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, August 13, 1968, at 9:30 a.m.

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

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

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

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

Mr. Cardon, Assistant to the Board of Governors
Mr. Farrell, Director, Division of Federal Reserve Bank Operations, Board of Governors1/

1/ Entered the meeting at the point indicated.

Mr. Wernick, Associate Adviser, Division of Research and Statistics, Board of Governors
Messrs. Keir and Weiner, Assistant Advisers, Division of Research and Statistics, Board of Governors
Mr. Bernard, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Mr. Latham, First Vice President, Federal Reserve Bank of Boston
Messrs. Eisenmenger, MacLaury, Baughman, Jones, Tow, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, New York, Chicago, St. Louis, Kansas City, and San Francisco, respectively
Messrs. Meek and Snellings, Assistant Vice Presidents of the Federal Reserve Banks of New York and Richmond, respectively
Mr. Shotwell, Senior Economist, Federal Reserve Bank of Cleveland
Mr. Stahl, Research Officer and Economist, Federal Reserve Bank of Philadelphia
Mr. Duprey, Economist, Federal Reserve Bank of Minneapolis
Mr. Fraser, Financial Economist, Federal Reserve Bank of Dallas

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on July 16, 1968, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on July 16, 1968, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period July 16 through August 7, 1968, and a supplemental report covering the period August 8 through 12, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. MacLaury said that the Treasury gold stock would again be unchanged this week at $10.367 billion. It had now been two and one-half months since the Treasury had had to announce any decline--thanks mainly, of course, to the sales of gold by France to the United States. Sales to the U.S. so far had amounted to nearly $300 million, or slightly less than half of France's total sales of about $650 million. Purchases by other countries of gold from the U.S. had continued, with about $75 million pending at the moment. However, since the Stabilization Fund still had nearly $280 million on hand, a need for a reduction in the Treasury gold stock in the near future was not apparent.

Mr. MacLaury remarked that he could not recall a period in the recent past in which the gold and exchange markets had been as free from tension as the month since the previous meeting of the Committee. That was not to say that a good deal had not been going on, mainly in the exchange markets; but the activity had been more or less neutral, or, as in the case of sterling until today, even bullish in its impact on market psychology.

In the London gold market, Mr. MacLaury continued, the price had held in a very narrow range around $39 since the last Committee meeting, with the exception of a brief period around the middle of July. At that time a number of rumors, particularly concerning agreement among central bankers not to buy South African production until market prices moved close to the official $35 price, unnerved the speculators and caused the price to drop as low as $37.75. Subsequent verbal exchanges--in what the market considered to be a war of nerves between the U.S. authorities and South Africa on the question of market gold sales--had had very little effect, on balance, on either trading or price. In general, although it was clear to the market that the final chapter of that dialogue had not yet been written, the net result for the time being at least was a feeling of greater stability for the two-price gold system than would have seemed possible a few months ago.

Mr. MacLaury observed that July was a very active month for sterling. As the Committee would recall, at the beginning of the month the Bank of England had had to borrow $500 million under its swap line with the Federal Reserve, after having cleared up that line with the proceeds of an International Monetary Fund drawing and U.S. purchases of guaranteed sterling only a few weeks earlier. A combination of factors, including the announcements of actual or potential credit lines for the Bank of France and for sterling balances, and particularly the improved U.K. trade figures for June announced at mid-month, brought relief from the extreme pessimism which had pervaded the markets during the early part of July. That improved atmosphere gathered a momentum of its own and produced market purchases of sterling during the latter half of July that enabled the Bank of England to pick up more than $500 million, more than offsetting the losses of early July. As a result, despite net repayments of $50 million of short-term central bank assistance, another $50 million in scheduled repayments, and a sizable amount of forward maturities, the Bank of England had been able to announce a reserve gain in July of just over $50 million. Although until today the sterling exchange rate had held near the peak of $2.3950 reached at the end of July, actual demand for sterling since the beginning of August had tapered off, and with it, acquisitions of dollars by the Bank of England. On balance during the period, however, the Bank of England had been able to reduce its indebtedness under the Federal Reserve swap line by $200 million, leaving $300 million outstanding at the moment. Clearly one could not expect sterling to continue as strong as it was in late July. Much would now depend upon the reaction to the trade figures for July that had been announced today. The figures were not good; imports increased substantially after declining in June, and although exports also rose somewhat the trade gap widened. Under the initial impact of that announcement the sterling rate dropped 15 points, from $2.3940 to $2.3925, but at the moment there was no particular pressure on sterling In any case, the Bank of England had sizable commitments to meet this month before it could show any reserve gains. These included not only the usual forward maturities, but the first instalment--amounting to about $85 million--on Britain's 1965 drawing from the IMF, and some scheduled European Payments Union debt repayments.

At the moment, Mr. MacLaury said, the most worrisome factor in the exchange markets was the persistent loss of dollars by the Bank of France. As the Committee knew, the Bank of France had now borrowed a total of $250 million under its swap line with the Federal Reserve. In addition, it had borrowed $170 million under its lines with continental European central banks. Since the crisis had broken out in mid-May, French reserves had declined by more than $2.5 billion; and the pace of losses in the last three weeks had remained above $100 million per week. French trade figures for July, announced yesterday, showed a surplus in contrast to the deficit for the preceding month, and the franc was off the floor today. On balance, the market remained highly uncertain about prospects for the franc over the coming year. In his opinion, developments with respect to the French franc posed the greatest potential threat to the stability of the international monetary system in coming months.

With respect to the Swiss franc, Mr. MacLaury commented, the demand pressures that had built up prior to the end of July were largely attributable to a tight internal money market. The result, nevertheless, was that the Swiss National Bank ended up with $150 million which it asked the System to cover by swap drawings totaling $145 million. Thus, the period in which the System had been completely free of indebtedness under the swap network was all too brief.

On the other hand, Mr. MacLaury observed, the continued existence of an extremely liquid banking system in Germany had facilitated continued capital outflows from that country and, in fact, had depressed the mark to its lowest level since the 1961 revaluation. Under those circumstances, the Account Management had been acquiring mark balances for both System and Treasury account, and last week a $50 million equivalent mark-denominated Treasury bond had been paid off in advance of maturity.

Mr. MacLaury then said he would report briefly on a few other matters. The first related to the $200 million of guaranteed sterling that the System had warehoused for the Stabilization Fund in mid-June, at the time of the repayment by the British of their drawings on the swap line with the System. It had subsequently become clear that the Stabilization Fund had sufficient resources to meet its exchange commitments for the time being, and it had therefore agreed to reacquire the warehoused sterling. Secondly, while he had no specific information on the progress of the British negotiations with sterling area countries with respect to the proposed sterling balance arrangements, he had the impression that Bank of England officials thought there were grounds for some moderate degree of optimism. Also, the Bank for International Settlements had called a meeting of central bank technicians for August 20 to review the arrangements; it had been agreed earlier that such a meeting would be held only if the British were making some progress in their current talks.

His final observation, Mr. MacLaury said, related to the System's $225 million swap arrangement with the National Bank of Belgium. As the Committee knew, that arrangement was unique in the network in that, at the wish of the Belgian authorities, a $50 million portion had always been fully drawn. He could report that in September the $50 million portion would be paid off and the full $225 million line put on the same basis as all of the other arrangements in the network.

By unanimous vote, the System open market transactions in foreign currencies during the period July 16 through August 12, 1968, were approved, ratified, and confirmed.

Mr. MacLaury noted that a number of drawings by other central banks on the Federal Reserve would soon be approaching the end of their first three-month terms. They were drawings of $100 million by the Bank of France, maturing September 5, 1968; of $25 million by the National Bank of Denmark, maturing September 6; and of $24.9 million and $29.8 million by the Netherlands Bank, maturing September 6 and 19, respectively. He recommended renewal of each of those drawings, if requested by the central bank concerned.

> Renewal of the drawings by the Bank of France, the National Bank of Denmark, and the Netherlands Bank was noted without objection.

Mr. MacLaury then noted that $18 million of System forward commitments in Swiss francs, originally undertaken in December 1967 and March 1968, would mature in the period August 19 to August 26, 1968. It had been possible to repay the $14 million of Swiss franc forwards that had matured in July, and Swiss National Bank officials thought the chances were good that the forwards maturing this month could also be repaid. In the event that their repayment was not feasible, however, he would recommend renewal.

> Renewal of the System's forward commitments in Swiss francs was noted without objection.

Chairman Martin noted that Messrs. Brimmer and Daane recently had attended meetings of the Economic Policy Committee and of Working Party 3, respectively, of the Organization for Economic Cooperation and Development. He invited them to comment.

Mr. Brimmer said that at the EPC meeting, which was held in late July, attitudes toward the U.S. economic situation had been as favorable as at any such meeting he had attended in the last few years. There was a general willingness to accept the prospect that the U.S. economy would cool off this year, although the Germans, and to some extent the Dutch, seemed to doubt that the slowdown would begin immediately. Some of the delegates expected the planned cuts in Federal spending to be offset in one way or another. The group hoped that the U.S. monetary authorities would act cautiously and not move too far too soon in reducing monetary restraint. At the same time, they agreed in general that other countries would have to modify their economic policies in response to the expected slowing of the U.S. economy. However, some countries would have administrative difficulties in doing so; problems were posed for the Germans, for example, by the calendar for their Government budget.

The main focus of the discussion, Mr. Brimmer continued, was on France. The hope was expressed that France would be able to adjust to the higher costs inherent in the wage settlements following the May-June disturbances by expanding output rather than by passing on the higher costs in the form of higher prices.

The group was critical of the trade restraints France had imposed recently. Somewhat surprisingly, France's partners in the Common Market were as critical of those restraints as other countries were.

Mr. Daane remarked that at the WP-3 meeting, held shortly after the EPC meeting, there was a lively discussion of the world adjustment process over the next two or three years on the assumption that the payments balance of the United States would move to equilibrium and that of the United Kingdom to surplus. The question arose as to whether early activation of the Special Drawing Rights scheme would not be required to permit the adjustment process to work out under the circumstances assumed. The French representatives remained aloof for the most part, expressing the view that the discussion was academic since the assumptions were unrealistic. They thought there would be no adjustment problem unless the United States over-shot the mark in moving toward equilibrium, and they were highly skeptical of the ability of the U.S. to get close to balance in the period in question.

The matter was left for further consideration at the next meeting of WP-3, scheduled for a date just preceding the Bank and Fund meetings, Mr. Daane said. The main significance of the discussion was that it might have signaled the beginning of a drift toward sentiment for early activation of SDR's. In that connection, it now appeared that by year-end the number of countries that would have ratified the amendment to the Fund's Articles of Agreement would be very close to the number required.

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 July 16 through August 7, 1968, and a supplemental report covering August 8 through 12, 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:

> The period since the Committee last met has demonstrated once again the pervasive effects that a shift in market expectations can have on interest rates and money and credit flows. Interest rates in all maturity areas moved sharply lower as market participants became increasingly convinced that the fiscal restraint package would succeed in cooling off the economy, thereby reducing demand pressures in financial markets, and that, as a consequence, monetary restraint would be relaxed over the coming months. In this atmosphere the market paid close attention to the cut in the repurchase agreement rate to 5-1/2 per cent on July 17 and to market letter and press comment on the likely decline in economic growth and on an early shift towards a somewhat easier monetary policy. Most market participants appear to have operated on the assumption that a cut to 5 per cent in the discount rate would be forthcoming shortly after the Treasury financing was completed. This assumption has come to be increasingly questioned in the past few days, and interest rates have retraced a portion of their earlier declines.
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> In this atmosphere the Treasury's offerings of a $5.1 billion 6-year note issue--priced to yield 5.70 per cent--was very well received, with allotments on large subscriptions amounting to 18 per cent. In addition to

refunding \$3.6 billion August 15 maturities held by the public, the Treasury was able--with an overallotment--to raise nearly \$1.9 billion in new money. This should be sufficient to meet Treasury cash needs until late October. Over the rest of the calendar year the Treasury needs about \$5-1/2 billion, and it is likely that the bulk of that need will be met through the auction of tax-anticipation bills--which implies minimal even keel considerations. Despite the size of the Treasury offering--the largest of its kind in over 20 years--prices of outstanding Treasury coupon issues rose sharply on balance, reducing yields on intermediate-term Treasury notes and bonds by 1/4 of a percentage point and yields on longer-term issues by 1/8 of a percentage point. Given the attractive pricing of the new issue, a fair amount of speculative interest was attracted, but it does not appear to have been excessive. In secondary market trading the new issue quickly moved to a premium which ranged at one point to as high as 3/8 of a point. In the past few days, as expectations began to shift, the premium fell back to about 1/8 of a point at the close of business yesterday.

