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 Monday, November 27, 1967, at 9:30 a.m., at the call of Chairman Martin.

PRESENT: Mr. Martin, Chairman1/
Mr. Brimmer
Mr. Francis
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Sherrill
Mr. Swan
Mr. Wayne1/

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

Mr. Irons, President of the Federal Reserve Bank of Dallas

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Baughman, Garvy, Hersey, Koch, Partee, and Solomon, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Cardon, Legislative Counsel, Board of Governors
Mr. Fauver, Assistant to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Reynolds, Adviser, Division of International Finance, Board of Governors

1/ Left the meeting at the point indicated.

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. Bilby, Eastburn, Mann, Brandt, and Tow, Vice Presidents of the Federal Reserve Banks of New York, Philadelphia, Cleveland, Atlanta, and Kansas City, respectively
Mr. MacLaury, Assistant Vice President, Federal Reserve Bank of New York
Mr. Deming, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Anderson, Financial Economist, Federal Reserve Bank of Boston
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 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 statement week ended November 22, 1967. A copy of this report has been placed in the files of the Committee.

In supplementation of the written report, Mr. MacLaury remarked that the financial world was quite different today from what it was when the Committee last met, less than two weeks ago: sterling had been devalued and, to paraphrase Secretary Fowler, the dollar had moved to the forefront in the defense of the international financial structure. Mr. Coombs was in Europe, along with Under Secretary Deming, Governor Daane, and President Hayes, trying to hammer out an agreement among the financial allies of the United States for dealing with the unprecedented pressures in the London gold market that broke loose last week, as anticipated, following sterling's devaluation. In a past report to the Committee Mr. Coombs had described the sterling and gold markets as like twin time bombs: if one exploded, the other would explode as well. That had now happened.

Mr. MacLaury said he would comment first on developments in the gold market. In the week preceding sterling's devaluation, the pool's losses amounted to $68 million; this past week, the pool lost $578 million. The latter week started relatively slowly since the London market was closed on Monday. In order to forestall any breakout of the price that day in other continental markets--mainly Zurich and Paris--arrangements had been made on Sunday to have gold made available through the Bank for International Settlements acting for the Bank of England as Manager of the pool. Total sales by the pool on Monday amounted to $27 million, a large figure by former standards but small in comparison with the rest of the week. With the reopening of the London market on Tuesday, demand increased each successive day. Sales on Tuesday were $44 million; on Wednesday, $106 million; on Thursday, $142 million; and on Friday, $259 million. Although the demand for gold would have been heavy in any case following the sterling devaluation, a report on Monday in the Paris newspaper Le Monde to the effect that the Bank of France had withdrawn from the gold pool and that two other central banks (of Belgium and Italy) were about to do the same undoubtedly exacerbated the situation, as no doubt it was intended to. In point of fact, the pool members had continued to support the pool's operations this past week, and had agreed to make contributions to the pool up to a cumulative total of $1,370 million. As of Friday evening, a leeway of only $113 million remained under that total. However, yesterday in Frankfurt there was agreement not to let the pool operations falter, as was indicated in the public statement issued yesterday by Chairman Martin and Secretary Fowler.1/ Turn-over in the London market was only about $35 million thus far today, down considerably from the levels of last week.

1/ The statement referred to is given below:

> "The Secretary of the Treasury and the Chairman of the Federal Reserve Board made available a communique issued in Frankfurt, Germany, today which reads as follows:
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> > "'The Governors of the Central Banks of Belgium, Germany, Italy, Netherlands, Switzerland, United Kingdom and the United States convened in Frankfurt on November 26, 1967.
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> > "'They noted that the President of the United States has stated:
> >
> > "'"I reaffirm unequivocally the commitment of the United States to buy and sell gold at the existing price of $35 per ounce."' (Footnote continued on next page)

As yet, Mr. MacLaury noted, the recent huge gold sales by the pool had not been reflected in gold losses by member countries. That was because the Bank of England provides the supply of bars to the London market from its own stocks during the month, with settlement by the other members of the pool early in the succeeding month. Thus, while the Treasury might get through this month without showing any reduction in its gold stock (and with perhaps $50 million in the Stabilization Fund), it would face the prospect of selling $434 million of gold to the Bank of England early in December, representing the U.S. share of the pool's losses of $723 million thus far in November. That figure made no provision for the possibility that France might convert all or part of its November dollar gains into gold, as reported in the press last week. Such conversion could cost another $200 to $300 million of gold, judging by the New York Bank's estimate of French reserve gains. Obviously, statements of central bank solidarity such as that issued yesterday

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"'They took decisions on specific measures to ensure by coordinated action orderly conditions in the exchange markets and to support the present pattern of exchange rates based on the fixed price of $35 per ounce of gold.

"'They concluded that the volume of gold and foreign exchange reserves at their disposal guarantees the success of these actions; at the same time they indicated that they would welcome the participation of other central banks.'"

in Frankfurt would help calm market fears temporarily, and it was his hope that last week's surge of demand would not be repeated this week. But it would take more than statements to calm the market if the Treasury's published figures began to indicate U. S. gold losses of several hundred million dollars. In the short run the Treasury might be able to limit the size of the losses shown by the published figures by borrowing gold from the BIS through a temporary gold-dollar swap. Such a palliative would be futile, however, unless action was being taken at the same time to deal with the problem of gold losses through the London market. Such action was what the U.S. representatives were now working toward at the current meeting in Frankfurt. It went without saying, however, that the ultimate restoration of confidence in the dollar would await action to correct the U.S. balance of payments deficit.

Before leaving the subject of gold, Mr. MacLaury said, he should mention that with the cooperation of the U.S. Air Force the Treasury and the Federal Reserve were involved in a crash program to airlift gold from this country to London. Although under normal circumstances the Bank of England supplied market demand during the course of the month from its own reserves, private demand had been so heavy this month that the Bank of England's readily available supplies in London had been exhausted with last Thursday's transactions. Arrangements had been made to have gold held in London by the German Federal Bank and the BIS placed at the disposal of the

Bank of England, in sufficient quantity to meet immediate demands, while "operation airlift" got into gear. While he would not go into the details, it was a formidable task to ship hundreds of tons of gold across the Atlantic and process them at the other end.

Turning to sterling, Mr. MacLaury noted that the New York Bank had provided a fairly detailed account of the final days of the $2.80 parity in its written report on recent foreign currency operations. As Mr. Coombs had mentioned at the previous meeting of the Committee on November 14, various types of credit packages were being discussed just prior to and at the time of the last Basle meeting on the weekend of November 12. In essence, the impasse was that continental central banks refused to provide credit to the British in the form of guaranteed sterling holdings although some of them were prepared to provide credit in the form of currency swaps; the Bank of England, however, was not prepared to take on any more short-term debt. At the initiative of Governor Carli of the Bank of Italy, a proposal for a $3 billion British standby credit from the Fund was considered, only to be rejected by the Fund itself, and possibly by the British Government as well, since it feared that unacceptable conditions might be attached to long-term credit in any form other than guaranteed sterling. The New York Bank's written report had quoted from Prime

Minister Wilson's explanation to the British public of the reasons for devaluing the pound. He (Mr. MacLaury) would be remiss if he did not add that President Stopper of the Swiss National Bank, echoing a similar statement attributed to the German Federal Bank, had said explicitly last week that the British could have had additional credit if they had wanted it, and that insofar as central bank credit was involved, no unacceptable conditions would have been attached. The blunt fact was that the British Government made the decision to devalue on its own accord.

Prior to the devaluation, Mr. MacLaury continued, personnel at the New York Bank were awaiting word of completion of a credit package as anxiously as was the market. On Thursday of that week, however, their hope for maintenance of the existing sterling parity began to fade fast when the news ticker carried a report that Chancellor Callaghan had refused in Parliament to confirm or deny rumors of a credit package. Market participants similarly interpreted that refusal as confirmation of their worst fears, and they sold sterling from morning till night on Friday at an unbelievable rate, draining more than $1 billion from British reserves on that single day. Less than half that amount was promptly reflected in reserve gains of major countries, and the presumption was that much of the difference was placed temporarily in the Euro-dollar market or represented short selling.

On Monday following devaluation, Mr. MacLaury said, the exchange markets were, of course, stunned and there was little real trading, especially since London was closed. Market participants were preoccupied with trying to assess the damage, keeping track of what other currencies were being devalued, straightening out trading positions in sterling (a subject to which he would return in a moment), and, of course, watching developments in the gold market. Tuesday was the first day of real trading, and even then quotations for most currencies were wide and forward quotations non-existent. Sterling, however, was at the new ceiling of $2.42 and the Bank of England took in $500 million. During the final three days of the week, however, British reserve gains were not very large, given the circumstances; they aggregated about $250 million, excluding the dollars taken in against market sales of gold. Thus, in the first week following devaluation the British had recouped less than three-quarters of what they lost on the preceding Friday alone. Although it was too early to tell, the British might have some uneasy times before they were out of the woods, despite the 14.3 per cent devaluation and apparently stringent domestic measures.

As the Committee knew, Mr. MacLaury remarked, last Tuesday the Bank of England drew the full $500 million still available under its swap line with the System to make payments against their purchases of sterling on the preceding Friday. At the same time the British liquidated their remaining holdings of U.S. agency securities, paying out the proceeds. He expected that the Bank of England would be repaying some amount of its swap drawings today. Although he did not know that amount at the moment, part of it probably would be financed by use of dollars taken in against market gold sales. If so, the British would need additional dollars by the date of the pool settlement, and hopefully they would have acquired them in market transactions.

Mr. MacLaury then said that he would digress from his report on market developments at this point to discuss the sales of sterling to U.S. commercial banks on a short-term (two- or three-day) swap basis on Tuesday and Wednesday of last week, for System and Treasury account respectively. A separate memorandum on that technically complicated question was in preparation and would be distributed to the Committee as soon as Mr. Coombs had had a chance to review it. However, since the Committee would be asked to ratify and confirm those transactions today, he would do his best to explain the matter succinctly.

