MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, March 5, 1968, at 9:30 a.m.

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

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

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

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

Messrs. Cardon and Fauver, Assistants to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors

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

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

The Secretary reported that advices had been received of the election by the Federal Reserve Banks of members and alternate members of the Federal Open Market Committee for the term of one year beginning March 1, 1968, that it appeared that such persons were legally qualified to serve, and that they had executed their oaths of office.

The elected members and alternates were as follows:

George H. Ellis, President of the Federal Reserve Bank of Boston, with Karl R. Bopp, President of the Federal Reserve Bank of Philadelphia, as alternate;

Alfred Hayes, President of the Federal Reserve Bank of New York, with William F. Treiber, First Vice President of the Federal Reserve Bank of New York, as alternate;

W. Braddock Hickman, President of the Federal Reserve Bank of Cleveland, with Charles J. Scanlon, President of the Federal Reserve Bank of Chicago, as alternate;

Monroe Kimbrel, President of the Federal Reserve Bank of Atlanta, with Philip E. Coldwell, President of the Federal Reserve Bank of Dallas, as alternate;

Hugh D. Galusha, Jr., President of the Federal Reserve Bank of Minneapolis, with George H. Clay, President of the Federal Reserve Bank of Kansas City, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after February 28, 1969, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, as the case might be, they would cease to have any official connection with the Federal Open Market Committee:

Wm. McC. Martin, Jr.	Chairman
Alfred Hayes	Vice Chairman
Robert C. Holland	Secretary
Merritt Sherman	Assistant Secretary
Kenneth A. Kenyon	Assistant Secretary
Arthur L. Broida	Assistant Secretary
Charles Molony	Assistant Secretary
Howard H. Hackley	General Counsel
David B. Hexter	Assistant General Counsel
Daniel H. Brill	Economist
Stephen H. Axilrod, A. B. Hersey, John H. Kareken, Albert R. Koch, Robert G. Link, Maurice Mann, J. Charles Partee, John E. Reynolds, Robert Solomon, Charles T. Taylor, and Parker B. Willis	Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Federal Open Market Committee after February 28, 1969.

By unanimous vote, Alan R. Holmes and Charles A. Coombs were selected to serve at the pleasure of the Federal Open Market Committee as Manager of the System Open Market Account and as Special Manager for foreign currency operations for such Account, respectively, it being understood that their selection was subject to their being satisfactory to the Board of Directors of the Federal Reserve Bank of New York.

Secretary's Note: Advice subsequently was received that Messrs. Holmes and Coombs were satisfactory to the Board of Directors of the Federal Reserve Bank of New York for service in the respective capacities indicated.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on February 6, 1968, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on February 6, 1968, was accepted.

Consideration was then given to the continuing authorizations of the Committee, according to the customary practice of reviewing such matters at the first meeting in March of every year, and the actions set forth hereinafter were taken.

By unanimous vote, the following procedures with respect to allocations of securities in the System Open Market Account were approved without change:

1. Securities in the System Open Market Account shall be reallocated on the last business day of each month by means of adjustments proportionate to the adjustments that would have been required to equalize approximately the average reserve ratios of the 12 Federal Reserve Banks based on the most recent available five business days' reserve ratio figures.

2. The Board's staff shall calculate, in the morning of each business day, the reserve ratios of each Bank after allowing for the indicated effects of the settlement of the Interdistrict Settlement Fund for the preceding day. If these calculations should disclose a deficiency in the reserve ratio of any Bank, the Board's staff shall inform the Manager of the System Open Market Account, who shall make a special adjustment as of the previous day to restore the reserve ratio of that Bank to the average of all the Banks. However, such adjustments shall not be made beyond the point where a deficiency would be created at any other Bank. Such adjustments shall be offset against the participation of the Bank or Banks best able to absorb the additional amount or, at the discretion of the Manager, against the participation of the Federal Reserve Bank of New York. The Board's staff and the Bank or Banks concerned shall then be notified of the amounts involved and the Interdistrict Settlement Fund shall be closed after giving effect to the adjustments as of the preceding business day.

3. Until the next reallocation the Account shall be apportioned on the basis of the ratios determined in paragraph 1, after allowing for any adjustments as provided for in paragraph 2.

4. Profits and losses on the sale of securities from the Account shall be allocated on the day of delivery of the securities sold on the basis of each Bank's current holdings at the opening of business on that day.

Mr. Holmes noted that the procedure for allocating the System Open Market Account which the Committee had just reaffirmed was based on the 25 per cent gold cover requirement for Federal Reserve notes. The House had already passed legislation removing the gold cover requirement and such action was under consideration in the Senate. While he had not recommended any change in procedure at this time, he thought the Committee might want to make a change promptly, perhaps by telegraph vote, if and when such legislation was enacted.

The simplest change would be to revert to the procedure followed before the decline in the over-all System reserve ratio called into question the ability of any individual Reserve Bank to maintain the legal requirement. That could be accomplished by dropping paragraph 2 of the present procedure under which almost daily adjustments were made to prevent any one Bank from falling below the legal requirement, and making minor changes in the present paragraphs 1 and 3, as shown on the copies of the suggested revised procedure that had been distributed.[1/]

The net result of the change, Mr. Holmes observed, would be to continue to reallocate the Account at the end of each month to equalize the ratio of gold holdings to note liabilities of each Bank based on its position on the last five business days. That

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1/ Appended to this memorandum as Attachment A.

procedure would no longer have any relation to the old legal reserve requirement but would avoid day-to-day adjustments. It would also be a convenient way of preserving roughly the same ratio of earning and non-earning assets in the portfolio of each Reserve Bank.

A proposed list for distribution of periodic reports prepared by the Federal Reserve Bank of New York for the Federal Open Market Committee was presented for consideration and approval.

By unanimous vote, authorization was given for the following distribution:

1. Members and Alternate Members of the Committee, other Reserve Bank Presidents, and officers of the Committee.
*2. The Secretary of the Treasury.
*3. The Under Secretary of the Treasury for Monetary Affairs and the Deputy Under Secretary for Monetary Affairs.
*4. The Assistant to the Secretary of the Treasury working on debt management problems.
*5. The Fiscal Assistant Secretary of the Treasury.
6. The Director of the Division of Bank Operations of the Board of Governors.
7. The officer in charge of research of each of the Federal Reserve Banks not represented by its President on the Committee.
8. The officers of the Federal Reserve Bank at New York working under the Manager and Special Manager of the System Open Market Account.
9. With the approval of a member of the Committee or any other President of a Federal Reserve Bank, with notice to the Secretary, any other employee of the Board of Governors or of a Federal Reserve Bank.

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* Weekly reports only.

By unanimous vote, the Committee reaffirmed the authorization, first given on March 1, 1951, for the Chairman to appoint a Federal Reserve Bank to operate the System Open Market Account temporarily in case the Federal Reserve Bank of New York is unable to function.

By unanimous vote, the following resolution to provide for the continued operation of the Federal Open Market Committee during an emergency was reaffirmed:

In the event of war or defense emergency, if the Secretary or Assistant Secretary of the Federal Open Market Committee (or in the event of the unavailability of both of them, the Secretary or Acting Secretary of the Board of Governors of the Federal Reserve System) certifies that as a result of the emergency the available number of regular members and regular alternates of the Federal Open Market Committee is less than seven, all powers and functions of the said Committee shall be performed and exercised by, and authority to exercise such powers and functions is hereby delegated to, an Interim Committee, subject to the following terms and conditions:

Such Interim Committee shall consist of seven members, comprising each regular member and regular alternate of the Federal Open Market Committee then available, together with an additional number, sufficient to make a total of seven, which shall be made up in the following order of priority from those available: (1) each alternate at large (as defined below); (2) each President of a Federal Reserve Bank not then either a regular member or an alternate; (3) each First Vice President of a Federal Reserve Bank; provided that (a) within each of the groups referred to in clauses (1),(2), and (3) priority of selection shall be in numerical order according to the numbers of the Federal Reserve Districts, (b) the President and the First Vice President of the same Federal Reserve Bank shall not serve at the same time as members of the Interim Committee, and (c) whenever a regular member or regular alternate of the Federal Open Market Committee

or a person having a higher priority as indicated in clauses (1), (2), and (3) becomes available he shall become a member of the Interim Committee in the place of the person then on the Interim Committee having the lowest priority. The Interim Committee is hereby authorized to take action by majority vote of those present whenever one or more members thereof are present, provided that an affirmative vote for the action taken is cast by at least one regular member, regular alternate, or President of a Federal Reserve Bank. The delegation of authority and other procedures set forth above shall be effective only during such period or periods as there are available less than a total of seven regular members and regular alternates of the Federal Open Market Committee.

As used herein the term "regular member" refers to a member of the Federal Open Market Committee duly appointed or elected in accordance with existing law; the term "regular alternate" refers to an alternate of the Committee duly elected in accordance with existing law and serving in the absence of the regular member for whom he was elected; and the term "alternate at large" refers to any other duly elected alternate of the Committee at a time when the member in whose absence he was elected to serve is available.

By unanimous vote, the following resolution authorizing certain actions by the Federal Reserve Banks during an emergency was reaffirmed:

The Federal Open Market Committee hereby authorizes each Federal Reserve Bank to take any or all of the actions set forth below during war or defense emergency when such Federal Reserve Bank finds itself unable after reasonable efforts to be in communication with the Federal Open Market Committee (or with the Interim Committee acting in lieu of the Federal Open Market Committee) or when the Federal Open Market Committee (or such Interim Committee) is unable to function.

(1) Whenever it deems it necessary in the light of economic conditions and the general credit situation then prevailing (after taking into account the possibility of providing necessary credit through advances secured by direct obligations of the United States under the last paragraph of section 13 of the Federal Reserve

Act), such Federal Reserve Bank may purchase and sell obligations of the United States for its own account, either outright or under repurchase agreement, from and to banks, dealers, or other holders of such obligations.

(2) In case any prospective seller of obligations of the United States to a Federal Reserve Bank is unable to tender the actual securities representing such obligations because of conditions resulting from the emergency, such Federal Reserve Bank may, in its discretion and subject to such safeguards as it deems necessary, accept from such seller, in lieu of the actual securities, a "due bill" executed by the seller in form acceptable to such Federal Reserve Bank stating in substantial effect that the seller is the owner of the obligations which are the subject of the purchase, that ownership of such obligations is thereby transferred to the Federal Reserve Bank, and that the obligations themselves will be delivered to the Federal Reserve Bank as soon as possible.

(3) Such Federal Reserve Bank may in its discretion purchase special certificates of indebtedness directly from the United States in such amounts as may be needed to cover overdrafts in the general account of the Treasurer of the United States on the books of such Bank or for the temporary accommodation of the Treasury, but such Bank shall take all steps practicable at the time to insure as far as possible that the amount of obligations acquired directly from the United States and held by it, together with the amount of such obligations so acquired and held by all other Federal Reserve Banks, does not exceed $5 billion at any one time.

Authority to take the actions set forth shall be effective only until such time as the Federal Reserve Bank is able again to establish communications with the Federal Open Market Committee (or the Interim Committee), and such Committee is then functioning.

By unanimous vote the Committee reaffirmed the authorization, first given at the meeting on December 16, 1958, providing for System personnel assigned to the Office of Emergency Planning, Special Facilities Division, on a rotating basis to have access to the resolutions (1) providing for

continued operation of the Committee during an emergency and (2) authorizing certain actions by the Federal Reserve Banks during an emergency.

There was unanimous agreement that no action should be taken to change the existing procedure, as called for by resolution adopted June 21, 1939, requesting the Board of Governors to cause its examining force to furnish the Secretary of the Federal Open Market Committee a report of each examination of the System Open Market Account.

Reference was made to the procedure authorized at the meeting of the Committee on March 2, 1955, and most recently reaffirmed on March 7, 1967, whereby, in addition to members and officers of the Committee and Reserve Bank Presidents not currently members of the Committee, minutes and other records could be made available to any other employee of the Board of Governors or of a Federal Reserve Bank with the approval of a member of the Committee or another Reserve Bank President, with notice to the Secretary.

It was stated that lists of currently authorized persons at the Board and at each Federal Reserve Bank (excluding secretaries and records and duplicating personnel) had recently been confirmed by the Secretary of the Committee. The current lists were reported to be in the custody of the Secretary, and it was noted that revisions could be sent to the Secretary at any time.

It was agreed unanimously that no action should be taken at this time to amend the procedure authorized on March 2, 1955.

In connection with the foregoing action, Chairman Martin said he would emphasize the need for maintaining the confidentiality of the Committee's records. While he was not suggesting that the names of any currently authorized persons be removed from the lists, the members should bear in mind the need for insuring that access to the Committee's confidential records was appropriately limited.

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 Open Market Account in accordance with the following continuing authority directive relating to transactions in U.S. Government securities, agency obligations, and bankers' acceptances:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent current economic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities in the open market, from or to Government securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government securities with the Treasury or allow them to mature without replacement; provided that the aggregate amount of such securities held in such Account at the close of business on the day of a meeting of the Committee at which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy or sell prime bankers' acceptances of the kinds designated in the Regulation of the Federal Open Market Committee in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed (1) $125 million or (2) 10 per cent of the total of bankers' acceptances outstanding as shown in the most recent acceptance survey conducted by the Federal Reserve Bank of New York, whichever is the lower;

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers' acceptances with maturities of 6 months or less at the time of purchase, from nonbank dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates not less than (1) the discount rate of the Federal Reserve Bank of New York at the time such agreement is entered into, or (2) the average issuing rate on the most recent issue of 3-month Treasury bills, whichever is the lower; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

2. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury;

> provided that the rate charged on such certificates shall be a rate 1/4 of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

Chairman Martin then noted that a memorandum from the Secretariat, entitled "Proposed revisions in the authorization for System foreign currency operations," had been distributed under date of February 28, 1968.[1/] He invited Mr. Coombs to comment.

Mr. Coombs said he concurred in the two revisions recommended in the Secretariat's memorandum, both of which affected paragraph 3 of the authorization. One change proposed was to add the words "Unless otherwise expressly authorized by the Committee" to the first sentence of the paragraph, before the statement that all transactions in foreign currencies should be at prevailing market rates. The purpose was to repair an omission that had been made inadvertently when the Committee's foreign currency instruments were reformulated in June 1966. Under the prior instruments, which included such a qualification, on two occasions the Committee had approved, simply by vote, the payment of a small commission on a bulk purchase of a foreign currency. As the authorization was presently phrased, however, an amendment would be required before the Committee could approve a similar transaction

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

in the future. While he would hope that occasions for such transactions would not arise often, it seemed desirable to amend the authorization now to simplify the Committee's action if they should arise.

The other recommendation, Mr. Coombs continued, was to delete the second sentence of paragraph 3, which read, "Insofar as is practicable, foreign currencies shall be purchased through spot transactions when rates for those currencies are at or below par and sold through spot transactions when such rates are at or above par, except when transactions at other rates (i) are specifically authorized by the Committee, (ii) are necessary to acquire currencies to meet System commitments, or (iii) are necessary to acquire currencies for the Stabilization Fund, provided that these currencies are resold forward to the Stabilization Fund at the same rate." He had never fully understood the purpose of the restrictions on foreign currency sales at prices below par and on purchases at prices above par, which had been included in the Committee's original foreign currency instruments adopted in February 1962. The Secretariat's memorandum suggested that those restrictions were intended to avoid operations that were destabilizing in the sense that they would drive exchange rates farther from their par values. But, as the memorandum also noted, sufficient safeguards against potentially destabilizing operations

would seem to be provided by the specification of the purposes for which operations were authorized in paragraph 2 of the foreign currency directive.

Moreover, Mr. Coombs said, various practical considerations militated against such restrictions. For example, it might often be desirable to repatriate earnings on a foreign currency even though its exchange rate was below par; as he had reported at the meeting of the Committee on November 14, 1967, that question had arisen over the preceding year or so in connection with System earnings on its holdings of sterling. Also, on various occasions during that period when Britain had been taking in dollars, Bank of England officials had suggested that it would be appropriate for the System to reduce its holdings of guaranteed sterling and he had acted on such suggestions. Finally, it would seem desirable for the System Account to be able to sell out, on short notice, its holdings of a currency that was on the point of devaluation, as had been done with sterling last November. As he had noted in the discussion at the November 14 meeting, some time ago he had checked with Chairman Martin through a member of the Board's staff regarding the Committee's intent with respect to the restriction on sales of foreign currencies below par, and had been advised to take a common sense view of the matter. In light of the various considerations that he had mentioned and that were discussed in the Secretariat's

memorandum, he agreed with the recommendation that the sentence be deleted.

Chairman Martin asked whether there were any questions concerning or objections to the proposed revisions of the authorization, and none was heard.

By unanimous vote, the authorization for System foreign currency operations was amended to read as follows:

AUTHORIZATION FOR SYSTEM FOREIGN CURRENCY OPERATIONS

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, and with the Bank for International Settlements:

Austrian schillings
Belgian francs
Canadian dollars
Danish kroner
Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Mexican pesos
Netherlands guilders
Norwegian kroner
Swedish kronor
Swiss francs

B. To hold foreign currencies listed in paragraph A above, up to the following limits:

(1) Currencies held spot or purchased forward, up to the amounts necessary to fulfill outstanding forward commitments;

(2) Additional currencies held spot or purchased forward, up to the amount necessary for System operations to exert a market influence but not exceeding $150 million equivalent; and

(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.