In both the corporate and municipal markets, prices also rose sharply, lowering yields by 1/4 of a percentage point or more over the period. Continuing growth of bank interest was an important factor in the municipal market, and despite lower yield levels there is as yet little indication that corporations are rushing to the market as they did in early 1967.

Short-term interest rates, spurred by the absence of an anchor issue in the August financing, showed even more dramatic declines. The 3-month Treasury bill declined by over 1/2 of a percentage point to as low as 4.86 per cent, although it bounced back to about the 5.00 per cent level over the past week. CD rates were lowered by as much as 3/8 of a percentage point, with only the shortest dated maturities still being issued at Q ceiling rates. Rates on bankers' acceptances and on commercial paper were also reduced.

Along with the decline in interest rates, bank credit expanded much more rapidly than had been anticipated as securities dealers turned to the banks to finance their swollen inventories, as bank investment portfolios increased, and as bank CD's became more competitive with other market instruments. In July the credit proxy rose at a 9 per cent annual rate, compared with the 1 to 4 per cent range projected at the last meeting; the inclusion of Euro-dollars would bring the increase to 11 per cent. For August a 16 to 18 per cent growth rate is currently projected, mainly reflecting the impact of the Treasury's financing operations. Thus the growth in the proxy for July-August combined is 5 to 6 percentage points above the rate anticipated at the last meeting. While, as the blue book[1/] suggests, this may well be a one-shot expansion, based on the desire of dealers and banks to catch the turn of the tide in interest rates, it is still a disturbingly high rate of increase.

As the pattern of bank credit expansion became increasingly apparent, open market operations became less accommodative. With interest rates declining more rapidly than had been expected and with strong investor interest in the Treasury financing, firmer conditions were allowed to develop in the money market as called for in the proviso clause of the directive. While a large volume of reserves had to be supplied on balance over the period, they were supplied somewhat reluctantly and only after some pressure had been felt in the Federal funds market. Thus, the Federal funds rate, net borrowed reserves, and member bank borrowings were all a shade higher than had been considered desirable at the time of the last meeting--desirable, that is, in the absence of the bulge in bank credit that actually developed. The degree of tautness that was permitted to develop in the money market was not enough to choke off the bank credit expansion. To have attempted to do so--in the face of expectations--would have required a very tight money market indeed and would have been completely inconsistent with even keel considerations.

The main consequence of the relatively taut day-to-day money market conditions that were permitted to develop has been to open a wide gap between dealer and other investor financing costs and the sharply lower level of interest rates on market instruments. Dealers obviously cannot for long finance Treasury bills yielding around 5 per cent with borrowing costs at 6-3/8 per cent. Thus, unless market expectations about a change in the discount rate are fulfilled in the next few weeks,

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

interest rates are likely to back up. There can be little doubt that the weight of expectations pushed interest rates too low too fast. Some correction may be needed, and in fact the bill rate has moved up considerably from the low point reached a week or so ago. In yesterday's Treasury bill auction, for example, average rates of 5.08 and 5.27 per cent were established for 3- and 6-month Treasury bills, 18 and 17 basis points above last week's auction, although still 40 and 28 basis points below the auction just preceding the last meeting of the Committee.

There is a risk, however, that the market may--as it usually does--push a rate reaction too far. Given the size of dealer and other investor inventories, the market is vulnerable to any basic change in expectations that some easing of monetary policy is likely to occur in the near future. It thus appears that the period ahead could see a head-on conflict between the Committee's desires with respect to interest rates and its desires with respect to bank credit expansion. More than ever it would appear important for the Committee to establish priorities as between these two sets of variables. I should also note that while the staff's draft directives[1/] make no mention of even keel, I would assume that the Committee would want the status of the Treasury's financing to exert some marginal influence on open market operations for the next week or so.

Mr. Mitchell asked Mr. Holmes if the dealers were becoming restive in view of the speculative positions they had built up. He also inquired whether in the Manager's judgment the size of their inventories should be a matter of concern for the Committee and if there was any information available about the size of bank speculative positions.

Mr. Holmes replied that in the past few days the dealers had become increasingly restive about the level of their inventories,

1/ Appended to this memorandum as Attachment A.

which they had built up to more than $5-1/2 billion. If the dealers attempted to unload their inventories, they would encounter considerable difficulties under prevailing market circumstances and might trigger a substantial market reaction. Such a reaction would tend to start with short-term rates and might well extend to longer-term rates. The dealers would also incur losses in the process, although--given the substantial profits they had made in recent months--they appeared to be in a good position to absorb such losses.

Mr. Holmes added that he did not have any reliable information about the size of bank speculative positions. Banks recently had been increasing their holdings of both U.S. Government and State and local government securities. In the case of Governments, such acquisitions were partly related to recent Treasury financing activity.

In response to another question by Mr. Mitchell, Mr. Holmes expressed the view that implementation of a "no change" directive might induce speculative holders to attempt to reduce their inventories.

Mr. Daane asked what the Manager's judgment would be concerning the impact of a reduction in the discount rate under current market circumstances. In particular, he (Mr. Daane) wondered if such a reduction would tend to generate market expectations which would carry interest rates down much further than anyone would like, of if it would tend to stabilize markets by encouraging dealers not to rush to liquidate their inventories.

Mr. Holmes replied that it was always difficult to judge the effect on expectations of any System action. A week or so ago he would have thought a reduction in the discount rate would have increased market expectations of still easier credit conditions, but now that expectations had chilled and rates had turned up, a discount rate cut could tend to stabilize rates or perhaps reduce them somewhat from current levels. Even if rates stabilized, dealers might still be inclined to reduce their inventories.

Mr. Daane asked whether the Manager saw any risk that the System would have to supply more reserves to the market in order to validate a reduction in the discount rate.

Mr. Holmes said he thought the contrary might well be true. There was a technical problem at the moment relating to the discrepancy between market rates and dealer borrowing costs, which in turn bore a close relationship to the Federal funds rate. A reduction in the discount rate should result in a lower Federal funds rate and in lower borrowing costs. If the Committee wanted to resist a rise in market rates, a reduction in the discount rate might help to accomplish that objective with a smaller provision of reserves than would be required if reliance were placed only on open market operations. However, one could not be sure about such judgments.

Mr. Hickman inquired whether the Manager thought that the size of a discount rate reduction would make a difference with respect to the amount of reserves that might need to be supplied. For example, it was possible that a 1/4 point cut in the discount rate would minimize expectations of a further cut--with the results Mr. Holmes had just outlined--and that a 1/2 per cent reduction would generate expectations of still easier credit conditions, thereby leading to a further build up in speculative positions and a greater increase in reserves and bank credit.

Mr. Holmes said that it was difficult to predict the market's reaction to a particular cut in the discount rate. Whether or not a reduction was regarded as the first in a series would depend not only on its size but also on press commentaries and attendant market circumstances.

Mr. Brimmer said he was interested in the Manager's observation in his report that the System might have to choose between a rate objective and a reserve objective. However, the Manager had also implied that use of the discount rate instrument might help the System to achieve its reserve objectives more comfortably by inducing speculative holders to reduce their positions, thereby helping to moderate the growth in bank credit.

Mr. Holmes noted that while a cut in the discount rate could create the technical conditions that would facilitate an orderly liquidation of positions, it was possible that dealers might choose instead to build up their inventories further if they viewed the action as the first in a series.

Mr. Brimmer asked Mr. Holmes if he was assuming any particular date for a reduction in the discount rate in his remarks about the possible impact of such a reduction. He also asked whether, in the absence of a discount rate cut, Mr. Holmes thought the present level of interest rates could be held for the next two or three weeks without having to supply a substantially larger amount of reserves than otherwise.

In response to the first question Mr. Holmes said he had no particular date in mind for a discount rate cut. On the second question, he could not speak with certainty, but he felt that there was a risk that upward rate pressures would be substantial enough to require a large provision of reserves.

Mr. Brimmer said he would be interested in hearing the views of other Committee members concerning the appropriate time to reduce the discount rate. He had formed the impression that the Treasury financing would not pose a serious obstacle to a rate reduction toward the end of this week. His own preference at the moment would be to change the rate earlier rather than later and by 1/4 point rather than 1/2 point. A 1/2 point reduction might be helpful, but a 1/4 point cut would seem preferable in terms of both reserve objectives and interest rate objectives.

Mr. Hickman expressed the view that a discount rate change in the current week might be somewhat premature and would provide the speculators who had bought the new note in the Treasury financing with an undeserved windfall. He did not think the Directors of the Cleveland Reserve Bank would be willing to act in the current week, although they might be prepared to establish a 5-1/4 per cent discount rate in the following week.

In response to other questions, Mr. Holmes said that if the Desk were instructed to maintain current money market conditions without resisting possible rises in interest rates, dealers would probably make strong efforts to reduce their inventories in the face of continued high financing costs. It was likely that buyers would tend to back away, however, and the result could be a slower run-down of dealer inventories than in a more receptive market situation. It was also likely that banks would attempt to reduce their speculative holdings of securities and, in fact, some selling by banks was reported yesterday. Earlier, the market had been anticipating an early 1/2 point reduction in the discount rate, but in recent days market participants had become convinced that it was no accident that the Federal funds rate had remained above 6 per cent.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period July 16 through August 12, 1968, were approved, ratified, and confirmed.

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

Mr. Brill made the following statement on economic conditions:

Faithful readers of the green book[1/] will undoubtedly note that the staff has clung to the rather pessimistic views on the outlook expressed a month earlier. We are still expecting a significant slowdown in over-all activity that will bring real growth practically to a halt this fall.

A legitimate question can be raised as to whether the economic information that has become available since the last meeting of the Committee supports or denies this outlook. Unfortunately, there is not enough information on which to base an adequate assessment, and what is available constitutes a rather mixed bag. On the one hand, the advance retail sales data for July are definitely much stronger than would be consistent with the staff outlook. Apparently, consumers went on a buying binge in July, not just for autos but also for the long-neglected nondurable goods. We had allowed, in our projections, for some initial adjustment in savings rates to higher taxes, an adjustment in which consumers maintained buying plans by reducing the proportion of income saved. But our projection for the quarter did not allow for anything like the surge in spending that the sales figures for July suggest.

I can't explain it, any more than I have been able to explain the quixotic behavior of consumers over the past two and a half years. It will be recalled that

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

1966 was marked by wide gyrations in consumer spending, with consumption expenditures rising at a 9 per cent annual rate in the first quarter, dropping to a 3 per cent growth rate in the second quarter, rising 7 per cent in the third quarter, and then falling back to 4 per cent in the traumatic fourth quarter. Growth in consumption was more stable, although slower, throughout 1967, but 1968 seemed to start off with a resumption of the see-saw pattern of 1966. An extraordinary surge in spending in the first quarter was followed by a sharp drop-off in the second.