On the Friday prior to sterling's devaluation, Mr. MacLaury observed, banks were inundated with offers of forward sterling from their commercial customers and correspondent banks. Since for all practical purposes it was impossible for the banks in turn to lay off those offers in the forward market, they had two alternatives: they could refuse to quote a rate to their customers, or they could lay off sterling in the spot market where the Bank of England was a steady buyer. Even in normal market circumstances, the latter was the method used by the banks to keep their over-all positions even, adjusting the time spectrum of their "books" subsequently. Under the highly abnormal circumstances that day, the banks found they had no choice but to sell out cash sterling balances they did not have, anticipating that they could buy in those balances on Monday in time to meet delivery commitments Tuesday. It was worth emphasizing that the banks were not going short on sterling; rather, they were acting to avoid being long as a result of customer sales of sterling to them. When the British suddenly declared Monday to be a bank holiday in London, many of the U.S. banks in question found that they were not going to be able to deliver on their sterling commitments on Monday in the manner they had anticipated. Their predicament was brought to the attention of the New York Reserve Bank on Sunday and it was taken up by the Foreign Exchange Committee the following morning. That Committee, composed mainly of the heads of the foreign departments of the major New York banks, recommended that the Federal Reserve survey banks to ascertain the dimensions of the problem, and that it act to prevent defaults or losses by those banks that could certify that their short cash positions were attributable to transactions undertaken at the initiative of their commercial customers or correspondent banks and were not the result of over-all short positions undertaken by the banks themselves.

The New York Reserve Bank staff was convinced that the case put to it was legitimate, Mr. MacLaury noted. It was also convinced that failure on its part to act would be detrimental to the reputation of the New York foreign exchange market and--unjustly--to the banks involved, and would also threaten to produce disorderly conditions in the exchange markets when sterling trading opened on Tuesday. Because of the limited time available, the New York Bank's staff simultaneously surveyed the positions of foreign exchange banks throughout the country with the assistance of the other Reserve Banks, sought the views of the Bank of England--which concurred in a proposal that the System use holdings of guaranteed sterling for the operation--and submitted the proposed transaction for approval to the Subcommittee of the Federal Open Market Committee established by paragraph 6 of the authorization for System foreign currency operations. The Subcommittee's approval was sought because an operation of the type under consideration was not explicitly authorized by the foreign currency directive, and there was insufficient time to consult with the members of the full Committee.

With the concurrence of a majority of the Subcommittee, Mr. MacLaury observed, the New York Bank sold to commercial banks a total of $87.2 million of sterling, value Tuesday, at $2.40 and repurchased an equivalent amount, value Friday, at $2.3925. The spread of 75 points between the two prices reflected the Bank's estimate of the market discount, as closely as that could be gauged under the circumstances. A similar operation, in the amount of $22.2 million, was carried out for Treasury account, value Wednesday, with repurchase value Friday. He was convinced that those operations did much to prevent disorderly conditions in the exchange markets that would otherwise have resulted from the unanticipated closing of the London market, without in any way bailing out speculators against sterling. Certificates from the banks involved attesting to their positions in sterling were on file at the Federal Reserve Bank of New York.

Before turning to other currencies, Mr. MacLaury said, he would note that the New York Bank had sold to the Bank of England the small System and Treasury balances of uncovered sterling on the Friday preceding devaluation. The United States therefore had suffered no exchange losses from its support operations in sterling. Also, as the members knew, this past week Chairman Martin had activated the authorization approved by the Committee at its preceding meeting to increase System holdings of covered or guaranteed sterling from $200 to $300 million equivalent, and to warehouse an additional $150 million equivalent of foreign currencies for the Stablilization Fund. On the basis of those actions and a Treasury authorization, the United States had made available to the Bank of England $500 million of additional credit facilities--$400 million for Treasury account and $100 million for System Account--in the form of a swap arrangement, entirely separate from the System's present $1,350 million facility. That $500 million credit line was part of the $1,500 million package of credits announced by the U.K. authorities as a supplement to its requested standby of $1.4 billion from the IMF to back up its new parity.

With respect to other currencies, Mr. MacLaury continued, it was difficult to make generalizations. There were major inflows to continental central banks on two days--the Friday preceding sterling's devaluation, as he had mentioned, and the Friday following (November 24). In between, there were either some losses, notably by the Netherlands, or small gains. Over the six trading days from Friday, November 17 through Friday, November 24, there were net increases of reserves by France, of $315 million; Germany, $303 million; the Netherlands, $116 million; Belgium, $55 million; and Switzerland, $75 million. On the other hand, it was known that Sweden and Japan lost about $50 million each during the week following devaluation, and Canada lost $86 million. Those flows of dollars had required certain operations by the New York

Bank, for either System or Treasury account. In the case of the Netherlands, since the swap line with the System was fully utilized prior to developments in the period, it was agreed that the Treasury would provide temporary swap facilities to cover any dollars taken in by the Netherlands Bank. A total of $126 million was covered in that fashion, with $40 million of that amount first repaid and then redrawn as the Netherlands Bank lost dollars immediately following devaluation and regained roughly the same amount on Friday. In addition, on Thursday and Friday the Netherlands Bank sold forward guilders for System and Treasury account totaling $16 million each.

In the case of Belgium, Mr. MacLaury observed, the System first bought $10 million equivalent of Belgian francs from the National Bank, value November 20, in a transaction unrelated to market developments, and then resold the same amount the following day to absorb dollars taken in on the Friday prior to devaluation. The Belgian arrangement had been fully utilized at the beginning of the period, but the Treasury issued a Belgian franc bond of approximately $60 million equivalent on November 24, thus freeing that amount under the swap arrangement. It had been Mr. Coombs' intention not to use that leeway since the Belgian arrangement was the one swap line on which drawings had been outstanding for more than six months. However, the choice was either to use the leeway or to sell gold; and given that choice the decision was made to use the leeway, at least temporarily. Accordingly, this past Friday the System drew approximately $41 million equivalent under the Belgian arrangement, using the proceeds to cover dollars taken in by the National Bank on Thursday and Friday of last week.

In transactions unconnected with recent developments, Mr. MacLaury remarked, the New York Bank acquired nearly $20 million equivalent of Swiss francs from the Swiss National Bank and the Bank of England and used them to reduce the System's swap drawings with the Swiss National Bank and the BIS to $123 million and $119 million equivalent, respectively. However, the Swiss National Bank took in nearly $70 million on Friday, and the chances were that cover would have to be provided for that amount.

In conclusion, Mr. MacLaury noted that it was hardly necessary to say that conditions in the gold and foreign exchange markets had been about as turbulent as one could imagine during the past two weeks. Whether or not less stormy weather lay ahead remained to be seen. One could say with certainty, however, that the problems ahead would be more manageable so long as central banks stood together, and that was the importance of yesterday's Frankfurt statement. He would make some recommendations intended to give further effect to that cooperation at a later point today. He had talked by phone with Mr. Coombs just before the meeting and could report that Mr. Coombs had been encouraged by the developments over the weekend.

Mr. Maisel asked Mr. MacLaury to amplify his remarks about foreign exchange market developments last Friday, and to comment on the sources of demand in the gold market and the methods that had been used in financing purchases of gold.

Mr. MacLaury replied that exchange market developments on Friday were quite different from those earlier in the week. In contrast to the small gains or losses of reserves by European central banks in the days immediately following the devaluation of sterling, there were large dollar gains on Friday. For example, the central banks of Germany and France took in over $100 million each on that day; the Netherlands Bank, about $40 million; and the Belgian National Bank, about $50 million. His interpretation of the week's developments was that in varying degree the continental currencies were less strong after devaluation than they had been before, so that there was an abatement or cessation of inflows to the central banks. Also, the markets' attention was focused on gold during that period, with participants speculating on a rise in the market price of gold. On Friday, however, perhaps as a result of developments in the gold market and the attendant publicity, there seemed to have been a wave of nervousness about the dollar; people simply wanted to convert holdings into their national currencies, without necessarily having any rational belief that those currencies would appreciate relative to the dollar.

With respect to the second question, Mr. MacLaury continued, most of the recent gold purchases were made through Swiss banks and the sources of demand were not known. There were rumors in the market that much of the demand in the past week originated in Paris and Moscow. It seemed clear that some Iron Curtain countries were buying, although not necessarily Russia. Communist China had bought $5 million of gold this morning. As to how the gold purchases were financed, as he had noted, less than half of the funds that moved out of sterling on Friday were reflected in reserve gains of major countries that day, and much of the remainder presumably went into the Euro-dollar market. Some of the funds moving out of sterling may have been used to buy gold. Also, gold was excellent collateral for bank credit, and some purchases may have been financed by bank loans in various countries. In that connection, he might note that the Swiss National Bank had undertaken a number of measures to help deal with the gold situation so far as it lay within its power. One measure was to get the agreement of the major Swiss banks to refrain from making loans against gold collateral, and to call any such loans now outstanding.

Mr. Brimmer asked if Mr. MacLaury would comment on a recent news report that some central banks were beginning to buy gold.

Mr. MacLaury remarked that last week the only central bank gold purchase from the U.S. Treasury was an $8-1/2 million purchase by Surinam. The New York Bank had asked the Bank of England to advise it of any identifiable central bank purchases on the London market, and none had been reported. Also, under a second measure taken by the Swiss National Bank, Swiss commercial banks had in effect agreed not to sell gold to foreign banks, including central banks.

Mr. Brimmer then referred to Mr. MacLaury's comments regarding the New York Bank's sales of sterling to commercial banks last week, and asked whether the central banks of any other countries had conducted a similar operation with their commercial banks.

Mr. MacLaury replied affirmatively. He noted that the Bank of Canada had done so, and also that the German Federal Bank had provided equivalent facilities to German commercial banks.

Mr. Mitchell referred to Mr. MacLaury's statement that "a majority" of the Subcommittee of the Federal Open Market Committee had concurred in the operation in question. He asked whether that implied that the Subcommittee was not unanimous on the matter.

Mr. Robertson said he had not concurred when the question was raised because he had not felt that the Federal Reserve should use its sterling holdings to assist banks that in turn had accommodated forward sales of sterling by their customers.

Mr. Mitchell asked whether the customers of the banks in question might have been speculating in sterling.

Mr. MacLaury replied that some of the customers might have been speculating; indeed, there had been a press report on Monday to the effect that some corporations had oversold their expected sterling receipts. That possibility had been a matter of great concern to the New York Bank. It seemed clear, however, that the commercial banks involved had done all that might reasonably have been expected of them to avoid facilitating speculation by their customers. For example, they did not accommodate forward sales of sterling by individuals. About the only way the banks could have policed the transactions more effectively would have been to ask every customer involved whether the sterling they wanted to sell forward represented bona fide expected receipts. He did not think it was reasonable to expect banks to do that under normal circumstances, and certainly not under the circumstances prevailing that Friday. While on the subject, he would note that in the certifications required of the commercial banks, the New York Bank had requested information on the banks' over-all position in sterling, and had deducted the amount of any net short positions from the sums of sterling made available to the banks, unless such positions could be explicitly justified.

