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, November 14, 1967, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Francis
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Sherrill
Mr. Swan
Mr. Wayne

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

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

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Mr. Hersey, Associate Economist
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Sammons, Associate Director, Division of International Finance, Board of Governors

Messrs. Kimbrel and Strothman, First Vice Presidents of the Federal Reserve Banks of Atlanta and Minneapolis, respectively

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on October 24, 1967, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on October 24, 1967, was accepted.

Chairman Martin commented that the next order of business today would be for the Committee to be advised of recent developments with respect to sterling, including various negotiations that were still in process. After Mr. Coombs had made his report, he (Chairman Martin) and Mr. Daane would each comment briefly on discussions in which they had participated. The Committee could then consider specific recommendations by Mr. Coombs.[1/]

Mr. Coombs observed that he had been concerned since June about the progressive deterioration in the position of sterling and in the gold market, and had been trying to provide the Committee with timely warnings about the prospects. The Committee had been given all of the information, however confidential, that was available to him. He would be equally candid this morning.

1/ Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period October 24 through November 8, 1967, and a supplemental report for November 9 through 13, 1967. Copies of these reports have been placed in the files of the Committee.

On the gold market, Mr. Coombs said, the basic problem posed by the excess of industrial and private demands over production was now being magnified by speculation. During the first 10 months of 1967 the London gold pool had incurred a deficit of $275 million. During that interval it benefited from South African sales out of reserves of $130 million, implying a total real deficit of over $400 million. So far in November the pool had made further net sales of $81 million. Even if sterling were not devalued the deficit for all of 1967 was likely to reach $600 million or $700 million. Accordingly, he was inclined to regard as optimistic a recent estimate by an independent expert (Mr. Edward Bernstein) that the pool would be incurring a $1 billion deficit by 1970. It was more likely that the deficit would reach that rate in 1969, or perhaps even in 1968.

Mr. Coombs noted that it had been necessary for the pool to get eight successive contributions from participants, totaling $50 million each; aggregate contributions were now $670 million, compared with their original level of $270 million. The seventh contribution had been negotiated on Wednesday, November 8, and had been virtually exhausted two days later; and the eighth had been negotiated this past weekend at Basle, in the course of the monthly meeting of the Bank for International Settlements. It had been agreed in principle at that meeting that the participants would continue to support the pool operation through the date of the

January Basle meeting. In any case, it was clear that the European central banks were approaching the end of the line as far as the operations of the gold pool were concerned. The U.S. representatives had reiterated the intention of this country to hold the market price of gold, acting alone if necessary.

With respect to sterling, Mr. Coombs continued, the prospect was that the British Government would devalue the pound this coming weekend--or even before--unless massive outside support in the form of medium-term credits was provided. The prospect of devaluation had been looming for some time now, and about two weeks ago the U.S. Treasury had suggested a possible set of arrangements designed to avert it. Specifically, the Treasury had suggested that after the British had repaid, with international help, their $250 million drawing on the International Monetary Fund due December 1, they get a standby credit from the Fund of $1.4 billion, representing the total of their residual drawing rights. Secondly, the Treasury had indicated that it would be willing to add $100 million to the amount of sterling guaranteed by the Bank of England that it would hold, and it hoped that that sum would serve as the nucleus for a larger package involving agreement by European central banks to acquire guaranteed sterling.

Events had come to a head this past weekend, Mr. Coombs remarked, with the sterling problem being discussed at simultaneous meetings in Washington and Basle. From the Washington discussions there had emerged a new proposal, involving the $1.4 billion of stand-by credits in the Fund together with a guaranteed sterling package of $1 billion, of which the U.S. share would be $500 million. That proposal had been transmitted to the Basle group on Sunday afternoon. The European central bankers flatly rejected the suggestion of the $1 billion guaranteed sterling package for both legal reasons and on policy grounds. A similar proposal had been rejected in 1965, and it appeared that the objections to such an approach had deep roots. Some of the central bankers present might have been willing to extend additional short-term credits to the British, but Governor O'Brien said that the Bank of England was not prepared to take on further short-term obligations. Governor O'Brien also expressed doubt about the value of the guaranteed sterling package. Among other reasons, he noted that such a package would pose a dilemma. On the one hand, if publicity was given to the arrangement there were likely to be angry reproaches from member countries of the sterling area now holding sterling outright; it would be difficult to persuade Australia or Kuwait, for example, that they were not entitled to similar guarantees on their sterling holdings. Not to publicize the arrangement, on the other hand, would be to sacrifice all of its potential psychological effect on the exchange markets.

Mr. Coombs went on to say that at that point, when an impasse seemed to have been reached, Governor Carli of the Bank of Italy had made another proposal; namely, that the Bank of England apply to the Fund for a credit not of $1.4 billion but of roughly $3 billion. To extend such a credit the Fund would have to waive the limit of 200 per cent of quota on its holdings of an individual country's currency. It would also be necessary for the Fund to activate, in substantial amount, the General Arrangements to Borrow, under which Group of Ten countries have undertaken to lend currencies to the Fund over and above the amounts provided by their quota subscriptions. The central bank governors at Basle--with the exception of Governor Brunet of the Bank of France--had indicated that they would be prepared to make favorable recommendations to their governments with regard to the provision of whatever sums the Fund would need to provide so massive a credit to the British.

That proposal, Mr. Coombs continued, had been communicated to Mr. Schweitzer, Managing Director of the Fund, who, after consultation with his staff, had taken a strongly negative view. At the moment discussions among Group of Ten representatives were proceeding in Paris, in the course of which, he understood, the U.S. Treasury representatives were pressing their proposal for European countries to join with the U.S. in agreeing to acquire a total of $1 billion of guaranteed sterling. There was some possibility that the German Federal Bank and the Bank of Italy together might agree to match the $500 million U.S. share suggested by the Treasury.

There was one ray of light in a generally dark situation, Mr. Coombs remarked. That was the fact that sterling had not fared badly in the exchange markets since Bank rate was increased to 6-1/2 per cent last Thursday. The British had incurred some reserve losses on Friday, but not unduly large losses, and they took in about $30 million on a swap basis yesterday. So far today they had managed to execute about $40 million of swaps, despite the announcement of extremely poor foreign trade figures for October, and both the spot and forward rates were up moderately. That kind of market reaction was being obtained on the basis of new reports that the British had received credit assistance through the BIS to repay the $250 million Fund credit. Thus, in view of the enormous short positions in sterling, it was possible that, if a reasonable package of credits to the British was arranged and if the British were able to cope with the recent wildcat dock strikes, return flows might be brought about that would give sterling a reprieve until the middle of next year. On the other hand, the French had now shifted to outright financial warfare against sterling and the dollar, and the markets might be flooded with pessimistic reports emanating from Paris. Sterling was poised on a knife edge.

At the Basle meeting, Mr. Coombs continued, there also was a good deal of discussion of an exchange rate for sterling--if the British decided to devalue--that on the one hand was likely to prove tenable, and on the other hand would be unlikely to precipitate competitive devaluations. The main alternatives considered were devaluations of 10 and 15 per cent. The Governors of all of the Common Market central banks except the Bank of France, and the Governor of the Bank of Sweden, indicated that their countries probably could hold their present exchange rates if the British devaluation did not exceed 15 per cent. Governor Brunet had noted that his Government was of the view that sterling should be devalued but that it could not accept a devaluation of 15 per cent without reacting. He did indicate that there was some chance that France would accept a 10 per cent devaluation. Since the difference between 10 and 15 per cent was not very great this position seemed to be simply another illustration of France's current tactics to keep things on edge, and perhaps pave the way for a subsequent French move if the British devalued.

One curious aspect of the discussion, Mr. Coombs observed, was that Governor O'Brien continued to press the question of the degree of devaluation the other countries could accept even after general agreement was reached on the desirability of approaching the Fund regarding a $3 billion credit to the British. That fact probably convinced the continental Europeans that Governor O'Brien personally favored devaluation. In any case, if the question of a sterling rate that would be tenable was being renewed in the current Paris meeting, there were serious risks of leaks.

It was his impression, Mr. Coombs continued, that both Prime Minister Wilson and Chancellor Callaghan were still determined to hold the present sterling parity, but that they were quite clearly in the minority within their own Cabinet. Further, they were taking the position that massive aid should be extended with no conditions, which might prove impossible. The apparent division of views among the British authorities was contributing to a feeling of hopelessness among those taking part in the discussion.

In conclusion, Mr. Coombs said that the U.S. Treasury, as previously indicated, had put forward a suggestion for a package of credit assistance to Britain that would include U.S. contributions of $500 million in the form of purchases of guaranteed sterling. In view of the possibility that the Germans and Italians might agree also to contribute to such a package, the Open Market Committee might be faced with the need to make a fairly quick decision on how much, if any, assistance the Federal Reserve would be prepared to extend in company with the Treasury.

Chairman Martin then noted, to complete the picture, that on Monday of last week (November 6) there had been a meeting at the U.S. Treasury--attended by Messrs. Coombs, Daane, Hayes, Solomon, and himself from the System--to discuss the general situation with respect to sterling. At that meeting he had been asked to explore with Governor O'Brien the possibility of a further increase in Bank rate from its level at that time of 6 per cent. Subsequently, he had quite a long discussion with Governor O'Brien by telephone. In response to Mr. O'Brien's request for his views on whether a Bank rate increase would be helpful generally, he had said it was his belief that the recent increase from 5-1/2 to 6 per cent had been inadequate to close the gap between short-term rates in London and abroad; that a further increase of one-half of a percentage point would be helpful; and that a further increase of a full percentage point might well be desirable, if it was feasible politically. Governor O'Brien indicated a willingness to consider a Bank rate increase. He had also commented on the matter of possible credits to Britain, saying--as Mr. Coombs had indicated he subsequently said at Basle--that Britain would not find further short-term credits useful and needed longer-term credits.

Chairman Martin added that later in the week, while in Dallas, he had received a call from Governor O'Brien, who advised that he had been trying to reach Chairman Martin to tell him that a decision had been taken to increase Bank rate by one-half of a percentage point. At the time the phone call was put through the announcement had been made. Market developments early on Friday, the day after the increase was announced, suggested that the rate change had not materially helped the situation, but subsequently, the market became calmer.

The Chairman then invited Mr. Daane to report on the Washington meetings in which he had participated during the past weekend.

Mr. Daane said that at the Treasury on Saturday, November 11, members of the so-called "Deming Group," including Under Secretary Deming, Mr. Fried of the White House staff, Mr. Okun of the Council of Economic Advisers, and himself, met with two representatives of the United Kingdom, Messrs. Rickett and Morse. The latter outlined Britain's position, to the effect that the alternatives were substantial long-term credit assistance or immediate devaluation. At that time the U.S. Treasury was urging that the best course would be for the British to seek a $1.4 billion standby credit from the Fund, with the hope that it would also be possible to put together a $1 billion package of guaranteed sterling holdings, of which the U.S. share would be $500 million and Germany and Italy $250 million each. The possibility was noted that this could be supplemented by private bank credit to bring the total package to about $3 billion. In the course of the discussion, which continued for some time, the Treasury made it clear that when speaking of U.S. participation they were describing only the nature of the recommendation they were prepared to make to the President, and that they could not pledge Federal Reserve participation. Later, word was received from Basle that the central bank governors there were not favorably inclined toward the guaranteed sterling proposal; and still later--on Sunday--it was learned that the Basle group of governors would recommend that Britain apply to the Fund for a $3 billion standby credit.