Does the resurgence of sales in July mark a return to a full quarter of upswing? I hesitate to make a prediction for so volatile a series, but I do think that the odds are against it, at least to the extent that current flows of income influence spending decisions. We are likely to be in for a period of sharply reduced rates of gain in disposable income. Here the July evidence does supply some support. The employment statistics for July reflect some further modest easing in labor market pressures. This shows up most clearly in the teenage group, where unemployment rates for both June and July were high and where in July large withdrawals from the labor force were symptomatic of diminishing job opportunities. Weakening in labor demand is also reflected in the very moderate employment growth in manufacturing in July, after allowing for the delay in model change-over in the auto industry, and for the last push in steel production before the settlement. The growth in jobs is beginning to lag significantly behind the growth in the labor force, and even with further withdrawals from the labor market and with possible reductions in the workweek, the unemployment rate should creep up over the months ahead.

Steel inventory liquidation for the next several months will be a major factor exerting a drag on employment, output, and incomes. In some previous post-settlement periods--most noticeable in 1965--developments in steel were swamped by other expansive forces in the economy. For example, the sharp acceleration in defense orders during the summer and fall of 1965 and the continued rise in business capital outlays far outweighed the contraction in steel output. That doesn't seem to be in prospect this year, however, barring a turn for the worse in peace negotiations or an outbreak of hostilities elsewhere. Indeed, our best guess at the moment is for a leveling-off in Federal spending in the third and fourth quarters, now that the initial impact of the pay raise is behind us.

It seems more plausible, then, to expect that the steel cut-back already in process will be reflected fully in the aggregate figures on output, employment, inventories, and income over the balance of the year. In the absence of exogenous boosts, such as the increases in social security benefits, minimum wages, and Federal pay earlier in the year, and with higher taxes being withheld from pay checks, the current flow of after-tax incomes should be operating as an increasing restraint on consumers in the months ahead. These are the factors underlying our projection of only a moderate growth in consumption expenditures this quarter and next. Whether consumers behave as logically as the staff forecasts remains to be seen.

Turning to another element of the staff's projections--prices--the July data appear to be consistent with the earlier staff outlook for some moderating in the pace of inflation. Industrial commodity prices advanced only slightly, and the diffusion of price increases was much smaller than earlier in the year. But the steel price increase--even after the partial roll-back effected by the Administration--could alone speed up the industrial price rise and threatens price stability over a wide range of industrial and consumer goods. Most steel users will be liquidating, rather than adding, to inventories for several months. But higher steel prices will undoubtedly be used as one basis for increases in the prices of many products. Whether the increases are large, and whether they become pervasive and stick, depends largely on the pace of activity in the economy as a whole. We're still betting that the forces tending to contract aggregate demand will be strong enough to counteract the continuing upward pressures on prices, as they did between the summer of 1966 and the spring of 1967.

In another area of activity--housing--our projection of sluggish activity over coming quarters appears to have received some additional indirect confirmation in July. Figures for the full month show a disappointing experience for thrift institution inflows relative to underlying needs for funds. The apparent success of mutual savings banks and savings and loan associations in attracting and retaining funds over the dividend- and interest-crediting period faded as the month progressed. This lackluster performance of savings flows, coupled with the reports obtained by Reserve Bank and Home Loan Bank staffs in the recent survey of mortgage lenders' experience and attitudes, do not suggest a rapid rebound in housing activity over the balance of this year. Indeed, unless a resurgence in savings inflows dispels lender uncertainties or substantial changes in the yields on competitive long-term investments make mortgages much more attractive, we may see only a sluggish recovery in housing starts even in early 1969.

This about exhausts the fragmentary information available on recent economic developments. I haven't dwelled on the production index--the index was up another half point in July--since production developments paralleled closely those in employment.

While this scattering of evidence isn't conclusive, the apparent conflict of trends is not unusual in an economy shifting gears. On balance, the changes that occurred in over-all financial conditions in early August seem to have been appropriate to the emerging nonfinancial situation. Much of the recent easing in financial conditions appeared to rest, however, on a shift in market expectations both as to the economic outlook and as to the course of monetary policy. Persisting tautness in financial markets threatens to reverse these expectations, and to return credit market conditions to a degree of tightness inconsistent with the degree of fiscal restraint that is now a fact, rather than a hope. It would be unfortunate if such a reversal occurred at a time when the economy is in transition to a significantly slower pace of real growth and diminishing pressures on resources.

In response to a question by Mr. Mitchell, Mr. Brill said his presentation was consistent with the adoption of alternative B of the draft directives.

Mr. Keir made the following statement regarding financial developments:

Since the bank credit proviso has been a constraint on the Account Manager during a good part of the period since the last Committee meeting, it seems appropriate at this point to ask what the nature of the unexpected upsurge in bank credit has been, and whether the strength of this upsurge casts any doubt on the staff outlook for slower economic growth just reiterated by Mr. Brill. In light of our recent experience you may also be wondering how confident the staff now is about its current credit proxy projection. As reported in the blue book, even with no change in policy stance we are now estimating a drop in the proxy from a growth rate of 16 to 18 per cent in August to a rate of only 5 to 7 per cent in September.

The reason we underestimated growth in the July and August proxies is clear. We simply failed to anticipate the marked changes in market expectations and interest rates that have occurred since the last meeting. A principal factor contributing to these changes was, of course, the conclusion reached in the market that the discount rate would soon be cut. No allowance was made for this possibility in our projection, nor did we anticipate that the Treasury would offer only a long option in the August financing, thereby creating a scarcity of short-dated paper. When Treasury bill rates in fact dropped well below the levels we had assumed, sales of bank CD's ballooned by $2 billion or roughly double our projected increase.

In this changed environment, banks moved aggressively to increase their liquidity and investment positions. At the same time, with dealers also expanding security inventories, demands for security loans at banks rose dramatically. Together, these two types of uses accounted for the lion's share of bank credit expansion in July. Business loans rose less than expected, despite the tax-induced enlargement of corporate income tax payments, and consumer and real estate loans accounted for only a small part of the total increase.

There is nothing unique in this response to changed expectations. A similar pattern emerged in late 1966 and early 1967, when interest rates also turned down sharply after a period of substantial monetary restraint and high interest rates. In that earlier period, the credit proxy also rose sharply above initial projections. But once banks had rebuilt CD's to a desired share of deposit accounts, added to liquidity, and enlarged other portfolio investments, and once dealers had profited from the initial interest rate turn, the pace of bank credit growth slowed down again. It seems likely that in the present circumstances too, the unexpected credit bulge is essentially a one-shot phenomenon, supported in this case by the very heavy level of Federal cash borrowing which provided a ready source of securities to accommodate dealer and bank objectives.

In short, the recent upsurge in bank credit does not necessarily contradict the staff economic forecast. On the contrary, it seems to have occurred precisely because the expectations of bankers and other participants in financial markets coalesced into a consensus similar to the staff view.

Looking to August, any effort to induce a significant reduction in the 16 to 18 per cent growth rate now projected for the credit proxy would probably require rather drastic action since so much of this change reflects events that have already transpired. For example, about two-thirds of the estimated growth represents an increase in average Government deposits resulting chiefly from already completed Federal cash financing.

As for September, the odds are quite strong that growth in the credit proxy will slow down as projected. Major city banks already show signs of bidding less aggressively for CD's. Federal cash borrowing will not add to credit demands again until late October. With dealers most recently becoming more cautious about their extended inventory positions, security loans should soon decline. Finally, if the staff economic forecast is correct, business borrowing at banks should slow.

For Committee members who put major stress on the money supply rather than the credit proxy, the outlook also is for slower growth. After expanding at nearly a 13 per cent rate on average in July, the money supply is projected to show no growth on average in August and to decline over the course of the month. In September, with Government deposits expected to be lower on average, growth of the money supply is likely to resume, but at a fairly moderate rate.

Turning now to questions of policy implementation, choice of an appropriate operating directive is complicated at the present time because short-term rates were reduced over the past month to levels that reflected widespread expectations of a near-term easing in policy. In the preparation of the blue book and the draft policy directives, the staff recognized that any Committee decision today which failed to fulfill market expectations of near-term ease would in time be likely to encourage a rise in Treasury bill rates to levels more consistent with recently prevailing day-to-day money rates and marginal reserve variables. Two different approaches were advanced for dealing with this problem.

Alternative A of the directive drafts was suggested as a means of maintaining something approximating the status quo in money and short-term credit markets. As explained in the blue book, this objective was assumed to be consistent with some back-up in Treasury bill rates from levels then prevailing. But provision was also made to allow the Account Manager to ease up on day-to-day money rates and marginal reserve measures if bill rates should show signs of moving up too rapidly. It was recognized that with dealers so heavily positioned in securities other than bills, any brisk snap-back in bill yields could spread more widely outside the bill area. In this regard the experience of late winter 1967, when a moderate shift in expectations led to a sizable back-up in yields throughout securities markets--even though policy was seeking to ease--may provide at least a partial analogy.

Alternative B was suggested as a means of guarding against the possible repercussions of any further upward movement in short-term rates. To achieve this objective, it was recognized that the Account Manager would have to ease both day-to-day money rates and marginal reserve measures as soon as the even keel period on Treasury financing was over. Also, it was recognized that a higher range of permissible growth in the credit proxy would probably be necessary than under alternative A.

As Mr. Holmes has already indicated, even before today's meeting market participants began to doubt their earlier expectations as to the timing of credit ease. As a result, the snap-back in bill rates has now become more a reality than a prospect. With yesterday's new 3-month bill auctioned at just under 5.10 per cent, the prevailing yield on this maturity is already fairly close to the point suggested by the staff as the one at which some modification of money market and reserve variables ought to begin to occur even under alternative

A. If alternative B were to become operative, some short-term rate roll-back would be required simply to get back to the 5 per cent level suggested as the upper end of the range allowable for 3-month bills.

In short, the key question now is how much modification of day-to-day money and reserve measures may be needed under alternative A to keep rates from rising too fast, and how much additional modification would be needed to achieve the lower rate objectives of alternative B. The blue book has specified suggested ranges for these relationships, but given the present sensitivity of market expectations, it is difficult to be absolutely sure that these specifications would be correct. Moreover, with money market banks recently operating consistently in a deep basic deficit position, it might require rather sizable Desk operations to reach even the lower end of the ranges specified under alternative A.

Clearly, the most direct way to forestall upward pressures on yields and to restore a more consistent relationship between day-to-day money rates and bill rates would be to cut the discount rate.

Mr. Mitchell said the staff evidently thought that the recent decline in the bill rate could prove highly temporary, and it recommended that increases be resisted. It was his understanding, however, that the bill rate had fallen well below the range the Committee had anticipated at its previous meeting.

Mr. Holmes agreed that the magnitude of the bill rate decline experienced had not been anticipated at the previous meeting. He had thought at that time that the directive adopted might be consistent with a range of 5-1/4 to 5-1/2 per cent for the bill rate, and the lowest figure suggested in the course of the Committee's discussion was 5.10 per cent, mentioned by Mr. Maisel.

Mr. Keir noted that while a bill rate as low as 4.89 per cent had not been expected, the directive issued had instructed the

Manager to accommodate the tendency toward somewhat less firm money market conditions that had developed since the June 18 meeting.

Mr. Maisel remarked that the recent pattern of events, in which market expectations had outrun policy, seemed to him to have been a direct consequence of the System's decision not to reduce the discount rate in the recent period. That pattern should not have been surprising; there was every reason to expect it at the time of the previous meeting, when most members had spoken against a near-term cut in the discount rate. In his judgment it would have been better for the System to have aided in a more rapid adjustment of market rates to the changed perspective for Treasury borrowing by reducing the discount rate, instead of fostering a speculative build-up in dealer positions based on expectations of such an action.

Mr. Swan observed that it was not at all clear to him that a discount rate cut would have served to avoid a speculative build-up in dealer positions.