C. To have outstanding forward commitments undertaken under paragraph A above to deliver foreign currencies, up to the following limits:

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

(2) Commitments to deliver Italian lire, under special arrangements with the Bank of Italy, up to $500 million equivalent; and

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

D. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N,

Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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

3. Unless otherwise expressly authorized by the Committee, all transactions in foreign currencies undertaken under paragraph 1(A) above shall be at prevailing market rates and no attempt shall be made to establish rates that appear to be out of line with underlying market forces.

4. It shall be the practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the

Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested insofar as practicable, considering needs for minimum working balances. Such investments shall be in accordance with Section 14(e) of the Federal Reserve Act.

6. A Subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors (or in the absence of the Chairman or of the Vice Chairman of the Board of Governors the members of the Board designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee his alternate) is authorized to act on behalf of the Committee when it is necessary to enable the Federal Reserve Bank of New York to engage in foreign currency operations before the Committee can be consulted. All actions taken by the Subcommittee under this paragraph shall be reported promptly to the Committee.

7. The Chairman (and in his absence the Vice Chairman of the Committee, and in the absence of both, the Vice Chairman of the Board of Governors) is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Secretary;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on such policy matters as may relate to the Secretary's responsibilities; and

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G (1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

10. The Special Manager of the System Open Market Account for foreign currency operations shall keep the Committee informed on conditions in foreign exchange markets and on transactions he has made and shall render such reports as the Committee may specify.

By unanimous vote, the foreign currency directive given below was reaffirmed:

FOREIGN CURRENCY DIRECTIVE

1. The basic purposes of System operations in foreign currencies are:

A. To help safeguard the value of the dollar in international exchange markets;

B. To aid in making the system of international payments more efficient;

C. To further monetary cooperation with central banks of other countries having convertible currencies, with the International Monetary Fund, and with other international payments institutions;

D. To help insure that market movements in exchange rates, within the limits stated in the International Monetary Fund Agreement or established by central bank practices, reflect the interaction of underlying economic forces and thus serve as efficient guides to current financial decisions, private and public; and

E. To facilitate growth in international liquidity in accordance with the needs of an expanding world economy.

2. Unless otherwise expressly authorized by the Federal Open Market Committee, System operations in foreign currencies shall be undertaken only when necessary:

A. To cushion or moderate fluctuations in the flows of international payments, if such fluctuations (1) are deemed to reflect transitional market unsettlement or other temporary forces and therefore are expected to be reversed in the foreseeable future; and (2) are deemed to be disequilibrating or otherwise to have potentially destabilizing effects on U.S. or foreign official reserves or on exchange markets, for example, by occasioning market anxieties, undesirable speculative activity, or excessive leads and lags in international payments;

B. To temper and smooth out abrupt changes in spot exchange rates, and to moderate forward premiums and discounts judged to be disequilibrating. Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified or curtailed unless upon review and reassessment of the situation the Committee directs otherwise;

C. To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions. Whenever exchange market instability threatens to produce disorderly conditions, System transactions may be undertaken if the Special Manager reaches a judgment that they may help to reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. In such cases, the Special Manager shall consult as soon as practicable with the Committee or, in an emergency, with the members of the Subcommittee designated for that purpose in paragraph 6 of the Authorization for System foreign currency operations; and

D. To adjust System balances within the limits established in the Authorization for System foreign currency operations in light of probable future needs for currencies.

3. System drawings under the swap arrangements are appropriate when necessary to obtain foreign currencies for the purposes stated in paragraph 2 above.

4. Unless otherwise expressly authorized by the Committee, transactions in forward exchange, either outright or in conjunction with spot transactions, may be undertaken only (i) to prevent forward premiums or discounts from giving rise to disequilibrating movements of short-term funds; (ii) to minimize speculative disturbances; (iii) to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders; (iv) to allow greater flexibility in covering System or Treasury commitments, including commitments under swap arrangements; (v) to facilitate the use of one currency for the settlement of System or Treasury commitments denominated in other currencies; and (vi) to provide cover for System holdings of foreign currencies.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period February 6 through 28, 1968, and a supplemental report covering February 29 through March 4, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said the Treasury gold stock would remain unchanged this week. However, the Treasury was faced with a prospective deficit in the Stabilization Fund's holdings over the coming week or so of well over $100 million. Most of the pressure on the gold stock had arisen from intervention by the gold pool in the London market. By the time of the British devaluation late last November, the

pool had run up a deficit of $680 million, compared with its original resources of $270 million. In the following six-week period through the end of 1967, the pool paid out an additional $1.5 billion.

With the announcement on January 1 of the new U.S. balance of payments measures, Mr. Coombs continued, many observers were hopeful that there might be at least a technical reversal in the pool situation for a time. At the Committee's January meeting, he had expressed the hope that the pool might recover as much as $200 million or $300 million before relapsing into deficit. Other observers had been even more optimistic. In fact, however, such hopes had not materialized. During January, there was a further drain on the pool's resources of $132 million, and the losses continued in February to the extent of $104 million. The February losses occurred despite the fact that in the latter part of the month there were heavy maturities of three-month forward gold contracts that had been executed during the week after the November devaluation, before the decision of European central banks at the Frankfurt meeting to ban forward contracts in gold. Earlier there had been some hope for a reflow of gold to the market when those forward contracts matured, but that did not occur. Since then, there had been a further heavy rush of gold buying in London. The pool lost $90 million last Friday and $53 million yesterday, and

buying pressure was continuing today with losses thus far amounting to $47 million. He thought that trend would continue; it was quite conceivable that the pool's losses for the week would come to $500 million.

During the past month or so, Mr. Coombs remarked, the supply of gold from South Africa had been abnormally low because that country was running a balance of payments surplus and accordingly was taking newly-produced gold into reserves rather than sending it to London. That situation was probably temporary. On the other hand, the conviction in markets all over the world, including New York, was that pool intervention in the London market would result in continuing and growing losses of official gold reserves and that the governments concerned would sooner or later abandon that policy as excessively costly. The past two months had witnessed a further crumbling of support by pool members; Italy bought gold from the United States at the end of January to replace what it had supplied to the pool during that month. There was a possibility that within the relatively near future only the United Kingdom, Germany, and perhaps Switzerland would be prepared to stay in the pool. It so, the U.S. share in pool operations would rise to about 80 per cent.

On the exchange markets, Mr. Coombs said, sterling remained in a precarious situation. One of the major risks involved in the

recent sterling devaluation, apart from its impact on the international financial system generally, had been the possibility that the gains the United Kingdom was expected to secure on trade account might be washed out by losses on capital account resulting from a disintegration of the sterling area. So far, such a balancing off of gains and losses from devaluation seemed to have occurred. The British trade figures for December and January were considerably improved and export orders looked promising. On the other hand, the sterling area countries were continuing to shift out of sterling into dollars and gold, while the Bank of England was in process of paying off heavy commitments in the form of forward exchange contracts reaching maturity; and such contracts would continue to mature over the next six months. On balance, during the three months since devaluation, the Bank of England's reserve position had deteriorated by $500 million; they had lost nearly $300 million in foreign exchange operations and had used $220 million in making year-end debt payments to the United States and Canada. During that period the British had made no reduction in their short-term debt to the Federal Reserve, the U.S. Treasury, and various foreign central banks, amounting to an aggregate of more than $3 billion. Indeed, they had received new credits of more than $300 million in the period, which had enabled them to show moderate reserve gains in January and February.

In general, Mr. Coombs observed, the exchange markets remained highly skeptical that the new parity would prove viable, and sterling thus remained vulnerable to speculative raids. Last Friday (March 1), for example, the British lost $220 million as the market was swept with rumors of impending changes in the U.S. gold policy and of prospective further liquidation of sterling area balances. They had not lost reserves so far this week, partly because sterling was permitted to slip below par and the forward discount to widen to nearly 4 per cent--developments which did not help confidence.

Unfortunately, Mr. Coombs continued, the situation of the Canadian dollar was almost as vulnerable, and speculative pressures in the various markets--gold, sterling, and Canadian dollars--were reinforcing one another. The Canadian problem resulted from the uncertainties created by the January 1 announcement of new U.S. balance of payments measures. The market thought the U.S. program would have adverse effects on Canada's position and would undermine the Canadian dollar parity. Since last November, the Bank of Canada had lost the huge total of $900 million, more than a third of its reserves, as a result of a capital flight together with a general drying up of the usual capital inflows. Much of those reserve losses had been replaced by the Canadian drawing on its swap line with the

System, by credits from the International Monetary Fund, and by a sizable volume of market swaps by the Bank of Canada. But such means of covering reserve losses could not be used indefinitely, and the Canadian officials no doubt had in mind Britain's experience of incurring large debts and then having to devalue anyway. The situation had now reached a critical stage; the next week or so might tell the story of whether or not a breakdown of the Canadian parity could be avoided. Needless to say, if the Canadian dollar were to go even heavier pressures could be expected on the London gold market, on sterling, and probably also on the Japanese yen, with repercussions on the whole international structure.

On a more cheerful note, Mr. Coombs said, he could report that a fair amount of progress had been made in reducing the System's swap debt which, as the Committee would recall, had reached a peak of $1.8 billion last December. He was hopeful that by the end of this week the debt would be reduced to somewhat less than $600 million, reflecting payoffs during the past two months or so of $1.2 billion. Those facts would be made public next week and hopefully would be met by a favorable market reaction.

Of the $1.2 billion of repayments, Mr. Coombs said, slightly more than $750 million resulted from a reversal of the heavy speculative flows that had been generated by the Mid-East war

and the devaluation of sterling, a reversal that was attributable in large part to the favorable effects of the January 1 announcement of the U.S. program. In addition, $166 million had been liquidated through issuance of securities denominated in foreign currencies, and another $120 million through acquisitions of foreign currencies arising out of the recent Canadian drawing on the IMF. By the end of this week a further $200 million would be settled through a U.S. drawing on the IMF and $25 million through a sale of gold to the Swiss National Bank. On the other side of the ledger, the British had made no progress since the end of November in paying down their swap debt to the System, which remained at $1,050 million.

As the Committee knew, Mr. Coombs continued, there had been quite a bit of concern when the new U.S. balance of payments program was announced on January 1 that there might be a severe tightening of conditions in the Euro-dollar market that would transmit further deflationary pressures to Europe, much of which had been experiencing slack business conditions for the past year or so. In fact, until very recently conditions in the Euro-dollar market had remained relatively easy. He thought that was attributable primarily to the usual post-year-end reflows of European funds to the Euro-dollar market, this year particularly from Germany and Switzerland--and also from Canada, which had lost

flight capital to the Euro-dollar market. Also, placements in short maturities of the proceeds of the heavy volume of Euro-dollar bond issues earlier this year had probably helped to keep the short-term Euro-dollar market easy.

However, Mr. Coombs observed, during the past week a definite turn seemed to have occurred, with the three-month Euro-dollar rate moving up from 5-1/2 to nearly 6 per cent. There was some feeling that the tightening process would continue. If so, that would put still further pressure on the British position, particularly since the Bank of England had now virtually withdrawn from the forward market; as he had indicated, the forward discount on sterling had widened to nearly 4 per cent yesterday. Rising Euro-dollar rates would also intensify the pressure on the Canadian dollar, and thus far the Canadian authorities had instituted no formal or informal measures to limit movements of funds out of the country. A week or so ago the central bank governors and finance ministers of the Common Market countries had declared in Rome that they would not allow interest rates to move up and thereby handicap business revival in their countries. It was by no means clear, however, just how they would be able to accomplish that objective if sharply rising rates in the Euro-dollar market excited sympathetic rate reactions in continental financial markets; in a number of the Common Market countries, at least, the instruments were lacking to

replenish the liquidity drawn into the Euro-dollar market. One possible means for dealing with pressures in the Euro-dollar market would be to arrange for the BIS to draw on its swap line with the System and place the funds in that market. However, he thought it would be a mistake to make such a suggestion to the BIS at this stage. It would be preferable, in his judgment, to follow the past practice of reserving that facility for emergency use.

Such an emergency might not be very far off, Mr. Coombs observed. The international financial system might be moving toward the brink of a major crisis which could far exceed in intensity the speculative storm caused by the British devaluation. He did not know whether there had been some contingency planning to deal with such a crisis; if there was not and the crisis erupted, the main burden of defending the dollar would again fall on the System swap network and forward operation facilities. Very large amounts could be involved, perhaps far exceeding the $2 billion of System swap drawings and forward commitments that resulted last year from the Mid-East war and sterling devaluation. If the System were to incur such massive foreign currency debts, he would again suggest that there be a clear understanding with the U.S. Treasury as to how those debts would be paid off if they did not prove reversible within the traditional six-month time span. At the Committee's meeting on November 14, 1967, he had referred to

the desirability of getting assurances that the Treasury would provide backstop facilities. In a subsequent meeting in which Chairman Martin and Mr. Hayes had participated, he had asked Secretary of the Treasury Fowler whether the System could count upon the Treasury's setting aside enough gold to insure repayment of any System debt in foreign currencies that could not otherwise be repaid. The Secretary had not been prepared at that time to offer categorical assurances on the point, and he (Mr. Coombs) thought that there now was an urgent need for pursuing the matter further.

Mr. Hickman asked Mr. Coombs to comment on the underlying causes of the recent problems in the London gold market.

Mr. Coombs said that for the past two and one-half years it had been his personal view--and that of officials of a number of European central banks--that a basic disequilibrium had developed between new production of gold and private demand, and that that disequilibrium would increase over time. Another view was that the bulk of current demand was essentially speculative, and that total demand would tail off rapidly to a level below new production if the market could be persuaded that the official price would never go up.

Mr. Hickman asked whether the development of an appropriate mix of fiscal and monetary policies in the United States would be

likely to have a substantial favorable effect on the London gold market.

Mr. Coombs replied that such an event would certainly tend to reduce speculative demands for gold. Whether or not it would completely remove the disequilibrium was a matter of judgment. His own view was that it would not; he would expect pool losses to continue.

Mr. Hickman then asked whether Mr. Coombs thought Congress in general--and particularly those Congressmen who were most influential with respect to fiscal policy--were being adequately informed about the gold situation.

Mr. Coombs replied that information on developments in the gold market was widely disseminated and that any interested person could keep informed simply by reading the newspapers.

Mr. Brimmer said that Mr. Coombs' comments on the Canadian situation raised three questions in his mind. First, if it proved impossible for the Canadians to hold to the present parity for their dollar, were they likely to shift to a new parity or move to a floating exchange rate? Secondly, given the recent parliamentary difficulties in Canada, was the Government in a position to act effectively? Finally, last autumn, before the British devaluation, Mr. Coombs had recommended that the System do what it could to help the British maintain the existing parity for the pound. Would

he make a similar recommendation with respect to the Canadian dollar now?

With respect to Mr. Brimmer's first question, Mr. Coombs said that if the Canadians were unable to maintain the current parity they were likely to shift to a floating rate. There was no evidence at the moment to suggest that the Canadian dollar was overvalued, and if the authorities were to consider establishing a new fixed rate they were likely to be in a quandary as to what rate to select. As to the third question, he thought it was essential for the Canadians to try to hold to the present rate. The question of how the new U.S. payments program would be implemented vis a vis Canada was currently under negotiation, and if that question could be resolved satisfactorily there might be a great deal to say in favor of a large package of special credits of one sort or another for Canada. Apart from supplying the Canadians with the money they needed and hopefully turning the tide of speculation against the Canadian dollar, such a package would provide a reaffirmation of international financial solidarity that was badly needed at the moment. A major factor affecting current attitudes in the market was the fear that the structure of international cooperation was coming apart, and a new demonstration that the nations were working together would be very helpful indeed.

Mr. Hayes said he agreed completely with Mr. Coombs' observations. With respect to Mr. Brimmer's second question, he thought there were still good grounds for hoping that the Canadians would soon take appropriate internal policy measures.

Mr. Maisel said he considered extremely important the Special Manager's earlier remarks about the need for discussing with the Treasury possible means for funding any large new swap debts the System might incur. Such discussions were desirable to insure not only that the means would be available to repay such debts, but also that account was taken of the real costs of System swap debts in the decision-making process. It should be clearly recognized at that stage that System swap debts were an ultimate charge against the U.S. Government. He hoped that the System would try to get a firm commitment from the Treasury of the type Mr. Coombs had mentioned.

Mr. Coombs remarked that it was the understanding of the System's swap partners that drawings would be settled in gold if necessary, and he thought that point should be stressed in discussions with the Treasury.

Mr. Mitchell commented that drawings under the swap network were intended to be used for dealing with transitory developments expected to prove reversible in the short run. From Mr. Coombs' remarks he gathered that the problems lying ahead were not of that

sort but rather would arise from unfavorable long-run trends. If that were the case he questioned whether an attempt should be made to deal with them initially by swap drawings.

Mr. Coombs said he had not meant to imply that there were unfavorable long-run trends in the exchange markets; his comments in that connection had been directed at the gold market. Whether secular trends with respect to the supply and demand for gold were unfavorable was a question on which well-informed people might disagree. Whatever their origins, however, developments in the gold market could precipitate tremendous short-run flows in the exchange markets, and it was reasonable to expect that pressures of the latter sort could be dealt with by utilizing the swap network. At the same time, it was necessary to know in advance how the swap debts would be repaid if they should prove not to be reversible within the customary period.

Mr. Mitchell then asked whether in his analysis of the gold situation Mr. Coombs was in effect saying that the price of $35 per ounce could not be held.