When the Deming group, plus Chairman Martin and Secretary Fowler, reassembled late on Sunday, November 12, to discuss the latest advice from Basle, Mr. Daane continued, everyone was quite enthusiastic about the proposal to seek a large standby credit from the Fund. But, as Mr. Coombs had already noted, the Fund management took a negative view of that proposal. Thus, as of yesterday there was more or less a fall-back to the earlier Treasury proposal. An effort was being made at a meeting now under way in Paris in which Mr. Deming participated to put together a support package employing the guaranteed sterling route, plus a $1.4 billion standby from the Fund.

Chairman Martin then commented that in the various discussions in which he and Mr. Daane had participated they had taken pains to make it clear that they could not in any way commit the System to participation in the guaranteed sterling proposal, and that such participation would involve a change in the character of the System's operations to date. For one thing, a question might easily be raised whether a sizable amount of guaranteed sterling would not be a holding of investment character, because the British obviously wanted longer-term credit. Thus, the System would have to look at any such proposition carefully. He personally had been quite enthusiastic regarding the proposal that the Fund extend a $3 billion credit to Britain, and Mr. Morse had also seemed encouraged. There was disappointment on learning that the Fund had reacted negatively. Yesterday morning he had suggested to Secretary Fowler that the latter might have a further conversation with Mr. Schweitzer to ensure that all aspects of the matter had been fully explored. Then he and Messrs. Fowler and Deming did have a luncheon meeting with Mr. Schweitzer, but they found the latter adamant on the $3 billion proposal.

It appeared that Mr. Schweitzer probably would acquiesce in a $1.4 billion credit to Britain, though with some reluctance, but he would not agree to a $3 billion credit.

The Chairman added that the situation had been reported to the President late yesterday. Mr. Deming then left for Paris, where he would endeavor to see whether Germany and Italy would participate along with the United States in a $1 billion package. It was not possible to say whether that would be successful. It was the Treasury's hope that if the arrangements were made the System would participate in them along with the Treasury. Whether the System should do so was the problem before the Committee today, and he understood that Mr. Coombs would make some specific recommendations on that point. A full discussion of the matter was desirable, since a decision might be required soon. Comments would also be in order on the broader question of the general approach the United States should take to the sterling problem, since the System had the responsibility for offering its best judgment to the Administration on that subject.

Mr. Hayes observed that for some time he had been concerned about the seriousness of the sterling problem, not only because of the uncertainty within the United Kingdom but more particularly because a devaluation of sterling could have serious consequences in terms of the gold market and the dollar's position in foreign exchange markets. He had consistently believed that it was in the interest of the United States to use all reasonable means to try to avert a sterling devaluation, and he had been happy to hear Secretary Fowler, in a summary statement made at the meeting a week ago to which Chairman Martin had referred, say that that was the official U.S. view. No one, Mr. Hayes said, could envisage all of the consequences of devaluation, but they could be grave. With that in mind, he and Mr. Coombs had worked hard at the Basle meeting to convince other central bank governors that it was in the general interest that the present parity for sterling be maintained. He had been pleased when Governor Carli's proposal won general backing at that meeting.

In his judgment, Mr. Hayes said, the situation was far from hopeless. There was a good chance it would be possible to develop some package of assistance to Britain that would have the necessary psychological impact to be effective. He believed that the influence of the U.S. authorities should be strongly directed toward trying to persuade the British that a move on their part could have serious consequences, both for the United States and for the financial world generally. He believed that with a sufficiently unified approach on the part of the major countries, including the United States, the British probably could succeed in holding sterling at its present parity.

Chairman Martin commented that while one might or might not agree with Mr. Hayes' hopeful outlook, it was helpful to have his views. But the immediate question before the Committee was what to do if the System was asked to participate in a guaranteed sterling operation.

Mr. Brimmer asked if Mr. Coombs would indicate the extent to which the present authorization to acquire guaranteed sterling and the System's existing swap network were now being utilized.

Mr. Coombs replied that of the System's $200 million authorization to buy guaranteed sterling, about $90 million was in use at present; and of the Treasury's $300 million authorization, about $195 million was in use. Thus, of the combined authorizations of $500 million, $285 million was in use and $215 million remained available. System drawings on the swap network totaled $862 million at the moment, of which $300 million were drawn on the Bank of Italy, $262 million on the BIS and Swiss National Bank together, $150 million on the Netherlands Bank, and $150 million on the National Bank of Belgium. Arrangements had already been made to pay off

$60 million of drawings included in the total, so that in effect the aggregate outstanding was $802 million. The System also had $500 million of technical forward commitments in Italian lire.

Mr. Coombs added that the System's outright holdings of sterling had been reduced to $4.5 million. If sterling should be devalued he would expect to receive word in advance, and would plan on immediately selling the System's remaining outright sterling holdings to the Bank of England at the present rate of exchange. Over the past year he had followed the practice of converting to dollars all of the System's interest earnings on sterling. In that connection, there was some ambiguity in the Committee's foreign currency instruments. On the one hand, under paragraph 2D of the foreign currency directive he was authorized to adjust System balances within limits specified in the authorization for foreign currency transactions; on the other hand, paragraph 3 of the authorization indicated that insofar as practicable spot sales of foreign currencies should not be made at rates below par except under certain specified conditions. In view of that ambiguity he had checked with Chairman Martin through a member of the Board's staff and had been advised to take a common sense view of the Committee's intention. It had been his conclusion that the language of the authorization had not been intended to preclude sales of a currency at a price below par when such sales were made in connection with repatriation of interest earnings.

Chairman Martin then asked Mr. Coombs for his recommendation, and the latter said that it might be helpful to the Committee if he first briefly reviewed the background of the System's holdings of guaranteed sterling. Such holdings had been initially authorized in August 1965--and the amount increased in September 1965--for the purpose of facilitating market operations in defense of sterling by the System, acting in collaboration with the Bank of England. The authorization had proved useful on a number of occasions when sterling was under pressure, most particularly in connection with the bear squeeze of 1965. A second justification for the original authorization had been that the sterling held under Bank of England guarantee was likely to prove useful from time to time for acquiring, through market swaps, other currencies needed for System operations. Although for the sake of flexibility no specific maturity dates were attached to the holdings, they were not intended as longer-term credits to Britain.

In his judgment, Mr. Coombs said, a $100 million increase in authorized holdings of guaranteed sterling--but not more--could be justified under the original rationale for such holdings by the System. Thus, if the original rationale was to be preserved and if the United States was to acquire an additional $500 million of guaranteed sterling, the Treasury's share would have to be $400 million. On that basis the Stabilization Fund might run short of cash at some point, although it was well supplied at the moment. To guard against that eventuality, the System might agree to stand ready to "warehouse" up to $150 million of guaranteed sterling acquired by the Treasury. The System Account already had authority, under paragraph 1(C)1 of the authorization for System foreign currency operations, to warehouse up to $200 million of foreign currencies to facilitate repayment of outstanding Treasury bonds denominated in foreign currencies.

In sum, Mr. Coombs said, he would recommend raising the limit on System holdings of guaranteed sterling in paragraph 1B(3) of the authorization from $200 million to $300 million, and raising the limit on outstanding System commitments to deliver foreign currencies to the Stabilization Fund in paragraph 1C(1) from $200 million to $350 million. Since paragraph 1B(1) of the authorization specified that the System Account could hold foreign currencies up to the amounts necessary to fulfill outstanding forward commitments, the latter action would in effect also increase the amount of currencies that could be held by a maximum of $150 million. It would also be necessary to change the wording of the present paragraph 1C(1), which at present limited the System's warehousing function for the Stabilization Fund to currencies in which the Treasury had outstanding indebtedness.

Mr. Coombs said he was acutely conscious of the fact that it would be necessary to explain System foreign currency operations in his published semi-annual reports and in other System releases. If those reports gave the impression that the Federal Reserve was extending long-term credits to the United Kingdom, the rationale of the System's foreign currency operations would be destroyed. It was for this reason, and because not more than a $100 million increase in authorized holdings of guaranteed sterling could be justified in terms of needs for market operations, that he had formulated his recommendations in the manner described.

Mr. Mitchell commented that a question prior to that of the mechanics of assistance concerned the economics of the situation. He gathered from Mr. Coombs' remarks that Governor O'Brien considered a sterling devaluation desirable if long-term credit assistance was not forthcoming.

Mr. Coombs replied that it was often difficult to assess the real reasons for which people took particular positions, and he could only speculate about Governor O'Brien's reasons in the present case. Mr. O'Brien was the custodian of the reputation of the Bank of England, and no doubt was unwilling to have the Bank take on additional short-term debts when it could not guarantee repayment on the due date. One could not be sure about his real views as to whether sterling devaluation was inevitable, although he certainly had conveyed the impression that he was prepared to see it occur. He was as fully aware as anyone of the damage that would be done by devaluation; perhaps he anticipated a chain of events under which the sterling situation would no longer be a special case.

Mr. Mitchell then asked whether the Fund's negative view on a $3 billion credit to Britain could be taken as an indication that the Fund management thought sterling had to be devalued.

Chairman Martin replied that it was hard to say. He had no information on the attitudes of the executive directors of the Fund, but from his conversations with Mr. Schweitzer he gathered that the latter had two reasons for his negative view on the $3 billion credit. First, he thought that so large a credit would endanger the entire structure of the Fund if anything went wrong. Secondly, Mr. Schweitzer apparently did not consider the economic case for the credit to be very good. In view of Britain's already large debts to the Fund and to others, he did not consider it desirable to extend another $3 billion credit to that country.

Mr. Daane remarked that while it was difficult to say whether or not Governor O'Brien thought devaluation was inevitable, the view of the British authorities--particularly those at the Bank of England--seemed to be that if sterling was to be devalued it would be best done while the country still had some international financial resources remaining. On the question just raised by Mr. Mitchell, he (Mr. Daane) could report that late on Sunday, when the Fund management expressed their negative view on the proposal for a $3 billion credit to Britain, they gave five reasons: (1) To extend a credit that would involve increasing the Fund's holdings of sterling to an amount in excess of 200 per cent of Britain's quota would constitute a significant departure from present Fund practice. The one precedent for such a credit--the case of Chile--had been of a very different order of magnitude, with much less serious implications. (2) Such a credit would exhaust the resources of the Fund. In this connection it was noted that of the $6 billion total available under the GAB, $3 billion represented the combined shares of the United Kingdom and the United States, and earlier British drawings had already made inroads into the remaining $3 billion. (3) For the Fund alone to provide the assistance needed by the British at the moment would be wrong; there should be tangible evidence that direct assistance in the form of long-term credits would be forthcoming from the continental Europeans as well. (4) The Fund management found it difficult to conceive that the British would make sufficient progress on their balance of payments to justify a credit of the proposed magnitude. (5) The Fund management thought it would not be possible to make the necessary arrangements fast enough to meet the urgent need.

On the last point, Mr. Daane added, he was not persuaded that the conclusion of the Fund management was correct. While it might take some time to work out the arrangements, the simple expression of a favorable attitude on the part of the Fund in itself would be quite helpful.

