts might serve satisfactorily, Mr. Clay said. However, alternative A seemed to fit more closely the policy course he favored.

Mr. Heflin said that Fifth District business continued to exhibit the same trends noted for the nation as a whole. Manufacturers in the Richmond Bank's survey reported a strong

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1/ (cont'd from previous page.)
bank borrowings averaging around $650 - $700 million. Pressures in the aftermath of the mid-June tax date, any difficulties banks might have in rolling over their very large Euro-dollar holdings, and corporate need to pay $1 billion of additional taxes within a short span of time after the tax bill is enacted are all factors that would put pressure on the central money market and hence may require net borrowed reserves more toward the shallow end of the range if the Federal funds rate is not to rise over the period ahead.

"Given this set of day-to-day financing costs and pressure on bank reserve positions, the 3-month bill rate can be expected to fluctuate within a 5-1/2 -- 5-7/8 per cent range. The effect on investor and dealer expectations of a favorable decision on taxes could accentuate any near-term tendency for bill rates to decline and moderate any upward pressure that might develop later. In the days immediately ahead, the bill rate could move toward the lower end of the range in reflection of reinvestment demand from holders of maturing June tax bills not turned in for taxes; in addition, the System is likely to be a sizable buyer for seasonal reasons and also to offset the reserve impact of swap repayments. But the odds suggest upward pressure on bill rates later as the Treasury markets bills to meet its cash need early in July, as businesses seek short-term funds to make tax payments, and as investors tend to lengthen portfolios."

orders position and some step-up in inventory accumulation. Further sizable increases in retail sales were also indicated, with new automobile sales showing good gains throughout the District. Construction activity, however, appeared to be easing, especially in the residential sector.

From the policy standpoint, Mr. Heflin was sure the Committee was keenly aware that its problem over the near-term future hinged heavily on Congressional action on the proposed fiscal package. While definitive action was expected within the week, he believed the Committee should be prepared to cope with the market impact of a further postponement of a vote. In such a case, it could be confronted with a significant backsliding in the market, with rates moving once again into a range that might induce considerable disintermediation and especially serious problems for thrift institutions. He would clearly favor resisting any tendency for rates to move into that range.

He did not like to contemplate the question of the impact on domestic and international financial markets if the conference proposal failed of passage, Mr. Heflin remarked. In such an event, he believed the Desk could only be instructed to do whatever it could to maintain orderly conditions in the market. He was assuming, however--largely because it was a more attractive assumption--that the conference proposal would pass, substantially

in its present form. In that case, it seemed to him that the Committee had to face the question the Board staff had raised at the last meeting--whether or not the Committee should move promptly to relax credit policy.

Mr. Heflin said he could agree with the Board staff that strict Administration implementation of the fiscal package, as proposed, would represent a significant move in the direction of fiscal restraint and that that, coupled with the current and built-in credit restraint, might well turn the business advance around in the course of the next four quarters. But he was, in the first place, rather skeptical as to the size of the cutbacks in Government spending that would be realized. The staff's estimates of the magnitude of the turnaround in the high employment budget could easily prove to be well over the mark. Moreover, he would be eager to avoid creating the impression abroad that the System might be watering down the effects of the fiscal action through a relaxation of credit that could prove premature. At the moment, the foreign problem remained sufficiently dangerous and the pay-off of a premature easing sufficiently forbidding to warrant an error on the side of too much restraint. It was also reasonably clear that, whatever the lags in monetary policy, an error on the restrictive side could be redressed later on without unacceptably great damage to the economy's performance in 1969. For that

reason, even assuming that the tax package became law, he would prefer to hold off from any overt move toward less restraint. He would be prepared, however, to accept short-term rate declines that might be associated with normal expectational reactions to the fiscal move, even though that might produce 90-day bill rates somewhat below the present discount rate. He favored alternative B of the draft directives.

Mr. Mitchell expressed the view that the Committee should plan on meeting again two weeks from today to consider what monetary policy was appropriate in light of the fiscal action he assumed would have been taken by that time and in light of the market's reaction. If that was agreed he would favor alternative A of the directive drafts.