Mr. Coombs replied that in his judgment the official price of $35 per ounce could and should be maintained. The price on the London market was another matter. At times earlier in the postwar period the free market price had ranged much above $35; there was no necessary connection between the two prices.

Mr. Mitchell asked whether Mr. Coombs' position could be summarized by saying the present U.S. policy with respect to the London gold market was not viable, and that if continued it would be necessary for the System to incur large swap debts and rely on the Treasury for their eventual repayment.

Mr. Coombs replied that there was a serious problem with respect to the London gold market and well-informed persons disagreed on the best means for dealing with it. He had never been absolutely persuaded of the appropriateness of any particular course, but rather thought of the problem as a choice of the least dangerous line of action. It seemed clear, however, that whatever policy was decided on--whether to continue to pay out gold to support the price; to impose restrictions on the market, which he favored; or to let the price go--speculative pressures were likely to be stirred up that would result in large short-term flows in the exchange markets. In his judgment it would be appropriate--indeed, essential--for the System to try to deal with those flows by utilizing the swap network. But plans should be made in advance against the possibility that developments would not permit the unwinding of the drawings within a six-month period.

Mr. Hayes said he wanted to underline the distinction Mr. Coombs had drawn between the official price of gold and the price on the London market. There should be no question about the maintenance of the former.

Mr. Galusha commented that it might be well for members of the Committee and staff to undertake contingency planning against the possibility that the London gold pool would be discontinued while the official price was kept at $35. He gathered that that was one of the less unpleasant solutions of the current problem.

Mr. Coombs replied that in his judgment an uncontrolled breakout of the London price would perhaps have the most disastrous consequences of any of the possible courses of action.

Mr. Brimmer referred to Mr. Coombs' earlier comment that if the Canadians were unable to maintain their present parity there was a good chance that they would move to a floating exchange rate. He asked about the role of the System's swap line with the Bank of Canada in such an eventuality.

Mr. Coombs said that if Canada moved to a floating rate the Canadian balance of payments would automatically move into equilibrium and there would be little occasion for drawings by either party on the swap line. In any case, he would not recommend actual drawings by either party while Canada had a floating exchange rate. At the same time, he would see no reason for changing the present standby swap arrangements, since the Canadians might subsequently revert to a fixed exchange rate.

By unanimous vote, the System open market transactions in foreign currencies during the period February 6 through March 4, 1968, were approved, ratified, and confirmed.

Mr. Coombs then noted that the System's $100 million swap arrangement with the Bank of France, which had a period of three months, would mature on March 29, 1968. After reviewing the considerations involved, he had again arrived at the conclusion that there would be little gain to the System in maintaining that swap line, but also little harm. On balance, he thought there would be a slight advantage in maintaining the swap line, in view of the possibility of some future change in the attitude of the Bank of France. Thus, by a narrow margin, he concluded that he would recommend renewal of the line unless there were some political considerations in favor of discontinuing it.

Chairman Martin commented that he saw no harm in maintaining the swap line with the Bank of France. If it were to be discontinued he would prefer to have the initiative taken by the French.

> Renewal for a further period of three months of the $100 million swap arrangement with the Bank of France, maturing on March 29, 1968, was approved.

Mr. Coombs recommended renewal of two System drawings on the Netherlands Bank that would reach the end of their first three-month terms soon. One drawing was of $20 million, maturing March 27, 1968, and the other of $15 million, maturing April 4, 1968.

Renewal of the two drawings on the Netherlands Bank was noted without objection.

Mr. Coombs then noted that a series of System drawings in Swiss francs would reach the end of their first three-month terms later this month. These included a drawing on the Swiss National Bank of $127 million, which would mature on March 18, 1968, and drawings on the BIS of $5 million, maturing March 18; $60 million, maturing March 19; $75 million, maturing March 20; and $75 million, maturing March 21, 1968. He was hopeful that perhaps about $140 million of those drawings might be cleared up through an arrangement involving a combination of the issuance of Swiss-franc denominated securities and a sale of gold. That arrangement was still in process of negotiation, however, and he recommended renewal of the drawings if that proved necessary.

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

In conclusion, Mr. Coombs reported that a $300 million Bank of England drawing on the System would mature for the first time on March 29, 1968. While the British might be able to repay the drawing at maturity that did not seem likely at the moment. He recommended renewal of the drawing if requested by the Bank of England.

Renewal of the drawing by the Bank of England was noted without

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 February 6 through 28, 1968, and a supplemental report covering February 29 through March 4, 1968. Copies of both reports have been placed in the files of the Committee.

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

> I have very little to add to the description of developments contained in the regular written reports of open market operations to the Committee and in the blue book.[1/] As these reports indicate, the successful completion of the Treasury's refunding and cash financing--coupled with sharp increases in estimates of bank credit expansion in February after the middle of the month--led to a significant increase in restraint on the banking system through open market operations. Net borrowed reserves averaged close to $100 million in the past two statement weeks, while member bank borrowing at the Reserve Banks increased by something over $100 million and the Federal funds rate was mainly in a 4-3/4 - 4-7/8 per cent range.
>
> Treasury bill rates were generally above levels prevailing just before the last Committee meeting, but a sustained nonbank demand for bills, reinforced recently by relatively heavy foreign central bank buying, tended to hold back rate increases. In yesterday's regular weekly Treasury bill auction average rates of 5.00 and 5.17 per cent were established on 3- and 6-month bills respectively, up 4 and 5 basis points from rates established in the auction just before the Committee last met.
>
> In the capital markets, the Treasury's February financing operations were carried out successfully.

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

Reception was good but not exuberant--and that is just as well since too much exuberance could have led to problems in the secondary market. Despite continuing concern over both domestic and international developments, the market for Government notes and bonds remained generally firm although there is an air of caution evident. In the corporate market, underwriters bid aggressively for new issues, but investors were less enthusiastic. As a result, syndicate terminations last week resulted in increases in yields of about 10 basis points on some recently placed issues. The calendar of new issues to be publicly offered remains relatively light, but the volume of private placements has been rising. Municipal bond yields rose generally throughout the period as the calendar remained heavy and the threat of resumed sales of tax-exempt industrial bonds grew with the working out of arrangements to protect investors against legislation that, if enacted, might remove the tax-exempt status from such bonds.

As far as open market operations are concerned, the interval between meetings breaks roughly into two periods. Until just after mid-month the Board staff estimates of the February growth in the credit proxy were edging down to the lower end of the 7 - 10 per cent range estimated at the time of the last meeting. This time span, of course, coincided with the most active period of Treasury financing, with the books closing in the Treasury's cash sale of 5-5/8 per cent notes on February 13 and payment date on the refunding two days later. Over this period there was no question of invoking the proviso clause of the directive, and day-to-day operations sought to keep the money market firm. Rather heavy member bank borrowing over the long Lincoln's birthday weekend led temporarily to excessive reserves in the banking system, and on February 14 the System sold over $3/4 billion of Treasury bills, including $280 million on matched sale-purchase agreements, to head off a sharp reduction in the Federal funds rate. After mid-month, the day-to-day reserve statistics began to indicate that required reserves were running ahead of projections. Estimates of the February credit proxy rapidly moved above the lower end of the range projected at the last meeting, and with the new Treasury issues performing well, reserves were supplied reluctantly through open market operations with the results noted earlier. On this

occasion, even keel considerations did not interfere with the Committee's desire--given the rate of bank credit growth--to move to firmer money market conditions. This was good fortune, but we cannot always expect to be so lucky during Treasury financing periods.

Looking ahead, we could be free of even keel considerations for the next two months. The Treasury may, however, run into cash problems just before the April 15 tax date, depending in part on whether an issue of participation certificates is marketed and on possible cash drains from international transactions. The possibility that the Treasury may be raising new cash at about the time of the Committee's next meeting cannot therefore be ruled out.

I have very little to add to the blue book discussion of the possible relationships among money market indicators under a no-policy change assumption or under the assumption that the Committee decides to move towards greater restraint. Perhaps it should be emphasized that as the Federal funds rate is pushed further from the discount rate there may develop a growing preference on the part of some banks to use the discount window rather than pay a rising premium on funds. This might be particularly true at a time like this when banks have generally not been frequent or lengthy borrowers from the Reserve Banks. If this should happen to any significant extent we might--particularly if the Committee decides on a policy of greater restraint--find that larger member bank borrowing and a deeper net borrowed reserve figure may be needed in order to keep the funds rate firmly at 5 per cent. And, of course, it goes without saying that the future course of interest rates can be affected significantly by new domestic or international developments along the lines noted by Mr. Coombs and the impact of such developments on market expectations.

Mr. Mitchell asked whether Mr. Holmes thought there was much room for additional monetary restraint at present without putting pressure on existing Regulation Q ceilings.

Mr. Holmes replied that the maturity of CD's on which the 5-1/2 per cent ceiling rate was available had shortened somewhat

recently; some banks were now offering that rate on four-month CD's. However, rates on shorter-term CD's were still below the ceiling. Also, as noted in the blue book, there were likely to be downward seasonal pressures on short-term rates in the coming period, partly because the Treasury would be redeeming maturing tax-anticipation bills. On the whole, he thought there was some room for greater restraint under existing Regulation Q ceilings, although perhaps not a great deal of room.

Mr. Brimmer said he had been pleased to note that in the recent period the Desk had been able to recapture some of the earlier firmness in the money market. He then referred to Mr. Holmes' comment that the Treasury might be raising new cash at about the time of the next meeting of the Committee, and asked if Mr. Holmes could provide any firmer indications regarding probable Treasury financing activity before the May refunding.

Mr. Holmes replied that it was not possible to predict the Treasury's financing requirements with any certainty at this point. There was a marked difference between the New York Bank and Treasury projections of the Government's cash needs in early April, with the projections made at the Board falling in between the two. According to the New York Bank's estimates, the Treasury could get through that period without borrowing in the market, although they might have to borrow some moderate amount from the

System for a brief period. The Treasury estimates were more pessimistic. As he indicated, the outcome would depend importantly on whether an issue of PC's was marketed and whether there were substantial cash drains in connection with international transactions.

In reply to a question by Mr. Swan, Mr. Holmes said that no decision had been made as yet with regard to the size of the possible PC offering, but it was likely to be substantial--in the area of $3/4 - $1 billion.

Mr. Francis noted that he had participated in the daily telephone conference call in the period since the last meeting of the Committee. As he had understood the sense of the Committee's discussion at that meeting, the Manager was to take actions to prevent bank credit from rising at more than a 7 per cent annual rate on average from January to February. Operations were to be conducted with a view to maintaining firm conditions in the money market and, when Treasury financing permitted, to attain still firmer conditions if bank credit appeared to be expanding as rapidly as was then projected.

Mr. Francis observed that during the period of Treasury financing prevailing conditions in the market were maintained, and it appeared that those conditions were consistent with growth in the credit proxy at a rate less than the 7 per cent annual rate

sought by the Committee. However, on Friday, February 23, following completion of the Treasury financing, it appeared from new data that commercial bank credit would rise at about a 9 or 9-1/2 per cent annual rate from January to February. Now, it appeared that bank credit rose at a 10 per cent rate, even faster than the 8.3 per cent rate of the previous month when there was substantial concern that monetary actions were too expansive.

In that situation, according to Mr. Francis' interpretation of the Committee's instructions, the Manager was to seek firmer conditions in the money market, and there might have been a slight move in that direction. Although the Federal funds rate continued to be quoted at 4-3/4 per cent most of the time and the three-month Treasury bill rate continued to move around the 5 per cent level--as they both had a month earlier--net reserves moved from about $100 million plus to about $100 million minus. He believed the Committee would have preferred more aggressive action in tightening the market in accordance with the instructions, and had so expressed himself before $250 million of securities were purchased on February 23 and again before another $200 million were purchased on February 29.

Mr. Francis thought the crucial problem remained of how to prevent the growth rate of the target monetary aggregate from falling outside the desired range, especially when, as in the past year, the misses tended to fall almost continuously on one side.

In view of that recent experience, he submitted two suggestions for the Committee's consideration:

1. The emphasis in the directives should be reversed by making the desired growth rates in the monetary aggregate the proximate goal in the directives, and using the proviso clause to provide for temporary deviations from such a course if money market conditions fluctuated too widely.

2. As Mr. Maisel had suggested at the last meeting, a longer time span should be used in judging the growth rate of the monetary aggregate, such as a three- or four-month period. Thus, if at the last meeting the Committee had desired a 6 per cent annual rate of growth in bank credit over a three-month period, the fact that credit grew at a 10 per cent rate in the first month would not have been too serious. With gradual reductions in the rate of reserve injections, credit might expand at a rate in the 4 to 5 per cent range for the next two months, thus averaging about a 6 per cent rate over the three months. In short, by taking a longer perspective, it was less likely that the Committee's misses would become cumulative.

Chairman Martin suggested that the Committee ask its staff to take under review the proposals Mr. Francis had made. There were no objections to that suggestion.

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

bankers' acceptances during the period February 6 through March 4, 1968, were approved, ratified, and confirmed.

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

Mr. Brill made the following introductory remarks for today's staff presentation:

> At the last meeting of the Committee, the staff presented a view of economic and financial developments in 1968 as they might emerge under the conditions of fiscal restraint stipulated in the January budget. Events since then certainly do not provide much confidence in such fiscal assumptions. Developments in the Far East seem to be pointing toward higher-than-budgeted defense spending, and the tax increase appears to be as inextricably bogged down in Congress as ever.
>
> Today, we are presenting another view of prospective developments, this based on the unhappy circumstance in which principal reliance is once again placed on monetary restraint to curb inflationary forces. Basically, the projection we will be discussing today represents our assessment of the changes in the size and structure of GNP, and the pressures that might develop in financial markets, if a program of monetary restraint were pursued to achieve roughly the same degree of cooling off in the economy by the latter part of the year as was intended by the fiscal program proposed in the budget.
>
> There are, however, some other important differences between the projection described at the last meeting and the one to be discussed today. One should not take the differences between the two models as reflecting entirely the different effects of using alternative tools of stabilization policy. One important modification relates to defense spending. We have assumed a speed-up in such spending beyond budgeted levels, beginning in this quarter and running through the next fiscal year. Since we are

not blessed with any especial military insights or foresights, the numbers we have plugged in are very rough guesses--on the conservative side--of the costs of a somewhat intensified military effort, but one not so large as to stampede Congress into tax action. On the revenue side, we have assumed continuation of the present excise taxes and further acceleration of corporate income tax payments, but we have not assumed enactment of the tax surcharge.

In place of fiscal restraint, we have substituted monetary restraint--enough, we think, to slow down the pace of GNP growth later in the year to about the rate that would have been achieved through the fiscal program proposed by the President. Necessarily, the slowdown would start from a higher level of activity. And because the momentum of inflation will be building up faster this spring in the absence of prompt fiscal restraint--and because we felt that the Council's model understated inflationary pressures after midyear in any event--the current projection shows a faster pace of price advance in the second half of the year than in the fiscal restraint model. There are some other less important differences in assumptions as between the two models, but I don't think they need be elaborated at this juncture.

In reply to questions by Messrs. Brimmer and Maisel, Mr. Brill said that the Council's model had projected growth in GNP, over the third and fourth quarters combined, at an annual rate of roughly $25 billion, assuming a tax increase, so that the degree of monetary restraint implied by today's model was that which would hold GNP growth to about that rate without a tax increase. Alternatively, the amount of additional restraint implied could be formulated in terms of the restraint which would offset the additional deficit in the Federal budget resulting from the absence of a tax increase--roughly $10 billion, on a national income accounts basis.

Mr. Partee then presented the following analysis of expenditure and income flows under conditions of monetary restraint:

The economic projection presented today calls for a GNP in 1968 totaling nearly $850 billion, $3 billion more than in the previous model which assumed enactment of the 10 per cent tax surcharge. The larger number for the year as a whole results mainly from our expectation that the second quarter, without the tax increase to curb growth in spendable incomes, will continue to show rapid expansion. For reasons detailed in the green book,[1] second-quarter GNP is now projected to rise at an $18.5 billion annual rate, nearly equaling the expected first-quarter rise and much more than the $14.5 billion increase that had been projected in the tax model. Defense spending also is projected to rise somewhat faster throughout the year in this model, with the increase from fourth-quarter to fourth-quarter $2 billion more than had been assumed earlier.

Despite the sharper increase in defense, growth in GNP is still projected to slow markedly after midyear, partly because of the monetary restraint assumed and partly for other reasons. As before, moderation in business inventory accumulation is expected, once auto stocks have built up and steel buying as a strike hedge ceases. And personal income rises less rapidly after midyear in both models, as the impetus from large one-time injections in the first half wears off. The new factor, however, is the increase in monetary restraint, the major initial impact of which falls on housing. Housing starts are projected to drop off to a 1.2 million rate in both the third and fourth quarters.

Prices continue to rise substantially in this model, with the increase in the deflator projected at an annual rate of 3.5 per cent or more in each of the first three quarters. But the third quarter may show some moderating tendency, excluding the Federal pay raise, and the rate of rise in the fourth quarter is projected to slow further as pressures on the economy abate. Growth in real GNP drops from more than 5-1/2 per cent (annual rate) in the first half to little more than a

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

2 per cent rate in the second, which, if correct, implies a significant easing on resource demands.