Mr. Hayes remarked that he found it difficult to follow the logic of the third point Mr. Daane had mentioned, which was a matter that had been discussed at Basle. It was obvious that for the Fund to provide a $3 billion standby credit to the British substantial contributions under the GAB would be required. As to the fifth point, it was true that there might be some problem of timing in making the arrangements. However, the general agreement on the subject among the central bank governors at Basle constituted a long step toward agreement by their Governments. Those Governments, including the United States and the United Kingdom, held an overwhelming proportion of the votes in the Fund.

In the absence of Mr. Solomon, who was in Paris today, Mr. Sammons was asked to summarize the views of the Board's staff on the fundamental issue.

Mr. Sammons said that as he understood Mr. Solomon's general position it was quite similar to that Mr. Hayes had expressed; namely, that a devaluation of sterling would pose serious dangers for the dollar. He could not speak for Mr. Solomon with respect to the specific recommendations Mr. Coombs had made. He would note, however, that Britain had been experiencing serious balance of payments difficulties for a long period. If further credits were to be granted to the British, it would be highly desirable to consider now what course would be followed if the situation did not change sufficiently to enable Britain to repay the debts incurred within a reasonable time.

Mr. Daane added that he had talked by telephone this morning with Mr. Solomon, who had raised two questions. The first was whether adequate consideration was being given to the alternative possibility of enlarging the System's swap arrangement with the Bank of England. On that point he (Mr. Daane) had noted that the British had indicated that they required long-term rather than short-term credit at this juncture. Mr. Solomon's second question--to which Mr. Daane did not know the answer--concerned the dilemma involved in the proposal for guaranteed sterling holdings; arrangements of that sort would not normally be publicized, but the need was for a package of assistance that would convince observers that the sterling parity would be maintained.

Mr. Coombs referred to Mr. Solomon's question about the possibility of an enlargement of the System's swap line with the Bank of England and indicated that he would not recommend such an enlargement. In his judgment it probably would have an effect opposite to that desired. The announcement of the last enlargement, in September 1966, had had a favorable psychological impact on the exchange markets because it had been possible then to report that the bulk of the previously-existing line was not in use. Such a statement could not be made now, and the market was likely to conclude that the United States was simply throwing good money after bad. Moreover, an increase in the swap line probably would elicit a hostile reception from the System's continental partners in the swap network; they might well charge that the System was financing credits to the Bank of England by drawing on its swap lines with their banks.

Mr. Coombs then referred to Mr. Daane's earlier comment that the Bank of England probably would prefer to have any sterling devaluation come at a time when Britain still had some international financial resources. In his judgment that line of reasoning begged the question of whether the announcement of new credit assistance to Britain would result in a sizable return flow of funds to that country. As he had noted, short positions in sterling were now of massive dimensions, which suggested that there would be such return flows. It would be known whether or not the flows were developing at a time--say, within three or four weeks--when the bulk of the new credits were still unused and when Britain still had substantial reserves. If the hoped-for market reaction had not eventuated, it would be possible to cancel the new credits at that time.

Mr. Daane said that he was no more enthusiastic than Mr. Coombs about going too far with the guaranteed sterling technique, and that he favored Mr. Coombs' exact recommendations. However, he wondered whether the Committee should take too inflexible a position with respect to the amount and form of its participation, in view of the fact that the Treasury was already urging two foreign central banks to commit $250 million each to the package.

Mr. Coombs noted that he had recommended that the System undertake to participate to the extent of $100 million in additional guaranteed sterling holdings, and to stand ready to warehouse another $150 million for the Treasury if the Stabilization Fund's resources proved inadequate. However, if Germany and Italy agreed to share in the package of arrangements, it was his feeling that their participation would not be through holdings of guaranteed sterling but would take the form of acquisitions of bonds issued by the British and denominated in the creditors' own currencies. Thus, there was not necessarily any direct connection between what the Federal Reserve did and what the other central banks might do. He would hope that in publicizing the credits the emphasis would be placed on their total and not on the particular forms in which individual countries participated.

Mr. Robertson remarked that while he was prepared to vote favorably on Mr. Coombs' recommendation he wanted to express his concern about the general approach this country was taking to the sterling problem. The primary question for the United States, in his judgment, was whether it should continue to urge the British not to devalue. Britain had been experiencing balance of payments difficulties since 1955 and their problem had been severe since 1963. He questioned whether further credits now would enable the British to hold to the present parity. Funds advanced to the British and disbursed by them were likely in the end to represent additional drains on the U.S. gold stock. The decision regarding the position of the United States was for the Administration rather than the System to make, but in his opinion the time for sterling devaluation was at hand. He would favor having the United States so indicate to the British and let the chips fall where they may. There would, of course, be repercussions in the form of market speculation, but the United States was in a better position to deal with them now than it might be one or two years hence. Most countries evidently would be prepared to accept a 10 or 15 per cent sterling devaluation; as an alternative, the British might shift to a floating exchange rate. In any event, the harm done by devaluation now could be less than the harm involved in prolonging the problem, which would be likely to become more and more acute. In sum, while he would go along with the recommendation, he thought the course of participating in further credit assistance in an effort to prevent devaluation was not a wise one.

Mr. Daane commented that the question could be debated at length. The best judgment of the British seemed to be that if sterling was over-valued at present the amount did not exceed one or two per cent. In the view of the staff at the Board and the New York Bank, if there was over-valuation in a basic sense the margin was slim. Nevertheless, if the British devalued, they would have to move 10 or 15 per cent, with possible consequences such as Mr. Hayes had outlined.

Mr. Hayes remarked that there had been no indication in the discussions at Basle that the British would be prepared to devalue by as little as 10 per cent; they seemed inclined more toward 15 per cent if they were to devalue at all.

Mr. Daane noted that the British balance of payments experience had been favorable in the first part of 1967. Mr. Coombs added that their international payments had been in balance in the fiscal year ending in June, and probably would still be in balance had there not been hostilities in the Middle East.

Mr. Wayne observed that the type of assistance to the British now under discussion represented something of a departure from the character of past System operations in foreign currencies. He asked whether it was possible to indicate the specific consequences that would follow if assistance was not given to the British and sterling was devalued. He personally was inclined to share the concerns Mr. Hayes had expressed.

Chairman Martin remarked that the consequences would be serious, but no one could specify them in quantitative terms.

Mr. Coombs added that while flat predictions of the consequences of sterling devaluation were not feasible it was possible to indicate the general nature of the major risks. First, devaluation was likely to result in large increases in the market demand for gold, perhaps to two or three times present levels. The other participants in the London gold pool undoubtedly would withdraw, and those demands would converge on U.S. gold stocks. Secondly, one could expect massive capital flows through the exchanges, with foreigners liquidating their holdings of U.S. securities. As a consequence, foreign central banks might take in as much as \$500 million or \$750 million within a week's time, posing the problem of how those dollar accruals should be financed. Obviously, the United States should have been engaged in extensive contingency planning, but to the best of his knowledge such plans had not been developed as yet. One reason to avoid sterling devaluation now would be to gain time to formulate adequate contingency plans.

Mr. Wayne then said that it would appear from Mr. Coombs' remarks that the fundamental purpose of Federal Reserve participation in new assistance to the British would be the same as that underlying all of its foreign currency operations--to defend the position of the dollar--even though the form of the assistance might be different from that used in the past. On that basis, he would support Mr. Coombs' recommendations.

Mr. Mitchell observed that an alternative to the approach Mr. Coombs had recommended would be for the System simply to indicate that it was prepared to warehouse up to $250 million of guaranteed sterling for the Treasury, rather than to agree to acquire an additional $100 million on its own account and warehouse $150 million. The responsibility for the policy would then be placed on the Treasury.

Mr. Coombs agreed that under the arrangement Mr. Mitchell had suggested the System's role would simply be one of accommodating the Treasury, and it would not be involved in the responsibility for the policy decision. He personally would see a good deal of merit in such an approach. He felt, however, that his own recommendation represented a reasonable compromise.

Mr. Maisel commented that, as Chairman Martin had noted earlier, the Committee had a responsibility not only for reaching a decision regarding System participation in any U.S. assistance to the British but also for giving the Administration its best advice on the general problem. On the latter, it was his view that the United States was overstaying its policy position with respect to sterling. Banks could go bad if they took a fixed position and failed to reappraise it. In his opinion sterling should be devalued; the present parity could not be held indefinitely. Over the long run the consequences of continued gradual drains were likely to be worse than those produced by the shock of a sterling devaluation now. The problem of upward pressure on the free market price of gold might be met by establishing a two-price system for gold, and that possibility was worth considering in connection with contingency planning. However, if the Administration did not accept such advice and decided to try to put together a package of additional credit assistance, he would be prepared to go along with Federal Reserve participation along the lines recommended by the Special Manager.

Mr. Brimmer said that he disagreed with Messrs. Robertson and Maisel on the role that the System should play in giving advice. He was aware of no reason to conclude that the underlying economic situation in Britain had deteriorated to the point at which sterling was over-valued at its present parity for longer-run purposes. The most significant fact was that the economic measures the British authorities had taken, in accordance with advice they had received from this country and elsewhere, appeared to be taking hold. In his judgment, the United States should help the British follow through on those measures.

With respect to Mr. Coombs' specific recommendation, Mr. Brimmer saw no advantage in confining the System's participation to warehousing guaranteed sterling acquired by the Treasury. Mr. Coombs had reported that an increase of $100 million in authorized System holdings of guaranteed sterling could be justified in terms of market considerations. That being the case, Mr. Brimmer would favor having the System participate directly in the arrangement, along with the Treasury, on the basis Mr. Coombs had recommended. If it was the Government view that that would reflect a proper stance, he would support it.

Chairman Martin asked Mr. Hackley whether he saw any legal problems in connection with Mr. Coombs' recommendation.

Mr. Hackley replied that he was handicapped in offering an opinion on that question because he was not sure he understood completely all of the ramifications of the proposal.

If there were any legal questions they probably would arise from the fact that under the language of the Federal Reserve Act the justification for System foreign currency operations was based on their character as open market operations undertaken to deal with such problems as short-run disturbances in the foreign exchange markets. An extension of longer-term credit by the System to the Bank of England--even if ultimately for the purpose of safeguarding the value of the dollar--was of a character quite different from open market operations. There was no express authority in the Act for the Federal Reserve to extend credits to foreign banks, although such an action might be justified under the authority for the Federal Reserve Banks to open accounts with foreign banks. There was a precedent for a longer-term System credit to a foreign central bank; in 1925 a $250 million, two-year credit had been granted to the Bank of England. However, the legality of that credit, which incidentally had not been drawn on, was later questioned in the Congress. In summary, he was not saying there was any serious legal question, but his comments reflected the kinds of considerations that were running through his mind.

Mr. Coombs asked whether Mr. Hackley would contest the legality of the Account Management's existing authorization to hold up to $200 million of guaranteed sterling, or its existing authorization to warehouse up to $200 million of foreign currencies for the Treasury.

Mr. Hackley replied in the negative.

Mr. Coombs then asked whether Mr. Hackley would question the legality of increasing the authorized amount of guaranteed sterling holdings from $200 million to $300 million.

Mr. Hackley indicated that in his opinion such an increase in the authorization probably would not involve greater legal questions than now existed.