Mr. Mitchell then asked what the consequences would have been if the New York Bank had not accommodated the commercial banks.

Mr. MacLaury replied that the banks would not have been able to deliver the sterling they had sold, despite the fact that their over-all positions were in balance. By abrogating those contracts, they would have been left in a long sterling position, having acquired forward sterling from their customers at a price of $2.76 or so.

Mr. Mitchell asked whether the amounts involved with respect to individual banks were reasonably related to the normal volume of their foreign exchange business or whether the transactions were heavily concentrated in one or two banks.

Mr. MacLaury replied that the sterling swaps made on Tuesday were heavily concentrated in one bank, but that bank was one of the most active foreign exchange traders in the market. Those made on Wednesday were more evenly spread among the total of ten banks involved. Details on the transactions with each bank would be included in the supplementary memorandum being prepared for the Committee.

Mr. Robertson said that, irrespective of any member's view of the operation, it should be noted that the Bank of England had concurred in it, even though it suffered a loss as a result. The Bank of England also had provided sterling to the Bank of Canada to facilitate a similar operation. Moreover, as Mr. MacLaury had reported, the German Federal Bank had provided such facilities to German commercial banks.

Mr. Mitchell commented that he was not unhappy with Mr. MacLaury's explanation of the operation, although he would be interested in studying the more detailed memorandum when it became available.

Mr. Robertson remarked that in his judgment the Account Management was fully justified in carrying out the operation on the basis of the approval it had received from a majority of the Subcommittee. The main value of the memorandum, he thought, would be in helping the Committee to determine how it should react if a similar problem arose in the future.

Mr. Wayne noted that a member bank had reported to the Richmond Reserve Bank that one of its commercial customers was asking it to make arrangements for them to purchase gold to be held in Canada. The Reserve Bank had replied that such a transaction by an American citizen was illegal. One possible implication of the inquiry was that the bank's customer knew of similar transactions that had been made in the past. Mr. Wayne asked whether this was likely to have been an isolated instance or whether other persons had engaged in such transactions.

Mr. MacLaury replied that he heard of no such transactions during the past week. Previously, however, he had heard that some American citizens were buying options on gold in Canada, which in effect were future contracts. Such purchases were considered by some to be technically legal, so long as the contracts were sold before the owner actually took possession of the gold.

Mr. Hickman commented that a news story over the weekend had reported rumors of gold purchases not only by nationals of foreign countries but also by American citizens. The article did not specifically mention Canada as the place at which the gold was held.

Mr. MacLaury remarked that there had been allegations of illegal gold purchases by U.S. citizens for some time, but he had no independent information on the subject.

Mr. Galusha referred to Mr. MacLaury's comment that the British Government had decided to devalue sterling on its own accord. He asked whether Mr. MacLaury thought the British had any real alternative, in light of the prevailing circumstances.

Mr. MacLaury replied that in his judgment they did have an alternative. Credits were available to them, and the period was approaching in which seasonal forces would be working in sterling's favor. He thought the British could have weathered the storm if, instead of devaluing, they had taken all or even some of the restrictive measures that they had found desirable as accompaniments of devaluation--including a much higher Bank rate, lower Government expenditures, curbs on bank loans, more restrictive hire-purchase controls, and so forth. While they had chosen to devalue it was still not clear that they were out of the woods. In his opinion, they were really no better off now in terms of their national interest than they would have been had the sterling parity been maintained.

Mr. Galusha commented that having devalued at this time the British might find it a little easier to do so again. He asked whether Mr. MacLaury thought that was an imminent possibility or a matter for concern over the longer run.

Mr. MacLaury replied that another sterling devaluation certainly did not appear imminent. The imminent concern in connection with the British situation related rather to the question of how quickly the Bank of England might be able to repay its short-term debts to the Federal Reserve and to others.

In reply to another question by Mr. Galusha, Mr. MacLaury said that Britain's reserve position was negative at the moment. As of the Friday before devaluation they held exactly $45 million in foreign currency reserves and approximately $1.5 billion in gold. Their outstanding short-term debts were now close to $2 billion; they had borrowed the full $1,350 million available under the Federal Reserve swap line and over $500 million under the sterling balance arrangement.

Mr. Ellis remarked that one implication of the statement that the British had a free choice with respect to devaluation was that they had full opportunity to negotiate with respect to credit assistance. However, the press reports gave the impression that they were not really free to conduct confidential negotiations; that there had been deliberate leaks to forestall free negotiations. Would Mr. MacLaury accept that as another reason the British chose to devalue?

Mr. MacLaury replied that if the British had been prepared to accept short-term credits he thought the necessary arrangements could have been made expeditiously and confidentially, as had been the case in the past. It was Britain's refusal to accept additional short-term credit--and one could advance arguments for and against their position--that prolonged the negotiations and led to the leaks.

Mr. Swan commented that while the U.S. Treasury would sell gold only to central banks and governments, the London gold market and the gold pool as presently operated provided private foreign buyers with easy access to gold stocks. He recognized that the present was not the time to make any structural changes in those arrangements, but looking ahead he thought it would be desirable to explore possible methods for restricting access to gold through the London market, in line with the Treasury's policy respecting sales out of its own stocks.

Mr. MacLaury then responded to a number of questions by Messrs. Sherrill and Maisel concerning technical aspects of recent flows through the sterling and gold markets. In the course of his comments he noted that much of the large volume of funds flowing out of sterling that had been temporarily lodged in the Euro-dollar market was now apparently being rechanneled in three directions: reflows into sterling, purchases of gold, and flows into continental currencies.

Mr. Brimmer reported that while in Paris on the Friday just before the devaluation of sterling he had spent some time with the manager of a branch of one of the large American banks, and had been told that Euro-dollar deposits at that branch and at the bank's branch in Frankfurt had increased by one-third in the course of Thursday and Friday. In the manager's judgment much of that inflow was coming from U.S. corporations that had had balances in sterling. That morning the newspaper Figaro had carried a front-page story reporting that sterling would be devalued, although it mistakenly set the new parity at $2.50 rather than $2.40. In light of such reports, it was not surprising that there had been tremendous inflows to the Euro-dollar market from sterling.

> By unanimous vote, the System open market transactions in foreign currencies during the period November 14 through 26, 1967, were approved, ratified, and confirmed.

Chairman Martin invited Mr. Solomon to comment on the devaluation of sterling and subsequent developments.

Mr. Solomon said that whatever one's views on the justification for the decision to devalue the pound, it was clear that once that decision had been taken the devaluation was accomplished in an orderly manner, with such details as notifying foreign monetary authorities handled appropriately. More important, the amount of devaluation was kept to a figure that did not stimulate other major countries to follow. It was fair to say that international monetary cooperation had continued and had even been strengthened under the stresses of the last ten days. Of extreme importance was the fact that all of the Group of Ten countries and many other countries as well had announced that they were holding to the existing parities for their currencies. One of the major concerns in the course of contingency planning had been that the British would decide to devalue by an amount larger than other major countries could tolerate, and that that would set off a wave of devaluations that would bring enormous pressures on the U.S. gold stock. That fear had not been realized.

In the contingency planning, Mr. Solomon continued, it was assumed that if market participants reacted rationally to a sterling devaluation they would conclude that it was not sensible to shift their dollar holdings into other strong currencies. Such a conclusion appeared warranted on the grounds that other countries inevitably would follow any devaluation of the dollar in terms of gold, so that there would be no speculative profits to be gained by shifting from dollars into other currencies--except, perhaps, sterling. For most of last week, it appeared that market participants were acting in a rational manner; until Friday, flows into continental central banks were quite moderate. On Friday, however, following large market sales of gold, there was a sizable flow to continental central banks, as Mr. MacLaury had indicated. Presumably uncertainties about the dollar had mounted on that day.

Mr. Solomon went on to say that in the contingency planning it had been anticipated that in the wake of a devaluation there would be heavy pressures in the London gold market, with losses by the pool on the order of $100 million per day. In fact, daily losses by the pool last week averaged a bit more than that. But the volume of private demands for gold should not be considered surprising, particularly since it was augmented by the French leaks to the press concerning their withdrawal from the pool and the possible withdrawal of Belgium and Italy, and concerning the size of recent losses by the pool--on which, incidentally, the French supplied inaccurate figures. The reasons for the heavy speculation on gold were a matter of interpretation, but it was his belief that private gold buyers were not betting on a rise in the official price of gold. It was likely, rather, that most of them were expecting a higher price in the London market on the assumption that pool members would stop supplying gold to that market.

Mr. Solomon commented that the weekend meeting in Frankfurt had been arranged against the background of those heavy private demands for gold. The meeting resulted in a strong reaffirmation of international financial cooperation and, specifically, in a decision to continue to support the gold pool. Meanwhile, consultations were continuing among the gold pool participants. The U.S. delegation to Frankfurt carried a proposal for a so-called "gold certificate" plan designed to strengthen the pool and to demonstrate to the market that the participating countries intended to continue to maintain the present price of gold. If that plan were agreed upon and its announcement had the intended effect on the market, the pool should have to sell very little gold because speculation would stop. A summary of the plan, which at this point was, of course, highly confidential, would be distributed to the Committee later today.[1/]

Mr. Solomon observed that the Swiss authorities revealed at Frankfurt that they had taken certain measures to tighten up on private purchases of gold. Those included the measures Mr. MacLaury had mentioned--prohibiting bank loans against gold collateral and asking banks not to sell gold to foreign commercial or central banks. In addition, forward sales of gold were stopped and maturing forward contracts would not be renewed. Governors of the other European central banks at the meeting agreed to do what they could

1/ A copy of this summary, dated November 24, 1967 and entitled "A Gold Certificate Plan to Stabilize the Gold Market," has been placed in the files of the Committee.

under the laws of their own countries to emulate the Swiss actions, especially that with respect to loans against gold collateral.

It was also agreed at Frankfurt, Mr. Solomon said, that if Friday's flows out of dollars into European currencies continued the central banks would operate in a coordinated way in forward markets to stem the flows and to encourage a reflow back to the Euro-dollar market. Forward purchases of dollars by European central banks in such operations would be covered largely by the U.S. Treasury but also, if the Committee approved, by the Federal Reserve. He understood that Mr. MacLaury would make a recommendation on that subject today, as well as recommendations for increases in certain of the System's swap lines that would be an essential part of the coordinated effort. He should note that Secretary Fowler had asked U.S. officials not to comment to the press with respect to the Frankfurt meeting; it was better to let the statement that had been issued stand on its own and let the market effects of the decisions taken speak for themselves.