Mr. Daane said that the staff obviously was in favor of alternative B, calling for somewhat less firm money market conditions, for the directive. However, he would have some misgivings about such a policy course. It seemed to him that unless the discount rate were to be reduced immediately a very large volume of reserves would have to be supplied to achieve the money market conditions associated with alternative B.

Mr. Holmes agreed, remarking that massive reserve injections were likely to be required to move the Federal funds rate down to the 5-1/2 to 5-3/4 per cent range specified under alternative B.

Mr. Galusha asked whether the staff thought any modification of the specifications for alternative A was required in light of the further increase in bill rates yesterday.

Mr. Brill replied affirmatively. He noted that on Friday, when the blue book was being prepared, market uncertainty was already evident but was not yet fully reflected in interest rates. The bill rate had closed at just below 5 per cent that day, and in formulating the specifications for alternative A the staff had suggested that the Federal funds rate should be permitted to drift down into the 5-3/4 to 6 per cent range if the bill rate were to approach or exceed 5.10 per cent. But the contingency for which that course had been suggested had already eventuated; this morning the new three-month bill was expected to trade at around 5.10 per cent. Accordingly, alternative A might now be interpreted to call for beginning immediately to move the funds rate down. How far the funds rate would have to be reduced to minimize further increases in bill rates would depend on the strength of the recent reversal of expectations, and any effort in that direction would be a probing action.

Mr. Hickman said he would prefer to permit the bill rate to rise to 5.20 or 5.25 per cent before beginning to move the Federal funds rate down. Such a course, in his judgment, would be consistent with the Committee's expectation at the previous meeting that the bill rate would not fall below 5-1/4 per cent.

Mr. Brill remarked that while the staff had suggested the trigger point for lowering the funds rate be set at a 5.10 per cent bill rate, it had not meant to rule out the possibility that as the funds rate came down bill rates would continue upward, perhaps to the neighborhood of 5.20 per cent.

At Mr. Daane's request, Mr. Keir reviewed the specifications for net borrowed reserves, member bank borrowings, and Federal funds rates given in the blue book in connection with the alternative policy courses. With respect to net borrowed reserves, he noted that under alternative A the range given was $200 to $400 million if bill rates remained close to then-recent levels, and $100 to $300 million if bill rates rose to or above the 5.10 per cent area. Under alternative B the range was $0 to $200 million.

Chairman Martin remarked that the differences in the specifications for the two alternatives did not strike him as particularly great.

Mr. Hickman noted that under alternative B bank credit was projected to rise at an annual rate of 7 to 9 per cent in September, following growth at a 16 to 18 per cent rate in August. In his view such rates of expansion were highly inflationary and larger than acceptable.

Mr. Sherrill commented that, as Mr. Keir had indicated in his statement, the high growth rate projected for August could be explained largely in terms of special circumstances and therefore did not necessarily have the significance that might ordinarily be attributed to it.

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

> For the past three months--beginning last May, the month the French troubles began--a remarkable improvement seems to have occurred, at least on the surface, in the U.S. balance of payments. I am not speaking of the second-quarter liquidity balance that will be publicly announced in a day or two, which was heavily weighted in a favorable direction by special transactions with Canada and Germany. I have in mind adjusted results that were beginning to show up in weekly and monthly settlement data for May and June and have been confirmed by the weekly indicators for July. Three months' data are perhaps enough to wash out the very short-run fluctuations that often bedevil our judgments. For these three months taken together, with rough allowance for seasonality, the adjusted deficit has been negligible. In April it had been extremely large. For the first four months of the year the deficit on the liquidity basis before special official transactions had been at an annual rate of over $5 billion and for the year 1967 over $4 billion. The improvement of which I am speaking is therefore very sizable.
>
> Nevertheless, the improvement is not of a kind to lessen the Committee's concern about the balance of payments problem. Part of what I want to do this morning is to repeat and underline some points Mr. Reynolds

made here four weeks ago in discussing the second-quarter results, which taken as a whole, showed no such improvement. With our balance of payments, unhappily, it's "plus ca change, plus c'est la meme chose."

One of Mr. Reynolds' main points, as you may remember, was that favorable changes in capital flows this year have offset a disastrous deterioration in our international trade position. That is still just as true as it was four weeks ago. We now have one more month's trade results, for June, with one more substantial rise in U.S. imports. For two months running, imports exceeded exports. Even if July saw a change for the better--which we do not yet know to have been the case--the three months' foreign trade balance must have been far inferior to the $4 billion rate of trade surplus we had in the first three quarters of 1967. With something like a $4 billion worsening in trade and something like a $4 billion improvement in the adjusted liquidity balance, it is evident that since a year ago something like an $8 billion annual rate improvement in other transactions has occurred. A major part of this improvement must have been in the capital account.

Mr. Reynolds' second main point was that some of the favorable developments in capital flows during the first half of this year are likely to lose force or be reversed as the year goes on. This is certainly just as true now as it was then, and perhaps more so. It applies particularly to flows of U.S. capital influenced by the Federal Reserve foreign credit restraint program or by the Commerce Department controls on direct investment, as well as to the mushrooming Euro-bond borrowings by U.S. corporations. It is quite impossible to visualize what could have caused the marked improvement in the over-all position that occurred after April without assigning high probability to favorable changes in the flows of U.S. corporate funds. It is even more likely now than it seemed four weeks ago that the Commerce Department program, like the Federal Reserve program, is well along toward achievement of the goals for 1968. Under both programs flows are likely to be less favorable in the remainder of the year.

The third main point that has to be stressed again is one that everyone concerned about the balance of payments has emphasized over and over. This is simply that no solution of the balance of payments problem is viable without a reasonably large surplus in the trade and services accounts of the U.S. balance of payments.

One would like to be more precise about this. Obviously the size of the needed current account surplus will depend on how much Governmental economic aid the United States will be providing for the less developed countries. It will also depend, crucially, on how large or small a net outflow of private capital gets established in the long run. The flows we have been experiencing in the past three months, whether or not they persist over the next three or six months, are not representative of what we can expect under stable conditions in the future. This is not only a matter of the outflows subject to regulatory programs, which presumably will be larger when the programs come to an end.

In recent months there has undoubtedly been an extremely large inflow of foreign capital in various forms on a scale that will not be maintained indefinitely. Any estimate of its size must be guess work, starting with the difference between known over-all results and known transactions in trade and in flows of U.S. capital. I would guess that the foreign private capital inflow in the past three months, including the purchases of Euro-bonds, but <u>not</u> including liquid funds coming to our banking system through the Euro-dollar market or directly, has been at an annual rate around $6 billion. The corresponding figure for the year 1966 was $1-1/4 billion, for 1967 $2 billion, and for the first quarter of 1968 over $4 billion. Some of the most recent inflow may never get identified and so would show up as a favorable shift in the "errors and omissions" account.

When one thinks about the possible causes of such an inflow, one realizes how unstable it can prove. The United States has been getting very large foreign purchases of U.S. corporate stocks over the past twelve months for a variety of reasons: a hedge against future foreign inflations, greater liquidity than European stock markets can promise, an alternative to gold hoarding, a response to the promotional efforts of the organizers of mutual funds, and so on. In addition, this year there have been large purchases of the convertible debentures issued in Europe by U.S. companies, facilitated by easier-than-average monetary policy in Germany. On top of all this have come the French troubles in the past three months, which no doubt have helped to prolong the wave of stock buying and no doubt have stimulated other flows into U.S. assets and repayments of liabilities to U.S. residents.

The conclusion to which one comes is that the recent improvement in the capital accounts of the U.S. balance of payments is unstable, and has not removed the necessity of getting an improvement in the current account. The need for checking the rise in U.S. costs and prices is as pressing as ever, because inflation is a slow process and because its effects in improving our trading position may be long delayed.

The Committee must, of course, be looking ahead on the domestic front, and asking itself whether immediate additional stimulation of domestic demand by the route of bank liquidity and credit availability is needed to achieve our stated goals for output and employment. I would urge the Committee to bear in mind that a 3 per cent rise in exports plus a 3 per cent fall in imports would stimulate the domestic economy by $2 billion annual rate, about the same as a 6 per cent rise in residential construction. Excessive credit stimulation, by prolonging and intensifying price inflation, could frustrate the chance we now have that foreign trade gains may bring progress toward external equilibrium and in the process help generate domestic output and income.

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

The economy expanded rapidly in the first half of 1968, and there is little evidence that the country is on the verge of a general decline. We have long stressed the need for a slowing down in the rate of expansion. Now we can expect a needed slowdown in the remainder of 1968 as fiscal restraint takes effect and as strike-hedge inventories are worked down.

A moderate rise in housing starts is likely in the coming months. The underlying demand for housing, the removal of fears of a credit crunch, the relaxation of usury ceilings, and the decline that has already taken place in many interest rates would probably stimulate more residential construction whether or not there were a further easing of monetary policy.

There is no evidence of "overkill." On balance, prospects are good for a pick-up in the rate of economic growth early in 1969 after the needed period of readjustment. The tax surcharge legislation is scheduled to expire in mid-1969; if, as time progresses, there are strong expectations that the surtax will be allowed to expire, the economy could be buoyed further.

The rise in consumer prices has continued unabated. There continue to be strong upward pressures on prices. Labor costs per unit of output rose sharply in the second quarter. The wage settlement in the steel industry was one more in a series of inflationary settlements. Although we can expect some dampening of the pressures, a reduction in the rate of advance in prices is likely to be quite gradual.

Recent balance of payments developments present a mixed picture. The tentative figures for July indicate the possibility of a surplus on the underlying liquidity basis in a month that customarily is unfavorable. But the heretofore favorable balance on the official reserves basis is likely to worsen.

Impressive gains in the capital and services account have been offset in large degree by a deterioration in our trade balance. Inflation may have undermined our international competitive position more than expected. The longer-run correction of our over-all international balance, free of direct controls, will require that a sizable trade surplus be restored. The further erosion of the purchasing power of the dollar that is inevitable in the coming months will make even harder the task of restoring a good trade surplus.

In recent weeks market expectations regarding the credit outlook and the level of interest rates have changed greatly. Interest rates, especially in the short-term area, have declined sharply amid widespread discussion of the likelihood of an easing of monetary policy in the near future. Government securities dealers have added aggressively to their inventories.

As general market rates have declined, there has been a significant improvement in the competitive position of deposits in banks and thrift institutions and of mortgages. The banks experienced a massive CD inflow in July, and have lowered their rates. While corporate demands on the capital markets have moderated somewhat, the demands of municipal borrowers have remained large. These developments, along with the Treasury financing operations, brought a large increase in bank credit in July, and another substantial gain is in prospect for August. Indeed, the growth rate has been disturbingly large, although special factors may account for most of it. In my opinion, a continuation of this rapid growth rate should be firmly resisted.

The successful sale by the Treasury of $5-1/2 billion of 6-year notes to the public for delivery August 15 will produce $1.9 billion cash for the Treasury, and will provide it with a breathing spell of a couple of months before it must go again to the market.

As for policy, it seems to us that the current and prospective economic situation at home and the balance of payments developments and prospects do not call for a further easing of credit or of interest rates at this time.

There are, however, some problems flowing from the recent rapid decline in interest rates, especially short-term rates. It has been costly for the dealers to carry securities but the dealers have been willing to bear the cost because they have expected further credit ease soon and a further rise in security prices. If these expectations are not fulfilled, there will be pressure to liquidate, with a resultant rise in rates, especially short-term rates.

The rate on three-month Treasury bills (on a discount basis) is now almost 1/2 of a percentage point below the Federal Reserve discount rate, whereas two months ago it was about 1/4 of a percentage point above the discount rate. There is little doubt that the Treasury bill rate--partly because of the nature of the current Treasury financing--moved down too fast and too far. An increase in the rate was to be expected, and has occurred in the last few days. But a sharp further increase, say to or beyond 5-1/4 per cent, should be resisted.