Chairman Martin observed that it was his impression that a majority of the Committee was prepared to participate with the Treasury in assistance to Britain if the Treasury so requested, along the general lines Mr. Coombs had recommended. Perhaps it would be desirable for the Committee to plan on holding a telephone conference meeting to discuss the question of specific amounts when the negotiations were at a later stage.

Mr. Robertson commented that a decision was likely to be required speedily when that stage was reached. Accordingly, it might be best for the Committee to vote on the matter today, but leave the decision as to whether its action should be implemented to the judgment of Chairman Martin, in light of the position taken by the U.S. Government in the current negotiations.

Messrs. Hayes and Wayne concurred in Mr. Robertson's suggestion.

By unanimous vote, and subject to a determination by Chairman Martin that such actions were in accordance with the position of the U.S. Government in the current international negotiations concerning sterling, the Committee (a) approved an increase from $200 million to $300 million equivalent in the limit on System Account holdings of sterling purchased on a covered or guaranteed basis in terms of the dollar under agreement with the Bank of England; (b) approved an increase from $200 million to $350 million equivalent in the limit on outstanding System Account forward commitments to deliver foreign currencies to the Stabilization Fund, and thereby also effectively increased by a maximum of $150 million equivalent the amount of foreign currencies that could be held spot or purchased forward for the purpose of fulfilling outstanding System Account forward commitments; and (c) authorized forward commitments by the System Account to deliver to the Stabilization Fund foreign currencies in which the U.S. Treasury did not have outstanding indebtedness.

In consequence of the foregoing action, and effective as of the date of the determination by Chairman Martin specified therein, the necessary amendments to paragraphs 1B(3) and 1C(1) of the authorization for System foreign currency operations were approved unanimously. With these amendments, on such a determination the affected paragraphs would read as follows:

1B(3). Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $300 million equivalent.

* * *

1C(1). *Commitments to deliver foreign currencies to the Stabilization Fund, up to $350 million equivalent.*

Secretary's Note: The amendments to paragraphs 1B(3) and 1C(1) of the authorization described above became effective on November 21, 1967, and November 22, 1967, respectively, upon determinations by Chairman Martin that such actions were in accordance with the position of the U.S. Government.

Chairman Martin then observed that if the British decided that sterling should be devalued, they might well ask for some interim assistance from the System under the swap line.

Mr. Coombs remarked that if the British should devalue sterling he would hope that they would proceed within a matter of weeks to repay their outstanding short-term debt to the System. In view of the fact that the dollar was likely to come under severe pressure after sterling devaluation, he personally would have reservations about the desirability of increasing the System's already sizable short-term credits to the Bank of England. That would result in putting more dollars into the market at a time when the success of the sterling devaluation was in doubt. He would hope that the bulk of any necessary assistance to the British after devaluation, if that occurred, would be provided by the Fund.

Mr. Daane asked whether Mr. Coombs would contemplate any role for the System's swap arrangement with the Bank of England in the period of unsettlement that undoubtedly would follow a devaluation of sterling. The British cash position was already low; what response would Mr. Coombs propose be made if they asked for further short-term assistance?

Mr. Coombs noted that there was still a margin of about $500 million available to the British under their swap line with the System. In reply to Mr. Daane's further inquiry as to whether Mr. Coombs would recommend against even a temporary addition to that margin, Mr. Coombs said that it was hard to visualize the precise consequences that would follow a sterling devaluation, but it was possible that enormous pressures would converge on the dollar. If that were the case, it would seem inconsistent to extend further short-term credit to the British. The problem underscored the need for contingency planning.

Mr. Daane said that he agreed with Mr. Hayes that it would be highly desirable for the British to avoid devaluation. If they did devalue, however, he thought the System would want to be as helpful as possible in minimizing the consequences of their action; and if extending some further short-term credit assistance to the Bank of England would be helpful in that regard, he would favor doing so.

Mr. Coombs then noted that the British would have substantial resources available to them in any case, including the $500 million margin under the swap line and residual drawing rights of $1.4 billion in the Fund. In the event of devaluation, he would favor having the System devote all of its attention to the protection of the dollar, which would not be an easy task.

Mr. Brimmer remarked that he thought there was a need for contingency planning against a possible devaluation not only in the international financial area but also in connection with possible use of domestic monetary policy instruments.

Mr. Brill noted that on two previous occasions in recent years the staff had developed contingency plans for Committee consideration in connection with possible sterling crises. Over the weekend the staff had prepared a new draft memorandum on the subject, copies of which were now available. While the Manager had not yet had an opportunity to review the draft, the Committee members might want to see it in its present form.

Chairman Martin suggested that the draft memorandum be distributed to the Committee members at this point, and that was done.1/

> By unanimous vote, the System open market transactions in foreign currencies during the period October 24 through November 13, 1967, were approved, ratified, and confirmed.

1/ A copy of the draft memorandum in question has been placed in the Committee's files.

The Chairman then asked whether Mr. Coombs had any further recommendations to lay before the Committee.

Mr. Coombs replied that he had a number of recommendations relating to swap lines and drawings. First, both the $100 million basic and $50 million supplementary swap lines with the National Bank of Belgium matured December 22, 1967. He would recommend their renewal for a full-year term, and if the Belgians were agreeable, their consolidation into a single line.

> By unanimous vote, renewal for a period of twelve months of the $100 million basic swap arrangement and the $50 million supplementary arrangement with the National Bank of Belgium, both maturing December 22, 1967, and the consolidation of the two into a single arrangement, were approved.

Mr. Coombs then noted that the $400 million swap arrangement with the German Federal Bank, which had been renewed for an interim period of approximately four months in August, would mature December 15, 1967. He recommended its renewal for a period of twelve months.

> By unanimous vote, renewal for a period of twelve months of the $400 million swap arrangement with the German Federal Bank, maturing December 15, 1967, was approved.

Mr. Coombs observed that the System's swap arrangements with central banks of Common Market countries now all had December maturities, and, except for that with the Bank of France, all had or shortly would have twelve-month terms. The other arrangements in the System's network matured at various times of the year. Of these, arrangements with the Swiss National Bank and the BIS had six-month terms, and the rest had terms of twelve months. In line with discussions at recent meetings of the Committee, he would propose to undertake negotiations with the System's swap partners other than the Common Market countries, looking toward converting the swap lines with them to twelve-months terms maturing in December.

> By unanimous vote, renegotiation of the System's swap arrangements with the BIS and the central banks of Austria, Canada, Denmark, England, Japan, Mexico, Norway, Sweden, and Switzerland, to arrange for lines having twelve-month periods and December maturities, with no change in the size of the lines, was approved.

Mr. Coombs reported that a $5 million drawing on the National Bank of Belgium would mature December 6, 1967. Also, disbursements of $50 million under the fully-drawn portion of the swap line with the Belgian Bank--which were the equivalent of a drawing--would have been outstanding for six months on December 22. He was hopeful that an agreement could be reached under which the Treasury would make arrangements necessary for repayment of drawings on the Belgian Bank as they reached the end of six-month terms--by drawing on the Fund, issuing foreign-currency bonds to the Belgians, or using U.S. gold stocks. In that connection, the Belgians had already agreed to accept a $60 million bond denominated in Belgian francs. He would recommend renewal of the $5 million drawing, which would be a first renewal. He would also recommend continuation of the $50 million disbursements under the fully-drawn portion of the swap line as an interim measure, pending completion of the arrangements for repayment.

> Renewal of the $5 million drawing on the National Bank of Belgium, and continuation of the disbursements of $50 million under the fully-drawn portion of the arrangement with that Bank, were noted without objection.

Mr. Coombs then recommended renewal of two drawings by the Bank of England, if requested by that Bank, which would mature soon. These were a drawing of $100 million maturing November 28, and a drawing of $50 million maturing November 30. He also recommended renewal of three System drawings, namely a $100 million drawing on the Bank of Italy, maturing December 19, and two $10 million drawings on the Netherlands Bank, maturing December 5 and December 14, respectively. All of these would be first renewals.

> Renewal of the two drawings on the System by the Bank of England, the System's drawing on the Bank of Italy, and the System's two drawings on the Netherlands Bank, were noted without objection.

Mr. Coombs reported that there were three System drawings which had already been renewed once but for which there seemed to be little prospect that progress toward repayment could be made before the end of the year. These were a $100 million drawing on the Swiss National Bank, maturing December 8; a $14 million drawing on the BIS, maturing November 30; and a $100 million drawing on the BIS, maturing December 7. He thought the Committee would share his view that the System should press strongly to have the Treasury make the arrangements necessary for repayment of those drawings as soon as possible after the turn of the year. In the interim, he would recommend their renewal.

> Renewal of the drawing on the Swiss National Bank and of the two drawings on the Bank for International Settlements was noted without objection.

Mr. Coombs then observed that contingency planning would seem desirable with respect to procedures for repaying the $802 million of System drawings now outstanding under the swap network if sterling was devalued. As he had indicated, it was difficult to visualize the particular events that would follow devaluation, but it was likely that among them would be tremendous pressures on the London gold market. Not only market participants but many central bankers were likely to conclude that the U.S. position--that it would maintain the present market price for gold--was untenable. Moreover, if the price of gold broke out in the London market it undoubtedly would do so in the Paris market also. Gold was of tremendous domestic importance in France. A breakout of the price of gold in Paris would thus put all parts of the French financial markets under great strain, and France might decide to follow Britain in devaluing its currency. That, of course, would magnify the tremendous pressures that were likely to be converging on the dollar.

Mr. Coombs went on to say that if the U.S. Treasury should decide in that eventuality to place an embargo on gold, repayment of the System's drawings under the swap network would not be possible unless the Treasury was willing to sell gold to the individual countries to which the System was indebted. Accordingly, he would recommend that the System move quickly to obtain an agreement in writing to the effect that, if it became necessary, the Treasury would provide the gold required to enable the System to meet its commitments. Until that point had been clarified he would recommend that the System be cautious with respect to any further drawings on the network, at least in sizable amounts.

In response to a question by Mr. Daane, Mr. Coombs said that under his recommendation the Treasury would be asked to commit whatever amount of gold would be required to repay the swap line debts of the System outstanding at the time. The amount that would be involved could not, of course, be predicted in advance. It had been clearly understood, throughout the period since the System first undertook foreign currency operations in 1962, that System drawings on its swap lines were for the purpose of avoiding or delaying purchases of gold from the Treasury by foreign central banks and governments. If an action by the Treasury prevented the System from repaying debts it had incurred for that purpose, to his mind the Treasury had a responsibility to provide the means for their repayment.

Mr. Daane commented that the Treasury might not have enough free gold to make good on the kind of commitment Mr. Combs thought should be requested.

Other members noted that the System could free additional gold for that purpose by suspending the requirement for gold backing of Federal Reserve notes, and Mr. Daane rejoined that under the Federal Reserve Act any such waiver could only be temporary. He agreed that the System would face a serious problem if the circumstances Mr. Coombs had described eventuated. However, he was not sure it was realistic to expect the Treasury to agree in writing to sell whatever amount of gold was necessary to repay the System's swap drawings, since they could not be certain now whether they would have enough free gold for that purpose.