The easing in demand pressures projected for the second half takes place in the face of a growing deficit in the Federal budget. Partly, this bigger deficit stems from the larger increase we have assumed in Federal expenditures for stepped-up manpower and ordnance needs in Vietnam. But of much greater importance, given these spending assumptions, is the slower growth in Federal receipts that results when GNP expansion is curbed by monetary restraint rather than by a tax increase. The estimated deficit, on an NIA basis, rises from $9-1/2 billion in the first quarter to $12-1/2 billion in the second and to more than $15 billion in the latter half of the year.

Offsetting the stimulative effects of the rising budgetary deficit are the developments assumed in the private sectors of the economy. First, residential construction expenditures are expected to fall by more than $1 billion in both the third and fourth quarters, reflecting a substantial curtailment in the availability of funds in the months immediately ahead. Second, the rate of inventory accumulation is projected to drop off to more normal rates in the second half, both for the reasons already noted and because of the growing tightness in funds. Third, consumer spending is not expected to be very buoyant. Rising prices, declining housing starts, tight money, and continued uncertainties stemming from the war and other factors are counted upon to hold spending down--particularly for durable goods--so that the saving rate remains above 7 per cent. This is a little less than the estimated saving rate in the past two quarters, but somewhat more than had been assumed in the tax model, where some of the initial adjustment to higher taxes was expected to take the form of reduced saving flows.

Under these circumstances, we also are not expecting much strength in business spending for plant and equipment. Outlays are projected to rise only $1 billion per quarter in the last three quarters--an annual rate of about 4-1/2 per cent, which is probably little more than the rate of price advance likely in heavy construction and capital goods. This projection seems consistent with recent information on manufacturers' capital appropriations and new orders for business equipment, and it is in the same

order of magnitude that we expect to be reported for the latest Commerce survey when it is released next week.

It should be recognized also that current levels of investment remain relatively high by earlier standards. Even without any further real increase, current spending is likely to add close to 5 per cent to total manufacturing capacity this year, about equal to the expected rise in industrial production. This would mean that capacity utilization would remain at about its current 85 per cent rate, rising somewhat in the spring and falling back again in the latter part of the year. Assuming a reasonable distribution among industries, an 85 per cent utilization rate--without apparent trend--seems unlikely to stimulate any unusual demand for increased capacity this year. Nor does this rate suggest that there will be strong upward price pressures resulting from capacity limitations.

Manpower resources, however, are expected to continue under pressure. The reduced rates in real GNP growth envisaged in the projection would result mainly in some reduction in the workweek and moderate declines in employment in construction and manufacturing activity--and then not until the second half of the year. Meanwhile, demands in trade and public and private services would be expected to continue strong and total employment to rise by 1.6 million during the year--close to the expected expansion in the civilian labor force. The unemployment rate should remain close to 3.5 per cent through the second quarter, then rise gradually toward 4 per cent by around year-end. For adult men, unemployment rates are expected to show little change--remaining under 2 per cent.

With demands for labor continuing strong, the cost of living still rising sharply, and wage settlements in union and nonunion activities accelerating, we can foresee no lessening of wage pressures this year. In manufacturing, the automobile settlement--which provided a first-year money wage increase of 7-1/2 per cent and an average of nearly 6-1/2 per cent in hourly compensation over the three-year contract--has become the standard if not the minimum sought. In white collar and public service industries, recent published wage agreements generally have been even higher than in manufacturing. For a time, sharper gains in productivity in manufacturing may be expected to offset a part of the

larger wage increases, and we have assumed a somewhat slower increase in unit labor costs in the first half of the year. But with manufacturing output projected to stabilize after midyear, unit costs could again be rising at the 5 to 5.5 per cent rate witnessed in 1967. In any event, wage increases will be exceeding productivity gains by a wide margin, thus maintaining upward pressure on prices.

Relatively strong markets and an inflationary mood, however, are encouraging businesses to pass higher labor and material costs through to higher prices. The rise in industrial commodity prices--averaging close to a 3-1/2 per cent annual rate over the last 6 months--has accelerated recently, and the incidence of price markups among commodity groups has widened markedly. Continuation of a rapid rate of advance seems highly probable, and food prices also seem destined to rise in the next few months, largely because of special supply situations. It is hoped, however, that the easing in demands projected for the last half of the year would set the stage for a lessening of inflationary pressures extending into 1969. This was the experience of early 1967 when, despite rising labor costs, industrial prices did show remarkable stability.

Mr. Reynolds then presented the following statement on the balance of payments and international implications of the new model:

In the chart show a month ago, we projected a surplus on goods and services of $4.8 billion in 1968, the same as in 1967. In the next-to-last of the tables before you today, we have revised the projected surplus on goods and services downward by $1/2 billion to $4.3 billion, the smallest since 1960.

The main revision comes in the projection of merchandise imports, which has been increased by $3/4 billion and now shows a year-to-year increase of 15 per cent--an unprecedented rise for a period in which capacity utilization rates are not expected to change much. About half of this revision reflects the change in assumptions. With monetary restraint trying to substitute--after a lag--for fiscal restraint, prices

and current dollar GNP rise more in this model than in that of the chart show. Furthermore, the composition of GNP is different. Housing, with a relatively low import content, is smaller, and other items with a higher import content are larger.

The other half of the import revision reflects the use of more recent data, including the further sharp rise in merchandise imports in January. It is possible that the projection is still too low. It implies that all imports other than strike-induced imports of copper and steel will be no higher for the full year 1968 than they already were in January.

The very sharp run-up in imports over the latest three months is a considerable puzzle. In squaring it with the projection, which is based on longer-run relationships as well as guesswork, we are relying on there having been a number of temporary elements--as yet unquantifiable--that pushed imports above trend in January. Such elements may have included poor seasonal and working day adjustments, a bunching of coffee imports, a catching up of U.K. exports to the United States earlier delayed by U.K. port strikes, and the kind of erratic peaking that sometimes happens in monthly foreign trade statistics.

Part of the upward revision in the import projection is offset by an upward revision of $1/4 billion in the projection for merchandise exports. This results from improved expectations about the expansion of economic activity in Western Europe. Industrial production increased very rapidly in Germany, France, and the United Kingdom during the fourth quarter, and since the turn of the year new stimulative policy actions have been announced in France and Belgium. Our exports may be hampered to some extent by rising domestic prices and military demands in key sectors of the U.S. economy, but given the likelihood of buoyant demand in most industrial countries abroad, we now project merchandise exports to increase by about 9 per cent from 1967 to 1968. This expansion seems to have gotten under way in January, when exports jumped to a rate 9 per cent above the fourth-quarter low. The January increase occurred in both agricultural and nonagricultural products.

The only other revision in the goods and services projections since the chart show of a month ago is a token $0.1 billion increase in projected military

expenditures abroad. Even with this revision, such expenditures are shown as increasing only half as much this year as they did last year, and this may be optimistic.

I should like to turn now to the more difficult question of what effect further monetary restraint in the United States may have on the economic policies of other countries and on international flows of capital.

It would be neither surprising nor harmful to us if Canada and Japan should let their credit conditions tighten along with ours, since their payments positions are already weak. But in principle, it seems to me, there is no reason why a tightening of credit here need affect the policies of major continental European countries. They ought to react only if excessively large capital outflows from their countries actually develop, rather than reacting automaton-like to U.S. interest rate movements alone. Some considerably greater net outflow of capital from Europe than in the past is not only tolerable, but is a necessary part of the needed adjustment toward payments equilibrium. Europeans cannot logically favor a long-term change in international interest rate relationships and in capital flows--as they say they do--while at the same time resisting such changes in the short run.

Would there in fact be large changes in capital flows as a result of a tightening of credit here and continued ease on the continent of Europe? There are three categories to consider. First, flows of U.S.-owned capital are already harnessed by control programs. A change in interest rate relationships could ease the administrative pressure on these programs, which would be all to the good, but could not significantly affect actual flows during 1968.

Second, inflows of foreign-owned nonliquid capital have recently consisted either of purchases of equities or of negotiated transfers of official funds into near-liquid assets. Neither of these flows are likely to be much affected by a tightening of domestic credit conditions.

Thus, the only substantial revision we have made since a month ago in the capital account items of the balance of payments table before you is in the third category--the flow of foreign private liquid funds from commercial banks abroad (including the branches of U.S. banks). Under the assumptions of the earlier

model, with fiscal restraint and declining U.S. interest rates, we had U.S. banks repaying a modest amount--$1/2 billion--to foreign banks. Under the new assumptions, with higher U.S. interest rates and tighter credit, we have U.S. banks instead borrowing a modest further amount--$1/2 billion. The magnitudes are, of course, highly uncertain, and could be larger. But this is the kind of change that might result from our changed assumptions. The inflow of foreign private liquid funds this year would probably be a good deal smaller than the inflows of 1966 and 1967, and ought not to be a source of major concern to the countries on the supplying end.

The question may be asked whether sterling is not particularly vulnerable--still--to a tightening of U.S. monetary policy. I do not think so. Sterling has had its devaluation, and will have had its budget restraints by March 19. From now on, it will stand or fall on its own feet, and cannot, in my view, be either toppled or shored up by small changes in interest rate differentials. More broadly, I would think that if the United States were finally seen to be coming to grips with its own inflation problem, this would have a calming effect on the gold market and might thereby help sterling.

The net results of our balance of payments projections remain, in Mr. Hersey's words at the preceding meeting, "not a pretty picture." The liquidity deficit before special transactions may approach $3 billion this year, with much of the gain from the President's program offset by a deterioration of the trade account. (It seems to have been at roughly this rate in January-February on the basis of very preliminary data.) The official settlements deficit may be in the vicinity of $2 billion. Emergence of numbers like these from data that will be published as the year unfolds are likely to generate continuing uncertainties in gold and foreign exchange markets. But these uncertainties will be less serious if domestic monetary restraint is seen to be gradually taking hold.

Mr. Brill then presented the following statement on the implications of the model for financial conditions and monetary policy:

Admittedly, this projection of an economy being curbed only gradually by monetary restraint is far from a pretty picture. As Mr. Partee indicated, inflationary momentum would carry through into the second half of the year, and as Mr. Reynolds indicated, the reflection of this on our international trade position would keep the over-all balance of payments deficit uncomfortably large. The most that can be claimed for the policies underlying this projection is that they would seem to set the stage for moderation on the price front without bringing about a complete cessation of real growth in the economy, and they should--in a rational financial world--avoid the atmosphere of panic and crisis that arose in financial markets during our restraint efforts of 1966.

What would be happening in financial markets and financial flows if monetary restraint were gradually intensified to achieve the degree of cooling off postulated in this model? The picture can be painted in just a few statistics. First, the total flow of credit would be close to that in the fiscal restraint model described at the last Committee meeting. With monetary restraint, the total flows would be a mite smaller, and would be somewhat lower relative to the GNP that has to be financed. But the total would still be large and well above the ratio of credit flows to expenditures that prevailed in 1966. Even with monetary restraint, this is not a picture of an economy being starved for funds.

What is most striking is the difference in the structure of credit flows, both on the demand and supply sides. Shifts in the borrowing structure reflect principally the substantially higher needs of the Federal Government, in the absence of revenues from the surcharge and with defense spending running higher than was budgeted. As we see the Treasury's needs, Federal borrowing in the second half of the year would be almost as large as in the second half of last year; it would be almost twice as large as in the fiscal restraint model, and would absorb almost one-third of all credit flows in this period, compared to less than a fifth in the model where revenues were boosted by the tax increase.

These large and insistent Government financing demands would elbow out other seekers of funds, especially mortgage borrowers. We would expect to

see mortgage flows begin to slow down this spring, partly because of the monetary restraint already in train, and then to slow down even further over the second half to a level about midway between the trickle of 1966 and the flood of 1967. State and local government borrowing would be pinched. A decline in business financing would also be likely, affecting both security markets and banks. This would reflect monetary restraint only in part; it would also reflect reduced inventory financing needs, and the reduced urgency of liquidity building, since so much of the 1966 ravages of corporate liquidity has already been repaired.

On the supply side, the dramatic shift would be in the contraction of the role of the banking system in meeting credit demands. As you will recall, in the fiscal restraint model we had projected a 9 per cent expansion in bank credit, with the banking system accommodating over one-third of all credit flows. But if the burden--and a bigger burden at that--is to be carried mainly by monetary policy, bank credit expansion would need to be limited to a pace of about 6-1/2 per cent for the year, with the second half running at slightly less than a 6 per cent rate. The banking system, therefore, would be able to satisfy less than one-fourth of total credit demands. And with flows of funds through nonbank savings institutions also contracting, a much larger share would have to be raised directly from the nonfinancial sectors of the economy.

Ordinarily, a marked shift in the structure of credit supplies such as this--away from institutions and toward direct flows into credit markets--requires sharply higher market rates of interest. Interest rate increases would occur with this projection but--and it's an important but--not nearly as dramatic a rise as we've seen accompanying similar shifts in the supply of funds in 1966 or in the second half of 1967.

What mitigates the rise? Essentially, it is the higher volume of savings available from the private sectors. As Mr. Partee noted, we are projecting a continued high personal saving rate, higher than in the tax surcharge model. And with incomes higher and no surcharge to pay, the volume of personal saving available for financial investment is larger. In comparison with the last period of substantial monetary restraint, 1966, the flow of personal saving is projected to be some $13 billion or 45 per cent larger. Also, corporate savings,

i.e., retained earnings and charges, would be somewhat larger than in 1966. Thus the private sector would be better equipped to accommodate larger credit demands.

We feel, therefore, that the interest rate response to a curtailment of bank credit flows such as is projected here need not be as severe as that in recent upswings in credit demands and limitation of bank supply. Bill rates in the 5-1/2 per cent area and long-term corporate bond rates ranging around 6-1/2 per cent would be indicative of the levels we think consistent with the stipulated degree of restraint. These aren't rates substantially higher than those prevailing recently, and given the adjustments that participants in financial markets have been able to make to successively higher levels of interest rates in recent years, they shouldn't produce the financial paralysis that occurred in the summer of 1966.

Not that institutions would be able to avoid some constriction of their inflows. Rate levels such as those mentioned above would put pressure on the Regulation Q ceiling for large CD's; we have assumed the ceilings would be raised before banks experienced significant runoffs. As for other savings flows, recent thrift institution inflow experience has been mixed, but over all seems to have been running at less than the pace projected here, even with competitive market rates below those consistent with the model. Some adjustment of the rates on consumer-type deposits and accounts would probably be needed before long, as short-term market rates began to invade the 5-1/2 per cent area.

The speed with which the need to adjust ceiling rates comes upon us depends in large measure upon the course of action the System takes over the next few weeks. Assuming the Committee decides today to intensify monetary restraint, there are two obvious courses open. One would involve a progressive snugging-up of open market operations, to increase gradually the pressure on reserve availability. The other would be a more abrupt but clearer policy signal involving an early increase in the discount rate, with open market operations keyed to maintain the higher market rates that would develop.

As usual, there are advantages and disadvantages to either course of action. A gradual intensification of restraint through open market operations over the next few weeks, aimed at bringing the Federal funds rate up to around 5 per cent fairly consistently, would

undoubtedly crowd more banks into the window, and add $100 million or more to borrowing, depending on how strongly banks come to prefer the discount window for adjusting their reserve positions. Tighter open market operations should also stimulate more aggressive solicitation of CD's, with banks rapidly sliding down the maturity scale as offering rates hit the ceilings. The increasing pressure of competition for funds, and higher Federal funds and dealer loan rates, should push up Treasury bill rates by about 1/4 per cent.

A virtue of this course is that it can be played with delicacy--unless market participants take the bit in their teeth--and thereby make it possible to avoid a confrontation with the Regulation Q ceiling issue before the dividend-crediting period at thrift institutions at the end of the month. Also, it wouldn't bind us as publicly and irrevocably into a policy posture we might want to reverse or modify if--miracle of miracles--some fiscal restraint should be forthcoming in the next few weeks.

But it does leave the System vulnerable to surges in credit extension, if, say, bank loan demands spurted as recognition of the policy tightening revived precautionary borrowing by businesses, or inventory financing needs began to show up in volume. Bankers report generally that they are very heavily committed, and could be faced with large demands on relatively short notice.

The proviso clause might keep too large a quantity of reserves from escaping through trading desk operations--if fortune smiles on our estimations of money market and reserve relationships--but substantial reserve expansion could occur, in any event, through member bank borrowing. It might prove difficult to police the discount window through administration alone, if the spread should widen substantially further between the cost of borrowing from the System and the cost of obtaining reserves from the Federal funds market or through sales of short-term securities at rising interest rates. At best, then, reliance on open market operations would only postpone, not avoid, the day of reckoning on the discount rate and thereby on Q ceilings. Given the undesirability of changing ceilings close to, or in the midst of, the month-end dividend crediting periods at thrift institutions, it would probably postpone this day of reckoning to about mid-April.

The alternative course would be a prompt increase in discount rates, backed up by open market operations that would capture the higher level of market rates likely to follow. Given the adverse developments in gold and foreign exchange markets described this morning, it might be desirable to provide a tightening signal easily read abroad as well as in domestic markets, so long as the signal did not carry overtones of a crisis action. A one-half percentage point increase in the discount rate would, I think, meet both of these criteria. We would expect the short-term consequences to be a rise in the Federal funds rate into the 5 - 5-1/4 per cent range, and bill rates moving a bit above that--say, to about the 5-1/4 - 5-1/2 per cent range.