It seems to us that the proper prescription for open market policy is to maintain about the present degree of firmness in the money market, with the understanding that an undue rise in the rate on three-month Treasury bills would be resisted. Such a prescription, we think, would involve a Federal funds rate of perhaps 1/2 to 5/8 of a percentage point above the discount rate;

member bank borrowing in the \$500 - \$600 million range; and net borrowed reserves in the \$200 - \$350 million range. A departure from these targets would be appropriate either to resist too great a rise in Treasury bill rates or to resist too sharp a decline stimulated perhaps by market expectations of a discount rate reduction or other acts of ease. Indeed it seems to us that, even if the discount rate were reduced in the near future, the System should resist a marked decline in Treasury bill rates from their present levels.

We have pondered the possibility of a reduction in the discount rate in the near future. There is a risk that a reduction would not be viewed by the market as simply a technical adjustment to the lower levels of short-term interest rates. It might well be interpreted as a signal of more ease to come.

I recognize that, with no change in the discount rate, the amount of reserves created to keep Treasury bill rates from rising too much could be excessive. In such a case, a modest reduction in the discount rate without relaxation of open market restraint would perhaps foster the necessary technical adjustment. The most desirable course is not crystal clear for it is hard to judge people's expectations. For several weeks there have been strong expectations of much more ease. These expectations seem to be diminishing, but it is too soon to conclude that there has been a significant change. On balance it seems to me that it would be premature to conclude now that there should be a reduction in the discount rate.

As for the directive, I would prefer alternative A.

Mr. Latham reported that the New England economy continued strong although there was evidence of a slowing down in the forward movement. While it was difficult to arrive at a true assessment of July data due to the substantial seasonal adjustment necessary for vacation shutdowns and the impact of strikes, it was clear that consumer spending accelerated in July. Net savings flows improved, building construction remained at a high level, and ample funds were available at commercial banks.

Of particular interest, Mr. Latham continued, was the evidence that consumers in New England had increased their spending pace in recent weeks. Weekly department store sales in the four weeks ending July 27 were 8 per cent ahead of the same period last year. That was larger than the percentage gain for the year through July 27, which was 6 per cent. After declining for three straight months the department store index moved up 6.8 per cent from June to July.

During July, Mr. Latham observed, net savings flow--deposits less withdrawals--improved appreciably at Boston mutual savings banks, and such banks elsewhere in the District continued to experience a comfortable net inflow. Mortgage rates continued their upward trend but increases were fewer than in recent months. Rates paid on savings deposits were increased in a few cases.

Policy loans of life insurance companies continued to rise in the second quarter, Mr. Latham added, with no apparent abatement in that trend in July. Despite that demand, mortgage and investment commitments continued at good levels. At commercial banks there were substantial increases in CD outstandings at reduced rates.

Mr. Latham felt that developments during the next four to six weeks would give a better reading on the impact of fiscal action and on how significant monetary actions should be.

Mr. Coldwell reported that the most recent information concerning economic developments in the Eleventh District still gave little hint of a downturn. In fact, although some of the prime indicators might not be growing as rapidly as in prior months, there still was evidence of a regional economy operating at vitually full production, employment, and utilization of resources. The production index for Texas dipped fractionally in June but virtually all of the decline centered upon a reduction in the output of crude petroleum. Even construction contract awards issued in the five Southwest States touched by the District advanced 3 per cent over the prior month and returned almost to the peak for the year reached in March, with strength primarily centered in nonbuilding construction. Department store sales levels in the Eleventh District for the month of July were 15 per cent above a year earlier, and the cumulative sales for the year to date were 13 per cent over a year ago.

Along with those evidences of continued strength, Mr. Coldwell said, the tempo of agricultural activities in the District generally increased with harvesting now moving rapidly ahead as dry weather set in. Some rain damage had occurred in cotton areas, but the crop was forecast at a level 22 per cent higher than in 1967. Range and livestock conditions were excellent.

There was, however, an uneasiness associated with that high level of production, employment, and spending, Mr. Coldwell observed. The impact of the new surtax and the curtailment of expenditures expected under the spending restraint program in a regional area heavily dependent upon Government contracts, as well as the uncertainties bred by the normal airing of the nation's problems in a political year, had given a tone to the District's outlook which--although not quantifiable--might be somewhat less optimistic than one might expect.

Financial conditions in the District mirrored some of the changes at the national level with heavy inflows of time and savings deposits, Mr. Coldwell continued. However, the District showed continued strength in loan demand. With investments, demand deposits, and time deposits advancing, the resources and liquidity of the banking industry appeared substantially improved. Negotiable time certificates of deposits at the weekly reporting banks reached a new record level, although the advances were concentrated in a few banks. Borrowings from the Federal Reserve Bank had increased recently while net purchases of Federal funds had declined. Bankers' opinions concerning their institutions' positions seemed to indicate a slightly easier tone but some element of surprise at the strength of the loan demand. Statistically, the financial conditions seemed reflective of the easier money market conditions and rates, and that had transmitted a feeling of somewhat greater ease to some of the District's larger banks; but with very high loan-deposit ratios and continued demands for credit, the bankers' feeling of uneasiness continued to persist, and their demands upon the Federal funds market and over-all borrowings through bills payable, recourse sales of loans, and other such devices were indicative of some tightness.

Nationally, it seemed to Mr. Coldwell that the economy reflected imbalances from the recent inflationary excesses, wage-cost price pressures, and downward influences of the recent fiscal action, steel decumulation, and auto model change-over. While some of those forces were transitory, their conjunction at the moment could be deceiving in a policy sense. Thus, although the short-run economy might be somewhat slow, the longer-range picture could be quite different. The consumer had not yet shown a marked shift in consumption patterns, and unless he did curtail spending the economy might be strong enough to weather the near-term downward pressures with only a modest lessening of the growth rate, especially if construction activity was stimulated.

Mr. Coldwell commented that financial demands were slowing in the corporate area but were still substantial from municipalities and consumers. If mortgage demands were regenerated and seasonal demands developed fully, the loan picture might be fairly strong. Credit supplies were improving; with the CD market strong and with recent excessive growth in the money supply, there was a more than adequate credit base for the near term. The very high rate of bank credit expansion pointed toward the distinct dangers in providing too much new credit before imbalances had been corrected.

As to policy, Mr. Coldwell said he would favor being basically accommodative to the market, without more than seasonal credit provision. He would permit short-term rates to back up but in an orderly fashion, with the three-month bill rate not over 5-1/4 per cent. A discount rate cut might be considered at a later time, preferably in September. For the present, he would hold to ranges of $200 - $350 million for net borrowed reserves, 5 to 5-1/4 per cent for the bill rate, and 5-7/8 to 6 per cent for the Federal funds rate. He would hope that growth in the credit proxy could be reduced to an annual rate of 7 to 9 per cent and that increases in the money supply could be held to minimal levels.

Mr. Coldwell then proposed certain changes in the staff's draft of the directive. In the opening sentence, reading "The information reviewed at this meeting suggests that some elements of economic activity continued to expand vigorously in early summer," he would replace the word "suggests" with "indicates."

The next sentence might then be recast to begin "Other data suggest that expansion in over-all economic activity may slow considerably in coming months...." In the statement reading "....growth in the money supply has continued large as U.S. Government deposits have been drawn down further on average," he would delete the reference to Government deposits, since rapid money supply growth had been associated with declining Government deposits in three successive directives.

For the second paragraph, Mr. Coldwell continued, he would prefer alternative A. However, he would suggest revised language calling for operations "with a view to attaining more balanced money market conditions at about the level prevailing at the time of this meeting."

Mr. Swan reported that in California the unemployment rate rose slightly in July; a small increase in employment was outpaced by growth of the labor force. Because the composition of demand for steel in the West differed from that in the rest of the country, western steel production had been affected less by the recent hedging against a strike; output had not risen as sharply as elsewhere before the strike deadline, and had declined less since the settlement.

In recent weeks, Mr. Swan continued, Twelfth District banks had been heavy net buyers of interbank Federal funds, had borrowed substantially under repurchase agreements, and had made a large volume of funds available to securities dealers. There had been no dearth of CD money in the District. There had been very little borrowing from the Reserve Bank in July and early August; such borrowing had declined both in absolute dollar terms and relative to the rest of the country. Otherwise, District banking developments had been similar to those in the nation as a whole.

With respect to policy, Mr. Swan said, despite the green book's forebodings about the economic outlook for the second half, and in light of the strength evident in July, he was disturbed by the excessive current and prospective rates of increase in bank credit. Consequently, he would be quite hesitant about moving toward further ease or about reacting to further rate movements. On the latter point, he would not favor action to offset increases in bill rates until the three-month rate rose to the neighborhood of 5.20 or 5.25 per cent. It was important to recognize that, as Mr. Holmes had indicated, the average rate for three-month bills in yesterday's auction was still 40 basis points below that set four weeks earlier. Also, he would approach the question of a discount rate reduction cautiously. At the moment he was inclined to wait until September before taking such action.

Mr. Swan said he would favor alternative A for the directive. In view of the high rate of bank credit expansion projected for

August and September, a one-way proviso clause was appropriate. However, he would strengthen the clause shown in the draft by deleting the word "significantly" from the statement that operations should be modified "if bank credit appears to be significantly exceeding current projections." Indeed, the clause might be strengthened even further by saying that operations should be modified "if bank credit appears to be approaching the upper limit of the range projected."

Mr. Galusha reported that in the Ninth District the crop price situation was turning out somewhat worse than had been expected earlier and there was nothing to indicate a turnabout. Virtually each day's market report presented new seasonal lows for almost every class of grain in both the cash and futures markets. Wheat prices, for example, had declined almost 15 cents since June and were currently about 45 cents a bushel below year-ago levels. Corn and soybean prices had followed the same downward path. That weakening had brought current prices to support levels. He expected them to hold at such levels during the remainder of the year, although further harvest-season declines might occur as farmers marketed grain from the fields. All signs indicated, however, that there would be little grain marketed this fall; the bulk of the crop would probably be placed under loan or in farm storage.

As a result of those developments, Mr. Galusha observed, cash receipts from crop marketings in the remainder of the year would likely run below those of last year and, because there was little prospect for an improved livestock picture, there would be a year-to-year reduction in total District cash income. Net income, because of the inexorable upcreep in costs, should register a rather pronounced drop. The addition of the surtax, of course, made the prospective cut in income all the more severe.

While all of the responses had not been received to the Minneapolis Reserve Bank's quarterly survey of District manufacturers, Mr. Galusha remarked, preliminary indications were that sales forecasts for the fourth quarter had been revised downward. District employment should grow at a slower pace as those revisions affected production plans.

Turning to the national scene, Mr. Galusha said the decline in market rates that had taken place since the last meeting of the Committee did not disturb him at all. Indeed, it seemed to him that the lower level of rates now prevailing placed the Committee, at least for the time being, in about the right position. A continuation of current levels should help to reduce the uncertainty that now existed over future deposit inflows and to encourage depositary institutions to move ahead with their commitments, thus improving prospects of a step-up in housing construction during winter months. Furthermore, he had been assured by a leading mortgage banker in the District that a number of multi-unit builders were now holding back in their search for commitments because of an anticipation of lower mortgage rates. Holding short rates, in particular bill rates, at current levels should foster a quicker reaction in mortgage rates and move the point in time closer when those builders who were hesitating stepped forward to complete their plans.