A question often asked, Mr. Solomon continued, was whether it was necessary for the United States to be so concerned about the free market price of gold in London as to undertake to sell gold to private buyers there through the pool, when Americans were not permitted to buy gold. In his judgment the major justification for that course was that a break-out of the London price would be likely to affect the behavior of central banks. If the market price was permitted to rise foreign central banks that had to sell gold for one reason or another would be tempted to sell it on the market, whereas those wanting to buy gold would take advantage of the official U.S. price of $35 an ounce. In fact, some central banks might be tempted to buy gold from the United States for the purpose of reselling it at the higher market price. Secondly, a rise in the market price might be regarded as a challenge to the official price of gold and lead many central banks to feel obliged, as a precautionary measure, to convert their dollar holdings into gold.

Mr. Solomon concluded with a comment on the role played by the French in recent developments. There was no doubt, he said, that they had acted in an unfriendly and mischievous fashion. It was important to note, however, that the French had little power to affect developments by any means other than making press statements and leaking confidential information in an effort to embarrass the United States. It would be a self-delusion, he thought, to conclude that the present problems would be much less serious than they were if the French had not acted mischievously. He was, of course, not trying to defend the French, but simply to put their actions into perspective.

Mr. Brimmer said he wondered whether the French were quite as impotent as Mr. Solomon had suggested. Mr. MacLaury had noted that the Bank of France might convert its substantial dollar gains of November into gold. Secondly, operations by the Bank of France to supply gold to the Paris market, while tending to hold down the price, appeared to run counter to the efforts the Swiss were making to limit private demands.

In response to questions by Mr. Mitchell, Mr. Solomon said that citizens of France, like those of Belgium, Germany, and other continental European countries, were free to buy gold in the private market. In general, gold was in circulation on the continent and unlimited amounts could flow into private hands. No action by the Bank of France was necessary to keep the price of gold bars in Paris in line with that in London; that function was performed by arbitrage between the two markets. In Paris, however, gold also was traded in the form of Napoleons, and if the price of such coins rose the Bank of France would sell them into the market. In his judgment such operations were not harmful to the interests of the United States.

Mr. MacLaury added that while Napoleons were freely available in France and the Bank of France operated in the market, they were not available "on tap" at the Bank. He then said, in clarification of his earlier comment on the subject, that he knew of no official indication that the French intended to convert their November reserve gains into gold. However, they had taken in over

$300 million thus far in the month, and the press was noting they now had the dollars with which to buy gold if they chose.

Mr. Sherrill referred to Mr. Solomon's comment that there had been considerable speculation on a rise in the London price of gold. He asked whether Mr. Solomon would anticipate a reflow of gold to that market if participants concluded that the price would remain firm.

Mr. Solomon replied that while the gold market this morning was much calmer than it had been, he did not know whether there would be a reflow.

Mr. Sherrill then asked whether there had been reflows in the past following periods of speculation.

Mr. MacLaury responded in the negative. Past bursts of speculation had been followed by abatements in demand, he said, but what selling had occurred had been more than offset by buying. On the other hand, market purchases had never been of the size experienced last week.

Mr. Ellis noted that Mr. Solomon had characterized the British devaluation as orderly. Certainly that was not the unanimous view in Britain; the Conservative Party in particular did not share it. Moreover, on the Friday before devaluation had been announced the British had suffered a tremendous loss of reserves. If the process was orderly, why had they not been able to forestall that loss?

Chairman Martin commented that from conversations with Governor O'Brien he had concluded that the devaluation had been planned in a highly orderly manner, with time allowed for dispatching people to the Commonwealth countries to explain the action in advance. However, the plans had been upset by Chancellor Callaghan's noncommittal answer to a question concerning a credit package in Parliament on Thursday, which precipitated the final wave of speculation against sterling. In retrospect, it appeared that it would have been best for the Bank of England to announce that their financial markets would be closed on Friday, but they had not anticipated that the Chancellor would make the statement he had.

Mr. Brimmer commented that in Paris on Thursday it was thought even after Chancellor Callaghan's statement that difficulties in the negotiations for a credit package were the source of the trouble. In his judgment the real mischief had been done by leaks in Paris that the British had decided to devalue.

Chairman Martin remarked that Mr. Brimmer's view might well be correct, since the news media were carrying reports on the devaluation decision on Friday morning. It was likely that analysts would be writing about the events in question for a long time to come and perhaps they would never be fully clarified.

Mr. Maisel asked whether information was available on the specific costs of speculating in gold, apart from foregone interest earnings. For example, were transportation and storage costs appreciable?

Mr. Solomon said he thought that the major cost was represented by the loss of interest earnings on the assets used to buy gold, which of course did not have to be dollar assets.

Mr. MacLaury agreed. There were no necessary transportation costs, he said, because the gold bought could be held in London. While he did not have exact figures on storage charges at hand, they were less important than the interest lost. Until lately, at least, there had been adequate storage facilities in Britain. However, he had heard one ironical comment to the effect that U.S. difficulties in supplying gold recently were matched by the buyers' difficulties in digesting it.

Mr. Galusha asked whether information was available on losses suffered by U.S. nationals as a result of the sterling devaluation, and Mr. MacLaury replied in the negative.

Chairman Martin then said he would bring the Committee up to date about other aspects of recent events. In his judgment the System had performed very well during the whole period. In the days immediately following the preceding meeting of the Committee on November 14, the Board did not act with respect to the higher discount rates that had been voted by the directors of two Reserve Banks. On Friday, November 17, Mr. Kirbyshire of the Bank of

England came to the Board's offices at 1:15 p.m. to inform Governor Robertson and himself of the decision that had been taken to devalue sterling. He (Chairman Martin) had suggested to Secretary Fowler that they talk with the President immediately, to urge him to press for action on the tax bill in light of the devaluation, and they did meet with the President. Later that afternoon he and Secretary Fowler attended a White House meeting with the leadership of both the House and Senate, including Chairman Mills of the House Ways and Means Committee. At that meeting the President reported that the British Ambassador had called at one o'clock to advise him that a devaluation of sterling would be announced the next day. The President placed considerable emphasis on the devaluation in speaking to the Congressional leaders about the need for fiscal action.

Subsequently on Friday, Chairman Martin continued, he, Secretary Fowler, and Under Secretary Barr met with Congressman Mills at the airport, from which the Congressman was leaving for a speaking engagement, and urged him to go forward with the tax bill. The Ways and Means Committee would hold open hearings on the subject on Wednesday, November 29, at which Secretary Fowler, Budget Director Schultze, Chairman Ackley of the Council of Economic Advisers, and he were scheduled to testify. He anticipated that each of those officials would urge the necessity of fiscal action. What the outcome would be could not be predicted at this time.

As the Committee members knew, Chairman Martin observed, the Board had met on the afternoon of Saturday, November 18, to approve the discount rate increases to 4-1/2 per cent that had been established by the directors of three Reserve Banks as of that time, as well as any similar increases at other Reserve Banks concerning which notification was received by 1 p.m. Sunday. By the latter time ten Reserve Banks had established 4-1/2 per cent discount rates. Prior to its action the Board had discussed at some length the question of whether the new discount rate should be 4-1/2 or 5 per cent, and had decided unanimously to approve the 4-1/2 per cent rate. On the whole, he thought the action had been well received as a moderate, precautionary move. It was acceptable to the Administration.

Moving on to the more immediate past, the Chairman continued, it had become apparent by Tuesday, November 21, that pressures were building up in the London gold market. On Wednesday the so-called "Deming group," on which the Federal Reserve, the Council of Economic Advisers, the State Department, and the White House were represented, began a series of meetings under the chairmanship of Under Secretary Deming. The group concluded that it would be desirable for the central banks participating in the gold pool to issue a joint statement designed to calm the situation in the gold market. Messrs. Deming and Daane brought to him (Chairman Martin) a draft of such a statement and suggested that he discuss it with the governors of the central banks concerned. While the draft differed in wording from the statement that was eventually issued, like the latter it included a quotation of the President's earlier reaffirmation of the U.S. commitment to the existing official price of gold. He was not able to reach Governor Carli of the Bank of Italy until Thursday--that is, Thanksgiving Day--but he talked with the other governors on Wednesday. Two of the governors were agreeable to the statement. However, others thought there should be some consultation before any announcement was made that the gold pool would be continued, and one was inclined to the view that the London gold market should be closed immediately.

By Thursday morning, Chairman Martin said, all of the governors agreed that it would be unwise to issue a statement without consulting with one another. Governor Blessing of the German Federal Bank agreed to chair a meeting of the governors, and arrangements were made to hold that meeting in Frankfurt on Sunday. After many hours of discussion the governors reached the agreements that had been outlined to the Committee today by Mr. Solomon. At about noon yesterday he and Mr. Solomon had met with Secretary Fowler and others, and received a full report from

Messrs. Deming, Hayes, and Coombs in Frankfurt on the outcome of the meeting. As a result of that report Secretary Fowler and he made available here copies of the statement to which reference had already been made.

The Chairman added that before learning of the outcome of the discussions he had been fearful that they would not be successful, in light of the views some of the central bank governors had expressed to him in the telephone conversations leading up to the meeting, and in light of the enormous demands for gold in London on Friday. In his judgment full credit should be given to Mr. Deming, who had done an outstanding job in the negotiations. The Frankfurt results were a major achievement in multilateral financial cooperation. The problem was yet not resolved by any means but at least the current wave of speculation had been ended. It was obvious that further steps would have to be taken soon, and others might be required as time passed. Mr. Solomon had noted that one of the agreements reached at Frankfurt concerned forward operations. A "command post" for forward operations had already been established in Frankfurt, which was manned at the moment by Messrs. Coombs, Tungeler, and Ikle.

The Chairman then suggested that at this point the Committee hear the recommendations of Mr. MacLaury, which were designed to facilitate the implementation of the agreements reached at Frankfurt.

Mr. MacLaury said he would start with a recommendation relating to the forward transactions to which the Chairman had just referred. As Mr. Solomon had noted, a number of the continental central banks were prepared to operate in the forward market, selling their currencies forward against dollars, which amounted to offering a pledge to the market that their present parities would be maintained. Such operations had been conducted in German marks and Swiss francs in 1961 following the revaluation of the mark and the guilder, and subsequently had been carried out successfully for a long time by the British. The U.S. Treasury had agreed to provide unlimited cover for any dollars bought forward by the continental central banks, and the Account Management felt strongly that the Federal Reserve should participate along with the Treasury in providing such cover. In fact, as he had indicated earlier, the Netherlands Bank had already started selling guilders forward against dollars, with the System and the Treasury jointly providing cover. It was not possible at this time to predict the amounts likely to be involved; if the market remained calm they could be small. However, in order to be prepared to carry out such operations in the amounts necessary, he would recommend that the Committee double the limit on authorized System commitments to deliver foreign currencies that was specified in paragraph 1C(3) of the authorization. In other words, he would recommend replacing the present limit of $275 million with a new limit of $550 million.