Such action would quickly tend to limit banks' ability to roll over the large CD maturities scheduled for March and April, and at the same time possibly stimulate a rush of borrowers to exercise their bank loan commitments. It would bring us face to face with the Regulation Q ceiling problem promptly, at least for large negotiable CD's.

An increase in the Regulation Q ceilings, if kept to the large CD's initially--and perhaps only by 1/4 per cent and only for intermediate- to longer-term maturities, where more of the pressures may show up--would moderate the impact on bank inflows. If our guesses as to bill rate consequences of the discount rate increase are reasonably accurate, a quarter-point increase in ceiling rates would seem to be enough to preserve present differentials. And perhaps a similar adjustment, on a uniform basis among the competing institutions, could be arranged to permit a little more flexibility in the competition for consumer savings, although this would not be an easy task of persuasion among the agencies involved.

On balance, the package of a half-point increase in the discount rate and a quarter-point increase in Regulation Q ceilings appeals to me as offering the best hope for achieving fairly prompt financial restraint on expenditures and attracting favorable attention from foreign investors, without engendering a panic reaction among financial institutions and in financial markets. I should note, however, that most, though not all, of my colleagues prefer the open market operations route, but all support at least some move toward more financial restraint.

Mr. Brimmer asked whether it was Mr. Brill's judgment that the monetary restraint implied by the model could be achieved only if the Committee moved quickly--which would, he assumed, call for adoption of alternative B for the directive today.[1/]

Mr. Brill replied that he thought prompt action to attain greater restraint was called for in order to achieve the effects desired in the second half of the year. However, he would not urge only the adoption of alternative B for the directive. As he had indicated, he considered a prompt increase in the discount rate, supported by open market operations, to be preferable to relying on open market operations alone.

Mr. Partee remarked that prompt action would seem to be required if the annual rate of housing starts was to be reduced to the neighborhood of 1.2 billion units by the third quarter.

Mr. Brimmer then said that Mr. Partee's observation would seem to imply the need for having greater monetary restraint in effect before the month-end dividend crediting period at thrift institutions. But Mr. Brill had implied that he thought it would be undesirable for the System to take discount rate action at a time close to that period.

1/ The alternative draft directives submitted by the staff for Committee consideration are appended to this memorandum as Attachment B.

Mr. Brill said he thought it was important to move promptly toward restraint, but at the same time to assure that the consequences for thrift institutions around the April 1 dividend crediting period this year were not as severe as their experience around that period in 1966. In his judgment the forthcoming dividend crediting period argued against increasing monetary restraint now through open market operations, with the intention of validating that action by raising the discount rate within the crediting period--say, in the last three days of March or the first ten days of April. In other words, the dividend crediting period was an important consideration in the choice of the date for a discount rate increase--the latter should come well before or after the crediting period--but it should not interfere with a decision today to increase monetary restraint.

Mr. Brimmer then asked whether Mr. Reynolds would offer his assessment of the probable effects on the Canadian situation of a System move to a firmer monetary policy, perhaps including a discount rate increase of one-quarter or one-half of a percentage point.

Mr. Reynolds replied that such action by the System probably would result in the Canadians' maintaining a firmer monetary policy for a longer period than they otherwise would. The Bank of Canada had raised its discount rate recently with the hope that it would

be able to lower it again soon, but it probably would not be in Canada's interest to do so. On the whole, he would not expect a firmer System policy to do much damage to the position of Canada. He personally would prefer a one-half percentage point increase in the Federal Reserve discount rate, primarily because it would be interpreted in Europe as a more substantial action than a one-quarter point increase.

Mr. Hickman remarked that as the Committee knew he had been in favor of moving to a slightly firmer monetary policy for some time. Nevertheless, he was puzzled by the staff recommendation for such a policy move today. According to the blue book projections, if money market conditions were unchanged the bank credit proxy would rise at an annual rate of 5 to 7 per cent in March, and more moderately still in April. For the first time in a number of months the outlook was for bank credit growth at a rate that he, for one, would consider desirable on a long-run basis. Moreover, the model presented today implied that bank credit should grow at a rate of 6.5 per cent over the year as a whole. It was not clear to him how the staff reconciled those elements of their analysis with a policy recommendation for firming.

Mr. Brill noted that the bank credit proxy had grown at an annual rate in excess of 9 per cent in January and February together, and if March expansion was at the midpoint of the

projected range, growth over the first quarter would be at about an 8 per cent rate. The blue book projection of more moderate growth in April was premised on the assumptions that the Treasury financing schedule would not be accelerated, and there would not be considerable further strengthening of business loan demands from banks. The model implied a bank credit growth rate of about 7 per cent in the first half of 1968, and in his judgment increased restraint now would be required to keep growth down to that rate.

Mr. Maisel remarked that according to his rough calculations, which assumed that the staff's projections for March and April would be realized, from late November 1967 through April 1968 total reserves would have risen at an annual rate between 4 and 5 per cent and the bank credit proxy at a rate between 5 and 6 per cent--growth rates which appeared desirable to him. He then asked Mr. Brill to comment on the consequences that might be expected to follow from an increase in Regulation Q ceilings at this juncture. Specifically, should such an action be interpreted as increasing or reducing restraint?

Mr. Brill replied that according to staff analyses, the effects of a change in Regulation Q depended on the sources of pressures existing at the time. When applied to present circumstances those analyses suggested that an increase in the Q ceilings would result in a change in the composition of credit flows that

would tend to raise interest rates. Thus, the action would be consistent with a package of other actions directed at increasing monetary restraint.

In response to questions by Mr. Sherrill, Mr. Brill said that at a time when the System's open market operations were putting pressure on the position of banks, an increase in Q ceilings would give banks somewhat greater latitude to compete for funds in the market and rates would rise as banks absorbed funds. The upward pressures would be primarily on shorter-term interest rates but, depending on the nature of credit demands, the pressures might spread to longer-term rates.

Mr. Hickman remarked that a failure to increase Q ceilings might result in extensive disintermediation with consequent upward pressures on intermediate- and long-term rates--and perhaps on short-term rates as well, although that was less clear. Thus, it might be argued that an increase in Q ceilings, by avoiding or reducing disintermediation, would moderate upward pressures on the interest rate structure.

Mr. Sherrill commented that experience would seem to indicate that raising Regulation Q ceilings increased the upward pressure on short-term rates but moderated such pressures on longer-term rates.

Mr. Brimmer asked whether Mr. Brill had in mind an increase only in the 5-1/2 per cent ceiling on large-denomination CD's, or also in the 5 per cent ceiling on consumer-type CD's.

Mr. Brill said he would recommend an initial increase only in the ceiling on large CD's. He personally was skeptical that an adjustment of ceiling rates on consumer-type time deposits could then be avoided for any length of time, but other members of the staff felt that such an adjustment might not be necessary given the volume of flows at current rate levels. There was no doubt in his mind, however, that a discount rate increase would raise the level of market rates to a point at which action on the large-CD ceiling would be required.

In reply to another question by Mr. Brimmer, Mr. Brill said that higher rates on domestic CD's would increase the attractiveness of Euro-dollar funds to those banks in a position to compete for such funds.

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

> The underlying business situation clearly remains quite strong despite the somewhat mixed picture presented by recent statistics. In particular, retail sales in January apparently achieved the first really substantial gain in many months. We still look for a strong business expansion through 1968, with Federal spending a strong plus factor on the basis of budget

estimates currently available. Beyond that, there seems to be a growing likelihood that defense spending will exceed budgeted increases, perhaps to a substantial extent, in view of the worsened Far Eastern situation. Such a development would of course add further to the pressure on prices already rather clearly indicated, especially if there is further delay or ultimate lack of action on the tax front. Both retail and wholesale prices have again risen significantly.

Unfortunately there is nothing to make us change our somber appraisal, at recent meetings, of the balance of payments outlook. On the contrary, the current quarter's underlying liquidity deficit may turn out to be about as bad as the $3.6 billion deficit, seasonally adjusted annual rate, recorded for the first quarter of 1967. The latest trade figures show the effects on imports of a very active economy, together with the important temporary adverse influence of the copper strike and anticipatory steel buying. It is hard to see how we can avoid some appreciable deterioration in the trade surplus for the full year as compared with 1967. And with savings attributable to the President's program unlikely to exceed $2 billion as compared with the announced aim of $3 billion, I can see much too large an over-all payments deficit shaping up for 1968, in the absence of new remedial policy measures, whether general or specific.

The gold and exchange markets are more nervous than when we last met, with an abundance of rumors and ill-conceived policy suggestions adding to the feeling of uncertainty. Sterling and the Canadian dollar are both in danger, and heavy speculative buying has erupted again in the London gold market.

Bank credit grew in January and February at an excessively rapid pace. Part of this growth of course reflects large Treasury financing; and the pace should moderate over the next several months since recent surveys indicate relatively modest loan expansion and since no major Treasury cash financing is in prospect. However, it would be unwise to count on this slowdown in credit growth without some reinforcing policy action on our part.

With rates on shorter maturity CD's generally below the Regulation Q ceiling, the banks have some leeway to cope with a further rise in open market rates. It is

interesting to note in this connection that the New York City banks have experienced a net decline in outstanding CD's of $515 million from December 27, 1967 to February 21, 1968, while other weekly reporting banks have gained $1.1 billion in CD funds in the same period. This clearly suggests that lately the New York banks have not been aggressive seekers of CD money, perhaps partly because of increased borrowings from branches abroad. The thrift institutions are also in a reasonably good position. Many of them had expected large deposit losses at the turn of the year, but instead January brought a seasonally adjusted increase at an annual rate of about 5 per cent, a bit above the December rate. Mutual savings banks in New York had sizable inflows in early February. Thus, for the moment, the disintermediation problem does not appear to be serious.

Given the dangerous inflationary tendencies of the economy, the very gloomy payments outlook, and the recent excessive pace of bank credit expansion, I think there is a strong case for a further change in monetary policy toward greater restraint--a move more explicit than the modest tightening that has been accomplished in the last couple of weeks. It seems to me that the financial markets have been expecting tighter System policy for some time and that the dangers of over-reaction in the markets are therefore small. The even keel calendar should be free of any inhibiting debt operations from now until the late-April announcement of the terms of the May refunding--although there is a chance that the Treasury may decide to undertake some unexpected borrowing operation. If, as seems fairly likely, we are free to move through most of March and April, any near-term open market actions could be reinforced or reversed, if either should prove desirable, before we are again constrained by Treasury considerations. A moderate tightening effort should be favorably received abroad as a means of strengthening the dollar, and strong adverse effects in the foreign exchange markets for other currencies do not seem likely. Thus the present is an appropriate time for a policy move.

I should think that we might aim at net borrowed reserves in a range of $150 to $250 million, a Federal funds rate of around 5 per cent, and average borrowings around $500 million. Unless hastened by adverse international developments, discount rate action can be deferred until we have progressed further with open

> market operations; and I would not recommend any change in Regulation Q at this time.
>
> With respect to the directive, alternative B is satisfactory, but I would change the proviso clause to read "provided, however, that operations shall be further modified if bank credit appears to be expanding more rapidly than is currently projected."

Mr. Ellis reported that manufacturing production and employment declined in January, but it was still accurate to describe the New England economy as strong and growing. Non-manufacturing job expansion had kept the employment total rising. Department store sales had risen sharply in the past four weeks; new orders to manufacturers were showing some improvement; capital expenditures were being held close to last-year levels; and manufacturers reported expectations of 8 per cent sales gains this year.

The Boston Reserve Bank's survey of mortgage lenders revealed that the general feeling of worry and uncertainty evidenced in the September survey had subsided, Mr. Ellis said. Borrower resistance to higher rate structures seemed to be diminishing, so lenders had greater confidence that demand would hold up well even while rates were adjusting upwards. As the market had tightened, each type of financial institution had tended to retrench somewhat in its lending scope to insure an uninterrupted flow of funds to its traditional borrowers in coming months. Mutual savings banks were writing fewer multi-family mortgages so they might concentrate

on single-family residential loans, while commercial banks were doing nearly the opposite. It was interesting to note that the ten largest insurance companies headquartered in New England had new commitments running at "normal" or 1965 levels for conventional multi-family residential mortgages and mortgage loans to business.

Mr. Ellis noted that for the past few months the Boston Reserve Bank Directors had been expressing, through a succession of telegrams to the Board, their concern that monetary policy had not been sufficiently aggressive in restraining the expansion of bank credit. At their meeting last week, free of the even keel restraint, their inclination to vote for an increased discount rate was restrained only by their greater desire to see reserve expansion slowed by open market operations. They concluded by requesting him to express their concern in this forum today, and he must confess that sharing their views made it easy to express them.

Without any pretension that monetary policy alone could do the job that should be done by a coordinated use of fiscal and monetary policy, Mr. Ellis said, like Mr. Brill and others he would urge now that monetary policy perform at least its responsible role in the application of needed restraint. The Federal budget involved an $8 billion or $20 billion deficit that was being propelled higher by escalating war expenditures. The Committee was advised that State and local governments were planning larger deficits,

business capital expenditures were projected to rise, and consumer expenditures were fortunately held to modest expansion only by virtue of inexplicable savings patterns. In addition, balance of payments news continued to be "bleak," to quote the green book. In this situation, there was no intellectually satisfying justification for continuing a rate of reserve expansion three times the rate of real GNP growth, as was the case in 1967 and in the first two months of 1968.

Mr. Ellis said that the policy move toward restraint initiated in December and triggered further by the proviso clause in the current directive had fortunately set policy in motion on a gradual basis. The blue book helpfully illustrated the slowed growth in reserves, bank credit, and the money supply that had resulted, by comparing growth rates in the May 1967-November 1967 period with those in the December 1967-February 1968 period. Although there was a downward bias in the latter figures because of the inclusion of data for December, when there was no Treasury financing and most of the aggregates declined, it was clear that the System had been making progress toward restraint. Member bank borrowings had risen in the past three weeks and there had been two weeks of negative net reserve positions. However, because those changes had been widely anticipated by the market they had had only modest firming effect on interest rates.

At present, Mr. Ellis continued, concern with the possible emergence of disintermediation should not be allowed to deflect or slow the Committee's course. Unless the Committee was prepared to apply restraint up to a point where banks did feel a shortage of funds to lend or invest, monetary policy would not be meaningfully affecting investing or spending decisions. Inevitably, as the Committee's posture stiffened, there would be some firming of rates. And as market rates rose it would be appropriate to confirm their new levels, probably in the next few weeks, with an increase in the discount rate--an action the Directors of the Boston Reserve Bank would gladly welcome.

Mr. Ellis said he wanted to thank the staff for the new 1968 projections presented today. Since they reflected the staff's own views, they were infinitely more useful and more reliable than those presented at the preceding meeting. Today's "no tax" model sketched the implications of the alternative of relying on monetary restraint alone. Mr. Brill had said that it was "not a pretty picture"; but he (Mr. Ellis) would say that it was a much better picture than that which would unfold in the absence of both fiscal and monetary restraint. Among the costs of greater monetary restraint would be declines in expenditures on residential construction in the third and fourth quarters of 1968--but expenditures in those quarters would still be at rates

$1 or $2 billion above those of 1966 and 1967. The GNP deflator would still rise at a 3.5 per cent annual rate in the first half, reflecting cost-push forces. For the year as a whole real GNP would advance at a pace nearly twice that of 1967. The unemployment rate would not exceed 3.9 per cent in any quarter, and for the year it would average slightly below the 1967 rate of 3.8 per cent.

Mr. Ellis said he appreciated having the projection tables in advance of the meeting since that permitted an assessment of unfolding developments against possible target values. The model implied annual rates of growth in the first half of 1968 of 4 per cent for the money supply, 7.1 per cent for bank credit, and 5.6 per cent for total reserves. According to his calculations, if the projections for March that assumed no change in prevailing money market conditions were realized, growth rates in the first quarter would be 5.5 per cent for the money supply, 8.1 per cent for bank credit, and 10.7 per cent for total reserves. Thus, if the Committee accepted the growth rates implied by the model as guidelines, first-quarter growth in all three variables would be found to be running above target rates.

Mr. Ellis noted that the staff's projections for March, taken alone, did fall within the target ranges. However, the blue book ascribed the projection of a slowed rate of growth of

bank credit in March "mainly (to) the absence of sizable Treasury cash financings." The green book presented new staff estimates that indicated "a need for larger gross cash borrowing by the Federal sector over the remaining four months of the fiscal year than the market currently appears to expect," and it placed the need for additional cash borrowing at a minimum of $2.5 billion.

His purpose in citing those passages from the blue and green books, Mr. Ellis said, was to emphasize that the present posture of monetary policy would not be sufficiently restraining to achieve the goals consistent with the staff projections presented today once Treasury financing resumed in the next four months, and certainly not during the inevitable heavy deficit period of the second half of 1968, as emphasized by Mr. Brill. The most important objective was to keep monetary policy moving steadily toward firmness now that the movement had been initiated. Alternative A of the draft directives, by confirming the action that had been triggered by the proviso clause, would make only slight progress in that direction. Alternative B would involve a further modest and, in his judgment, necessary step toward firmness.