However, Mr. Mitchell continued, if the Committee was not prepared to schedule an interim meeting he would prefer alternative B, with two amendments. First, he thought the proviso clause in the staff's draft would be clearer if the contingency involved--enactment of the proposed fiscal legislation--was stated explicitly. For that purpose, he would insert after "provided, however" the words "that if the proposed fiscal legislation is enacted..." Secondly, he would favor adding the proviso relating to bank credit that Mr. Swan had suggested. However, alternative B was distinctly his second choice; he would much prefer adopting alternative A today and agreeing to hold an interim meeting.

Mr. Daane said he had not attended the WP-3 meeting at which Mr. Solomon had discussed U.S. monetary policy but from the latter's report today he concluded that Mr. Solomon had struck precisely the right note in emphasizing the need for flexibility. The problem for monetary policy now was one of timing. In light of the various existing uncertainties, including those relating to the fiscal package, he thought the Committee should not change its policy today. The System should not resist the market reactions to enactment of the fiscal package; if, as he expected, there were downward pressures on interest rates following fiscal legislation, he would favor permitting rates to decline. However, he thought the System should not attempt to lead rates down. Mr. Brill had referred to the risk of misleading the market regarding the System's policy intentions if alternative C were not adopted. But he (Mr. Daane) thought adoption of that alternative would risk misleading observers into believing that the System was acting to offset fiscal restraint. In his judgment it would be better to await evidence of the effects of the fiscal package, standing ready to move flexibly and quickly at the appropriate time. He thought the Committee could safely wait until July 16--the tentative date for its next scheduled meeting--before deciding whether monetary policy should be changed, and that it was unlikely to have additional evidence,

apart from the market's reaction to warrant a meeting at any date much earlier than that.

In conclusion, Mr. Daane said he favored alternative A for the directive. As interpreted by the Manager, that directive would be consistent with some fairly significant declines in rates following fiscal legislation and then some fluctuations.

Mr. Maisel referred to Mr. Solomon's report regarding the cautions offered at the recent WP-3 meeting against undue monetary easing in the United States following fiscal action, and noted that he had encountered a somewhat different view on his recent European trip. Several central bankers, while also suggesting caution in monetary easing, had indicated that they would welcome lower interest rates in the United States. In their judgment lower U.S. rates would reduce their internal problems of monetary management and would lead to a better functioning international monetary system. It was also his impression that if the fiscal package were adopted the Europeans would change their view of what constituted "equilibrium" in the U.S. balance of payments, because of the probable adverse effects on them of the type of improvement in the U.S. trade accounts that would be needed to reduce the over-all deficit below $2 or $3 billion.

Mr. Maisel said he would favor maintenance of current monetary policy if action on the fiscal package was delayed. If

fiscal action was taken, however, he thought the Committee should think in terms of the combined effects of fiscal and monetary policies. The degree of monetary restraint that had been effected had been felt justified because needed fiscal restraint had not been imposed. If fiscal restraint was finally forthcoming, there was no reason for the System to feel locked into the existing degree of monetary restraint. It was not proper, he thought, to view monetary easing as "offsetting" fiscal tightening. Rather, it would represent a proper coordination of the two types of policy. The System had urged greater fiscal restraint to take the place of monetary restraint. It should now follow its own advice by making certain that the current degree of monetary restraint was not added to a package of fiscal restraint that was greater than initially requested.

Finally, Mr. Maisel said, if the Committee concluded that a reduction in U.S. interest rates would be appropriate once fiscal action was taken, it should not permit such a reduction to depend on the effects of market expectations, as called for by alternative B of the draft directives. In his judgment monetary policy should not be dominated by expectations; if a rate decline was desirable the System should take action itself to bring one about. Accordingly, he favored alternative C of the draft directives, although he would add a bank credit proviso based on

an expectation of an annual rate of expansion in bank credit in the 3 to 6 per cent range in both June and July.

Mr. Brimmer said he thought it would be undesirable for the Committee to decide on a change in policy today, two days before the House was expected to vote on fiscal legislation. He was impressed by the apparent willingness of some members of the Committee and staff to assume that the vote would be favorable. While he also would like to be optimistic, the events of recent months suggested that it was risky to count on enactment of the measure.

Accordingly, Mr. Brimmer continued, he agreed with Mr. Mitchell that the Committee should adopt alternative A for the directive today and plan on holding an interim meeting in two weeks. If the consensus was against planning an interim meeting, however, he would favor alternative B with the amendments suggested by Messrs. Swan and Mitchell.