Mr. Galusha suggested the System's efforts should be directed at stabilizing the market as best it could. Unless it moved fairly resolutely, there was a real risk that the very recent reversal of the earlier market trend would continue. A discount rate reduction immediately after the settlement date in the current Treasury financing would provide a needed signal and would reduce the amount of open market intervention necessary to achieve the range of bill rates specified in the blue book in connection with alternative A. He was not urging a move toward pronounced increased ease, such as was implied by alternative B, which he interpreted as differing more in a qualitative than a quantitative sense from A. It seemed to him a prompt change of 1/2 per cent in the discount rate would check the tendency of short rates to move up and would probably put them closer to the middle of the proposed target ranges.

He realized that this was flying in the face of numbers for retail trade, the money supply, and the credit proxy, Mr. Galusha said. As to the former, Federal expenditure reductions and the surtax would take their toll; and he did not think the two pay periods that had intervened since the surtax became effective had been enough to change consumer thinking. As to the money supply and bank credit, the staff explanation was quite credible.

As he had implied, Mr. Galusha continued, he favored alternative A for the directive. He would accept ranges for money market variables that combined the two sets of ranges given in the blue book in connection with that alternative.[1/] Specifically, he favored ranges of 4.90 to 5.10 per cent for the bill rate, 5-3/4 to 6-1/8 per cent for the Federal funds rate, $400 to $650 million for member bank borrowings, and $100 to $400 million for net borrowed reserves.

1/ The blue book passage referred to read as follows: "If bill rates were to remain relatively close to recent levels--say, fluctuating between 4.90 and 5.10 per cent--the Federal funds rate could be maintained in the 6--6-1/8 per cent range of recent weeks. These conditions would likely be associated with average borrowings of $500 to $650 million, and average net borrowed reserves of $200 to $400 million. If, however, bill rates were to approach or exceed the top of this range, and particularly if they were rising rapidly, the Federal funds rate could be permitted to drift down, perhaps into the 5-3/4 to 6 per cent range. Such easing in the cost of reserve funds would likely be associated with marginal reserve measures about $100 million lower."

Mr. Treiber asked whether Mr. Galusha would change his target for the Federal funds rate if the discount rate were changed, and Mr. Galusha replied affirmatively. He added that he considered the timing of the discount rate action to be of critical importance; he thought a change at this juncture would have the maximum effect in stemming the reversal of earlier expectations that seemed to be proceeding rapidly, without requiring substantial intervention by the Desk.

Mr. Scanlon commented that although real growth in the economy probably was slackening in the third quarter, evidence available in the Seventh District suggested no dampening in the general price uptrend and little if any improvement in the supply of labor relative to demand. A number of observers in the District were concerned that excessively expansionary monetary policy was likely to offset the impact of the new fiscal restraint package. Partly because of that, he found little support at this time for the view of Administration spokesmen that the package might prove too restrictive.

Mr. Scanlon noted that the expected sharp decline in steel output had occurred in the first week of August. Actually, ingot production had passed its high in his region in April and had declined 10 per cent by the second half of July. Rolling mills continued to operate at a high rate and shipments, at about 10.5

million tons in July, were much higher than in any earlier month. Manufacturers' holdings of finished steel might have reached 15 million tons by August 1, but that was less than the 17 million tons total for August 1965--when there was a similar strike-hedge buildup--and consumption was much higher now. Delivery schedules for steel had been well maintained through the inventory buildup. In general, there was less "water" in steel order books and customer inventories were less excessive now than in 1965 and some earlier periods. Nevertheless, a rapid inventory liquidation was anticipated. He was told that most of the decline in labor needs in the steel industry was expected to be accommodated by use of deferred vacation time and the dropping of temporary help, but some layoffs of experienced personnel might also occur.

The strong trend in auto sales starting in May had raised industry forecasts of sales for all of 1968 to 9.3 million units, including more than 900,000 imports, Mr. Scanlon said. Sales of both domestic and foreign cars were at a record pace in May, June, and July. Forecasts indicated a 21 per cent year-to-year rise for auto sales in August and a total of 1.9 million for the third quarter--13 per cent above last year and a new high for the period. Factory shipments of television, hi-fi sets, and most appliances had been excellent, with some of the District's producers reporting record volume in recent months. The picture for capital goods varied greatly from industry to industry.

Although attitudes of lenders and builders varied, Mr. Scanlon said, the gloom noted earlier concerning construction prospects for the remainder of the year appeared to be lifting. Permits granted for residential projects in the Chicago area had been very large, especially for apartment buildings. Throughout the Seventh District a seller's market prevailed for real estate. Vacancy rates were very low. Costs and prices continued to rise sharply. Because of demand for residential, commercial, and public construction, he was told labor probably would be fully utilized throughout 1968 and into 1969 as well. Crop prospects in the District were excellent and as a result, prices of the District's most important farm commodities, both crops and livestock, were expected to be under downward pressure.

Mr. Scanlon observed that District banking figures showed evidence of moderate credit demands from the private sector, on balance, and very ample ability of the banks to meet it. Business borrowing appeared to have been lighter last month than had been expected. Consumer loans, on the other hand, showed the strongest gains in many months. Meanwhile, opportunities to add to investment portfolios at the high current yields and the profit potential associated with expected further declines in interest rates had been reflected in substantial acquisitions of securities and real estate loans, which appeared to have absorbed most of the funds obtained in the CD market last month. Despite the fairly deep reserve deficit positions indicated for large Chicago banks, they were not under any pressure to meet loan demands. Rather, their increased reliance on borrowed funds, in addition to funds acquired in the CD market, reflected a huge expansion in investments.

The very rapid expansion in total reserves and bank credit in recent weeks and projected for at least the remainder of this month troubled Mr. Scanlon for two reasons. First, those rates were considerably faster than projected at the Committee's last meeting, even though money market rates (other than on Federal funds) had declined substantially and rebounded slightly in the intervening period. Second, those rates were greater than would appear to be consistent with the trends of prices and production he believed to be desirable. As he had noted the last time the Committee met, it appeared that the path to stable economic growth would entail a period of little or no growth in real terms in order to ease the excessive demand for labor and the excessively large wage settlements and to achieve a slower rate of price increases. The current rates of reserve and credit expansion had not been consistent with economic stability at full employment in the past and were unlikely to be in the months ahead. He was additionally concerned since he expected the tone of economic activity to be pitched somewhat higher than might be inferred from the staff's projections, keeping in mind that revisions of staff projections had been rather consistently on the upside.

Mr. Scanlon preferred a slower--although not slow--rate of expansion in total reserves, on the order of 4 per cent annually, and he would expect that to be associated with a growth rate in bank credit of about 8 per cent. While not greatly different from the rates experienced in the first half of the year, in conjunction with the change in fiscal policy those rates of expansion in reserves and bank credit should accommodate the necessary slowing in economic expansion during the remainder of the year and begin to mitigate price pressures, without interfering with the emergence of some pick-up in activity beginning early in 1969 as additional labor resources became available.

The problem was how to attain the desired rates of growth in those measures, Mr. Scanlon said. Projected linkages between money market measures and aggregate monetary measures had been exceptionally poor in recent weeks and not very good in earlier periods. The current rapid rate of growth of bank credit had occurred despite a Federal funds rate and a free reserve level estimated at the Committee's last meeting to be consistent with significantly slower rates of expansion. He again urged that the Manager be instructed to attain some specified target of total reserves or bank credit. If the 4 per cent reserve and 8 per cent credit targets were to be associated with some rise in interest rates, he would interpret that to indicate that the demand for credit was stronger than expected and he would not offset it. He would, of course, offset abrupt rate changes in either direction in the interest of providing continuity in financial markets.

Mr. Scanlon did not favor reducing the discount rate immediately. He preferred alternative A for the second paragraph of the directive although, like Mr. Swan, he would delete the word "significantly" from the proviso clause.

Mr. Clay expressed the view that the domestic economy was performing quite well so far as current activity was concerned. A slower rate of future growth was expected, but there was room for differences of judgment as to the degree of adjustment ahead. Over all, the cost-price situation continued to be a problem. While the foreign exchange position of the dollar had improved, the basic situation in foreign trade and the balance of payments remained a matter of concern.

Under the circumstances, it had appeared best to move cautiously in adjusting monetary policy subsequent to the enactment of the surtax, Mr. Clay said. That still appeared to be the appropriate view. It was important to avoid undue restraint on economic activity with marked adverse consequences upon employment and output, but it also had to be recognized that the cost-price inflation needed to be slowed down and brought into balance over time. The cost-price problem could not be corrected without some adverse effect upon growth in employment and output. An attempt to do otherwise could be expected to bring an acceleration in the cost-price inflation.

Developments of recent weeks once again raised the issue as to how open market operations should be conducted during periods of Treasury financing, Mr. Clay continued. As it was, the System seemed to lose control of bank reserve and credit expansion during such periods and the results sometimes deviated sharply from what was intended. Recognition of statistical seasonal adjustment problems did not preclude the judgment that credit policy appeared to have been much more expansive in recent weeks than the Committee had intended. Changed market expectations and increased inflows of CD funds were factors in the credit expansion. Presumably the bank credit proviso clause could not be implemented effectively in view of the behavior of several money market indicators, including Federal funds rates and dealer loan rates. At the same time, security yields generally, and Treasury bill yields particularly, had moved downward sharply.

Mr. Clay noted that it was expected that the rate of growth in bank reserves and bank credit would slow down markedly as Treasury financing operations ceased to be a dominant factor in the money markets and in the conduct of monetary policy. Staff estimates indicated a bank credit growth rate of 5 to 7 per cent for September, assuming a continuation of the "present stance of policy." That rate of bank credit growth would appear to be acceptable, although a growth rate at the lower end of the range would be preferable. That approach might be associated with a 90-day Treasury bill rate of 5.00 to 5.25 per cent, net borrowed reserves of $200 - $400 million, and member bank borrowings of $500 - $600 million.

A near-term reduction in the Federal Reserve discount rate would seem to be premature, Mr. Clay observed. In a highly speculative securities market such as had developed recently, some market adjustment was to be expected and should not surprise professional market people. Accepting the responsibility to avoid any such market adjustment would severely handicap the administration of monetary policy. Toleration of a moderate upward adjustment in securities yields probably would be consistent with a more appropriate rate of growth in bank reserves and bank credit. Moreover, Federal funds and dealer loan rates probably would ease under those circumstances, as some short-term speculative positions were liquidated.

Alternative A of the draft economic policy directive appeared to Mr. Clay to be satisfactory.

Mr. Heflin reported that business activity in the Fifth District over the last four weeks had shown some signs of deceleration. While business indicators had registered no significant declines, they were growing at a reduced rate and the Richmond Reserve Bank's business conditions survey indicated a definite shift in business sentiment. Some tapering off was apparent in the rate of growth of employment and retail sales, and cutbacks in residential building were reported to be under way in some parts of the District.

Mr. Heflin remarked that his views on policy today were determined more by the economic outlook than by evidence in hand on actual economic developments. He thought there was good reason to expect a significantly slower rate of growth in the national economy over the next several months. The steel negotiations had ended without a strike, but the cutback in steel production already under way would exert a dampening influence for several months to come. Add to that the impact of the recent fiscal measures and weakness in private construction and it seemed reasonably clear that a lessening of pressures on the economy was in prospect. The System had been trying to achieve some dampening effect, of course, but it must also face up to the question of whether the prospective curtailment in demand was greater than was necessary. It seemed to him that given the combination of deflationary forces now in prospect, the current posture of credit policy involved a definite risk of too much restraint. For that reason, he believed that some reasonably early move toward a less restrictive policy was in order.

The Committee's actions since the last meeting had permitted, if not encouraged, a continuation of the welcome downdrift of interest rates in process since the end of May, Mr. Heflin said. He was concerned, however, about the changes in the pattern of rates that had accompanied that downward rate movement. Treasury bill rates had fallen somewhat more sharply than expected, largely because of the nature of the Treasury's refunding operations. But dealer loan and Federal funds rates had remained at higher levels than appeared desirable. That, combined with large dealer bill positions, could produce a back-up in bill rates and retard the orderly progression of the entire spectrum of rates to lower levels. In brief, it seemed to him that confirmation of the recent rate declines required some adjustments within the rate pattern, and particularly a reduction in Federal funds rates and in the costs of dealer financing. A cut in the prime rate might also be desirable.