Mr. Mitchell asked why Mr. Coombs thought that an agreement of the sort he had suggested had to be made in writing. Mr. Coombs replied that the System had asked for and received certain statements in writing from the Treasury in connection with the package of credit assistance to the British arranged in September 1966, and a far more important problem was now facing the System.

Mr. Hayes commented that the difficulty Mr. Daane had noted might be met by asking the Treasury to commit some specific amount of gold for the purpose of repaying System swap drawings. While that amount might prove insufficient, it would at least give the System some leeway.

Mr. Coombs remarked that that possibility was worth consideration. The result, however, would be to paralyze the System's swap network beyond a certain point, which would mean that gold would then have to be paid out immediately as necessary.

Mr. Daane asked whether the understanding had ever been formalized that the Treasury would take over any System debts under the swap network that had run on for six months.

Mr. Coombs replied in the negative. Nevertheless, he said, there was no question that the understanding was clear; it had been acted on whenever System swap drawings reached the end of six-month terms during the whole period the swap network had been in existence. However, he thought it would be useful to formalize the understanding now.

Mr. Mitchell remarked that he would not favor issuing an ultimatum to the Treasury. In his judgment an appropriate method for dealing with the matter at hand would be for Chairman Martin to discuss the problem with Secretary Fowler.

Mr. Coombs said he was less concerned about the precise form of the assurance than with obtaining the assurance.

Other members of the Committee then concurred in Mr. Mitchell's suggestion, whereupon Chairman Martin said that he would take up the question with the Treasury.

The Chairman remarked that the System was indebted to Messrs. Hayes, Daane, and Coombs for the long hours they had put in trying to find a solution to the problem under discussion.

Chairman Martin then observed that in light of the current international situation it seemed obvious that the Committee would not want to make any overt change in monetary policy today. No disagreement with the Chairman's statement was voiced.

Mr. Scanlon asked whether it was possible to estimate how long domestic monetary policy might be locked in by the international situation.

Mr. Coombs commented that if sterling was to be devalued, the action might be taken as early as tomorrow and probably by Friday of this week. It should be known by the weekend whether the negotiations for a new credit package to the British were likely to prove successful, although it might not be possible at that time to rule out a subsequent breakdown. If the negotiations were successful, evidence as to whether the new package of assistance was having the desired effect in turning the market situation should be available within two or three weeks.

Chairman Martin commented that the situation posed a timing problem for domestic monetary policy which was particularly serious for those members who were inclined to make an overt move toward a firmer policy. However, he did not think that any member would favor changing policy today.

Mr. Hayes indicated that he shared the Chairman's view regarding a possible policy change at this time. However, he also shared a view expressed by Mr. Scanlon that some policy change might be indicated before the date of the next scheduled Committee meeting (December 12).

The Chairman remarked that it could be desirable to hold the next meeting in two weeks, on November 28, except that a meeting of the Board with its academic consultants was scheduled for that day and a change in that date would present difficulties. Another possibility would be to agree to meet in three weeks, on December 5, rather than on December 12.

Mr. Daane noted that there was the alternative of scheduling a Committee meeting on a day of the week other than Tuesday if necessary.

Mr. Irons suggested that the Committee not attempt today to schedule any meeting before December 12, but to agree to meet on short notice if that should prove desirable. If such a meeting were held, he thought it would be desirable for the members to assemble in Washington rather than to hold a telephone conference. All of the members could reach Washington by plane with a relatively few hours of travel time.

It was then agreed that any meeting of the Committee prior to December 12, 1967 would be held at the call of Chairman Martin.

Mr. Maisel said that an increase in the Federal Reserve discount rate should be considered in connection with contingency planning against the possibility of devaluation of sterling.

Chairman Martin commented that he understood such an action was discussed in the staff memorandum that had been distributed today. The Chairman then observed that alternative A of the draft directives submitted by the staff[1/] appeared to be consistent with maintenance of the Committee's current monetary policy. He suggested that the members vote on that alternative.

> 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, while the direct and indirect effects of strikes have been retarding activity in some areas of the economy, prospects still favor more rapid economic growth in the months ahead. Although prices of farm products and foods have declined recently, upward pressures persist on industrial prices and costs. While there recently have been further inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large. The volume of new private security issues has expanded further and interest rates remain under upward pressure, reflecting in part increased doubts in financial markets concerning enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

1/ Appended to this memorandum as Attachment A.

> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified as necessary to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

The Committee then considered the procedure that should be followed during the remainder of today's meeting. It was agreed that the usual go-around of comments and views on economic conditions and monetary policy should be dispensed with, but that the Committee should hear the Manager's report and the staff economic and financial reports, and that it should take up the remaining items on the agenda.

At this point the following members of the staff entered the meeting:

Messrs. Baughman, Craven, Jones, and Koch, Associate Economists

Mr. Fauver, Assistant to the Board of Governors
Mr. Reynolds, Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Miss McWhirter, Analyst, Office of the Secretary, Board of Governors

Messrs. Eisenmenger, Link, Eastburn, Mann, Taylor, Tow, and Green, Vice Presidents of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Atlanta, Kansas City, and Dallas, respectively
Mr. Monhollon, Assistant Vice President, Federal Reserve Bank of Richmond
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

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 October 24 through November 8, 1967, and a supplemental report for November 9 through 13, 1967. Copies of both reports have been placed in the files of the Committee.

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

> The period since the Committee last met was characterized by an atmosphere of developing gloom and demoralization in the capital markets and by a Treasury financing that evoked an enthusiastic investor interest that quickly soured after the books had closed on October 30. Behind this atmosphere was disappointment and alarm about the lack of action on the tax bill, the heavy calendar of corporate and municipal issues, and the knowledge that an offering of a Federal National Mortgage Association participation certificate--which the market has come to regard as anathema--was to be forthcoming. All this raised the spectre of tight money policy in the light of what the market considers to be inevitable inflation, and there was deep and growing apprehension about capital and other direct controls. Long-term interest rates generally rose 1/4 per cent or more over the period, despite a comfortable money market and virtually unchanged short-term rates.
>
> The Treasury offering of a 15-month 5-5/8 per cent note and a 7-year 5-3/4 per cent note--to refund $10.2 billion November 15 maturities and to raise $2 billion in cash--was priced attractively on the day after the Committee last met. For the first time in many months the offering was viewed with genuine enthusiasm by investors and underwriters. Indeed there was some speculative interest in the longer note, the first to be issued under the new legislation that extended the maturity definition of a note to seven years and hence exempted it from the interest rate ceiling. Although some of the speculative fervor evaporated on October 30, the day the books were open, the longer issue was heavily

oversubscribed with an allotment of larger private subscriptions at only 7-1/2 per cent, below market expectations. With such an enthusiastic response the issue, under any normal conditions, would have been expected to sell at a premium when secondary market trading opened on Tuesday, October 31. But these are not normal times. Further pessimistic assessment of the likelihood of Congressional action on taxes in this session, an announcement of a large corporate bond offering, and realization of the imminence of a PC offering brought about another sharp shift in market sentiment of the sort that has become all too common recently. Efforts by speculative investors to dispose of their holdings soon forced the issue to a discount. Substantial purchases of when-issued securities by Treasury trust accounts probably avoided further drastic price erosion on Tuesday and Wednesday, but did not bring the new issues back to par. At the market's close last night the 5-5/8s were quoted at a discount of 7/32, and the 5-3/4s at a discount of 12/32. One unhappy result of the poor secondary market experience with the new issues, despite the Treasury's generous pricing, will probably be to make the underwriting of future Treasury issues more difficult unless market conditions improve substantially.

The rise in yields on outstanding issues of intermediate- and long-term Government securities was even more pronounced. In the 5 - 7 year area yields had risen to close to 5.95 per cent. The bellwether 4-1/4s of 1987-92 had risen to 5.80 per cent, up nearly 35 basis points since the time of the last Committee meeting, and 3/4 of a percentage point above the 1966 high in yield. The rapid rise in rates on intermediate- and long-term Government securities, however, enabled dealers to lighten their positions of securities maturing in more than 1 year from the $913 million level reached after their underwriting of the new Treasury issues to $412 million at the close of business last Friday. Dealers now have only $79 million of their allotment of $271 million of the new 5-3/4s and $291 million of their allotment of $668 million of the new 5-5/8s.

Consequently, the period ahead is burdened with only minimal even keel considerations. Late last Friday a $1 billion issue of FNMA participation certificates was announced, of which $450 million of a 26-month maturity and $200 million of a 20-year maturity are scheduled for public offering on November 28. The remaining $350 million are to be taken up directly by Government trust accounts.

While this will be the Government's last financing of calendar 1967 and the amount to be taken up by the public is substantially less than the $1 - $1-1/2 billion that had been anticipated in the market, the news was not greeted with any particular enthusiasm.

While there was pressure in the market for Government notes and bonds, the corporate market was even more sorely afflicted. Syndicate terminations resulted in upward yield adjustments ranging up to a 1/4 per cent or more. At the end of last week there was a virtual crisis of confidence among underwriters about their ability to price new issues coming to the market in heavy volume--particularly today when over $800 million corporate and municipal issues were to be offered. As you know, U.S. Steel decided yesterday to postpone its scheduled $225 million bond offering, and a large convertible issue was reduced to half the original amount. Whether this will give any real relief to the market remains to be seen. The opening report from the market today indicated a firmer tone, with recent corporate issues and long-term Governments up 1/4 to a full point. Since the opening the market has begun to fade a bit.

While long-term rates were adjusting sharply higher, the money market and short-term rates were generally stable. Indeed, part of the demand for short-term instruments could be attributed directly to the placing of funds raised in the capital markets and to investors seeking a storm cellar until the disturbances in the capital market quieted down. In yesterday's auction rates of 4.65 and 5.16 per cent were established for 3- and 6-month Treasury bills, 6 and 4 basis points, respectively, above rates set in the auction just prior to the last meeting of the Committee.

As for open market operations, even keel considerations predominated. As the written reports indicate, the System supplied a net of over $600 million in reserves to the market over the period, mainly through the outright purchase of Treasury bills although repurchase agreements were used on several occasions late in the period to meet temporary reserve needs. The bank credit proxy rose at a 12 per cent annual rate in October, well within the range of expectations current three weeks ago, and there was consequently no need to implement the proviso clause of the directive.

Looking to the future, expectations are for some slowing in the rate of growth in the bank credit proxy in November, to a 7 - 10 per cent range on Board staff estimates and somewhat below that according to estimates of the Research Department at the New York Bank. The blue book[1] notes that while the System will be supplying reserves on balance between now and the next meeting of the Committee, the precise amount is subject to more than the usual degree of uncertainty. At the moment, reserve projections made at the Board and at the New York Bank are far apart. In the most recent estimate our Research people tell us that it is possible that we may have to absorb, rather than supply, a substantial amount of reserves by mid-December. While there are a number of reasons for the disparate estimates, the chief one appears to be a more pessimistic appraisal of the Treasury's cash position by the New York staff, which envisages that Treasury balances in the Reserve Banks will have to be drawn down to zero by December 13 and that the Treasury may have to borrow a substantial amount directly from the System. The Board--and particularly the Treasury--estimates are more optimistic and I hope they turn out to be right. Otherwise, the movement in the Treasury position will eliminate System open market purchases at a time of considerable pressure in the money markets. Given a need to supply reserves, I would think it appropriate to buy some coupon issues in the weeks ahead. We shall also have to be alert to deal with any incipient disorderly market situation.