In reply to a question by Mr. Hickman, Mr. MacLaury said that under the proposal the continental central banks would be operating in their respective markets for the account of the System and the U.S. Treasury, just as the Federal Reserve operated in the New York market for the accounts of foreign central banks. In effect they would be guaranteeing the availability of their currency to participants in their markets who had forward commitments or other needs for forward cover back into their currency, in order to avoid pressures on the spot market. By way of illustration, he might refer again to the situation with respect to German marks in 1961. As the Committee might recall, after the 5 per cent revaluation of the mark in that year there was much speculation about a possible additional 5 per cent revaluation. Traders who had forward commitments in marks wanted cover, and had they been able to buy forward marks at a reasonable premium they would have done so. Initially, however, such cover was not available; the market was one-sided. The traders, therefore, borrowed dollars and sold them for marks in the spot market, and there was an immediate dollar inflow into Germany. As soon as the nature of the problem became apparent the New York Bank, acting for Treasury account and in cooperation with the German Federal Bank, began to sell marks forward to provide the cover traders were seeking, and that substantially moderated the dollar inflow to the German Federal Bank. Such operations could be used not only to reduce or prevent dollar inflows to foreign central banks but also to induce outflows. So far today, according to the latest information he had received, the German Federal Bank had sold $44 million of three-month forward marks, reducing the forward premium on marks from approximately 3 per cent to about 1-3/4 per cent in the process and inducing an equivalent outflow--at least in the first instance--of dollars from Germany into the Euro-dollar market. Such operations could be of real benefit in the foreign exchange markets, because in effect they guaranteed that present parities would be maintained.

Mr. Maisel asked whether operations of the type under discussion should not be evaluated in terms of more general policy objectives.

Chairman Martin commented that in his judgment the policy objective was to maintain present currency parities in terms of gold.

Mr. Maisel said that there appeared to be other kinds of policy questions involved as well; thus, decisions made under the contemplated operations would affect the volume of dollar reserves held by foreign central banks. He had raised the question because he was concerned that the United States might find itself in the same situation as the British had recently, in which the Bank of England had to determine continually the extent to which it was prepared to take on forward commitments as an alternative to suffering losses of reserves. From the British experience, he concluded that such forward operations could be very expensive and critical They had various implications--for the balance of payments, for monetary reserves, for costs--which had to be considered together. It was for that reason that he thought some sort of general policy objective had to be specified. For example, was the objective to bring the deficit in the U.S. balance of payments down to zero?

In reply, Mr. MacLaury first noted that the Treasury had already determined that this type of operation would be beneficial to the interests of the United States; in agreeing to provide unlimited forward cover, it had already decided to take the same route that the Bank of England had followed in trying to defend the pound. Secondly, although forward operations had not by themselves succeeded in avoiding devaluation, they had made it possible for Britain to hold the pound at its previous parity for three years; without them, he thought, Britain would have run out of reserves as early as 1964. If the United States was determined to hold the present dollar price of gold, forward operations would be helpful as one means of reducing the inflows of dollars into foreign central banks. As Mr. Maisel had suggested, a judgment was involved between undertaking forward commitments or having dollars accumulate in the reserves of foreign central banks. One consideration affecting that judgment was the fact that for the most part information on changes in reserves of foreign central banks was published weekly, whereas information on the volume of forward operations could be withheld so long as it was in the public interest to do so. Thus, by forward operations it might be possible to avoid a process in which reports of dollar reserve gains abroad fed market speculation that continental currencies were undervalued.

Mr. Maisel said he was not objecting to the proposed forward operations. His point was that they were one possible prong of policy. But there were other possible prongs that warranted serious consideration--for example, measures to affect interest rates paid domestically on foreign deposits and measures to affect Euro-dollar flows to the United States. It seemed to him that the Committee was being asked to make a policy decision without having all of the relevant considerations before it. For a number of years the state of the U.S. balance of payments had been one of the major factors the Committee had been urged to weigh in making decisions on domestic monetary policy. Now he gathered that it was being suggested that the Committee use a different method to deal with this problem. In his judgment the Committee should be clear in what it hoped to achieve by choosing among the available policy instruments, each of which might be best adapted to a particular end.

Mr. MacLaury observed that the forward operations under discussion, by affecting the dollar holdings of foreign central banks, would have implications for the U.S. balance of payments on the official settlements basis; however, they would not affect the balance on the liquidity basis. He agreed that to some extent the proposed provision of forward cover was an alternative to a tighter domestic monetary policy as a means of limiting dollar accruals by foreign central banks. Under present circumstances, however, he felt that forward operations would be a useful supplement to, rather than a substitute for, other policy tools. The different types of measures could reinforce one another.

In response to Chairman Martin's request for comments, Mr. Solomon said he thought the point Mr. Maisel had raised was a valid one, and he agreed in general with the comments Mr. MacLaury had made concerning it. He would add only that according to the information received from Frankfurt yesterday, there was another objective for forward operations in addition to that Mr. MacLaury had mentioned. Any large shift out of dollars this week could result in very high interest rates in the Euro-dollar market. That in turn could increase the pressures already existing on some countries, including Japan and Sweden, to devalue. It was hoped that forward operations would help avoid that outcome.

Mr. MacLaury agreed. By way of background to Mr. Solomon's observation, he noted that while the three-month rate in the Euro-dollar market was 5-3/4 per cent just prior to devaluation, during the early part of last week it was 6-1/2 per cent; and on Friday it rose to 7 per cent, where it remained today.

Mr. Mitchell asked whether the operations under discussion amounted, in effect, to window dressing the position of the United States. If so, for how long it was proposed to continue such window dressing?

Mr. Solomon remarked that window dressing would seem to be involved only to the extent that information was withheld on the volume of forward operations.

Chairman Martin observed that the additional authority for forward operations that Mr. MacLaury had recommended might never have to be used. The proposal was a temporary one in the sense that the goal was to stabilize market flows that were disorderly at the present time. In the words of the Frankfurt communique, the central bank Governors "took decisions on specific measures to ensure by coordinated action orderly conditions in the exchange markets . . . ."

Mr. Hickman asked whether it was proposed to continue to engage in forward operations of the type discussed after the present emergency had passed.

Chairman Martin said he thought the Committee should consider that question as it went along; the matter should be subject to regular review. As he had indicated, the objective at the moment was stabilization of flows in a crisis situation.

Mr. Wayne remarked that he was puzzled by the implication of some of the preceding discussion that the proposal was for a new type of operation. The Committee had resolved the policy question when it had authorized forward operations some time ago; what was at issue today was merely a matter of magnitudes.

Mr. Brimmer referred to Mr. MacLaury's earlier remark that the Treasury had already decided to provide unlimited cover for forward operations. He asked Mr. MacLaury to comment on the role of the System in the matter as opposed to that of the Treasury.

Mr. MacLaury replied that since the System first undertook foreign currency operations in 1962, the term "U.S. monetary authorities" had been interpreted generally--and appropriately--as encompassing both the Treasury and the System. The defense of the dollar was certainly one of the main tasks of the Committee; the Federal Reserve had as much responsibility to act in the international area as in the domestic, although in the former case it presumably should act jointly with the Treasury. The operation in question was one way the Federal Reserve could participate with the Treasury in the defense of the dollar.

Mr. Brimmer then said he had been concerned that Mr. MacLaury's earlier comment might be taken to imply that the Committee was being asked today simply to ratify a decision that had been made solely by the Treasury. He was satisfied in his own mind that that was not the case. Members of the Committee and its staff had in fact participated in the formulation of the policy under discussion.

Mr. Sherrill asked whether the group now operating the "command post" in Frankfurt had objectives formulated in terms of interest rates on Euro-dollars.

Chairman Martin replied they did not; they were concerned with stabilizing flows.

Mr. Brimmer reported that at the meetings of both Working Party 3 and the Economic Policy Commission two weeks ago the U.S. representatives had been urged to take steps to limit the inflows of Euro-dollars to the United States. It was argued that those flows were putting pressure not only on sterling but also on the German mark. At the WP-3 meeting, Messrs. Deming and Solomon had responded for the United States, but it had been suggested to him (Mr. Brimmer) first privately and then during the EPC discussion that the System should act to limit the inflows. Unlike Mr. Maisel, he did not think that direct action with respect to Euro-dollar flows to the United States was a feasible policy alternative. He did think, however, that forward operations would be useful in reducing the problems posed by the Euro-dollar market.

Chairman Martin concurred in Mr. Wayne's observation that the matter at issue was one of magnitudes rather than adoption of a new policy. He thought it might be desirable, however, for the staff to prepare a study on the points Mr. Maisel had raised.

Mr. Maisel commented that the questions in his mind had already been answered to his satisfaction. Earlier he had thought the Committee was being asked to make a basic policy decision that would have consequences for the next several years, but it was now clear that the purpose was immediate market stabilization. While he was willing to approve the proposed operations, he was not sure that he agreed with Mr. Wayne that they represented no departure from those of the past. In any case, he still felt that the Committee should take pains to insure that it was using its various policy tools in a logical manner. In the present case he thought the Committee should recognize that it was employing one particular instrument--appropriately, he hoped--in preference to others to attain a particular objective.

Chairman Martin reiterated his view that the Committee should plan on reviewing the matter continually; it was not a closed book. The technique proposed might prove not to be the best for the purpose, but emergencies often had to be dealt with by experimental methods.

The Chairman then suggested that the Committee postpone a vote on the proposed increase in the limit on forward operations until it had heard Mr. MacLaury's other recommendations, which he understood were to increase the size of certain swap lines. In considering those recommendations the Committee members should have in mind the possibility that they might prove to be desirable on a temporary basis only. It was not clear to him that permanent enlargements of the lines in the magnitudes Mr. MacLaury would propose would be appropriate.

Mr. MacLaury said that, as Mr. Solomon had noted earlier, the proposed swap line increases were an essential part of, and had grown out of, the agreements reached in Frankfurt to stand firm on the present parities and to insure stability in the market.