Mr. Brimmer thought an interim meeting would be desirable whatever the outcome of the vote in Congress. Failure of the bill probably would result in financial market disturbances of a type that could not be adequately dealt with simply by deciding today to give the Manager more than the usual degree of leeway; an interim meeting would be required to formulate specific instructions for the Manager's guidance. Such a meeting also would

provide a useful forum for discussion of measures the Board might take. In his judgment there would be a need for emergency credit facilities like those instituted in the summer of 1966 and perhaps additional measures as well.

If the fiscal package was enacted, Mr. Brimmer said, the Committee should meet in two weeks to decide on the appropriate degree of monetary easing; in his view, such a decision should not be put off until July 16. It would be a mistake, he thought, for the Committee to proceed on the assumption that the full $6 billion reduction in Government expenditures was not likely to be made, as an earlier speaker had implied. Rather, the Committee should assume that the terms of the legislation would be carried out in good faith by the Administration. It would also be a mistake to permit concern about "offsetting" the effect of fiscal restraint to delay action. Like Mr. Maisel, he thought "offsetting" was the wrong word. What would be involved was a change in the fiscal-monetary policy mix, in which fiscal restraint substituted for some degree of monetary restraint. The System had acted judiciously over the recent period in which it had applied increasing monetary restraint, and it would be unfortunate if it now followed a policy course that risked a recession. In his judgment, the combination of the proposed fiscal package and existing monetary policy involved too much restraint as the

economy moved through late 1968 and into 1969. Rough estimates by the staff suggested that such a combination of policies would reduce the real growth of the economy in the first half of 1969 to a rate considerably below the 1.5 per cent projected to result from a combination of fiscal restraint and moderate monetary easing. In his view the result would be a growth rate that was too low.

Mr. Sherrill said he thought an interim meeting would be desirable if the fiscal legislation failed to pass, but not otherwise. On close balance, he favored alternative A for the directive, on the understanding that it would be interpreted as the Manager had suggested.

Mr. Sherrill remarked that enactment of the fiscal package would require a relaxation of monetary policy at some point, but there was a difficult question of timing. The long-range need probably would remain that of restraining inflation. In order to achieve that objective it would be necessary to resolve the underlying problems, one of which was a psychological problem posed by the widespread view in the business community that inflation was automatic. The Committee should not encourage the assumption that monetary restraint would be eased whenever fiscal restraint was brought to bear.

In Mr. Sherrill's judgment the major argument in favor of easing monetary policy at present was the need to sustain housing

activity at acceptable levels, and there was some risk in that connection in not moving toward ease. He doubted, however, that there would be a marked change in the willingness of thrift institutions to supply mortgage funds so long as the pace of inflows to such institutions continued about as at present. The prevailing high levels of mortgage interest rates in themselves provided strong incentives to make mortgage loans, and the prospect that those rates would decline some time after fiscal action was taken would put the institutions under added pressure to commit their funds to mortgages at present rates.

On the other hand, Mr. Sherrill said, if after some initial decline bill rates started to rise as a result of Treasury financing in July, a tendency for them to approach the upper end of the 5-1/2 to 5-7/8 per cent range specified in the blue book might create fears of disintermediation and lead thrift institutions to cut back on their mortgage commitments. Accordingly, while he favored alternative A for the directive, he would want the Desk to resist increases in bill rates beyond the middle of the range specified.

Mr. Hickman remarked that the step-up in inventory investment and an expected improvement in net exports seemed to assure that the second-quarter gain in GNP would be even larger than that of the first quarter. Looking ahead, with or without

fiscal restraint a significant slowing of economic activity could be expected in the second half, as temporary stimuli subsided and as the lagged effects of monetary restraint took hold. Near-term moderation was suggested by the weakness of residential building contracts and other leading business indicators. Although the labor market might ease somewhat, wage and cost pressures would remain intense and profit margins would be squeezed. The recent slowdown in the rate of increase of industrial prices was probably temporary, and upward pressures on consumer prices would undoubtedly persist, reenforced by the resumption of the rise in farm prices.