In principle, Mr. Ellis observed, he was prepared to accept a two-way proviso clause, such as was included in alternative B, to forestall firming actions "to the point at which bank credit growth is halted or reversed," to quote from the notes attached to the

draft directives. However, in endeavoring to establish the meaning of the term "current expectations" as used in the proviso clause, he had referred to the blue book discussion under the heading "Further restraint through open market operations." There he had read, "Such a tightening of money market conditions may have relatively little effect on bank credit and deposit expansion in March." Accordingly, he judged the projected March growth rate of 5 to 7 per cent in bank credit, given earlier under the discussion of the "no policy shift" alternative, to be the numerical equivalent of "current expectations" as used in alternative B. Unhappily, there was a narrow two-point spread--from 5 to 7 per cent--within which the growth rate of bank credit would have to fall to avoid the question of whether or not the deviation was "significant" enough to trigger a change in policy.

To resolve the problem, Mr. Ellis continued, the Committee could either (1) delete the proviso clause, (2) indicate a broader range of current expectations, such as 2 to 8 per cent, (3) interpret the term "significant deviations" as meaning shortfalls of as much as 3 or 4 percentage points below the 5 to 7 per cent range, or (4) adopt a one-way proviso clause, such as Mr. Hayes had suggested. His own choice would be to eliminate the clause, realizing that when policy was moving to new goals it was unusually difficult to attempt to achieve specific targets in

a close range. It would not be traumatic, in his judgment, if--as was the case in December--bank credit failed to grow in one month when the Treasury was out of the market.

Thus, Mr. Ellis concluded, he would favor alternative B, without a proviso clause, for the directive. He would interpret "somewhat firmer conditions" as involving targets for net borrowed reserves in a $150 - $250 million range and for member bank borrowings in a $450 - $500 million range, with short-term rates probably rising by 1/8 to 1/4 of a percentage point. He expected that there would be a need for a discount rate increase of 1/2 of a percentage point to confirm those rate advances within the next few weeks. He would also concur in Mr. Brill's proposal to raise Regulation Q ceilings to ease the market adjustment. He recognized that that would involve some cost in terms of a higher rate of reserve provision, but thought it should be one of the Committee's objectives to avoid a sharp rise in short-term interest rates and the development of a crisis atmosphere in the market such as had occurred in 1966. He would prefer to seek a gradual intensification of restraint through what Mr. Brill had described as "a progressive snugging-up of open market operations."

Mr. Coldwell reported that economic conditions in the Eleventh District remained strong, with activity at high levels in most sectors. Industrial production was up marginally, mainly due to an advance in petroleum output; crude oil production

currently was almost 9 per cent higher than a year ago. As elsewhere, the construction picture was variable with some gains expected in multi-family units. The supply of mortgage money was fairly well balanced with demand. Employment was down less than expected on seasonal grounds, but the tone of the labor market was temporarily a little softer. The retail sales picture was strong; department store sales were 14 per cent above a year ago.

Mr. Coldwell commented that recent financial conditions in the District were similar to those in the country as a whole. With funds available for bank loans and with business loan demand weak, banks were not aggressively seeking additional funds. Bank investments in Government securities increased with the recent Treasury financings but municipal holdings declined. Net purchases of Federal funds by large banks had fallen sharply; currently there was a virtual balance at District banks between gross purchases and sales of Federal funds, whereas normally purchases exceeded sales by $100 - $200 million per day.

With respect to the national situation, Mr. Coldwell thought the country was moving toward a serious and perhaps critical juncture of destabilizing forces. Wage-cost-price pressures were increasing. The large prospective budget deficit was growing with the enhancement of possibilities of further increases in defense spending. Domestic inflation was gaining

strength and business decisions on wages and prices were being made in anticipation of rising price levels. The balance of payments deficit showed no improvement and runs on the gold market were occurring with increasing frequency. The over-all situation demanded restraint. Monetary policy could, and in his opinion must, be more restrictive. Business attitudes had to be restrained and the developing tendencies toward speculation had to be brought under control.

Noting the absence of even keel considerations at the moment, Mr. Coldwell said he would favor maintaining the momentum of the move toward further restraint that had been initiated in the recent period. In his view, the Desk should permit market forces to absorb reserves and use open market operations to smooth the transition but to insure steady tightening. He would expect net borrowed reserves of $150 to $250 million, short-term Treasury bill rates in a 5-1/8 to 5-3/8 per cent range, and the Federal funds rate in a 5 to 5-1/4 per cent range. He was prepared for very early consideration of a discount rate increase--within one or two weeks--to validate the developing levels of market rates. He advocated alternative B for the directive, and would agree with Mr. Hayes' proposed modification.

Mr. Swan reported that Twelfth District business activity was quite strong in January. In the Pacific Coast States total

non-agricultural employment increased by 0.7 per cent, compared with no change in December and with an increase nationally in January of 0.1 per cent. Employment rose in all major categories, with the largest gain in construction activity. The unemployment rate dropped sharply, to 4.3 per cent from 4.7 per cent in December. Conditions in lumber markets were extremely strong, with both orders and prices rising. On the other hand, the copper strike continued to exert a depressing influence on the level of activity in the intermountain region, although many of the more skilled workers affected had obtained other jobs. Within manufacturing, aero-space employment failed to rise for the first time since last spring and prospects for resumption of growth within the next few months were not particularly favorable. There was a good deal of discussion in that industry about the difficulties anticipated when existing labor contracts expired in July.

The District banking situation had been relatively strong recently, Mr. Swan observed. The rate of credit expansion at weekly reporting banks had been higher through the week ending February 21 than in the comparable period of 1967, and also higher than in the rest of the country this year. Much of that strength reflected growth in bank loans. All major categories of loans had expanded, and growth in the total had been large relative to that in other parts of the country. The position of District banks with respect to time and savings deposits still appeared to be relatively

stable as did that of savings and loan associations. According to Home Loan Bank figures, savings capital at California savings and loan associations declined by about $14 million in January. The reduction nationally was about $200 million, so that California associations experienced a much smaller loss relative to their outstandings than did associations in the country as a whole.

Turning to policy, Mr. Swan said he agreed with the view that it was necessary to increase the degree of monetary restraint at this point. Additional restraint certainly was called for in light of the strength in the business situation, the Federal budget position--including the growing possibility of higher defense expenditures than had been anticipated, lack of Congressional action with respect to taxes, the adverse developments with respect to the balance of payments, and the general international situation with respect to gold. As had been mentioned, Committee action was not constrained at the moment by even keel considerations. He would not comment on the earlier discussion of recent and prospective rates of expansion in bank credit, except to note that some reduction in the rate of growth appeared appropriate to him in view of the business outlook and the probable volume of Treasury financing activity over the rest of the year. He concurred in the general descriptions others had given of desired money market conditions, including net borrowed reserves in a $150 - $250

million range, borrowings between $450 and $500 million, the Federal funds rate around 5 per cent, and the three-month Treasury bill rate somewhat above 5 per cent.

Mr. Swan remarked that he hoped an increase in the discount rate could be delayed for a few weeks. In order to reduce the announcement effect, it would be desirable to raise the discount rate at a time when the Federal funds rate had been established at a level around 5 per cent. However, he already sensed some increase in the willingness of banks to come to the discount window, so discount rate action probably could not be delayed for long. He was interested in Mr. Brill's implied suggestion that the Committee should extend even keel considerations to the interest crediting periods at thrift institutions. He had not resolved in his own mind the question of whether the date of that period should affect the timing of a discount rate increase, partly because he was not sure that investors' decisions regarding shifts of funds were more likely to be influenced by a discount rate action than by increases in market rates.

As to the directive, Mr. Swan said he favored calling for somewhat firmer money market conditions, as in alternative B. He would want to retain a proviso clause, but he agreed with Mr. Hayes that under present circumstances there was no need for a two-way clause as shown in the staff's draft of alternative B. However, he

would prefer the language of the one-way clause shown in alternative A to that proposed by Mr. Hayes. In particular, he thought it was desirable to say that operations should be modified "as necessary to moderate" significant upward deviations of bank credit, rather than to say simply that operations should be modified if such deviations occurred.

Mr. Galusha said he would pass over District developments, which were of a pattern with the national developments described in the green book, and turn directly to a discussion of Committee policy. As he saw the situation, the need was for increased monetary restraint, and he believed the Committee should direct the Manager to seek higher short-term interest rates. As he had said before, he wished the Board would increase the Regulation Q ceiling rate for large-denomination CD's. If it did, discount rates could be increased by one-half of a percentage point without anguish.

But it would seem possible at this stage, Mr. Galusha said, to increase short-term rates somewhat--perhaps 20 basis points for the bill rate--without precipitating large-scale disintermediation. According to the blue book, that bill rate target implied targets for net borrowed reserves of between $100 and $250 million and for the Federal funds rate of 5 per cent. In his judgment, the Desk should move toward those targets over the next four weeks,

desisting only if it got evidence along the way of truly large losses of liabilities threatening financial institutions.

He wanted to state clearly, Mr. Galusha continued, that he was not of the opinion that increased monetary restraint would extricate the country from its present difficulties. The Committee did, however, have a responsibility to do what it reasonably could.

Mr. Galusha commented that he had been worried before he came to today's meeting about the international financial situation; and although it was hardly Mr. Coombs' fault, he was not particularly reassured, to say the least, by what the latter had reported today. He was worried, of course--as he was sure most members of the Committee were--by a continuing gold rush, a rush which could easily become even more feverish than it had lately been. No doubt the U.S. Government, with the Federal Reserve's help, had been busily engaged for some time now in planning how to deal with its gold losses. At least he hoped so, for the danger was that, if it had not done its contingency planning, the Government would be tempted in an emergency to take the seemingly easy way out--that is, to increase the official price of gold. Whatever certain influential members of the business and financial community might believe, he was totally convinced that that would be unwise. If some response was forced upon the United States, he believed--if with a hesitancy befitting

a novice--that suspending sales of gold would be the better way to deal with persisting gold losses.

Mr. Galusha was not optimistic, even about the immediate future. He knew--simply on the basis of his newspaper reading--that Government spending was going to increase, and he suspected that the increase would be greater than the Board's staff had assumed. He had in mind not only defense spending, but nondefense spending as well--that is, spending intended to rehabilitate the cities. He doubted that the Government would be able simply to acknowledge the recently issued report of the committee investigating last years' urban riots. The vote changes in the Senate yesterday that led to invoking cloture on the civil rights bill presaged a more serious look at urban problems. According to his Congressional sources, however, it was not likely that there would be a tax increase--before November anyway--even if, as seemed likely, the nation's Vietnam war effort was escalated and Government spending was increased immediately and sharply. His point was that events, domestic and international, were moving with a terrible swiftness, and the Committee's responses had to be quick and sure--which placed a premium on contingency planing and on timing. For, whatever the Committee did, foreign confidence in the dollar could well decrease further. That was why he was pessimistic, and why he hoped the Government had been drawing up contingency plans.

Of course, the Committee had a responsibility to be prepared for the unthinkable.

Mr. Galusha said that in his judgment an increase of one-half of a percentage point in the discount rate now, coupled with a Regulation Q increase of one-quarter of a point, would be well timed and an excellent preparatory move. After all, there were few things the System could do with greater environmental effect. As to immediate Committee policy, he favored alternative B of the staff's draft directives. For the proviso clause, either the language proposed by Mr. Hayes or that in the staff's draft would be satisfactory to him.

Mr. Scanlon remarked that he saw nothing in recent developments, either in the Seventh District or on the national scene, to alter his view that the basic problem facing the economy was excessive demands upon resources, especially labor. Any increases in defense requirements resulting from recent events in the Far East could only aggravate the situation.

Strikes were continuing to hamper output in the District, especially in the cases of motor vehicles and farm equipment, Mr. Scanlon said. Settlement of labor-management negotiations appeared to require offers of at least 6 per cent additional total hourly compensation.

Machinery and equipment producers with whom Reserve Bank people talked reported a gradual but unspectacular rise in orders

since last summer and they expected that trend to continue. That view fell between a recent bearish evaluation of capital expenditure trends by the National Industrial Conference Board, based on business "appropriations", and a very strong projection by McGraw-Hill, based upon expectations of manufacturers of equipment.

Mr. Scanlon reported that structural steel fabricators were working at capacity, limited by on-site labor supplies, and a large volume of new plans for structures appeared to be building up in architects' offices. A Chicago-based factory-locating service reported a heavy volume of new projects submitted to it. Customers of steel firms were commonly planning to build an extra 30-day supply in addition to a normal 30- to 45-day supply. Steel producers were encouraging the inventory building process, by offering to hold customers' orders for delivery some time prior to the August 1 strike deadline and by arranging additional storage outside of mill premises so that deliveries could be made even if a walkout occurred.

The uptrend in home building appeared to Mr. Scanlon to be continuing in the Seventh District, with the Chicago area in a particularly strong position. Prices of existing houses in the area had continued to rise sharply, and homes placed on the market were sold readily. Retail sales appeared to have improved at both hard and soft goods stores. Trade sources indicated a degree of

color television that was not yet reflected in data published by the Department of Commerce.

Mr. Scanlon said that demand for bank credit from the private sector had remained moderate, although the most recent figures suggested some strengthening. Meanwhile, the large banks appeared to have scaled down their expectations about business loan demand, possibly because earlier guesses had proved too optimistic. Out of 15 large District banks, all but one had reported last November that they expected moderately stronger business loan demand for the quarter ahead. The February survey indicated that in only one case had that expectation been fulfilled; more than a third of the banks reported in February that loan demand had weakened. Only half of the survey participants now said they expected stronger demand in the next three months. Most of the February bank credit expansion, of course, was attributable to the absorption of new Treasury issues. Purchases of municipals had slowed somewhat. The large Chicago banks remained in a strong position to meet additional loan demand.

Mr. Scanlon thought that current and projected developments in economic activity indicated a need for additional restraint. Prices were rising excessively, in part because of overly generous wage settlements; and that trend was almost certain to continue, and possibly to accelerate further, unless additional restraint was

forthcoming. The temporary absence of major Treasury financings presented an opportunity to make a policy change now.

By a policy change, Mr. Scanlon said, he meant a further slowing of the rate of growth in total reserves, permitting some firming in money market conditions. He believed that the markets expected a firmer policy and, in retrospect, he believed the Committee would want the record to show that it moved to such a policy--not that it had arrived there by accident. As he had noted at the last meeting, the Committee might do a better job of achieving its policy objectives if it were to alter the format of the second paragraph of the directive. He suggested that the Committee instruct the Manager to undertake to attain some approximate change in total reserves, provided that money market conditions did not fluctuate outside a specified range. Altering the directive in that manner would require no change in the Committee's posture on quantification, although he would favor such a change.

While he would prefer to have the directive formulated in terms of a desired rate of growth in total reserves, Mr. Scanlon continued, he would support the objectives of alternative B as amended by Mr. Hayes. He would also urge a prompt increase in the discount rate. Like Mr. Swan, he saw evidence that banks were beginning to look to the discount window rather than to the Federal funds market. He would not object to increasing the discount rate in steps of one-quarter of a percentage point, if the System wanted

to begin to develop the feeling in the banking community and on the part of the general public that a revitalized discount mechanism such as was envisioned in the current System study on that subject would call for more frequent small changes in the discount rate to keep it more in line with market rates.

Mr. Clay commented that both recent and prospective economic developments underscored the need for public economic policies of restraint. New current evidence of price inflation was accompanied by further indications of strong upward pressure on prices in the months ahead. The military situation and the further build-up of military personnel and supplies already apparent was pushing defense spending beyond official budget estimates, with the distinct possibility of an escalation of such spending. That came as additional pressure on the country's resources at a time when costs and prices already were rising at a disturbing pace. When one looked at what was happening in the national economy today, he could not find any assurance that price inflation was being restrained. Rather, he found indications suggesting that the rate of price inflation probably would accelerate.

One of the key factors was the scarcity of manpower, Mr. Clay said. Virtually all manpower with qualifications sought in the labor market was employed. Reference frequently was made to the bargaining strength of labor unions, cost of living pressures, and the cost-push aspect of price inflation, and those and other related

factors were highly significant. It had to be recognized, however, that combined military and civilian demand had created a scarcity of manpower that made it easier to obtain large wage increases. In making such a statement there was a risk of oversimplifying a situation that was in fact quite complex. There was merit, however, in underscoring the fact that there was a strong demand for labor and a tight labor market, and that that was related to the aggregate demand for goods and services already existing in the national economy.

Mr. Clay commented that the international balance of payments problem put an added premium on measures to bring price inflation under control. That took on further significance in view of the crucial importance of the balance of trade and the evidence of a declining trade surplus in recent months. Reassuring evidence that the United States was correcting its international payments imbalance was by no means apparent. More serious was the lack of evidence that the country was improving the basic factors involved, of which its competitive position in world trade was of particular importance.

Once again, in February, member bank credit expanded at a faster pace than was desired, Mr. Clay remarked. That was related primarily to Treasury financing, which also was an important factor in the rate of bank credit expansion in January and in the latter

factor in policy formulation in the near term, it would become important again later in this fiscal year and presumably would continue to be important during the balance of the calendar year thereafter. A few month ago, a project of reviewing the role of System open market operations during Treasury financings was undertaken at the suggestion of Mr. Bopp. Considering the prospective large volume of Treasury financing activity following the open period of the next few weeks, it would be well to move ahead on that project as rapidly as possible at this time.

In view of the prevailing economic situation, both domestic and international, and particularly the serious price inflation developments, Mr. Clay thought monetary policy should be shifted toward restraint. That policy move might be carried out in terms of the financial conditions set forth on pages 7 and 8 of the blue book.[1/] It should be recognized that the degree of restraint probably would increase member bank borrowing at the Reserve Banks.