Mr. Heflin believed that an early reduction in the discount rate might be a necessary step in achieving such rate adjustments. In his view, the question currently was primarily one of timing. While he would not argue for immediate rate action, it seemed to him that in the absence of a rate change, the Desk should seek to attain somewhat easier market conditions. If there was to be a change in the discount rate he would favor alternative A, as modified by Mr. Coldwell, for the directive.

Mr. Mitchell remarked that while the staff's GNP projections might have a higher probability of being realized than others which could be offered, he did not think that probability was very high. As Mr. Brill had indicated, it was not easy to predict what consumers might do. He would prefer to hedge against the staff's projections by following the policy course implied by alternative A of the directive drafts.

Mr. Mitchell observed that he was not overly concerned about the bill rate, even though its recent substantial gyrations were explainable only in part by technical factors related to the Treasury financing. He thought it would be unwise to give much attention to bill rates in formulating policy today, subject to one qualification--he would become somewhat concerned if rates rose to a level at which banks would not have leeway to sell intermediate- and longer-term CD's.

Like others, Mr. Mitchell remarked, he was disturbed by the speculative buildup in the positions of banks and Government securities dealers. In his judgment, however, for the Committee to validate the expectations that led to that buildup would be going well beyond its intentions at the last meeting when it agreed to accommodate tendencies toward less firmness. He thought the tendencies that had been meant were those associated with the market forces of supply and demand, not expectations regarding Federal Reserve policy.

Mr. Mitchell said that Mr. Keir's explanation of the recent and projected performance of the bank credit proxy satisfied him, although he doubted that it would satisfy some of the System's critics. As to Mr. Coldwell's suggestion that the reduction in Government deposits should not again be mentioned in the directive as an explanation of the recent rapid growth in the money supply, he (Mr. Mitchell) saw no reason for omitting the explanation so long as it was valid. By the same token, however, he would want to have the directive mention rises in Government deposits when they were the cause of declines in the money supply. He concurred in Mr. Swan's suggestion that the word "significantly" should be deleted from the proviso clause.

In concluding, Mr. Mitchell remarked that he would have been prepared to accept a 1/4 point reduction in the discount rate if it had appeared likely that the market would conclude that that was as far as the System planned to go for the time being. From the Manager's comments, however, he (Mr. Mitchell) gathered that it would take quite a bit of explaining to convince the market of that. Accordingly, he would not favor a discount rate cut now.

Mr. Daane said he found the question of appropriate System policy to be a particularly difficult one today. In general, he favored continuing on the course of gradually letting up on the brake of monetary restraint, while retaining flexibility. He was concerned more with the rate at which reserves were supplied than with the particular fluctuations in bill rates, and did not favor alternative B for the directive since its adoption evidently would lead to massive injections of reserves. It was possible that a course combining alternative A for the directive with a discount rate reduction would involve the smallest injection of reserves; if so, a discount rate cut would be in order. But, as the Manager had wisely observed, one could not be sure of the market's reaction to a discount rate cut. In his judgment the discount rate would have to be reduced by 1/2 rather than 1/4 point, since the market was not likely to view a 1/4 point cut as a one-time technical adjustment. More likely, there would be expectations of another cut soon and renewed speculative activity.

In sum, Mr. Daane said, he favored alternative A for the directive. While a discount rate cut might be needed to avoid the need for large reserve injections, he would hope that consideration of such action could be postponed for a few weeks.

In reply to a question by Mr. Galusha, Mr. Holmes said that since the market was now less certain than a short time ago of the course of System policy, there probably was less risk now that a small discount rate change be interpreted as signaling substantial further ease to come. That judgment was supported by developments in the market this morning, which suggested that the recent reaction was continuing. As he had indicated, however, one could not be sure of the effect on the market of a discount rate cut.

Mr. Maisel remarked that he did not consider the choice today between alternatives A and B for the directive to be particularly important because he thought that policy for the bulk of the period between now and the Committee meeting tentatively scheduled for September 10 should be set in a telephone conference meeting following an immediate lowering of the discount rate.

The problem, Mr. Maisel continued, was clearly one of attempting to evaluate the effect on total credit expansion of a failure to act. It seemed to him that a failure to lower the discount rate at this time would constitute a change in policy. The System would be trying to retrace time and the market actions of the past six weeks. That would be a positive action--shown as a failure to act--which the market and the country would correctly interpret as a sign that the Federal Reserve System was assuming that the current fiscal policy would not be likely to bring about an increase in unemployment and a fall in the rate of real growth. It would be assumed that the Federal Reserve believed that sufficient fiscal restraint would not be forthcoming, and as a result was determined to hold interest rates up--at record levels compared to previous years--rather than allowing the fall in demand for credit to carry rates down. Furthermore, it would be assumed that because of that belief, the System was not changing the discount rate in order to force the whole complex of rates back up to higher levels.

Mr. Maisel felt that a discount rate reduction now would not be a change in policy to lead rates down; rather it would be the theoretically neutral expression of adjusting the discount rate to coincide with market rates, which had correctly fallen as participants read the implications of the Committee's policy cut in the repurchase rate plus previous statements regarding the correct mixture of monetary and fiscal policy. A failure to adjust the discount rate would, on the other hand, be a strong policy statement in favor of greater monetary constraint.

While it was clearly a matter of judgment, Mr. Maisel said, he thought those who felt that delay and small movements were safe and conservative were incorrect since they allowed the market to force moves of an undesirable size. The failure to control events by actions, as had just been seen, was likely to lead to more rapid and abrupt movements than desired. He thought a 5 per cent discount rate now, with a slower provision of reserves than had been the case, was preferable to the System's present stance.

As he indicated at the previous meeting, Mr. Maisel continued, the Committee's goal for this quarter and the next should be basically that of a neutral monetary and credit policy, defined as growth in total deposits at an 8 to 9 per cent annual rate. In actuality, that was about the rate that was indicated for the current quarter. It probably would have been better if the initial expansion--particularly in bank credit--had been slower. He believed that the System was, however, paying the penalty for delaying last time and allowing the market to take over with a speculative binge based on expectations. As he pointed out in his statement at the last meeting, the System could have cut down the rate of expansion in reserves and the buildup of speculative positions in bills and notes based on expectations by changing the discount rate after the previous meeting.

Mr. Maisel observed that what had not been done was past; the market had moved ahead of the System. Now the System should simply adjust the discount rate to the existing market situation.

With respect to the directive to be issued today, alternative A would probably cause an undesirable reaction; he would favor alternative B in case there was any delay in the discount rate change and the telephone meeting of the Committee. Clearly, however, the situation with respect to both alternatives was confused because of the changes that had occurred in the market since the blue book was written. The Manager would have to rely on his interpretations of the statements made by members today. His (Mr. Maisel's) view was that the bill rate should be kept around 5 per cent. He would expect that the Federal funds rate would have to be decreased and large amounts of reserves furnished to keep the rate near 5 per cent unless the discount rate was lowered.

Mr. Brimmer said he thought it would be appropriate at this juncture for the Open Market Committee to stand aside and permit the Reserve Banks and the Board to make the next policy move by reducing the discount rate. Earlier he had indicated that he favored a reduction of 1/4 point, but in light of the subsequent discussion he was now inclined to a 1/2 point cut. In his judgment the action should be taken no later than the middle or end of next week, and preferably earlier. He concurred in the view that a discount rate cut was likely to reduce the volume of reserves that would have to be supplied. There was no doubt in his mind that in the absence of such action the bill rate would remain under upward pressure.

Mr. Brimmer remarked that the Committee had taken a "rate" action at its previous meeting when there had been a consensus for reducing the RP rate from 5-5/8 to 5-1/2 per cent at the first possible moment. RP's were in fact made at 5-1/2 per cent the next day, and the market had correctly read that as a policy action. While the Committee had not anticipated that the Treasury would not include a short-term anchor issue in its financing, the market had interpreted that decision as a quasi-monetary action.

Mr. Brimmer said he had no particular comments to make with respect to language for the directive. In general, he thought open market operations should be directed at backing up the discount rate reduction, which might call for money market conditions somewhere between those specified for alternatives A and B. He agreed with Mr. Heflin that it was appropriate to formulate policy in light of projected economic developments rather than by considering only the situation at the moment.

Mr. Sherrill said he thought the System had to take account of the effects of its policy actions not only on such variables as money and bank credit but also on market expectations. Recently, interest rates had declined sharply as a result of heavy speculation on an imminent easing of monetary policy, and then had reversed course as doubts about System intentions began to grow. At present, he thought the worst expectation the System could engender would be one of a rapid, deep decline in interest rates. But the next worst expectation was the opposite--that the current exceptionally high structure of rates would continue indefinitely. Ideally, the System's actions should indicate a long-run policy intent of lowering the rate structure in an orderly manner over a reasonable period.

To do that would not be easy under current circumstances, Mr. Sherrill remarked, but he would suggest a possible two-stage strategy. In the first stage, which would be launched immediately, the Federal funds rate would be allowed to drop below 6 per cent in the hope that that would stop the bill rate from rising and would lead to an orderly liquidation of speculative positions. If those hopes were not realized it would be clear that a move to the second stage--a reduction in the discount rate--was necessary.

Mr. Hickman remarked that as expected, the economy seemed to have moved into a period of virtually no growth in real GNP. Signs of cooling were accumulating, particularly in the heavy industries. Inventories of autos and steel were being liquidated, and steel output was being reduced drastically. Consequently, industrial production would show little growth during the second half of 1968, and the margin of unused plant capacity would widen further. Despite the current no-growth phase of economic activity, cost-price pressures and inflationary psychology were prevalent and pervasive. Until inflationary forces and sentiment had moderated substantially, he saw no reason for the Committee to change its policy position.

Having said that, Mr. Hickman continued, he had to confess that he felt somewhat less certain than usual about what the stance of monetary policy actually was. As he interpreted the directive adopted at the last meeting, it called for open market operations that would accommodate the somewhat less firm conditions then existing in the money market, provided that the bank credit proxy did not deviate significantly from current projections. Including adjustments for Euro-dollar flows, the projections indicated growth at an annual rate of 6 to 10 per cent, on average, for July and August. For several weeks now, the July-August estimates of the credit proxy had been indicating a rate of expansion far in excess of a 6 to 10 per cent range--in fact, 13 or 14 per cent, according to the latest estimates. Open market operations should therefore have become less accommodative up to the announcement of the Treasury financing, and no more accommodative thereafter; at least that was the way he interpreted the proviso clause.

As a participant in the morning conference call during the past four weeks, Mr. Hickman said, he had been deeply troubled by those inconsistencies. The Committee's reluctance to bring open market operations fully to bear on bank credit stemmed largely, he thought, from the fact that the Committee was concerned with a broad constellation of variables rather than a single one--and those variables frequently did not behave as expected under the complex conditions of the market place, given institutional changes and shifting expectations. If the proviso clause had been invoked when it should have been, considerably different patterns would have developed for a number of key money market variables. For example, the Federal funds rate would probably have moved even higher--in fact it was well above the staff projection most of the time; the bill rate would not have been so low as it was--early in the period it fell well below the staff projection; net borrowed reserves would have been much deeper; and so on.

That suggested to Mr. Hickman that the proviso clause had not been allowed to perform its intended function. If the proviso clause was retained in the policy directive, the Committee should be prepared to accept wider swings in either direction in the major money market variables. If it was not prepared to accept wider swings, then the proviso clause should be eliminated. He personally would vote to retain the proviso clause, and would tolerate wider swings in money market variables than the Committee had been willing to accept thus far.