Mr. MacLaury then listed the proposed changes in the swap lines with the central banks of the indicated countries and with the BIS as follows, with all figures in millions of dollars:

	Increase	From	To
Belgium	75	150	225
Netherlands	75	150	225
Germany	350	400	750
Italy	150	600	750
Sweden	100	100	200
Japan	300	450	750
BIS (Other European currencies/dollars)	300	300	600
England	150	1,350	1,500

In explaining the proposed increases Mr. MacLaury noted that the present swap line with the Netherlands Bank was already fully drawn and there was a leeway of only about $19 million remaining under the present Belgian line. There had been no drawings on the German line recently, but a drawing of $50 million was planned for the very near future to enable the System to offer marks spot in the New York market. With that arrangement about to be activated the increase proposed appeared to be desirable. At the moment drawings of $300 million were outstanding on the arrangement with the Bank of Italy, and the System had been asked to draw another $200 million to cover dollar inflows to Italy that had occurred prior to the sterling devaluation. Accordingly, $500 million of the present $600 million Italian line would be in use shortly.

Mr. MacLaury observed that the situation with respect to the lines with Sweden and Japan was somewhat different. Those countries had not been taking in dollars recently; indeed, they had each lost about $50 million last week. However, as Mr. Solomon had noted, their currencies could come under pressure in the exchange markets in the wake of the sterling devaluation, and the suggested swap line increases were intended to provide means for coping with such pressures. As the Committee knew, relatively few countries of any size had followed Britain's course thus far--mainly New Zealand, Spain, and Denmark. If other major countries that had initially decided to stand on their present parity were forced off later, a new wave of speculation was likely to break out.

The purpose of the proposed increase in the arrangement with the BIS was also different, Mr. MacLaury continued, and was connected with the objective of insuring stability in the Euro-dollar market. Some $68 million, drawn in mid-November, was now outstanding on the affected line, which provided for drawings of dollars by the BIS against European currencies other than Swiss francs. However, the full amount of the existing line had been utilized in the past, and the line was extensively used as recently as midyear in the aftermath of the Middle East hostilities.

The increase in the line with the Bank of England had been suggested by Mr. Coombs this morning, Mr. MacLaury said. In effect, it was proposed to substitute a $150 million enlargement of that swap line for the $100 million increase the Committee recently had authorized in System holdings of guaranteed sterling and for $50 million of the $400 million of such holdings the Treasury had indicated earlier that it was prepared to acquire. Briefly, that substitution was suggested because the previous authorization to acquire additional guaranteed sterling had been recommended at a time when it was hoped that the British would be able to maintain the prior sterling parity. As the Committee knew, there was no definite time limit established in connection with guaranteed sterling holdings. Under the new circumstances, with sterling devalued, it seemed appropriate to have definite maturities apply to any enlargement of the System's facilities with the Bank of England. Increasing that swap line by $150 million also had the incidental advantage of rounding off the total of the enlargements to the figure of $1.5 billion.

If these increases were approved and the arrangements for them satisfactorily completed, Mr. MacLaury observed, it was planned to announce the enlargement of the System's network late in the day on Thursday, November 30. That timing was suggested because the impact of the announcement--which he thought would be considerable--would then occur initially on Friday, typically the day of maximum difficulties in the exchange markets.

Mr. MacLaury said he would recommend that the Committee approve today the proposed increases in the swap lines with the central banks of Belgium, Italy, the Netherlands, and Sweden, and that in the swap line with the BIS. In those cases the other parties had indicated, in the course of discussions that had taken place over the weekend, that they were agreeable to the enlargements. However, negotiations had not yet proceeded similarly far with the British, Germans, and Japanese. Accordingly, he recommended that the Committee approve the increases in the lines with the latter three central banks, subject to a determination by Chairman Martin that the negotiations had been satisfactorily completed. Finally, to implement the proposal that the enlargement of the British swap line be made as a substitute for the recent increase in the limit on guaranteed sterling holdings by the System, he recommended a revision of paragraph 1 B(3) of the authorization to reduce the limit specified there on guaranteed sterling holdings from $300 million to $200 million.

Mr. Scanlon asked whether the matter of swap line increases had been discussed at all with the central banks of England, Germany, and Japan.

Mr. MacLaury replied that preliminary discussions had been held with officials of the three banks, but that certain formalities had to be accomplished before they could give a definite reply.

Mr. Scanlon then asked whether a failure of any one of the three central banks in question to agree to the proposed enlargements would have implications for the increases contemplated for the others, and Mr. MacLaury said it would not.

Mr. Robertson asked whether it might not be desirable to increase the swap line with the Bank of England by $500 million rather than $150 million, even if it was thought that the extra facilities might never be used, on the grounds that the psychological impact on the market would be greater.

Mr. MacLaury replied that he did not think a $500 million increase in the British swap line would be desirable at this time, since it would bring that line to the clearly disproportionate level of $1,850 million and would increase the likelihood that cut-backs in the lines from their new levels would be required at a later date. He noted that the United States was participating to the extent of $500 million in the $1.5 billion credit package to the British that had already been announced, and that an announcement was expected shortly by the International Monetary Fund that a $1.4 billion standby facility to the British had been approved.

Mr. Brimmer observed that no increases had been recommended in the swap lines with a number of central banks. He was not surprised to find the Bank of France in that group. However, if the list of recommended increases was announced he suspected that question would be raised as to the reasons for the omission of certain other central banks.

Mr. MacLaury replied that increases had been recommended in the cases in which they seemed desirable in light of the likely sources of exchange market pressures. While the Committee might want to consider enlarging other lines at some point, the need for acting quickly suggested the advisability of limiting the number of enlargements now to those considered necessary at this time.

Mr. Hickman commented that the omission of the line with the Swiss National Bank in particular might lead to questions about the willingness of the other party to cooperate with the System.

Mr. MacLaury said that at present there were drawings of $242 million under the System's two Swiss franc swap lines--with the Swiss National Bank and the BIS--leaving a leeway of $258 million, which appeared adequate for the time being. If the willingness of the Swiss authorities to cooperate with the System should be questioned one need only point to the fact that they had demonstrated such willingness by many individual actions.

Chairman Martin commented that there were no doubts in his mind on that score. In each of four conversations he had had recently with President Stopper of the Swiss National Bank the latter had said that he would cooperate fully with the Federal Reserve.

Chairman Martin then asked whether there were any further comments or questions on Mr. MacLaury's recommendations. Hearing none, the Chairman suggested that the Committee vote on those recommendations.

> By unanimous vote, paragraphs 1B(3) and 1C(3) of the authorization for System foreign currency operations were amended, effective immediately, to read as follows:

1B(3). Sterling purchased on a covered or guaranteed basis in terms of the dollar, under agreement with the Bank of England, up to $200 million equivalent.

* * *

1C(3). Other forward commitments to deliver foreign currencies, up to $550 million equivalent.

By unanimous vote, the table contained in paragraph 2 of the authorization for System foreign currency operations was amended, effective immediately, to read as follows:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	100
National Bank of Belgium	225
Bank of Canada	500
National Bank of Denmark	100
Bank of England	1,350
Bank of France	100
German Federal Bank	400
Bank of Italy	750
Bank of Japan	450
Bank of Mexico	130
Netherlands Bank	225
Bank of Norway	100
Bank of Sweden	200
Swiss National Bank	250
Bank for International Settlements	
System drawings in Swiss francs	250
System drawings in authorized European currencies other than Swiss francs	600

By unanimous vote, the table contained in paragraph 2 of the authorization for System foreign currency operations was amended to change (1) the amount of the reciprocal currency arrangement with the Bank of England from $1,350 million equivalent to $1,500 million equivalent; (2) the amount of the arrangement with the German Federal Bank from $400 million equivalent to $750 million equivalent; and (3) the amount of the arrangement with the Bank of Japan from $450 million equivalent to $750 million equivalent, in each case to become effective upon a determination by Chairman Martin that the negotiations looking toward such change had been satisfactorily completed.

Secretary's Note: Chairman Martin determined that negotiations had been satisfactorily completed with respect to the increases described above in the reciprocal currency arrangements with (1) the Bank of England, on November 28, 1967; (2) the Bank of Japan, on November 28, 1967; and (3) the German Federal Bank, on November 30, 1967. Also on November 30, 1967, Committee members approved a recommendation by the Special Manager that the amount of the reciprocal currency arrangement with the Bank of Canada be increased from $500 million equivalent to $750 million equivalent. Accordingly, the table contained in paragraph 2 of the authorization for System foreign currency operations was amended, effective on the indicated dates, to give effect to the indicated increases in the four reciprocal currency arrangements.

Mr. Wayne left the meeting at this point and Mr. Ellis, alternate, served as a voting member for the remainder of the meeting.

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 November 14 through 22, 1967. A copy of this report has been placed in the files of the Committee.

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

> For the past week domestic financial markets have been dominated by events surrounding the devaluation of the pound sterling. In the securities markets, there was an initial sharp downward adjustment of prices after the devaluation and the change in the discount rate, followed by a sharp rally based on the news that hearings on the Administration's tax bill would be held by the House Ways and Means Committee in this session of Congress. On Friday, however, the growing uncertainties in the gold and foreign exchange markets worked their way into domestic financial markets and security prices again moved sharply lower. The written report to the Committee covers developments through Wednesday, November 22, when rates on three- and six-month Treasury bills were 15 basis points below the peak reached on Monday. By the close on Friday, rates at 4.91 and 5.48 per cent, respectively, were nearly back to the peak, and stood 25 - 30 basis points above the levels prevailing at the time of the last Committee meeting.
>
> It scarcely needs to be said that future developments in our domestic financial markets will depend on the success that is attained in restoring order in the gold and foreign exchange markets, on the resolution of fiscal problems, on the future course of monetary policy, and on how all of these things react on the real economy, on credit demands, and on expectations. In the meantime, we shall have to live with sharp and erratic fluctuations in security prices and market interest rates. We must also be prepared for a flexible use of open market operations and other tools of monetary and debt management policy to preserve the orderly functioning of financial markets. International uncertainties pose a serious threat to the dollar, and the threat would only be compounded if our domestic markets were to get out of hand.

Pending clarification of some of these basic forces affecting both domestic and international markets, it is virtually impossible to sort out the kind of monetary aggregates, money market conditions, and interest rates that would be compatible with the new discount rate. In general, I would agree with the approach taken in the staff's interim report on money market and reserve relationships.1/ At the moment, fortunately, bank credit appears to be expanding less rapidly than earlier this year and a somewhat slower rate of growth is tentatively being projected for December. The current level of short-term interest rates, however, is already beginning to raise questions about disintermediation and Regulation Q.