Mr. Hickman thought monetary policy recently had been about right. Until its next meeting, the Committee should try to hold its ground and seek to maintain current money market conditions as specified on page 5 of the blue book. That would include net borrowed reserves in a $300 to $450 million range, borrowings averaging $650 - $700 million, a Federal funds rate in a 6 to 6-1/4 per cent range, and the three-month bill rate within a 5-1/2 to 5-7/8 per cent range. As he understood it, that was roughly the situation covered by the staff's alternative A. He would expect money market rates to move temporarily toward the lower end of the indicated ranges, or even below them, in the event of favorable fiscal legislation, and he would not resist

such movements. If Congress failed to enact a fiscal program in the near future the market might become disorderly, and a special meeting of the Committee probably would be necessary. He would also be willing to attend an interim meeting--say, on July 9--if the fiscal program was enacted. He doubted, however, that significant new information on the real economy would be available by that date, and accordingly he would prefer to have the next meeting held on the scheduled date of July 16.

Mr. Bopp said that since the last meeting of the Committee he had been reconsidering the question of the proper mix of monetary and fiscal policy which the staff had raised in its provocative chart presentation. Assuming Congress passed a 10 per cent surcharge and a $6 billion cut in expenditures within the next week or so, should monetary policy move promptly toward less restraint?

The difficult question raised by the chart show, Mr. Bopp continued, was the proper posture of monetary policy given the outlook for the next few quarters and the lagged effects of both monetary and fiscal action. Insofar as current behavior of the domestic economy was an indicator of the future, there was no case for less restraint. Inflationary pressures continued to dominate the U.S. economy. Demand was strong and rising and labor was tight. Conditions in the international economy certainly were

not those which ordinarily called for less monetary restraint. The balance of payments, and especially the balance of trade, were still very unfavorable and the precarious state of sterling and the French franc continued to threaten progress toward a more viable international monetary system.

As he projected likely developments, Mr. Bopp remarked, the strength of consumer demand suggested that inventories would not act as a depressant during the second half. Spending for plant and equipment would be stronger than estimated earlier. The flow of funds into mortgages might well be greater--although at higher interest rates--and consequent reductions in home building less than thought earlier. Finally, he doubted whether Federal Government spending actually would be cut by $6 billion even if the pending bill passed. Notwithstanding Mr. Brimmer's comment, he thought judgments on that score were relevant to the Committee's policy deliberations--although, of course, such judgments might be wrong.

Therefore, Mr. Bopp said, taking a longer-run view, he would be reluctant to move now toward less monetary restraint simply to offset the proposed fiscal package. There was a calculated risk in that position, of course. Given lags in its effects, monetary policy might not be able to counteract an overkill from fiscal action. And in view of the social unrest

that could develop from a significant increase in the unemployment rate, that was a serious risk to take. Nevertheless, he was inclined to take that risk for both domestic and international reasons. However, he recognized the possibility that the Committee might have to ease suddenly and decisively on short notice. If such action proved necessary, the even-keel requirements that would prevail during most of the second half of the year might have to be assigned lesser priority.

Although he would not favor moving in anticipation of the tax bill, Mr. Bopp observed, he would not want to counteract the more relaxed atmosphere likely to prevail in money and capital markets if the bill was passed. The Board's staff described a continuation of recently prevailing conditions in the money market as implying increases in the bank credit proxy at annual rates of 3 to 6 per cent in June and 1 to 4 per cent in July. Although that, too, suggested less restraint than in recent months, it seemed to him appropriate and it would make action of an overt nature easier if and when it should be needed. That judgment was consistent with alternative A of the directive drafts.

In conclusion, Mr. Bopp said he would favor holding an interim Committee meeting if any member thought one was needed.

Mr. Kimbrel reported that the liquidity positions of Sixth District member banks had begun to show more effects of the

somewhat tighter policy the System had been following. During the first week in June District country banks as a group were in a net borrowed reserve position for the first time this year, although the reserve city banks had been in a net borrowed reserve position for several months. During the last half of May and so far in June, borrowing by country banks had exceeded borrowing by reserve city banks, measured both in dollar volume and in the number of borrowing banks. Then, of course, the tighter conditions had been reflected in higher interest rates banks were charging their customers. The quarterly interest rate survey results for May showed that new business loans made by the large reporting banks bore an average rate of 6.6 per cent, compared with 6.3 per cent in February.