Mr. Maisel referred to Mr. Holmes' comments concerning the forthcoming offering of FNMA PC's, and asked whether the Manager was authorized by the Committee's existing instruments to make outright transactions in such securities. He also asked whether the Desk would distinguish between PC's and direct

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

Government debt with respect to even keel considerations or with respect to operations undertaken to cope with disorderly markets.

Mr. Holmes replied that in his judgment the legal authority to undertake outright transactions in FNMA PC's was quite clear, although there was some question as to whether any acquisitions of the original issue from the FNMA would come under the authority to lend directly to the Treasury or under the authority to buy U.S. Government securities in the open market. However, even though there was no legal problem about the purchase of such PC's, he would not want to undertake such operations without the Committee's specific approval. As to even keel considerations, he would not consider them to apply to an offering of PC's in the same way as they did to an offering of direct Treasury debt. Finally, if the PC offering ran into difficulties, the best procedure in his judgment would be for the Government trust accounts to support the issue. Such support operations in the current situation might lead to a need for the Treasury to borrow directly from the Federal Reserve; if so, he thought System intervention in that manner would be appropriate.

Mr. Daane said he would concur in the approach the Manager had outlined.

Mr. Brimmer asked whether Mr. Holmes meant to imply that he would want special authorization from the Committee to deal with disorderly market conditions if they developed in connection with the PC offering.

Mr. Holmes replied that he had full authority to act if the market became disorderly. His comments about trust account operations were directed to the possibility of a potential failure of the PC issue itself, and not to that of general market disorder.

Mr. Maisel remarked that direct Treasury borrowing from the Federal Reserve traditionally had been for very short periods, so that the procedure Mr. Holmes had outlined for dealing with a possible failure of the PC issue might require the Treasury to come back to the market sooner than would be necessary if the System purchased PC's directly. He thought that was one factor that should be considered among others in weighing the relative advantages of trust account purchases and System purchases if it became necessary to provide support to the PC issue.

Mr. Holmes commented that any direct Treasury borrowing from the System made necessary by trust account purchases of PC's would probably be of a short term; the Treasury was likely to have sufficient funds by about December 18 to repay such a borrowing. The Treasury would in any case be returning to the market for cash some time in January, and if the trust accounts had bought PC's the Treasury would have to raise a bit more cash at that time. Such purchases would not, however, force the Treasury to borrow at an appreciably earlier date.

Mr. Koch said that in connection with the Government securities market study the Secretariat had been planning to send to the Steering Committee very shortly a draft policy paper concerning direct System operations in Federal agency issues including PC's, and a staff study broadly discussing the market for such securities. Ordinarily the Steering Committee would review such materials before they were distributed to the Federal Open Market Committee and the Treasury, and that seemed particularly desirable in this case because the staff views were divided. However, if it was the desire of the Open Market Committee the package could be sent to everyone at the same time.

Mr. Daane said he thought it would be best to follow the customary procedure, since the question at issue involved basic, long-range considerations. Meanwhile, he would favor dealing with the immediate situation in the manner Mr. Holmes had suggested.

Chairman Martin agreed that the distribution should be handled in the usual manner.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period October 24 through November 13, 1967, were approved, ratified, and confirmed.

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

Mr. Brill presented the following introductory statement:

> At the meeting three weeks ago, the Committee asked the staff to follow up the presentation we made then--an analysis of GNP and financial flows in the context of a tax increase--with a review of what the world would look like if the tax bill did not go through. That is what we will try to do today, but with less than a full-scale chart show. For one, we haven't tried to complete integration of the very fluid international situation; there are problems enough without it.
>
> The materials distributed for today's presentation[1/] listed the major assumptions of the projection, but let me review them briefly. We assume _no_ tax increase, but the same moderate restraint on Federal expenditures as in our tax model. The social security package in the projection is the House bill--recent developments in the Senate came along too late to be incorporated. Finally, we assume a gradual move toward firmer monetary-credit conditions, the details of which we will spell out later.
>
> Just a word about the format of the GNP tables and the charts distributed to you. We have deliberately shown changes over half years, in order to avoid getting bogged down in squabbles about the precise timing pattern of prospective GNP developments. There are many uncertainties about the specific pay-out dates for social security and Federal pay hikes, about the timing of resumption of full auto production and of steel wage negotiations, and about many other elements folded into the projection. We haven't wanted to let such timing uncertainties divert the focus from the more significant aspects of the time-profile in this GNP outlook, and our charts and tables, therefore, are designed to highlight

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

broad half-year patterns, rather than precise quarterly movements.

Mr. Koch then presented the following review of the GNP projection:

Our projection of GNP has an unusual pattern. We start from a current economic situation that has a somewhat weaker feel to it than had generally been expected. The unemployment rate has risen; industrial production has declined; and retail sales have been less ebullient than anticipated. But strikes in the auto, copper, steel hauling, and agricultural machinery industries have tended to distort many of the current statistics, and we don't really know by how much.

Nevertheless, in the absence of fiscal restraint we would expect a sharp rebound in GNP to a rapid growth rate in the first half of 1968. The average quarterly growth of GNP in the first 6 months could well be over $20 billion. This strong upsurge is likely to result largely from special factors boosting inventories and incomes sharply in the next few months, factors which aren't likely to repeat later in the year. Therefore, we would expect a slowdown in the GNP rise after midyear, only partly the result of the tighter financial conditions assumed; it mainly reflects the withdrawal of the special stimulants that produce the acceleration earlier.

Prices would no doubt continue to be under heavy pressure, especially in the first half, when the GNP deflator is projected to rise at about a 3-3/4 per cent annual rate. Real growth in the first half might be at about a 7 per cent rate.

This projected rate of growth in GNP during the first half is far too fast for the economy's long-run health, and we have postulated some further financial restraint to slow it down. However, this slowing is not likely to show up until later in the year. But moderately tighter credit conditions, together with the withdrawal of temporary stimulants, would produce some cooling off in the second half and would make a start at slowing price inflation. Nonetheless, given current wage patterns and forthcoming negotiations, average prices in the second half could probably still be rising at a 3 per cent annual rate or more.

A major source of the projected uneven pattern of growth lies in inventory developments. In the first half, there will be a large make-up of auto inventories, and probably a buildup in steel and aluminum stockpiles prior to contract termination dates. And major users of copper, lead, and zinc will no doubt rebuild inventories once their strikes are over. Sharply higher final sales and rising prices would also act as inducements for inventory building.

After midyear, these special forces would largely have been played out and some liquidation, strike or no strike, is likely to occur in steel. Defense inventories may also be declining. Total inventory investment, therefore, is expected to level off, and because of this, one of the major sources of the upward momentum early in the year would be lacking.

Final sales may also display a similar pattern of a strong first half and a milder second half, although the second half moderation could be somewhat less than in the case of inventory investment. The strength in the first half would be concentrated in consumer spending. Personal incomes are likely to be bolstered not only by the rapid increase in over-all output, but also by several large exogenous income injections early in the year. Our projection assumes passage of a social security bill similar to that recently passed by the House. This bill would raise incomes by $3.2 billion, annual rate. And on February 1, minimum wage rates go up 15 per cent. Also, the Federal pay increase is still expected to pass before year end.

These special factors contribute to a sharp rise in aggregate disposable income in the first half of next year. This is expected to generate strong consumer markets, especially for durables. Auto sales would be particularly strong in the early months of the year, as buyers also make up for some deferred purchases resulting from the strike-induced shortages of the current quarter.

The advance in consumer expenditures during the first half is expected to about keep pace with income growth, and thus the savings rate would remain about unchanged.

Income changes in the second half could more nearly reflect current output developments. With inventory investment leveling off, growth in Government spending moderating, and housing being restrained by financial conditions, disposable income would grow less rapidly. We would expect this slower income growth to be accompanied by an increase in consumer spending relative to income, and thus to some decline in the savings rate. But even with reduced savings, the quarterly average dollar increase in consumer spending seems likely to be appreciably smaller than the unusually high amounts of the first half.

Projected Government purchases is another area contributing to a calmer second half. We are assuming, as we did in our "tax model," progressively smaller increases in defense spending in 1968--in line with recent trends in defense orders and in the size of the armed forces--and we also assume moderate cutbacks in other budget expenditures. These projections, if realized, would mean growth in Federal purchases at the slowest pace since the first half of 1965. Gains in State and local purchases would also taper off somewhat, reflecting cuts in grants-in-aid programs.

With Federal expenditures rising more slowly and tax receipts accelerating because of higher income levels, the projected Federal deficit on a national income accounts basis would decline. The drop is from an estimated $13 billion annual rate in the fourth quarter of this year to $10 billion in the first half and $7.3 billion in the second half of next year. These deficits are still uncomfortably high but moving in the right direction.

How much, then, would remain for monetary policy to do to reduce GNP growth to the projected rates of the second half? The most critical area to examine is residential construction. The reaction to the assumed restraint is projected to be much milder and more gradual than in 1966. Builders, we think, are likely to draw on the currently high level of commitments to sustain housing starts in the first half at a level close to that of the current half year. But then, with the assumed higher costs of borrowing and more limited availability of funds, starts might gradually decline to, perhaps, a 1-1/4 million annual rate in the second half--well above the 1966 lows. The drop in construction expenditures would be still more moderate because of rising costs and the lag between starts and expenditures.

Let me turn now to what the projected GNP growth would mean for resource use. It is likely that manufacturing output would rebound sharply early next year, following settlements of work stoppages in autos and the beginning of inventory accumulation in metals. Gains in output through midyear could be expected to be faster than the assumed 5 per cent growth in capacity and the utilization rate would rise during the first half. Capacity use might level off in the second half as real growth slows. Although higher than the current rate, capacity use next year would likely remain well below the peak of 1966.

Mainly for this reason, we do not anticipate there would be much stimulation to the over-all economy from business fixed investment during 1968. And any speed up of investment plans resulting from the higher prices and profits projected early in the year would tend to be limited by tighter financial conditions. Therefore, we have held to the 5 per cent increase in business fixed investment next year reported by recent private surveys.

While productive capacity would remain in adequate supply, labor resources are likely to continue tight. With sharply expanding output in the first half, unemployment would dip to rates experienced earlier--even though substantial gains are anticipated in the labor force. The second half slowdown in real growth would be reflected in some easing in the labor market, with unemployment rising to perhaps 4.0 per cent by late 1968. But unemployment rates for adult men and skilled workers would be expected to remain low.

Under our assumed conditions, therefore, there would likely be little easing of cost pressures next year. Wage increases might continue at recent rates, and while more rapid gains in productivity could be anticipated, unit labor costs would still be rising.

With economic activity expanding briskly in the first half of next year and with unit costs still rising, the outlook for prices would not be favorable. Industrial commodity prices are projected as rising at about a 3 per cent annual rate in the first half. The total index might go up a little less, since ample supplies of food and foodstuffs would hold down price increases in that area. Consumer prices might go up at a 3-1/2 per cent rate in the first half.

The slowdown in activity projected for the second half would take some of the heat off prices--particularly wholesale prices. And while we would still have some distance to go to get back to satisfactory price behavior, we would at least be making a start.