Domestic open market operations, like the financial markets, were strongly influenced over the period by the British devaluation and the increase in the discount rate to 4-1/2 per cent. While it was obviously impossible to predict over the devaluation weekend what the precise money and capital market reaction would turn out to be on Monday morning, it was readily apparent that prompt and decisive System open market operations could do much to facilitate an orderly adjustment to the new set of circumstances.

Prior to the weekend, as uncertainty about sterling grew, we began to concentrate at the Trading Desk on the general course of action that might be required if a full-fledged exchange crisis developed over the weekend. Our considerations were based on the general philosophy contained in the contingency planning memoranda that have been in the Committee's files for some time--a late draft having been submitted by the Committee staff at the last meeting. The essential points were the desirability of avoiding disorderly market conditions, while encouraging the market to find a new viable level of prices and yields--i.e., to provide for an orderly adjustment while avoiding any suggestion of pegging of prices. In approaching these twin objectives it seemed clear that both the immediate and longer-run functioning of the market could be seriously disturbed if dealers

1/ A copy of this report, prepared for the Committee by the Board's staff, has been placed in the files of the Committee.

tried to dispose of their portfolios of Government securities in an unreceptive and uncertain market.

As developments unfolded over the weekend--with an actual devaluation accompanied by an 8 per cent British Bank rate and a 1/2 per cent increase in our discount rate--it became abundantly clear that domestic financial markets would face a substantial problem of adjustment on the following day. Accordingly, after the announcement of the increase in the discount rate at 2 p.m. on Sunday, the officers of the Securities Department met at the New York Bank to plan a specific approach for next morning.

In order to make sure that the Government security dealers had all the available facts to consider over Sunday night, we called senior representatives of each dealer firm late Sunday afternoon or early Sunday evening to read them the full text of the Board's announcement--which apparently was not being carried in detail on radio news broadcasts. In addition, we told each dealer that we hoped the market would function as smoothly as possible on Monday under the circumstances, and that we would be in the office early on Monday morning.

Our judgment was that early and decisive System action to reduce dealer positions, particularly in coupon issues, would help head off distress dealer selling that would only have pushed prices lower in a vacuum. The strategy decided on was to bid dealers for about 40 per cent of their net long positions of issues maturing in 1 to 5 years and about two-thirds of their holdings of longer maturities. In order to include all dealers in the operation we decided to bid those dealers who had net short positions in the 1- to 5-year area for a token amount. Dealers who had net short positions in securities maturing in over 5 years would not, however, be given bids in that area. Under these guidelines, we would be bidding for about $125 million 1- to 5-year Government securities and about $75 million longer-term Governments. Parenthetically, I should add that the fact that the Desk now receives individual dealer figures greatly facilitated our planning.

In determining the prices that we would bid the dealers, we decided that a differential of 2/32 to 8/32, depending on maturity, below the prices that the market was bidding at the close on Friday would be appropriate. This would place our bids generally 6/32 to 24/32 below composite dealer offering prices on Friday. We recognized that these prices were arbitrary to a certain extent and that market prices on Monday would be likely to fall below these levels. Nonetheless, we concluded that this approach would underscore our desire to preserve the capacity of the dealers to make markets effectively, and would encourage the market to adjust on its own to a new and viable price level following what was obviously a "clear the decks" System operation.

On Monday morning at 9:15--well before the market's normal opening time--we called each dealer firm and bid them for a specific amount of securities in the 1- to 5-year and over 5-year maturity range, indicating that the amounts were based on positions as of the preceding Thursday. Dealers were told that they were under no obligation to accept our bids, but to inform us what particular securities they wanted to sell and we would indicate our bid price. Bids totaled $124.5 million in the 1- to 5-year area, of which dealers accepted all but $3.5 million, and $72.3 million in the over 5-year area, of which all but $7.1 million were accepted.

At about 10:15 the System returned to the market with a regular go-around to buy Treasury bills. Dealer offerings were close to $1.2 billion at rates generally 25 - 35 basis points above Friday night's close. Our purchases amounted to $427 million, or about 15 per cent of dealers' net positions. Following these two operations, the System was able to remain out of the market for the remainder of the week.

As we had hoped, the market was quick to adjust prices to the new set of circumstances, and in an orderly and constructive fashion. Prices began to stabilize by late Monday morning, and while trading over the rest of the day was light, dealers were enough encouraged by the System actions to make markets. And with the announcement later in the afternoon that the House Ways and Means Committee would take up the President's tax bill before Congress adjourns, market sentiment, as noted earlier, improved sharply.

I have dwelt on System open market operations on Monday following the devaluation and the change in the discount rate in some detail because they represented something of a departure from the approach we would normally make. We are in process of preparing a detailed memorandum describing the operations and hope to mail it to members of the Committee and to the Presidents not now serving on the Committee as soon as possible.

Clearly the circumstances were extraordinary. The actions undertaken, I believe, were in full accord with the Committee's desire for prompt and decisive action to avoid disorderly market conditions in an emergency situation. The market's reaction to the System approach was universally favorable, even though prices by Tuesday night had risen above those we paid on Monday morning. It is perhaps not surprising that dealers who were taken out of long positions in a falling market reacted favorably. More significant was the fact that a similar reaction came from the dealers that were short and to whom we made only a token bid. Dealers were saved capital losses by our action, but more importantly the whole market was encouraged to undertake an orderly adjustment, and dealers did not withdraw to the sidelines.

Looking to the future, it is quite obvious that reserve projections and domestic open market operations will continue to be strongly influenced by international flows of funds, by gold market developments, and by their impact on bank reserves, on the Treasury's cash position, and on foreign account operations in the Treasury bill market. Last Friday, for example, we had indicated on the morning call that we contemplated taking no action to affect reserves that day. Later on, however, we unexpectedly received large foreign account orders to sell Treasury bills at the very time that the bill market was undergoing a rapid upward adjustment of yields. To avoid adding pressure to the market we took directly into the System Account the $191 million of bills for sale by the foreign accounts.

Obviously the System cannot afford to abandon its reserve goals entirely in order to ensure orderly market adjustments, but some give and take may be necessary. In the last statement week free reserves were at a low level despite a massive supply of reserves through both domestic and foreign operations. (It is interesting to note that last Tuesday, when payment was made for the $427 million Treasury bills purchased the previous day, various foreign operations were supplying nearly twice as many reserves to the banking system.) Fortunately, the $92 million free reserve level for last week--a number that came about more through chance than design--was accompanied by very comfortable money market conditions on Tuesday and Wednesday.

For the period immediately ahead, reserve projections will be subject to sudden change depending on the ability of the United Kingdom to repay its swap drawings, on the timing and amount of the gold pool settlement, on System and Treasury operations to mop up dollar inflows into central banks abroad, as well as on the usual factors affecting bank reserves. In addition, we still have major discrepancies in the projection of the Treasury's cash balance in mid-December, and I fervently hope that the Treasury's prediction that they will not have to borrow from the System proves correct. Consequently, the reserve projections contained in the spread sheet attached to the written report to the Committee had best be ignored for the present. We will need to maintain the closest coordination among the Committee staff, the Treasury, the foreign department of the New York Bank, and the Trading Desk just to keep on top of the situation as it develops.

I apologize for taking up so much time with details. But I believe it is important in the period ahead for us to be clear about the problems involved in attaining reserve objectives, in preserving orderly financial markets, and in accommodating the international flow of funds. Maximum flexibility in the conduct of open market operations will be required and the Treasury has indicated its willingness to cooperate to the extent that it can by a flexible management of its balance with the Reserve Banks.

In closing, I might note that the Federal National Mortgage Association will price its offering of participation certificates tomorrow morning. As of Friday night the syndicate managers were anticipating a good reception, particularly of the longer issue.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period November 14 through 26, 1967, were approved, ratified, and confirmed.

Mr. Brill then made the following statement on economic and financial developments:

It is far too early to observe any meaningful reactions in the domestic economy to last week's international events. The most we can do is reassess the state of the economy on the eve of the events, and speculate as to their likely impact over coming months.

In this connection it is important to note that the strength of economic expansion so far this quarter has been somewhat less than we had projected earlier. Just some five weeks ago, we were expecting GNP to increase at about a $20 billion annual rate this quarter. Today we would probably trim that estimate by at least $3 billion--perhaps somewhat more--although when November data come in, the situation may look a bit rosier.

One can readily identify several factors contributing to this reduced appraisal of economic activity. The auto strike is making a bigger dent in incomes, consumption, and stock-building than we had allowed for earlier. Ford was down for about two weeks more than we had expected, and some work stoppages--or at least some drag on output--at General Motors is still a strong possibility. Moreover, some of the inventory increase we had expected to show up in the fourth quarter--especially in a build-up of automobile stocks--had occurred earlier and was captured in the latest revised figures for third-quarter GNP. These developments in the auto industry would trim from $2 to $3 billion from our earlier estimate of the GNP rise in the current quarter.

Secondly, the enactment of the Federal pay raise is, sorrowfully, coming later than penurious Government workers had hoped. The raise won't be showing up in pay checks until too late in the quarter to boost consumption as much as had been projected earlier.

Offsetting these factors causing us to reduce our estimates of the current pace of expansion is the stronger showing being made in residential construction, which has continued a strong recovery. Housing starts hit the 1.5 million annual rate in October. Also, there may be a catch-up underway in defense spending, which fell significantly short of projections in the third quarter, but may make up some of the short-fall by year end. Balancing out these pluses and minuses, we would now estimate GNP growth in current dollars this quarter to be in the $16 - $18 billion range, instead of the $18 - $20 billion range projected earlier.

We won't know until Wednesday--when the BLS releases new price data--whether there is any reason to change our estimate of how large a share of the current-dollar increase in GNP reflects price increases, and how much real output gains. You will recall that nearly half of the third-quarter rise in GNP represented higher prices rather than real growth, with the deflator increasing at a shocking 3.8 per cent annual rate. Our estimate for the deflator in the fourth quarter is for a rise of about 3 per cent in prices, plus about a seven-tenths of a percentage point increase for the Government pay raise. The reduced number of newspaper reports of price increases suggests that some slight improvement in price performance may indeed be under way, but we will have to wait another day or so to get official confirmation.