Despite the broadening effects of the more restrictive policy upon Sixth District member bank borrowing, it was hard for Mr. Kimbrel to find much evidence of a major shift in the banks' lending policies. Borrowing did not seem to be a response to widespread runoffs in deposits. As a matter of fact, at District banks in May both time and demand deposits increased on a seasonally adjusted basis. Large commercial banks in the District had been able to hold on to their large denomination CD's fairly well. A decline during the first week of June, the first in eight weeks, was accounted for almost entirely by a runoff at one bank.

Seasonally adjusted loans in May were down slightly from April, but in early June loans at the large banks advanced moderately. In May, total investments at all member banks were up on a seasonally adjusted basis.

Mr. Kimbrel commented that the latest indicators of District economic conditions showed few effects of credit restraint. Manufacturing and nonmanufacturing employment declined in April after seasonal adjustment. Retail sales dropped, and consumers borrowed less from banks. However, those figures reflected in part work stoppages and special circumstances. He was told that preliminary indicators for May suggested the April pause was temporary.

So far as the Sixth District was concerned, Mr. Kimbrel was not convinced that monetary policy had been too restrictive. There was always a danger in generalizing on the basis of limited observation, but the national picture gave him the same impression.

Of course, Mr. Kimbrel said, he recognized that any effects of monetary policy generally showed up only after some time lag. It was the appreciation of a time lag, he supposed, that suggested to some persons that the Committee should immediately ease monetary policy following passage of legislation increasing Federal taxes and reducing expenditures, lest it be guilty of overkill. There was, of course, much to be said for that point

of view. On the other hand, the best of economic forecasts and projections had a certain amount of imprecision. The Committee hoped the fiscal package would help cool the overheated economy, but it did not know how soon it would do so nor to what extent.

It seemed to Mr. Kimbrel, therefore, to be premature to shift immediately towards an easier policy when the Committee had observed neither the effects of its past policy on slowing down inflationary developments nor the effects of a change in fiscal policy. Moreover, an immediate overt move toward ease could well dissipate the hoped-for increase in confidence both at home and abroad that the nation was getting its fiscal and monetary affairs under control. For those and other reasons, he favored alternative A for the directive.

Mr. Francis commented that total demand for goods and services continued to rise excessively, causing increased inflationary pressures, further deterioration in the nation's balance of payments, and misallocation of resources. The green book projection of demand for the third quarter seemed low to him in view of recent policy actions and the current economic momentum. Two of the basic causes of the excessive demands were the fiscal actions of the Government and the rapid monetary growth.

Even if Congress passed a 10 per cent tax increase and a $6 billion cut in spending soon, Mr. Francis said, the very rapid

monetary expansion should be moderated to assure a more balanced economic growth. He suggested that the increase in the money supply, which had been at a 7 per cent annual rate, be held to a 3 to 4 per cent range and that interest rates should be permitted to seek their equilibrium level in response to changing market forces. Less expansionary fiscal actions would tend to make that task easier, and the Committee should not lose the opportunity.

Mr. Francis noted that some comments this morning, as well as the staff presentation at the Committee's last meeting, indicated that passage of the pending fiscal package would cause the level of interest rates to decline from current levels in the near future. In fact, that drop in interest rates had been considered by some to be a necessity in the face of fiscal restraint. Over the past year the System had aggressively advocated fiscal restraint as a necessity to rational stabilization policy. Yet now that such restraint appeared likely, there seemed to be growing fear of its destabilizing impact.

Mr. Francis did not share those views. It was his conclusion that much of the impact of the tax-spending cut package had been discounted in both prices and inventories by market participants. Those fiscal measures were generally expected to be temporary, and thus much of the tax burden on consumers would probably come from reduced saving and much of

the burden on corporations would probably come from increased borrowing, causing offsetting upward forces on interest rates. The tax measure, because of its temporary nature, might actually cause some acceleration of investment spending, to gain additional benefit from depreciation in the early months.

Then, too, Mr. Francis continued, despite the Government's fiscal actions, the recent excesses in the economy were apt to continue to place upward pressure on interest rates for some time. Inflation would probably be present for a long time, and expectations of higher prices would make borrowing attractive because repayments were made in depreciated dollars. Also, business inventories were now low relative to sales in some lines as a result of the surge in consumer spending; as they were rebuilt, credit demands would strengthen.