The main lesson I get out of this projection of economic prospects without a tax increase is that market forces later next year may well be operating to slow down activity enough so as to warrant only moderate further financial restraint on the economy early in the year. Some restraint is likely to be achieved through the operation of market forces alone, although the financial assumptions of the model would also require a follow-through in open market operations. Price pressures would be strong but if increased financial restraint could keep them from snowballing, we might find our monetary task later in 1968 easier than it was in 1966.

Mr. Brill continued the presentation with the following comments on the projections of financial developments:

The nonfinancial projection just described by Mr. Koch has in it the makings of some real tests for central banking. Failing fiscal restraint, we would likely be looking at some very large GNP numbers and rapid price movements over the next 6 months. Obviously, the Fed could not shirk its responsibility in such a situation. But neither could it expect instant success. Short of precipitating a major upheaval, domestically and internationally, there's not much that either fiscal or monetary restraint could do at this juncture that would end the inflation abruptly. The policy assumption underlying our projection, then, is one of gradual intensification of financial restraint that would hope, initially, to prevent inflationary pressures from accelerating and cumulating, and then begin to moderate them as the year progressed. And it would hope to avoid a financial "crunch" of 1966 dimensions.

Keeping our "cool" would not be easy, in the face of continued rapid increase in GNP and prices, and large demands for credit and liquid assets. The credit flows consistent with the GNP model would likely remain as large in the first half of 1968 as in the last half of this year. While Federal borrowing would decline from the exceptional volume of the past 6 months, revenues _ex_ a tax increase wouldn't be large enough to permit the usual seasonal debt repayment in the first half of 1968. On the contrary, the Treasury would have to be a net borrower over the first half year. At the same time, private credit flows would probably be rising sharply, reflecting partly the expected surge in consumer durables purchases and the rebuilding of inventories, and partly the initial response one can expect from even a gradual increase in the intensity of monetary restraint.

In the last half of the calendar year, however, we do foresee some cooling off in the credit flows--as the projected pace of GNP growth moderates, and as credit restraint begins to take its toll in private borrowing.

There isn't time today to explore all the nuances of the financial projection. Perhaps we can consider the corporate sector's flows as typifying the major elements. Corporate borrowing is projected to jump sharply in the first half with the big increase coming in bank loans. Increased levels of inventory investment provide one source of increased demands for bank loans. It is also likely that an increasing portion of corporate longer-term credit demands would take the form of term loans at banks, given the exceptionally high costs of market borrowing. Corporations have been rebuilding their relationships with banks this year for just this contingency. Nevertheless, corporate demands on the capital markets would remain uncomfortably large in the first half, not very much below the rate of borrowing in the last half of this year. We would expect a slowdown in corporate borrowing and liquid asset building as next year progressed partly in reflection of reduced financing needs, partly as fears of a fund dry-up were tranquilized.

It is reasonable to expect that a gradual move toward more restraint would initially result in some acceleration in bank credit growth, as both banks and their customers try to stock up on funds. The bank credit growth numbers would therefore continue to be large for a while. The decline projected in growth of total loans and investments during the first half of 1968 reflects mainly a decline in bank purchases of Treasury securities that accompanies the reduced rate of total Federal borrowing. The rate of bank loan growth, however, is projected to increase materially in the first half. Given the GNP pattern described earlier, we have projected total bank credit expansion in the 9 to 10 per cent range during this period, compared with the 12 to 13 per cent we now expect for the second half of this year. The effects of financial restraint on the economy and on credit flow quantities would show up later in the year; for the second six months of 1968, we are projecting bank credit growth at a $23 billion annual rate, which is in the 6 to 7 per cent range.

Growth of both money and time deposits are projected to recede only a little during the first half, in reflection of rapidly rising incomes, a high savings rate, and the initial expectational reactions to firmer monetary and credit conditions. Our time deposit projection assumes also that large denomination CD's remain competitive, and that part of the addition to corporate liquid assets takes this form.

Growth of these quantities could be expected to slow markedly in the second half: GNP growth moderates, the personal savings rate declines, and corporations trim their rate of total liquid asset acquisitions. And, by that time, the higher level of interest rates resulting from monetary restraint should be reflected in a somewhat different distribution of financial asset holdings.

Through an oversight--some might consider it a Freudian slip--I neglected to have the figures on changes in total reserves included on the charts or on the flow of funds tables. The relevant figures are as follows: The reserve growth consistent with the deposit projections would be at about an 11 per cent annual rate for the second half of 1967, dropping to a rate of about 6-1/2 per cent in the first half of next year, and then to about 4-1/2 per cent in the second half. The rapid rate of reserve growth in the current half year is inflated by the increase, after seasonal adjustment, projected in the Treasury cash balance; much of the drop in reserve growth going into 1968 is the result of our projected leveling off in the balance. If we focus only on reserves behind <u>private</u> deposits, these are projected to drop from about an 8-1/2 per cent annual rate this half year to about 7 per cent in the first half of 1968.

Turning back to the credit flow analysis, growth of nonbank savings accounts would not be immune to the forces reducing the public demands for bank deposits. Indeed, the impact would likely come earlier on thrift institution flows than on bank deposits. But what we are projecting here is much more gradual and also milder than what occurred in 1966, essentially because the projection assumes no change in competitive relations between banks and nonbank intermediaries in the markets for consumer time deposits.

The interest rate level and structure consistent with a GNP model and a set of financial flows are always rough guesses, and difficulties are magnified now by the current turbulence in financial markets. But we have made some estimates of how much higher rates might have to go to get the degree of credit restraint that was cranked into the GNP model, and to produce the financial flows just discussed. We would judge that our projection is consistent with interest rate levels of roughly 5-1/4 per cent for Treasury bills, 6-1/4 per cent for medium-term Governments, and new Aaa corporate issues pushing up to about 6-3/4 per cent. The pattern of GNP growth suggests that in the absence of more potent measures of fiscal restraint than are in the model, we would need this kind of restraint sooner rather than later. At the same time, however, the model presumes <u>gradual</u> firming of financial conditions and orderly rate adjustments. This suggests that the estimated rate levels might be targets to work towards over the next few months, rather than to achieve, say, before the end of this year.

This completes our brief sketch of an economy in which monetary policy once again would have to bear the lion's share of the job of restraining an unsustainable expansion. It's not a comforting picture,

> generally. But perhaps there is some comfort in the analysis, in that it suggests that we may not need much more monetary restraint to achieve our objectives. The record levels of interest rates in capital markets are now exercising some restraint. Those who would discount current interest rate levels because of the inflationary expectations they may incorporate must remember that rate ceilings, usury laws, and returns on mortgages portfolios are fixed in nominal terms, and it is the rise in nominal rates that threatens the ability of thrift institutions to sustain mortgage flows. Thus, I think we are relatively well positioned to move as Congressional action--or inaction--dictates.

Mr. Ellis asked what degree of confidence the staff had in its projections of Federal expenditures.

In replying, Mr. Brill said he might first note that the projections of Federal expenditures had not been changed from those used in the "tax" model both because no new information had been received from the Budget Bureau regarding the expenditure outlook, and because the use of consistent Federal expenditure projections in the two models highlighted the effect of the change in the assumption regarding taxes. As to the figures themselves, he had little basis for evaluating the reliability of the projections of defense spending. In the past, the staff had tended to rely heavily on Defense Department estimates, which had proved wrong on occasion and could be wrong again. At the moment, various types of nondefense spending were being held down severely, and the figures on total spending currently becoming available were tending to run below levels that would be consistent with the projection. That, however, might be a temporary phenomenon.

Mr. Hickman asked whether Mr. Brill could indicate the general level of free or net borrowed reserves that would be consistent with the projections for total reserves.

Mr. Brill said that the answer would depend on the particular techniques the System used to achieve the indicated degree of monetary restraint; it would vary, for example, depending on whether main reliance was placed on open market operations or whether the discount rate and Regulation Q ceilings also were modified. He had not worked out the level of marginal reserves that would be implied by some one combination of measures.

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

> The kinds of changes in the balance of payments that we can foresee dimly are not likely to cut next year's deficit significantly below this year's. Today I will not go over again the ground Mr. Reynolds covered in his discussion here three weeks ago. So far as concerns the current account, what he said on the assumption of a tax increase would hold good equally on the no-tax assumption. We hope for stability in the merchandise trade surplus, and for improvement in some other elements of the current account.
>
> The general problem of balance of payments adjustment has been getting a good deal of attention in OECD committees and working groups for several years now, and undoubtedly it will stay on the agenda. One line on which a consensus may some day form is that the European Common Market countries will have to generate net capital outflows to the rest of the world while the United States will have to enlarge its current account surplus.
>
> A few years ago it looked as if we could do the second part of that easily. But this year our trade

surplus is running lower than in either 1963 or 1964; and our competitive position, which was improving after 1960, now seems to have been worsening since 1965. The importance of a reasonable degree of price stability in the United States, if we are to make our proper contribution to international economic equilibrium, can hardly be overstressed.

It would be well not to take lightly the difficulties of the other half of the adjustment program, of developing European capital markets and enlarging European capital outflows. German Government bond yields are still almost as far above ours now as they were in 1963 and 1964. The long-run need in Germany is for tight fiscal policy, at the various levels of government, so that more private savings will be available for international investment, and so that monetary policy can safely pull German interest rates downward. But these long-run needs are hard to fit into short-run developments. The immediate dangers are that German fiscal policy next year will not be easy enough to get economic growth going properly, and that German monetary policy will be too vigilant about the distant dangers of German inflation.

All in all, the two-pronged adjustment program of which I have spoken could take another decade to work out.

I will conclude by saying a little more about how prospects for the U.S. balance of payments in the next several months would be altered by a gradual narrowing of bank liquidity and tightening of bank credit availability. The main early effects on the U.S. balance of payments would be on certain types of capital flows. Direct investment might not be much affected, nor would market dealings in outstanding equity securities. Canadian and other new foreign issues might be slowed--not necessarily by higher U.S. long-term rates, but if not, then by the cessation of the rise in U.S. long-term rates, which sooner or later will occur as the market realizes it has over-discounted the future. But the two most obvious effects would be to slow the net outflow of U.S. bank credit that has begun to develop this year, and to magnify the inflow of Euro-dollar money through American bank branches.

> Quantitatively, one might tag the bank credit effect as tending to keep next year's outflow nearer a quarter billion than the half billion dollars it might otherwise be reaching. But that is only a guess. The Euro-dollar flow is far harder to guess at. In the early part of October and again this month there have been increases in the outstanding liabilities to foreign branches, without any further widening of the rate spread between Euro-dollars and U.S. CD's; Euro-dollar supplies have probably been fed by funds moving out of sterling. I would think that the flow over the next several months will depend greatly on whether there is some restoration of market confidence in sterling, comparable, for example, with the situation in the early months of 1967. If that happens, U.S. banks might have to bid fairly strongly if they wanted to keep adding to their liabilities to branches. Whether they would want to do so might well depend on whether or not they saw a financial market crunch developing here. Without a crunch in prospect and if sterling were looking better, there might be little Euro-dollar inflow to the United States or even an outflow. If sterling continues to bleed, there will be Euro-dollars to pick up without trying. Clearly, the uncertainties about sterling make it pointless to attempt an estimate of the Euro-dollar inflow over the next several months.