1/ The blue book passage referred to read as follows: "If the Committee wishes to add further to pressure on bank reserve positions and the money market, it may want to consider conditions including net borrowed reserves in a $100 - $250 million range and member bank borrowings generally in a $450 - $550 million range. Federal funds would be likely to trade most frequently around 5 per cent although bank preferences for meeting reserve needs through the discount window could tend to moderate upward pressures on the funds rate. Along with an associated rise in dealer new loan rates to around 5-1/4 - 5-1/2 per cent, the 3-month bill rate may move into a 5-1/8 - 5-3/8 per cent range--moving more toward the upper end if expectations of a discount rate increase became more prevalent."

It also would set the stage for an increase in the Federal Reserve discount rate to 5 per cent.

Alternative B of the draft directives appeared satisfactory to Mr. Clay, with the change in the proviso clause of the second paragraph suggested by Mr. Hayes.

Mr. Wayne said he would add his voice to others in commending Mr. Brill and his associates for an excellent, sobering, and persuasive report this morning. He would also commend Mr. Coombs for a somber but honest appraisal of U.S. international problems.

Under the circumstances, Mr. Wayne continued, the case for increased monetary restraint was overwhelming. While monetary restraint might not be able to reverse cost-push pressures, it could moderate the extent to which higher costs might be passed on in the form of higher prices. Even keel considerations no longer prevailed, and if the move toward greater restraint was made gradually it should be possible, given the current tone of credit markets, to avoid an overly sharp rate reaction. Interest rates would no doubt rise, but there was still some leeway before disintermediation became a threat. Moreover, higher interest rates, which could be lowered, were preferable to higher prices, which tended to become permanent.

Mr. Wayne said he favored alternative B for the directive with Mr. Hayes' proposed amendment. In his judgment an increase in

the discount rate should support rather than precede the "snugging-up" in the market.

Mr. Mitchell said he also would commend the staff on an excellent presentation, in which the issues now facing the System had been pointed up very well. He would add, however, that he did not agree completely with the staff's views.

Mr. Mitchell favored increasing monetary restraint to the extent that could be done without causing extensive disintermediation. In his judgment, it would be easier to achieve tightening in the first half of 1968, when Treasury financing operations were likely to impose fewer constraints on Committee decisions than they would in the second half. He noted that debt management could be a useful supplement to monetary policy if the Treasury did much of its financing this year at longer term, but that the problems of monetary policy would be greater if financing was done primarily at short-term. That issue, however, need not be faced at the moment.

As had been observed, Mr. Mitchell continued, the Committee's objective should be to curb bank credit expansion. A curtailment of bank credit growth would force borrowers into the open market, and the higher interest rates and more onerous terms they would encounter there would help moderate the economic expansion. The Committee could reasonably expect to slow bank credit growth in the short run--the next three to five months--by affecting expectations; that is, by making it obvious that credit conditions were going to

get a little tighter and that there was no assurance that the System would provide relief if the banks found themselves under some pressure. If bankers became convinced that they would not have access to as large a supply of loanable funds as might be demanded they would tend to be more cautious in making loan commitments. They would also tend to buy fewer municipal securities and perhaps to sell some of their holdings of Government securities. It was extremely important, he thought, to create that type of uncertainty at banks.

In considering possible targets for the first half of 1968, Mr. Mitchell said, he might note that over the year 1967 total demand deposits of commercial banks had increased by about $10 billion and time and savings deposits by about $25 billion, with roughly $5 billion of the latter rise in the form of large CD's. U.S. bank holdings of Euro-dollars had changed little on balance. He thought appropriate targets for the first half of 1968 would include growth in demand deposits at roughly half the 1967 rate--perhaps at a $5 or $6 billion annual rate. For time and savings deposits the staff model suggested growth at about a $14.5 billion rate, which struck him as about right.

Mr. Mitchell said he had considerable sympathy with Mr. Francis' view that the structure of the second paragraph of the directive should be changed, with the proximate goal stated in terms of the desired growth rate in the monetary aggregate and

with money market conditions relegated to the proviso clause. However, he thought the staff was not yet sufficiently confident of its projections to want to see such a change made. He would be inclined to retain the present format for the directive until the staff was prepared for the format Mr. Francis had suggested.

Mr. Mitchell favored alternative B for today's directive, except that he would include a one-way proviso clause--either the clause shown in alternative A or that suggested by Mr. Hayes. As to the discount rate, he thought an increase of one-quarter of a point should be made quite soon, although he felt much more strongly about the desirability of a quarter- rather than a half-point increase than he did about the timing of the change. The smaller rise would be appropriate not only for the reason Mr. Scanlon had mentioned but also because he thought it was about as much as could be done without producing disintermediation.

Mr. Mitchell favored retaining the present ceiling rate on large CD's partly for balance of payments reasons. It would be desirable to influence banks with access to the Euro-dollar market to seek funds in that market on as large scale as possible. He would not want to increase the Regulation Q ceilings unless it was found that bank credit was not expanding at the rate the staff had projected. Run-offs of large CD's, by themselves, need not require an increase in the ceiling rate for such instruments, if inflows of consumer-type time deposits continued.

Mr. Maisel thought the System should demonstrate that it was shifting to a firmer policy by an immediate one-quarter point increase in the discount rate, and then adjust its open market operations in line with the greater pressures that would result. The advantage of using the discount rate as the primary instrument of policy at the moment was that it would be perfectly clear that there had been a change in policy. A higher discount rate would put a welcome amount of additional pressures on banks. At the same time, a quarter-point increase would have a smaller announcement effect than a half-point rise, while leaving open the possibility of a second change of similar size if that should prove desirable. The System had not changed the discount rate by one-quarter of a point for ten years, and it would be appropriate to reintroduce that type of flexibility now. A quarter-point change would also demonstrate to European observers that the Federal Reserve was acting carefully and gradually, with awareness of the situation but with no sense of panic.

Mr. Maisel said he was not prepared to express any firm view at this point about the desirability of an increase in Regulation Q ceilings; he thought a staff study of the considerations involved was needed. He did feel, however, that some of the comments on Q were based on an assumption that the Committee would continue to follow an incorrect policy of neglecting what was happening to monetary and credit aggregates because it was so hypnotized that it would only watch marginal reserves and money market conditions.

Mr. Maisel noted that changes in Regulation Q and the ability to attract large CD's need not determine the rate of expansion of bank credit unless the System allowed that to happen. The Federal Reserve had the power to determine the total deposits of member banks through its control of bank reserves. Problems with Q might, however, mean that the rate of creation of reserves or the reserve ratios had to be adjusted to the distribution of reserves behind different types of deposits. In addition, Regulation Q ceiling changes did affect the distribution of credit among banks and among competing credit instruments. He felt it important, as he had stated previously and as had been noted by several prior commentators, that the Committee should consider shifting the form of its directive so that the primary instruction to the Manager would be given in terms of the reserves, money, and credit aggregates, with the proviso for alternative actions drawn up in terms of large and undesired shifts in money market conditions.

While he would want to consider the matter carefully, at the moment Mr. Maisel felt that an increase in Q ceilings should be held off as long as possible, unless it became apparent that present ceilings were preventing growth in bank credit at an appropriate rate. He feared a replay of the first four months of 1966 when, because of a concentration on marginal reserves, the System had allowed bank credit to expand at an inflationary rate in order to meet the greater demands for reserves from the banks as they

expanded their time deposits with the aid given by the increase in Q ceilings in December 1965. Another consideration in favor of retaining present Q ceilings, as Mr. Mitchell had noted, was the desirability of encouraging Euro-dollar borrowing by U.S. banks.

Mr. Maisel added that the need to focus on growth in the aggregates suggested the importance of using a two-way proviso clause in the proposed directive for today. Such a clause would make clear that the Committee was not over-reacting in its policy, and that its objectives encompassed continued growth at a non-inflationary rate in the aggregates.

Mr. Brimmer said he gathered from the comments made today about the gold situation that Committee members were firmly convinced that the United States should maintain the official price of gold at $35 per ounce. At the same time, he detected some uneasiness about the present policy with respect to the gold pool. A meeting of the Open Market Committee was not the best forum for the purpose, but it would be desirable for the members of the Board and the Reserve Bank Presidents to reach some conclusions as to the appropriate System attitude with respect to U.S. gold policy. If at any point the System reached the conclusion that present policy was wrong in any respect, he would hope that it would be able to register that conclusion with the Treasury and the Administration. Advice to the effect that the System no longer supported some aspect of U.S. gold policy would, in his judgment, have a considerable impact in the counsels of the Government.

Mr. Brimmer remarked that he was disturbed about the Canadian situation. He assumed that there was no question but that the System should provide assistance to the Canadians if they got into difficulty. At the same time, he would be reluctant to encourage them to go deeply into debt if it was likely that the ultimate outcome would be similar to Britain's experience. As Mr. Coombs had indicated, Canada recently had lost one-third of its reserves, in part because flight capital had been moving from Canada to the Euro-dollar market. He personally was in a quandary as to the best course for the System under the circumstances.

Before turning to the domestic economic situation, Mr. Brimmer said, he would note that he also had been pleased to receive the staff's new set of projections before today's meeting. The staff had provided an outstanding body of documentation for this meeting, setting forth clearly the probable consequences of various policy actions. He assumed that the Committee was agreed that monetary policy had to compensate for the failure of Congress to pass a tax bill, while recognizing that that course would produce different effects from those that would have resulted if there had been increased fiscal restraint. It would appear from the staff projections that one cost of relying on monetary rather than fiscal restraint would be to lower the rate of housing starts in the fourth quarter by nearly 300,000 units. Another cost of greater monetary restraint might be a reduction of 200,000 persons in labor force growth and an increase in unemployment of about

the same magnitude. He personally was prepared to accept such costs of a tighter monetary policy for the reasons other speakers had already advanced today.

Mr. Brimmer said he had come to today's meeting prepared to advocate some snugging up through open market operations while looking toward an increase in the discount rate from 4-1/2 to 5 per cent in mid-April, provided that the Treasury was not engaged in a financing at that time. He had assumed it would be desirable to postpone discount rate action until mid-April in order to avoid undue attrition of deposits at thrift institutions around the April 1 interest crediting date. The staff's comments suggested to him, however, that in the interest of achieving the necessary degree of restraint the discount rate action might best be taken in mid-March. As to the appropriate size of the increase, he had been concerned earlier that a rise of one-half point might be required to avoid giving the impression abroad that the System was temporizing. But now he thought that a quarter-point rise would be adequate if it were backed up by further restraint through open market operations.

Mr. Brimmer said the Committee should keep in mind the fact that any action it might take on the discount rate would have implications for the Regulation Q ceilings. At present, rates on shorter-maturity CD's were still below the maximum level and he would not favor an immediate increase in the ceilings. Consideration might be given later to raising the ceiling rate on large CD's, but he would

not do so uniformly for all maturities. He would prefer to take the opportunity to reintroduce variations in ceilings by maturity, with maximum rates perhaps set at 5-3/4 per cent for 60-89 day CD's, at 5-1/2 per cent for those of shorter term, and at 6 per cent for those of longer term. The general objective would be to ease the impact of restraint on larger banks, enabling them to retain the volume of CD's they had outstanding but not enabling them to avoid restraint by expanding their outstandings.

Mr. Brimmer said he had originally favored alternative B for the directive as written--that is, including the two-way proviso clause in the draft--because of the need for acting judiciously in moving toward a firmer policy. On the other hand, while the Committee obviously was concerned about the possibility that bank credit might expand too rapidly in the coming period, there did not seem to be much risk that it would grow too slowly. Accordingly, he could accept Mr. Hayes' suggested one-way proviso clause. He had two comments about the draft of the first paragraph of the directive. One was simply a matter of English; rather than saying "the imbalance in U.S. international payments remains large," it would be better to say the imbalance "remains serious." His second comment, which related to the statement in the draft that "Growth in bank credit has been substantial thus far in 1968," was more substantive. By focusing on the period since the beginning of the year, that language failed to reflect the fact that bank credit growth--while still substantial--had slowed

on average since the System first began to shift toward restraint in November 1967. He would prefer language that reflected the fact.

Mr. Sherrill said he shared the view that monetary restraint was appropriate at this time, but he would emphasize the importance of avoiding financial disruption. Increased restraint obviously would affect the housing industry, and he would consider appropriate the kind of impact on housing implied by the staff's model. It should be kept in mind, however, that the effect on housing would be much greater if there was extensive disintermediation. In addition to its disruptive effects on housing, disintermediation might have another undesirable consequence in leading to borrowing by thrift institutions which, in turn, could nullify the System's actions to some extent. Moreover, unusually heavy borrowing by thrift institutions might force the monetary authorities into the position of considering some form of direct controls, perhaps along the lines of the "September 1" letter the System had sent to commercial banks in 1966. All in all, he believed the Committee should try to implement restraint in a manner that would avoid disintermediation. He thought adoption of alternative B for the directive, with the desired money market conditions taken to be those set forth on pages 7-8 of the blue book, would be consistent with that objective, and would accomplish a useful degree of restraint.

Mr. Sherrill remarked that he was not prepared to advocate an increase in the discount rate at this stage. He would want to

have some evidence on how banks were reacting to the firming of System policy before reaching a conclusion regarding possible discount rate action. If banks turned increasingly to the discount window, a discount rate increase would be appropriate; but if they turned primarily to the CD or Euro-dollar market for funds, the case for an increase would be less persuasive.

He also did not favor raising the Regulation Q ceilings at this time, Mr. Sherrill said. Bank managements viewed the level of the Q ceilings as an important determinant of the availability of funds to them, and the possibility that the ceilings might not be raised could have significant effects on their policies. To increase the ceilings before it was clearly necessary to do so would be to sacrifice an important psychological means for effecting restraint.

Mr. Sherrill agreed with Mr. Brimmer that a two-way proviso was unnecessary because the risk of inadequate bank credit growth was limited. Accordingly, he favored Mr. Hayes' proposed one-way clause.

Mr. Hickman commented that all the evidence available indicated that the economy was surging ahead. Unfortunately, that surge was being reflected in sharply rising prices, which in turn had been fueled by excessive bank credit expansion.

For nearly three years, Mr. Hickman said, through cooperation and cajolement the Federal Reserve System had attempted to participate in the shaping of a responsible stabilization policy. Unfortunately, it had not been overly successful on the fiscal front, and monetary

policy had erred--first on the side of ease, then on the side of excessive tightness, and then again on the side of too much ease. In short, the System had moved too slowly, and when it did move it overreacted.

Mr. Hickman suspected the root difficulty was that, in its efforts to cooperate and participate in the formulation of stabilization policy, the System had adopted, and identified with, the official point of view on the economic outlook and appropriate public policy. At the last meeting, for example, the Committee reviewed rather uncritically the official projections of the economic outlook and associated financial flows implied in the President's budget message. Many informed people less closely identified with the official position were skeptical about the low level of defense spending assumed in the budget message, and about the modest increases projected for the GNP price deflator. To the extent that the Committee was influenced by the official forecast, then its policy was overly easy, in the light of existing inflationary pressures and the probable size of the budget deficit. The projections presented to the Committee today were a step in the right direction, although it was his hunch that both defense spending and the GNP price deflator were still understated.

Mr. Hickman remarked that the Committee could not abdicate its role in the public partnership, but he thought it should begin

to call the shots more as it saw them, based on its own independent analysis. It was one thing to help develop and participate in a consensus; it was quite another thing for the Committee to allow itself to formulate monetary policy on grounds or hopes that might be unrealistic or untenable. It was perhaps not too immodest to point out that the Federal Reserve System had the best economic intelligence available and was capable of providing impartial economic analysis and policy recommendations.

So much for philosophy, Mr. Hickman said. As a practical matter, based on present events and the immediate outlook for the future, he believed there was a danger that recently the Committee had been too easy, and that later on it might be forced to overreact on the side of too much tightness. The money supply, bank credit, and the reserve aggregates had been growing at rates in excess of the real growth of the economy. That had been the case despite the delicate policy shift in December, which was reaffirmed at the Committee's last meeting. As a matter of fact, in February, despite the directive adopted at the last meeting, money market conditions were allowed on occasion to become quite easy, thereby contributing to excessive expansion in bank reserves and credit.

Consequently, Mr. Hickman thought the Committee should attempt to achieve a considerably less easy monetary policy for the immediate future. The figures now projected for March, on a daily average basis, were a good target providing they were not exceeded.

The money supply and bank credit should not be allowed to expand, on the average over the next two or three months, by more than a 4 to 6 per cent annual rate, which would accommodate a full-employment rate of growth in GNP. At a time when defense spending seemed to be expanding, when the U.S. trade balance was critically weak, and when increases in wages, costs, and prices were accelerating, more moderate rates of growth in money and credit than in the recent past were clearly needed. If the Committee acted in a forehanded manner now, the likelihood of its having to act in a heavy-handed manner later on would be considerably reduced.

In conclusion, Mr. Hickman said that since the projections for March were about where he would want the figures to come out, he could vote for alternative A with a one-way proviso, at least for the next few weeks. On the other hand, in view of the outlook for large Treasury financing, a further move now, as called for in alternative B, would seem to have the edge. He would be happier, however, if alternative B contained a two-way proviso clause. He would hold off on a change in the Regulation Q ceilings now, but would favor an increase in the discount rate of either one-quarter or one-half of a point as soon as possible. He would like to consult further with regard to the appropriate size of the discount rate increase.

Mr. Bopp remarked that current indicators were not very helpful in suggesting an appropriate policy for coming weeks.