Mr. Francis observed that there were risks of either setting rates too high and unduly restraining activity or pushing them too low and excessively stimulating the economy. It appeared to him that it would be more prudent for the System to expect and allow continued high interest rates for a few months, even assuming passage of the tax increase and spending cut. The risks of such an approach to the economy seemed to him to be less than those of the opposite approach. Higher rates would also be of some benefit to the critical balance of payments situation. Once the inflationa

psychology began to weaken, rates would decline and at that time the System should not retard them. However, prematurely to anticipate a rate decline ahead of market forces could unduly aggravate an already serious inflationary situation.

Mr. Francis' recommendation was to firm money market pressures slightly during the next three weeks, assuming that the surtax and spending cuts were implemented. If they were not, he would let short-term interest rates rise about one-half to a full percentage point, and would recommend the appropriate accompanying actions with regard to discount rates and Regulation Q. Those actions would be taken with a view to moderating the very rapid rate of monetary growth of the past sixteen months.

Mr. Francis preferred alternative A of the directive drafts.

Mr. Robertson made the following statement:

> One way or another, we have to deal with two key policy questions today--what kind of monetary policy to maintain until such time as the fiscal restraint package is assured, and what kind to follow thereafter.
>
> So long as fiscal action remains a hope and not a reality, I think we are best advised to hold our monetary posture just about where it is. There can be no doubt we still need this much restraint--major economic indicators do not show any significant slowing of inflationary pressures. At the same time, with the money market a bit less taut than the extreme reached--partly through inadvertence--in early May, we have a set of financial conditions that stops short of generating major distortions. In a nutshell, our current policy is firm, but not too firm--and that is just where I want to be right now.

Immediately ahead of us is the key House vote on the fiscal package. I expect this to turn out favorably, but I think the results should be in before we make any policy adjustment. After affirmative action on the fiscal side is actually in hand, then we can turn to the welcome task of adapting our policy to deal with an economy in which fiscal policy is acting as a brake rather than an accelerator.

Even so, I think we ought to move cautiously. The kind of fiscal restraint we are contemplating is a mixture of fairly certain and highly uncertain elements. The tax increase will come on stream promptly, but its depressing effects on income are scheduled to last only one year. The proposed spending cuts have to be regarded as more problematical, since they probably have to take place primarily in the first half of calendar 1969, by which time they will have had to run the gauntlet of a new Administration and Congress. In these circumstances, I think the proper strategy for monetary policy is to relax only gradually, making use of all available governmental and market information to judge the strength and timing of the actual fiscal bite into economic activity.

A good way of doing this in the short run, I think, is to allow the initial market appraisal of the fiscal action to set the speed and extent of any rate declines between now and our next meeting. That means to me that the Trading Desk should follow along behind any declines in the bill and other short-term rates, adjusting operations enough to avoid exercising an upward tug that might reverse the bill rate decline. I do not regard this as abdicating to the market; rather, it means we are making use of the market's appraisal to set the first stage of our response, with the second stage being a balanced reassessment of appropriate interest rates and rates of money and credit growth at our next meeting, when we will have the benefit of an extra few weeks of perspective.

The most I would be willing to do in the way of an overt System initiative in the interim would be to pull back down the interest rate on repurchase agreements to 5-1/2 per cent. As you know, I saw more problems than gains from the start in the experimental increase in the repurchase rate above the discount rate, and I would be glad to see it disappear. Furthermore, its reduction on the heels of the tax bill passage would be a kind of

> mini-signal to the market that the worst of System pressure is behind them.
>
> With these views, I would be prepared to vote in favor of directive alternative B as drafted by the staff with the amendments suggested by Mr. Swan. I would, of course, be agreeable to an earlier meeting of the Committee, but I doubt we will have much information available prior to the middle of July.

Chairman Martin said he would favor holding an interim meeting of the Committee if the fiscal package was voted down. He also would want such a meeting if the vote was postponed, because further delays might produce problems in financial markets nearly as serious as those that would result from a negative vote. If the vote was favorable, however, he thought there would be little purpose in meeting before July 16, partly because relatively little new economic information would be available before that date.

The Chairman then remarked that the Committee members did not seem to be far apart today in their views on policy. At the outset of the meeting he had been prepared to vote for alternative B for the directive. However, he could accept alternative A--which most members seemed to prefer--if it was interpreted as the Manager had suggested. The difference between the two alternatives was not great, particularly if the bank credit proviso that Mr. Swan had proposed was added to alternative B.