Chairman Martin noted that certain staff memoranda on the subject of "even keel policy" had been distributed to the Committee on November 9, 1967, in preliminary response to the request made at the preceding meeting.[1/] He asked Mr. Holmes to comment.

Mr. Holmes remarked that he had little to add to the memoranda at this point. He would note the basic feeling of the staff that extreme caution should be exercised in making any change in the long-established procedure of maintaining an even keel in the money markets during Treasury financings, because of the fundamental

1/ Copies of the memoranda in question have been placed in the Committee's files.

questions involved of the System's relations with the Treasury and the market. As the memoranda indicated, staff work on the subject was continuing.

The Chairman asked whether Mr. Bopp, at whose suggestion the work on even keel policy had been undertaken, would care to comment.

Mr. Bopp said that his inquiry at the Committee's last meeting arose out of a concern that maintenance of an even keel during periods of Treasury financing might conflict with the Committee's fundamental obligation to maintain conditions in money and capital markets appropriate to basic economic developments and prospects. The possible conflict was not of overriding practical importance so long as Treasury offerings were infrequent, because monetary policy could be adjusted promptly when the need to maintain even keel had passed. However, when the Treasury was in the market almost continuously for refunding and new money the conflict could become serious, indeed, since there might be no time at which the System could move, especially toward greater restraint.

Since 1694, Mr. Bopp continued, when the Bank of England was founded specifically to help finance the war with France, central banks had been obliged to see to it that their governments had not failed to pay their obligations "merely" for lack of cash. Modern central banks, however, also had the obligation to conduct monetary policy in the general interest. His inquiry was a plea that the Committee re-examine its even-keel policy in the light of its dual responsibilities.

Mr. Bopp said that he was enthusiastic about the speed with which the authors of the several memoranda had produced significant documents. He hoped, incidentally, that he was not the only person in the room who was surprised by the extent of fluctuations in money market variables during even keel periods, as revealed in the memoranda. It seemed that almost anything could happen--and that almost everything had in fact happened--while an even keel was being maintained.

Mr. Bopp remarked that the Committee needed additional analysis before making any recommendations as to possible modifications in its even keel policy. For example, what compelling reason--other than convenience and habit--was there for the Treasury to allow two weeks between the dates of subscription and payment in the case of coupon issues and only one week in the case of bills? Would not the size of the issue, rather than the type of security, be the relevant consideration?

Meanwhile, Mr. Bopp concluded, he wanted to thank the staff for the illuminating memoranda they had prepared.

Chairman Martin agreed that the memoranda were excellent. He asked whether there were any further comments on the subject at this time and none was heard.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, December 12, 1967, at 9:30 a.m.

Chairman Martin then suggested that the Committee discuss the proposed tentative schedule for its meetings in 1968, consideration of which had been postponed at the preceding meeting. He invited Mr. Ellis to open the discussion.

Mr. Ellis remarked that the staff, in its memorandum on the subject of October 18, had indicated that it still thought the tentative 14-meeting schedule originally distributed on September 22 was preferable to the 12-meeting schedule that had been suggested by some members when the Committee first discussed the matter at its October 3 meeting. The 14-meeting schedule involved inter-meeting intervals of three and four weeks, and he wondered whether meeting after an interval as short as three weeks did not represent an effort to introduce more "fine tuning" of the economy than was feasible. He would urge the Committee to consider whether it could not discharge its responsibilities as well by meeting twelve times a year, on the third Tuesday of each month. In that connection, Mr. Mitchell had noted at the October 24 meeting that no one time of the month appeared markedly superior to other times from the point of view of data availability. While such a statement might hold for national data, in terms of the availability of regional data meeting dates shortly after midmonth had advantages.

Mr. Ellis agreed that 1968 might not be the appropriate year to change to a twelve-meeting schedule. Also, as the staff memorandum had noted, Committee meetings on the third Tuesdays of some months would conflict with the meetings of the Federal Advisory Council with the Board, which under present FAC by-laws were scheduled for the third Tuesdays of four months of the year. Looking toward 1969, however, he would suggest that the question be raised with the FAC soon as to whether they could amend their by-laws to specify different meeting dates--perhaps second Tuesdays--to free third Tuesdays for FOMC meetings.

Mr. Hayes said he would second Mr. Ellis' suggestion. All things considered, in his judgment, there were some real advantages in holding Committee meetings twelve times a year, shortly after the middle of each month, and no significant disadvantages. Obviously, Committee meetings on the third Tuesday of each month would conflict with FAC meetings as presently scheduled, and it would be well to give the FAC plenty of time to see whether they could adjust their schedule. As for 1968, he thought the schedule the staff had originally proposed had been worked out well, and he had no objections to it.

Mr. Hayes then noted that in a memorandum dated October 18, 1967, dealing mainly with the question of the date of the Committee's organization meeting, the General Counsel had raised the possibility of modifying the present procedure under which newly-elected members of the Committee and most alternate members take their oaths of office in Washington on the day of the organization meeting in early March. It had been Mr. Treiber's practice each year to take his oath as the alternate member from the Second District at the Federal Reserve Bank, on March 1. No objections had been raised to that procedure on legal grounds, and he thought that the same practice might usefully be followed by all newly-elected members and alternates. The advantage, of course, was that new members would be qualified to act on any Committee matters that arose between March 1, the day their terms began, and the date of the Committee's organization meeting.

Mr. Hackley remarked that the legal staff had given considerable thought to the matter and had found no legal objection to a procedure under which newly-elected members and alternates would take their oaths of office at their own Federal Reserve Banks. The practice of executing the oaths at the Board's offices on the date of the organization meeting had simply developed as a custom. Some potential problems might be avoided if the newly-elected members took their oaths on March 1; indeed, they might even take them prior to that date.

Chairman Martin then suggested that the Committee agree on the tentative schedule for its 1968 meetings as originally proposed in the staff memorandum of September 22. At the same time the staff would be asked to study the proposal for a twelve-meeting schedule for 1969, including any problems posed by the meeting dates of the Federal Advisory Council.

There was agreement with those suggestions.

Mr. Mitchell commented that the Committee might also give some consideration to possible changes in the form of its meetings and the documentation for them. He was troubled by the length of the meetings and by the magnitude of the staff effort in preparing the green book and other reports. The Committee received an overwhelming volume of material in connection with each meeting. He thought there was a good deal to be said for holding Committee meetings more often than monthly, but he would favor shorter meetings with a smaller volume of documentation over-all. In the latter connection, one possibility would be to have full documentation for certain meetings--perhaps those held at bi-monthly or quarterly intervals--and more limited materials prepared for intervening meetings.

Mr. Daane agreed with Mr. Mitchell that some means should be sought for simplifying Committee procedures. The volume of staff time that now went into preparing reports for the Committee was so large that it adversely affected the staff's flexibility in meeting its other responsibilities. Moreover, there was a great deal of repetition within the staff materials, and also in oral statements at the meetings, which it would be useful to avoid. In addition to supporting Mr. Mitchell's suggestion for exploration of possible changes in the forms of Committee meetings and staff materials, he would favor having the staff study the proposal for holding twelve meetings a year.

Mr. Maisel thought Mr. Mitchell's suggestion was well taken. He added that one consideration relevant to the question of frequency of meetings was the lag in the internal operations of the Committee. Quite often the analyses presented in the go-around statements that members prepared for a particular meeting represented their reactions to issues raised at the previous meeting. The longer the interval between meetings, the more serious would be that lag.

Mr. Hayes said he was puzzled by Mr. Maisel's comment. He thought the positions that members took at each meeting were based on their reactions to the economic circumstances and outlook at the time, as reflected in the latest available data and projections. That would be the case, in his opinion, whatever the intervals at which meetings were held.

Mr. Mitchell agreed that the members' views on policy did reflect the current situation--that certainly had been the case in connection with the policy decision today. Their comments also tended to reflect the discussion at the meeting itself. Nevertheless, he thought Mr. Maisel had a valid point, because often some time was required to absorb fully the significance of a particular economic development or a particular line of argument. Thus, a member's immediate reaction at a meeting might be more fully developed and perhaps modified by the time of the next meeting.

Mr. Brimmer said he would not favor a twelve-meeting schedule, since it would involve a number of five-week intervals during the year. He thought a schedule of the present type, with meetings at intervals of three or four weeks, was preferable. He noted that the Committee had agreed to experiment with occasional longer meetings to provide the time for full discussions of staff projections, and that it had held the first such meeting on October 24. If that program were continued the intervening meetings could be shortened and the amount of documentation prepared for them reduced.

Mr. Hayes said he personally doubted that meetings scheduled at intervals of three or four weeks had any particular merit relative to monthly meetings. One advantage of a monthly schedule was that it would reduce the burden of travel on the Reserve Bank Presidents and staff, some of whom were at a considerable distance from Washington.

Mr. Daane commented that lessening the frequency of Committee meetings somewhat might reduce rather than increase the problem of internal lags which Mr. Maisel had noted. He agreed that there were such lags, but he thought they were partly the consequence of the formidable volume of documentation prepared for each meeting. By meeting less frequently the Committee might be able to focus closely on the central issues for policy formation, as it had today.

Mr. Wayne recalled that until 1955 the Committee had followed the practice of meeting as seldom as four times a year, with the executive committee holding frequent intervening meetings. When the executive committee was abolished in June 1955, the full Committee began meeting at three-week intervals. That interval had been adopted experimentally; the purpose was simply to meet often but at no fixed time of the month. On the problem posed at present by the length of the meetings, he thought it would be highly desirable for the Reserve Bank Presidents to comment somewhat less extensively at each meeting on conditions in their respective Districts, perhaps making more detailed reports at every other meeting. While the Committee might agree on other changes of format, that change in itself would add to the time available for considering particular current problems of policy.

Chairman Martin suggested that the staff be asked to study the several suggestions for changes in procedure that had been made today.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

November 13, 1967

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on November 14, 1967

Alternative A

The information reviewed at this meeting indicates that, while the direct and indirect effects of strikes have been retarding activity in some areas of the economy, prospects still favor more rapid economic growth in the months ahead. Although prices of farm products and foods have declined recently, upward pressures persist on industrial prices and costs. While there recently have been further inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large. The volume of new private security issues has expanded further and interest rates remain under upward pressure, reflecting in part increased doubts in financial markets concerning enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to sustainable economic expansion, recognizing the need for reasonable price stability for both domestic and balance of payments purposes.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in the money market; but operations shall be modified as necessary to moderate any apparent tendency for bank credit to expand significantly more than currently expected.

Alternative B

The information reviewed at this meeting indicates that, while the direct and indirect effects of strikes have been retarding activity in some areas of the economy, prospects still favor more rapid economic growth in the months ahead. Although prices of farm products and foods have declined recently, upward pressures persist on industrial prices and costs. While there recently have been further inflows of liquid funds from abroad through foreign branches of U.S. banks, the balance of payments continues to reflect a substantial underlying deficit. Bank credit expansion has continued large. The volume of new private security issues has expanded further and interest rates remain under upward pressure, reflecting in part increased doubts in financial markets concerning enactment of the President's fiscal program. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions, including bank credit growth, conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to moving toward somewhat firmer conditions in the money market, and toward still firmer conditions if bank credit appears to be expanding significantly more than currently expected.