For one reason, they had been pointing in different directions. In January, unemployment, retail sales, and housing starts improved; industrial production, new orders, and personal income were less favorable. For another reason, some of the indicators reflected special circumstances. The decline in the unemployment rate resulted from a drop in the labor force rather than from an increase in employment; and personal income rose little compared with December because the earlier month contained large Federal pay increases.

At the same time, the broader view of 1968 seemed to Mr. Bopp to have clarified somewhat. It now looked as if the second half would be more vigorous than had been thought. One reason might be the behavior of inventories. Although total consumer spending in the next few months would rise considerably simply because of strong increases in income, some adjustment might be necessary in the auto sector. As a result, total inventories might not rise as much as had originally been forecast, thus mitigating any problem of adjustment in the second half. If that was so, one argument for an over-strong first half and a less-strong second half might be less persuasive than before. More important, however, it now seemed almost certain that defense spending would be larger than budgeted.

That new outlook for the latter part of the year considerably altered the environment in which monetary policy would be operating, Mr. Bopp observed. In recent months he had viewed with misgivings the substantial increase in money and credit at a time of rapidly

rising prices. There was some question, however, whether a more stringent policy could succeed in slowing inflation without endangering the pace of the economy later in the year. The course of the Vietnam war seemed to have eliminated that problem.

Mr. Bopp thought a less rapid expansion in bank credit would be appropriate now to help prevent excessive over-all demand from aggravating cost pressures. Furthermore, consumers were building liquidity rapidly and businesses were restoring their liquidity. Because of the changing outlook for the latter part of the year, and in view of past increases in money and credit, a further rapid increase would be undesirable.

Mr. Bopp favored alternative B of the draft directives, as modified by Mr. Hayes.

Mr. Kimbrel remarked that those who had trouble finding answers to policy questions could, he believed, find comfort in learning that some academic economists were having the same trouble. Since the last meeting of the Committee, the Atlanta Bank's research staff had sponsored two seminars for college professors of economics and finance in Florida and Tennessee. At the end of each one-day meeting, the participants were asked their views on certain policy questions. The poll of about 90 economists showed that a little over half believed that reserves, bank credit, and the money supply had been growing too rapidly during 1967 through November. But there were many who thought the rates of growth had been about

right; and, indeed, about one of ten professors believed that the rate of expansion had been too low.

Mr. Kimbrel commented that the economists in the seminars had no conclusive answer as to the future. Twenty-seven per cent thought the System should conduct its operations so as to produce about the same slightly lower rates of increase in reserves, bank credit, and the money supply as had prevailed from December through mid-February; and 56 per cent favored lower rates of increase. Only about 16 per cent believed higher rates of increase would be in order. They were about equally divided on maintaining present money market conditions or moving toward firmer money market conditions, and they were almost split down the middle on whether or not discount rates should be kept unchanged or raised. What seemed to him to be most significant about the poll was that the division of opinion was around the degree of tightening--not on whether there ought to be any tightening at all.

Mr. Kimbrel found the same sort of inconclusiveness in the way economic measures were behaving. Apparently, many analysts and the financial press had concluded that the System had finally turned toward somewhat greater restraint. Last week's net borrowed reserve figure, he was sure, bolstered their conclusion. Yet, when one looked at other measures of money market and credit conditions, it was hard to see in their behavior an indication of a move toward tightness.

Even though the District's economic activity was still expanding, Mr. Kimbrel said, there was diverse behavior among the various nonfinancial indicators. Similar inconclusive behavior seemed characteristic of national developments. For that reason, any sharp movement toward more tightness might be considered inappropriate at the moment. Nevertheless, after admitting all of the uncertainties, he was still convinced that the Committee should be cutting down on the rate of increase in bank credit. Although there might be a need to move cautiously, there should be constant movement in that direction. The committee needed to move now before further Treasury financing complicated the problem.

Mr. Kimbrel said he also would like to associate himself with those who suggested this was an appropriate time to consider seriously bringing the discount rate into closer touch with the market. Many in the System had hesitated about a discount rate change for fear that it might set off a chain reaction based on expectations of further credit tightening that would push rates up far beyond their present levels. There was, of course, always the danger that increasing the discount rate would have too great an announcement effect. It would seem to him, however, that that danger was more likely to be associated with the periods of extreme credit tightness than with a period like the present one. There seemed to be a greater chance that it would be correctly interpreted now than that it would be in the future.

Under those circumstances, Mr. Kimbrel favored alternative B of the draft directives with the proviso clause suggested by Mr. Hayes.

Mr. Francis said he would first like to compliment the Board's staff on developing techniques for estimating rates of growth in the bank credit proxy and the deposit components more frequently than once a week. With more frequent information on those aggregates, there should be an improvement in the System's short-term operations. He would hope that at some point those estimates could be added to the daily wire so that the members of the Committee not on the daily call would have access to them.

For about six months, Mr. Francis observed, the members of the Committee had agreed in general that containing inflation should be the goal of monetary policy. The Committee had changed its policy directive three months ago, and the inflationary pressures which led the Committee to that decision had not abated. All of the major aggregate measures--employment, production, spending, and prices--had continued to increase at rapid rates through the end of February.

Mr. Francis noted that fear had been expressed in some quarters that there would be a weakening in total demand in the second half of this year. The only consideration which seemed to point to such a development was the possibility that the rapid accumulation of inventories in the first half of the year in anticipation of a strike would be worked off in the second half. There was no way, however, for stabilization policy to influence

that type of short-term random economic event. Although the Committee had to be aware of their existence, it could not conduct policy on the basis of such developments.

There seemed to Mr. Francis to be no good theoretical reason for anticipating a slowdown in the second half. There was general agreement among the various theories which attempted to explain the course of economic activity, that if both monetary and fiscal policy were stimulative the economy would continue to expand at a rapid rate. If one looked at monetary and fiscal actions, one observed that they had both been stimulative. The Government had been running the largest deficit since World War II, and monetary actions during 1967 were more expansionary than in any previous year since World War II. Projections of the Federal budget for the rest of this year indicated a continued stimulative fiscal policy, unless there was a substantial tax increase, which many observers had become disillusioned about achieving. Although monetary policy had been less stimulative in the last three months, monetary aggregates had increased at rates generally higher than during the first four years of the present upswing. Most theoretical points of view led to the same conclusion; inflation was still the single most important domestic problem the Committee faced.

In Mr. Francis' opinion, therefore, the Committee had adopted an appropriate policy with a directive calling for bank credit growth at less than a 7 per cent annual rate. For those

members who placed some emphasis on rates of growth in the money stock, the 3 to 4 per cent rate of increase over the past three months seemed nearly appropriate, and money growth should be held near the 3 per cent level. He believed that those trends in monetary aggregates were more likely to be attained in the near future with some further tightening in money market conditions, as suggested in alternative B, but he would have more confidence if the proximate goal in the directive was stated in terms of the bank credit proxy, with money market conditions referred to in the proviso clause.

Mr. Francis favored an immediate discount rate increase of one-half of a percentage point along with a simultaneous increase in the Regulation Q ceilings on both large-denomination and consumer-type CD's.

Mr. Robertson said that in view of the lateness of the hour he would make only a few brief remarks and would ask that the statement he had prepared be included in the record. He agreed with the prevailing view today that greater restraint was desirable, and accordingly he favored alternative B for the directive. He would prefer to include the two-way proviso clause shown in the staff's draft of that alternative, but if such a clause was not acceptable to the Committee his second choice would be the one-way proviso shown in alternative A. Mr. Hayes' proposed one-way proviso was his third choice. He would favor a one-quarter point increase in the discount rate, but only because of the effect it would have on

attitudes abroad; except for that consideration, he thought it would be better to delay discount rate action. In his judgment, it would be a mistake to raise Regulation Q ceilings at this time because attainment of the appropriate degree of restraint required avoidance of an increase in the outstanding volume of large-denomination CD's. Action on Regulation Q might be needed later to prevent disintermediation, but any such action should take a form that would prevent banks from increasing the volume of their large CD's outstanding. He had worked out a proposal under which a bank would be permitted to offer CD's at a rate above 5-1/2 per cent if its outstandings declined, with the ceiling for the bank reverting to 5-1/2 per cent as soon as outstandings exceeded their earlier level.

Mr. Robertson's prepared statement read as follows:

> In a discussion focused as much on the need for restraint as ours has been this morning, I think it is worth while to keep in mind that we are not quite in an unrestrained boom. Consumer spending has not been mounting excessively, and business investment is certainly not mushrooming in classic boom time fashion. All the extraordinary fiscal stimulus of the past year has not yet managed to generate a full-blown wave of private spending.
>
> Credit for this, I suppose, must go partly to the sense of caution and uncertainty--even unease--in the minds of consumers and businessmen. But in addition, I think, we need to recognize that the financial situation itself is probably also working as a moderate but constructive drag on excessive spending. The cost of money is high, by any reasonable standard, and aggregate bank credit and money flows, as the blue book reminds us, have slowed substantially over the past three months as a whole. Flows through nonbank savings institutions, of course, have slowed up even more. Given our knowledge of the lagged effects of financial variables, we can look

forward to a major part of such restraining influence on GNP showing up as the year progresses.

Having said these cautionary words, however, let me go on to say that I still believe that the moderating influences I have cited are being overridden by still more powerful inflationary forces. Three interrelated elements trouble me a great deal. One is the momentum of the wage-price spiral, which is strong and apparently getting stronger. The second is the clear possibility that spiraling costs and prices of things will engender new and stronger financing demands. And the third is that our fundamental balance of payments position, far from being improved as is so badly needed, is instead being eroded still further by the inroads of inflation on our trade surplus.

In this situation prudence demands the application of a greater degree of restraint on growing demands. Much as we would prefer that to come from the fiscal side, we cannot afford to wait longer for either Government expenditure cuts or a tax increase. Therefore, I conclude that we must move ahead with a gradual and calculated tightening of monetary policy.

I am glad we were able to accomplish as much as we did in the way of tightening during the period since we last met. I commend the Manager for doing what he did to minimize any slippages back toward temporarily easier money market conditions, and I urge him to be even more assiduous in resolving all doubts on the side of tightness during the next four weeks.

As long as I am handing out bouquets, I would also like to point out that the Committee's keen interest in tightening if circumstances warranted over the last four weeks was well served by the operation of the proviso clause. I believe this is the second time (the first being October 1966) when the proviso clause has actually worked to trigger a change in Desk operations that in retrospect has been a highly desirable move. Perhaps equally important, it has never yet worked to make the Manager change his operations in a way that looked disadvantageous in retrospect. With this kind of performance, I think the proviso has well justified its place in our kit of tools, and I hope we continue to use it regularly.

To me, the essence of appropriate monetary policy from now until our next meeting is orderly, gradual, but unrelenting tightening. I think that prescription best fits the rather sensitive business, financial, and political

situations in which we find ourselves, both domestically and internationally.

With these views in mind, I would like to have the Manager conduct his operations with a view to achieving roughly the conditions spelled out as the tightening alternative on pages 7 and 8 of the blue book. As to the formal directive language, I would favor alternative B as suggested by the staff.

Chairman Martin commented that it was useful for the Committee to discuss all instruments of monetary policy, including discount rates and Regulation Q, because of the need for coordinated use of the various policy tools. But decisions on policy instruments other than open market operations could not, of course, be made by the Committee; responsibility for initiating changes in discount rates lay with the Directors of the individual Reserve Banks, and the Board had responsibility for Regulation Q.

It was the unanimous view of the members today that greater monetary restraint was desirable, the Chairman continued. As was often the case, however, there were problems of timing. Personally, he was not prepared at the moment to advocate an increase in the discount rate of either one-quarter or one-half of a percentage point. He would want to increase restraint gradually and unaggressively, while watching developments closely. The present period was one in which events could alter circumstances quickly.

Chairman Martin remarked that while the Committee members were agreed that alternative B was preferable to alternative A for the directive, there were differences in view regarding the

proviso clause. He personally could accept either a one-way or a two-way clause.

Mr. Sherrill said that that was his position also. He had spoken in favor of a one-way clause earlier because he thought a two-way clause was unnecessary, not because he had objections to such a clause.

Mr. Robertson remarked that in his judgment a two-way proviso clause would serve a useful purpose because events could differ from expectations. In general, the value of the proviso clause had been demonstrated, as indicated in his prepared statement, by the fact that it had twice led to desirable changes in Desk operations and had never led to undesirable changes.

Mr. Hayes commented that in light of the Committee's unanimous view that policy should be firmed he did not think a two-way clause was desirable. To include such a clause would be to instruct the Manager not to seek firmer money market conditions over the next four weeks if bank credit appeared to be deviating significantly below expectations. He personally would not want to issue such an instruction today because he would not consider bank credit estimates that appeared to be on the low side a sufficiently significant development to justify what would be a major change in the course of policy.

Chairman Martin remarked that one could make a good case on either side of the question. Using a two-way clause might be

considered an act of humility and he thought it would not be likely to do any harm.

Mr. Swan commented that when the record for today's meeting was published readers were likely to be puzzled if they found that the Committee had included a two-way proviso clause.

Mr. Mitchell noted that the present directive included a one-way proviso clause. While the Committee might want to shift to a two-way clause at some point, he thought this was a singularly inappropriate time to make such a change.

Other members concurred in Mr. Mitchell's observation.

At Chairman Martin's request, Mr. Holland then read proposed new versions of the two sentences in the draft of the first paragraph that Mr. Brimmer had suggested should be revised. It was agreed that the revised sentences were appropriate.

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

The information reviewed at this meeting indicates that over-all economic activity has been expanding rapidly, with both industrial and consumer prices rising at a substantial rate, and that prospects are for continuing rapid growth and persisting inflationary pressures in the period ahead. The foreign trade surplus has been at a sharply reduced level in recent months and the imbalance in U.S. international payments remains serious. Interest rates on most types of market instruments have edged up recently, following earlier declines. While growth in bank credit has moderated on balance during

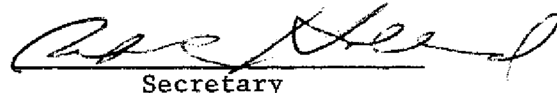
> the past three months, bank credit expansion has been substantial in February, mainly reflecting Treasury financings. Growth in the money supply slowed in February, while flows into bank time and savings accounts expanded moderately. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat firmer conditions in the money market; provided, however, that operations shall be further modified if bank credit appears to be expanding more rapidly than is currently projected.

Mr. Hayes said that before adjournment he would like to ask whether the Special Manager thought a one-quarter point increase in the discount rate would have as useful an effect on attitudes abroad as a one-half point increase would.

Mr. Coombs replied that in his judgment a one-quarter point increase would have relatively little impact on attitudes abroad. On the other hand, an increase of one-half point might well have serious consequences for the Canadian dollar and the pound, if it were put into effect before conditions in markets for those currencies had settled down a little.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, April 2, 1968, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

Suggested revised procedure for allocating System Open Market Account in event Congress removes gold cover requirements

1. Securities in the System Open Market Account shall be reallocated on the last business day of each month by means of adjustments proportionate to the adjustments that would have been required to equalize approximately the average ~~reserve~~ ratios of GOLD HOLDINGS TO NOTE LIABILITIES OF the 12 Federal Reserve Banks based on the RATIOS OF GOLD TO NOTES FOR THE most recent ~~available~~ five business days. ~~reserve ratio figures.~~

~~2. The Board's staff shall calculate, in the morning of each business day, the reserve ratios of each Bank after allowing for the indicated effects of the settlement of the Interdistrict Settlement Fund for the preceding day. If these calculations should disclose a deficiency in the reserve ratio of any Bank, the Board's staff shall inform the Manager of the System Open Market Account, who shall make a special adjustment as of the previous day to restore the reserve ratio of that Bank to the average of all the Banks. However, such adjustments shall not be made beyond the point where a deficiency would be created at any other Bank. Such adjustments shall be offset against the participation of the Bank or Banks best able to absorb the additional amount or, at the discretion of the Manager, against the participation of the Federal Reserve Bank of New York. The Board's staff and the Bank or Banks concerned shall then be notified of the amounts involved and the Interdistrict Settlement Fund shall be closed after giving effect to the adjustments as of the preceding business day.~~

2. ~~3.~~ Until the next reallocation the Account shall be apportioned on the basis of the ratios determined in paragraph 1. ~~after allowing for any adjustments as provided for in paragraph 2.~~

3. ~~4.~~ Profits and losses on the sale of securities from the Account shall be allocated on the day of delivery of the securities sold on the basis of each Bank's current holdings at the opening of business on that day.

ATTACHMENT B

CONFIDENTIAL (FR) March 4, 1968

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on March 5, 1968

FIRST PARAGRAPH

The information reviewed at this meeting indicates that overall economic activity has been expanding rapidly, with both industrial and consumer prices rising at a substantial rate, and that prospects are for continuing rapid growth and persisting inflationary pressures in the period ahead. The foreign trade surplus has been at a sharply reduced level in recent months and the imbalance in U.S. international payments remains large. Interest rates on most types of market instruments have edged up recently, following earlier declines. Growth in bank credit has been substantial thus far in 1968, in part reflecting Treasury financing operations. Growth in the money supply slowed in February, while flows into bank time and savings accounts expanded moderately. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

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

Alternative B

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat firmer conditions in the money market; provided, however, that operations shall be modified as necessary to moderate any apparently significant deviations of bank credit from current expectations.