Mr. Maisel said he thought the choice between the two alternatives would make relatively little difference if the

Committee planned to hold an interim meeting. If such a meeting was not planned, however, the fact that alternative B took account of the expected fiscal action, and A did not, seemed to him to make a great deal of difference.

Mr. Brimmer agreed, noting that he had indicated earlier that he would favor alternative B if the Committee did not plan to hold an interim meeting.

Mr. Daane commented that he did not see much difference between alternative A as interpreted by the Manager and alternative B if one was thinking about the expected declines in bill rates; the Desk would not resist such declines under either alternative. The real difference related to the Desk's reaction to any subsequent reversal of the downward movement, which would be resisted under B but not under A. He gathered, however, that such a reversal was not likely to occur until late in the period before the Committee's next scheduled meeting. Accordingly, he thought there was little need for an interim meeting if the vote in Congress was favorable. He would favor such a meeting if the fiscal package did not pass.

Mr. Mitchell agreed that there would be relatively little new economic information for review at an interim meeting. There would, however, be information on the market's reaction to enactment of the fiscal package. As had been indicated, if the

Committee adopted alternative A today and did not schedule an interim meeting, the Desk would not resist any upward pressures on bill rates that might occur in July. That could lead to problems, particularly since the Treasury would be engaged in a financing operation then.

Chairman Martin remarked that prospective Treasury financing was one reason he preferred alternative B. While he thought it would be reasonable for the Committee to decide today to permit market forces to have some play in the coming period, he would have some question about the desirability of meeting in the midst of a Treasury financing to consider an overt change in policy. Also relevant was the fact that the Treasury would be back in the market in late July in connection with its August refunding. While he favored alternative B, however, as he had mentioned earlier he could accept alternative A.

Mr. Holmes referred to Mr. Sherrill's comment that it would be undesirable to permit bill rates to rise to the upper end of the range indicated in the blue book. If alternative A was adopted the Committee might want to consider whether the Desk should be instructed to resist any such tendency.

Mr. Swan said he strongly preferred alternative B. While the difference between alternatives A and B was narrow if the former was interpreted as suggested by the Manager, it was not at

all evident from the language of A that such an interpretation was intended. Thus, adoption of A was likely to confuse readers of the published record with respect to the Committee's intentions

Chairman Martin and Mr. Galusha expressed agreement with Mr. Swan's observation.

Mr. Mitchell remarked that the choice between alternatives A and B still seemed to him to depend on whether the Committee planned to hold an interim meeting. If not, he thought adoption of alternative B was much the safer course.

Chairman Martin said that developments might well make it desirable to hold an interim meeting. He thought, however, the Committee should act today on the assumptions that the fiscal package would be passed and that there would be no need to meet before July 16. On that basis, he agreed that alternative B was the better choice for the directive.

In reply to a question by Mr. Hickman, Mr. Holmes said that under alternative A, unless the Committee instructed otherwise, bill rates would be permitted to rise to the upper limit of the 5-1/2 to 5-7/8 per cent range. Under alternative B the Desk would be given a mandate to resist increases in bill rates after initial declines.

Mr. Hickman then said that while he continued to prefer alternative A to B he would favor adopting an upper limit for the

bill rate somewhat below 5-7/8 per cent since a rate that high might well result in disintermediation.

Mr. Brimmer asked how probable the Manager thought it was that there would be upward pressures on bill rates during the Treasury financing, assuming that the fiscal package was enacted.

Mr. Holmes replied that some such pressures were likely, but he could not say how strong they would be. Large bill purchases for System account probably would be needed to keep net borrowed reserves in their recent range, and those purchases would offer a major moderating influence on upward pressures. Also, the Desk would normally resist bill rate increases if they were sufficiently marked to affect the Treasury financing adversely.

Mr. Daane commented that alternative B would be improved if the bank credit proviso suggested by Mr. Swan were added, and that B had an advantage over A in that it referred to the pending fiscal legislation. However, while he could accept alternative B he was still concerned about the possible implication that the Committee was rushing to ease monetary policy immediately upon enactment of the fiscal package. He would be more inclined to favor B if it were interpreted to call for cushioning any upward movements in the bill rate rather than preventing them from occurring.