Looking ahead, one can also find several reasons for trimming estimates of future GNP increases. The principal modification relates to the expected increase in social security benefits, for which three different proposals are under consideration in the Congress. Without getting into too many technical details, the principal difference in the proposals under consideration relate to the amount and timing of benefit payments. We would now guess that the most likely compromise will be closer to the version reported by the Senate Finance Committee, rather than to the House version we had used earlier. The Senate Finance Committee's version, while providing larger benefits, would postpone the initial payments to beneficiaries until April 1, and thereby reduce significantly the projected income and consumption flows in the first quarter.

On a more general basis, one would also have to assume that if the domestic and international financial developments of recent days have any effect on consumer and business spending propensities, it would be in the direction of inducing greater caution in spending. All of the talk--however unfounded--of the collapse of international monetary arrangements, and of possible collapse in international trade, and of new restrictive measures, must operate to cause reconsideration of some major expenditure decisions.

Moreover, at today's levels of short-term interest rates, there is no great financial hardship in temporarily remaining relatively liquid, and in postponing commitments for long-term physical or financial investments. And at today's levels of longer-term interest rates, a growing number of borrowers appear to be priced out of the market.

A tally of municipal bond postponements, for example, shows a significant increase in the number and dollar volume of issues recently postponed or cut back in size. The level of mortgage rates has continued to creep closer to the 1966 peak; even before the discount rate increase, the data indicated that insured mortgages were trading at a level only about an eighth of a percentage point below that of last November. And reports abound of more restrictive non-price terms, suggesting that some potential home owners may find it difficult to finance their intended purchases.

The record volume of mortgage commitments outstanding should maintain construction activity at high, but not significantly rising, levels into next spring. But if thrift institutions experience significant withdrawal symptoms over the year-end dividend crediting period--an increasing possibility, given the tapering in inflows that has already occurred and the increasing attractiveness to savers of market instruments--the flow of new commitments to support housing activity later next year is likely to be cut back significantly.

Over all, then, there seem to be adequate reasons for lowering somewhat our expectations as to the prospective pace of economic expansion. But even after allowance for all of the factors contributing to a lessening of ebullience in the economy, we're still left with prospects of an excessively rapid increase in demands. The projection presented at the last Committee meeting indicated that without adequate fiscal restraint, GNP would rise at a rate of about $22 to $23 billion over the first half of 1968, patently too rapid a pace in a relatively fully employed economy. But even lowering our estimate to $19 or $20 billion a quarter isn't much comfort. Expansion of demands at this rate would still leave us with intolerably large price pressures.

Thus, there is no occasion yet to modify our advocacy of fiscal restraint, particularly since it is needed not only on domestic grounds, but more than ever before to reassure holders of dollars abroad of our determination to maintain the strength of our economy and our currency. Until we win the fiscal battle, we will have to run the risks inherent in increased monetary restraint. Therefore, as soon as orderly market conditions permit, I would recommend implementing through open market operations the action taken on the discount rate, in order to achieve the money market conditions specified in the interim blue book.

Chairman Martin then invited Mr. Solomon to amplify his earlier remarks about recent international developments.

Mr. Solomon noted that the staff materials distributed to the Committee before this meeting included some details on the British program, announced simultaneously with the devaluation, to reduce domestic demand and thus free resources for expansion of exports. The ultimate objective was an improvement in the U.K. balance of payments of $1.2 billion per year at the new exchange rate. After a preliminary analysis the staff had concluded that the program was reasonable, but its success obviously would be contingent on the way in which it was implemented as time passed.

The point had been made, Mr. Solomon continued, that by devaluing in 1967 rather than in 1964 the British simply had wasted three years. But that was not necessarily the case. For devaluation to be successful it was necessary, first, that there be some slack in the British economy to permit an expansion of exports; and second, that increases in wages and prices not be permitted to erode the competitive advantage offered by the change in parity. If the British had accomplished nothing else over the last three years, they had produced some domestic slack and they had developed the beginnings of an incomes policy. Accordingly, he thought it was misleading to say that they had simply wasted three years.

Mr. Solomon added that as a matter of simple arithmetic an improvement of $1.2 billion in the U.K. balance of payments would involve an equivalent deterioration in the balance of payments of the rest of the world. Meanwhile the United States also would be trying to improve its payments balance. Continental Europe was the only area in the world that could afford to sustain much of a deterioration in its balance of payments; the Far East could tolerate a little, but not much. It was reasonable, then, to expect that in the months ahead there would be some acute discussions of the need for international payments adjustments not only by countries in deficit but also by countries in surplus. Unless continental Europe was willing to accept a smaller surplus in its payments balance it would not be possible for the United Kingdom and the United States to achieve the improvements they sought.

Chairman Martin then said that it was necessary for him to leave at this point to attend another meeting. Accordingly, he would briefly state his views on domestic monetary policy. In his judgment a posture of "steady in the boat" was called for at this juncture; there were too many crosscurrents at work for the Committee to do anything but mark time until its next meeting, on December 12. He favored adoption of the draft directive submitted by the staff.[1/]

1/ Appended to this memorandum as Attachment A.

Chairman Martin then withdrew, and Mr. Robertson assumed the chair.

Mr. Brimmer noted that Mr. Brill had recommended implementing through open market operations, when the opportunity arose, the policy of less ease implied by the discount rate increase. He asked whether Mr. Brill believed such an opportunity might arise before December 12.

Mr. Brill said he thought the answer probably would have to be in the negative, in light of Mr. Holmes' remarks today on the problems facing open market operations in the period immediately ahead.

Mr. Holmes commented that mainly by chance free reserves in the last statement week were at their lowest level in a long time, and the rate on Federal funds had moved up to a 4-1/2 - 4-5/8 per cent range. Thus, it might be possible to attain the complex of money market conditions specified in the interim blue book, but whether all of the conditions could be maintained was uncertain.

Mr. Hickman remarked that he had not interpreted the money market conditions specified in the interim blue book as involving further tightening. Although they included a somewhat higher bill rate, they also included ranges for free reserves and borrowings of $100 - $300 million and $75 - $150 million, respectively. But Mr. Brill's suggestion for implementing through open market operations the discount rate action seemed to imply seeking more restrictive levels of marginal reserves and borrowings.

Mr. Mitchell asked whether Mr. Brill had intended to suggest that the Committee shift to a tighter posture for monetary policy just at the time when prospects for Congressional action on a tax increase had brightened.

Mr. Brill said that, first, with respect to Mr. Hickman's comment, interest rates could rise with relatively little change in marginal reserves and borrowings under present circumstances, as had been noted in the interim blue book. However, in view of the many other factors that were likely to be impinging on reserves, marginal reserves might turn out to be far from recent levels, whatever the System's intent. As to Mr. Mitchell's question, Mr. Brill noted that interest rates had already moved up; as of this morning, the bill rate was 30 basis points higher than at the time of the discount rate action. As he saw it, the question was how soon the full amount of the discount rate increase should be reflected in the level of bill rates. Not being as convinced of the imminence of fiscal restraint, he would recommend moving to achieve money market conditions consistent with the new higher discount rate as soon as conditions in the markets had stabilized.

Mr. Hickman commented that the level of bill rates that would emerge also would depend to a large extent on the action taken by the Ways and Means Committee this week.

Mr. Brimmer remarked that he saw no basis for changing policy before the next meeting of the Committee. He interpreted the staff's draft directive as authorizing the Manager, in light of the existing uncertainties, to exercise his best judgment in dealing with any unusual pressures that might develop.

Mr. Robertson suggested that in view of the lateness of the hour the members confine their comments in the go-around to the subject of the directive. Personally, he thought that the period until the next meeting would be one of adjustment to recent events. Accordingly, he believed that the Committee should not change policy today, and that it should give the Manager leeway to adapt operations to emerging developments.

Mr. Bilby said that this was a time for the Committee to let the dust settle. He found the draft directive to be satisfactory, and would stress that the Manager had to have considerable freedom to adjust to unforeseen developments in the period ahead. He hoped that some assistance would be forthcoming from fiscal policy.

Mr. Ellis said he would accept the draft directive on the grounds that the objective of facilitating orderly market adjustments was of overriding importance at the moment. He would emphasize, however, that that was a short-range objective. He also viewed the increases in the swap lines that had been approved this morning as having a short-range objective; for the longer run, their effect might not be entirely positive. One important ingredient of a program to defend the dollar in the short run might very well be convincing evidence that the Committee intended to contribute to that defense over the longer run through its domestic monetary policy. Accordingly, he would endorse Mr. Brill's suggestion that when possible the Committee should make it clear that it intended to validate the discount rate action through open market operations.

Mr. Irons thought that under the existing circumstances the draft directive submitted by the staff was appropriate for the brief period until the next meeting, on the understanding that the Committee would make a thorough review of the situation at that time. He agreed that, when possible, open market operations should be used to validate the discount rate action.

Mr. Swan said he would accept the draft directive for the period until the next meeting. Obviously it carried no implications for the policy to be pursued in the subsequent period.

Messrs. Galusha and Scanlon indicated that they found the draft directive acceptable. The latter added that he shared the views Mr. Ellis had expressed.

Mr. Tow commented that both clauses of the draft directive appeared proper for the next two weeks.

Mr. Mitchell agreed that the draft directive was appropriate. He thought the policy course Mr. Brill had recommended was inappropriate, and was inconsistent with the latter's own remarks on the economic outlook.

Mr. Maisel agreed with Mr. Mitchell's observation. It was not his understanding that the discount rate action necessarily implied any basic change in the Committee's reserve targets.

Messrs. Brimmer and Sherrill indicated that they approved the draft directive. Mr. Sherrill remarked that the Desk was to be complimented on its operations of last Monday, which in his judgment were entirely appropriate.

Mr. Hickman approved the draft directive. He thought Mr. Mitchell's comments were well taken, and he saw no reason for any definite change in policy at this time. Such a change would have the disadvantage of injecting monetary policy into the forefront of the debate on fiscal policy at a time when Congressional interest in a tax bill had been renewed.

Mr. Francis said he was no less concerned about the domestic situation than he had been for some time. However, he recognized the critical environment existing at the moment and thought that the course indicated in the draft directive was appropriate for the present. He hoped that economic visibility would be improved by the time of the Committee's next meeting.

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:

System open market operations until the next meeting of the Committee shall be conducted with a view to facilitating orderly market adjustments to the increase in Federal Reserve discount rates; but operations may be modified as needed to moderate any unusual pressures stemming from international financial uncertainties.

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

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

November 24, 1967

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on November 27, 1967

System open market operations until the next meeting of the Committee shall be conducted with a view to facilitating orderly market adjustments to the increase in Federal Reserve discount rates; but operations may be modified as needed to moderate any unusual pressures stemming from international financial uncertainties.