Chairman Martin repeated that he thought the members were not particularly far apart in their policy views. In his judgment the references to "resisting" any bill rate increases that might follow initial declines were generally intended to mean cushioning rises rather than choking them off completely.

The Chairman then suggested that the Committee vote on a directive with a first paragraph consisting of the staff's draft, with the amendment to the final sentence Mr. Swan had suggested; and a second paragraph consisting of alternative B, with amendments to include the bank credit proviso proposed by Mr. Swan and the additional phrase suggested by Mr. Mitchell.

Mr. Brill said he thought it would be desirable to clarify the Committee's intent with respect to the bank credit projections mentioned in the proposed additional proviso. For alternative A, the blue book projected bank credit growth at annual rates in the ranges of 3 to 6 per cent in June and 1 to 4 per cent in July. For B, however, the blue book said only that "bank credit expansion in July would likely be toward the upper end of the range indicated above, or larger...." That language might be taken to imply a projection of bank credit growth in July at a rate ranging up to, perhaps, 6 per cent under alternative B.

Mr. Maisel remarked that he had had the need for such clarification in mind when he had suggested earlier that the

Committee accept a range of 3 to 6 per cent as the expectation for bank credit growth in both June and July.

Mr. Swan noted that he also had suggested acceptance of such a projection for purposes of the proviso clause.

Chairman Martin commented that it was well that the point had been clarified.

By unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

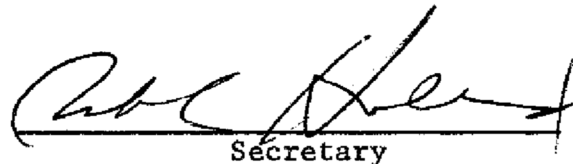
The information reviewed at this meeting indicates that the very rapid increase in over-all economic activity is being accompanied by persisting inflationary pressures. Enactment of fiscal restraint measures now under consideration in Congress, however, would be expected to contribute to a considerable moderation of the rate of advance in aggregate demands. Growth in bank credit and time and savings deposits has been relatively small on average in recent months, although the money supply has expanded considerably as U.S. Government deposits have declined. Both short- and long-term interest rates have receded from the advanced levels reached in May, mainly in reaction to enhanced expectations of fiscal restraint. The U.S. foreign trade balance and over-all payments position continue 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, while taking account of the potential impact of developments with respect to fiscal legislation.

To implement this policy, System open market operations until the next meeting of the Committee

shall be conducted with a view to maintaining generally firm but orderly conditions in the money market; provided, however, that if the proposed fiscal legislation is enacted operations shall accommodate tendencies for short-term interest rates to decline in connection with such affirmative congressional action on the pending fiscal legislation so long as bank credit expansion does not exceed current projections.

It was agreed that the next meeting of the Committee would be held on July 16, 1968, at 9:30 a.m. Chairman Martin noted that as discussed earlier, a meeting would be called before that date if developments suggested that that was desirable.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

June 17, 1968

Drafts of Current Economic Policy Directive for Consideration by th
Federal Open Market Committee at its Meeting on June 18, 1968

FIRST PARAGRAPH

The information reviewed at this meeting indicates that the very rapid increase in over-all economic activity is being accompanied by persisting inflationary pressures. Enactment of fiscal restraint measures now under consideration in Congress, however, would be expected to contribute to a considerable moderation of the rate of advance in aggregate demands. Growth in bank credit and time and savings deposits has been relatively small on average in recent months, although the money supply has expanded considerably as U.S. Government deposits have declined. Both short- and long-term interest rates have receded from the advanced levels reached in May, mainly in reaction to enhanced expectations of fiscal restraint. The U.S. foreign trade balance and over-all payments position continue 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, while taking account of the potential impact on financial markets of developments with respect to fiscal legislation.

SECOND PARAGRAPH

Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual pressures should develop in financial markets.

Alternative B

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining generally firm but orderly conditions in the money market; provided, however, that operations shall accommodate tendencies for short-term interest rates to decline in connection with affirmative congressional action on pending fiscal legislatio

Alternative C

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining generally firm but orderly conditions in the money market; provided, however, that somewhat less firm money market conditions shall be sought in the event of affirmative congressional action on pending fiscal legislation.