In that vein, Mr. Hickman said, he favored alternative A-- or a modified version under which the bill rate would be allowed to drift above present levels. That would be consistent with no change in policy and a reduced rate of bank credit expansion in September, as projected in the blue book. He would underscore the word "provided" in the second paragraph of the directive, and would delete the word "significantly" from the following clause. As to the discount rate, he would move slowly and at this time would prefer a reduction of 1/4 rather than 1/2 point.

Mr. Bopp commented it was still too early to predict with any confidence the vigor of the economy by year-end. However, preliminary second-quarter data did confirm earlier forecasts of a slowing down in the rate of increase in economic activity, and further moderation was likely. Thus, with the steel settlement in hand, a key component in the inventory buildup had shifted from a plus to a minus factor in the economic outlook. Residential construction probably would show a smaller volume of outlays in the third quarter, owing to a drop in starts. The bite of the surtax on consumer expenditures was yet to be felt.

In the Third District, Mr. Bopp continued, the Reserve Bank's Business Outlook Survey indicated that a majority of manufacturers expected business to continue at present rates for the next several months, but they were becoming less optimistic about the year-end. Prospects were for continued price increases, both paid and received, although those opinions were not quote so prevalent as a month earlier. Philadelphia commercial banks said that loan demand had picked up modestly, as they had expected.

Mr. Bopp concluded that both nationally and locally the signs of softness were still relatively few and that the evolving moderation in the pace of the economy should not be interpreted as weakness. Near-term moderation should be welcomed in view of persisting cost-price pressures. Further out, the bite of the fiscal package might be considerably less than expected. Thus, two-thirds of the proposed expenditures reduction for fiscal year 1969 had already been offset by additional appropriations in the categories exempt from expenditure constraints. The surtax notwithstanding, consumers were in a position to accommodate the higher tax liabilities without cuts in spending levels.

The big problem, of course, was to project economic conditions by year-end when policy decisions made now would be taking hold, Mr. Bopp said. But money market developments since the last meeting gave the Committee additional time to wait and see. The July growth in the credit proxy and the money supply had been well above the upper limit projected a month ago. Bill rates had fallen substantially more than expected. For August a further substantial increase in the credit proxy was projected and, although the expectation was for little or no growth in the money stock, the annual rate of growth for the past several months would still average over 6 per cent. By most of the usual financial and monetary indicators, considerable easing had already taken place.

As had been predicted by the Board staff, Mr. Bopp noted, signs of weakening had been few in July. Should more of those signs begin to show up in August, four weeks from now would be time enough to consider a positive move toward ease. Granting the dangers of a delayed recognition of, and reaction to, a significant slowdown in the economy, he still believed those risks were outweighed by the risk of further inflation with all its implications for domestic and international stability.

Therefore, Mr. Bopp recommended alternative A as the appropriate directive for the period until the next meeting of the Committee. He would delete the word "significantly" from the second paragraph.

Mr. Kimbrel remarked that so far as the Sixth District was concerned he found little in the economic indicators to suggest that the widely predicted economic slowdown had yet started. Employment, retail sales, and personal income continued to advance. The outlook for crop production and livestock prices seemed favorable. District construction had been surprisingly strong. Basic conditions in most housing markets had been and remained favorable for further expansion even though at the present time there might be a tendency to hold off a bit on making further commitments at current money costs.

Those generalizations, of course, were based upon past statistics, and statistics were always stale, Mr. Kimbrel said. If he had not heard the discussion at the meeting of the Atlanta Reserve Bank Board last Friday, he possibly could be convinced that when statistics became available on the economic situation of the present moment, they would reveal a change in the trends. But neither in the economic reports from the Branch Directors on the current situations in their respective States nor from the general discussion had he detected any suggestions that the Sixth District was entering into a phase of declining activity. He did hear a great deal about price increases, both past and anticipated.

It seemed to Mr. Kimbrel that any further monetary policy easing could be justified at the present time only on the basis of a possible slowdown to come and not on what was happening now. The dangers of awaiting very definite evidence of a slowdown before turning to an easier policy had been pointed out not only at meetings of the Committee but also in the press. But if there was a danger of doing too little, too late, there was also a danger of doing too much, too soon. He hoped that the System had not already done so.

Mr. Kimbrel recalled that the Manager had rightly pointed out at the last meeting of the Committee that firm predictions could not be made about the relationship between the money market variables and bank credit for the period just past. It had been a difficult period in which to conduct operations. Nevertheless, as others had suggested today, reserves and bank credit had expanded more than the Committee had thought desirable and interest rates had fallen more than it had anticipated. He would hope, therefore, that the Committee could agree at least to hold the line.

Mr. Kimbrel preferred alternative A of the directive drafts but agreed that the word "significantly" should be deleted in the second paragraph. He shared Mr. Daane's feeling that the System would have some difficulty in conveying the full significance of a 1/4 point reduction in the discount rate. At the same time, he thought an early reduction of a larger size would be premature.

Mr. Francis remarked that total demand for goods and services had continued to rise excessively and prices were advancing at a 4 per cent annual rate. Nevertheless, many analysts seemed to be preoccupied with fear of a coming recession. In his judgment, the view that the recently adopted fiscal package would, by itself, adequately restrict total demand and cure the inflationary problems was overly optimistic. Monetary actions had continued to be excessively stimulative, negating the desirable anti-inflationary impact of the fiscal package.

The nation's money stock had risen at a 7 per cent annual rate since the first of the year, more than double the trend rate, Mr. Francis observed. References to the very rapid growth of money in the second quarter usually noted that a reduction of Treasury deposits in that period contributed to the high growth rate of money. Those references implied a subsequent increase of Treasury deposits and a lower growth rate of money.

It was true, Mr. Francis said, that the movements of Treasury deposits were a factor in the rapid monetary growth in the second quarter and in the slower growth in July and early August. He would submit for the record a table showing the determinants of the money supply in the second quarter and in the first six months of the year.1/ Growth in the first quarter was restrained as the Treasury built up its balances more than was usual for that period. Money then rapidly increased in the second quarter as Treasury balances were drawn down. If the excessive growth of money from March through June was attributed to the decline in Treasury balances, the substantially slower growth at present might similarly be attributed to a rise in Treasury balances. Over the whole period since December, money had grown at an excessive 7 per cent annual rate, and he considered that to be the trend or effective rate up to the present time.

1/ The table referred to is appended to this memorandum as Attachment B.

The greater concern about a possible recession than about present and prospective inflation seemed unwarranted to Mr. Francis. Projections of little real growth by the first quarter of 1969 appeared unduly low as judged by economic models which placed significant weight on monetary variables. But a lack of economic growth might be desirable for a brief period as a necessary accompaniment of reducing the intense inflationary pressures and to set the stage for the tax reduction next July. Unless total demand during the coming year was sufficiently limited, there was no hope of restricting the onward rush of prices.

Mr. Francis remarked that the Committee might receive some guidance in formulating an appropriate monetary policy at a time when fiscal policy was being changed significantly by reviewing an earlier period when fiscal policy was approximately the same as was now foreseen for fiscal 1969. According to the Reserve Bank's estimates, the high-employment budget was expected to shift from about a $14 billion deficit in the first half of 1968 to about a $10 billion surplus in the first half of 1969. In the period from 1961 to mid-1965, the Federal Government also ran high-employment surpluses averaging roughly $10 billion. Despite that fiscal stance, the early sixties were a period of generally rising total demand and real production, declining unemployment, and relatively mild price increases. During that 1961 to 1965 period the money stock rose at a 3 per cent annual rate, and he felt that a rate of increase of about 3 per cent was the best policy that the Committee could adopt for the near future.

Mr. Francis said he did not question that interest rates should be lower during the next year than they would have been if the fiscal action of late June had not materalized. But that did not mean that the Committee should undertake to push them down any further or any quicker than the supply and demand forces determined.

With respect to the U.S. international payments situation, Mr. Francis felt it would be a mistake to undertake to push U.S. interest rates down relative to those in other countries. While one must regret the inflation and the Federal deficits which had contributed so much to the high U.S. interest rates, the rates had become more consonant with those of other countries. That benefit should not be abandoned lightly.

Along that line, Mr. Francis thought it would be a mistake to reduce discount rates at this time. With the Federal funds rate still at 6 per cent, a 5-1/2 per cent discount rate was none too high. With member bank borrowings from Reserve Banks amounting to from $500 to $700 million, he saw no reason to invite an increase. The discount rate should not be reduced with the idea that that would be a signal affecting anticipations and forcing interest rates down. If the supply and demand forces called for lower interest rates, they would come down anyway and that would be a good time to reduce the discount rate. If the forthcoming demand and supply forces did not call for lower interest rates, then anything the Committee did to push them down would not avoid their coming back up and would simply have contributed to inflationary forces.

Mr. Robertson made the following statement:

> It seems to me that a fair degree of ease--at least relative ease--has developed in financial markets. This is one of the expected consequences of the tax increase. The position of banks has improved, in the sense that they have more funds for lending and investing. It would appear that mutual savings banks and savings and loan associations, too, are in a somewhat better position to expand mortgage commitments. And certainly the Treasury has had little difficulty in marketing recent issues.
>
> As financial conditions have eased, so too have prospects for economic activity become weaker. Thus, the ease in financial markets not only averts what could have been undue strains on various financial institutions but also provides a basis for encouraging credit demands--such as in the housing area--to keep economic activity from slowing excessively. The principal question at this meeting is whether we need even more financial ease at this time.
>
> My answer to that is that we should do our best to hold what we have, while being sure to keep market psychology from reversing itself, hopefully without adding more and more to the growth of the money supply and, if necessary, by using a reduction in the discount rate. However, I would prefer not to move at this time toward substantial further ease because it seems to me that, while our staff is fearful of a sharp weakening in economic activity, we do not yet have sufficient evidence to establish that as the certain course of events. Clearly there will be a slowdown, and some slowdown is desirable. But whether the slowdown will tip us into a contraction of activity, or be in the nature of a pause before we move into a period of more

sustainable growth, requires further evidence. I take the recent comparatively good performance of retail sales to be on the hopeful side. Furthermore, the steel price increases, even trimmed as they have been, suggest that inflationary pressures are still with us.

The July-August expansion in bank credit bothers me as it does others. It was more than we anticipated. It would bother me more if I were not fairly sure that it represented, in good part, an expectational or psychological response of banks and Government securities dealers to the changed financial atmosphere, rather than any basic strength in credit demands. In any event, I am glad that it now appears that a more moderate bank credit expansion is in prospect for the period immediately ahead.

As to the directives before us, I would prefer one that would be interpreted to mean that we should continue to keep following down the gradual easing in <u>over-all</u> money market conditions, without any overt action designed to ease them further and faster, but with adequate measures to ward off a reversal of the trend. Whether this means "A" or "B" of the alternative drafts is immaterial to me. We should recognize, of course, that the various elements of money market conditions may, and sometimes should, show shifting relationships; it is the <u>over-all</u> picture that we should keep in mind.

The bank credit proviso should be included and be two-way. Now that banks have recovered to their previous level of outstanding CD's they may be less eager to obtain such funds at a rapid rate. If bank credit were to expand less rapidly than projected, this might indicate that basic credit demands were weakening further and would signal to me that the Manager ought to let market conditions ease further--and vice versa, if bank credit were rising well above projections. However, I would be much more hesitant to tighten market conditions than to ease them, particularly if a larger than expected credit expansion appears to represent mainly security investments by banks as a counterpart to a return flow of time and savings deposits.

Mr. Robertson added that he would favor changes in the opening sentences of the first paragraph of the directive along the lines of those proposed by Mr. Coldwell. He thought that with such changes the directive would more clearly reflect the sense of the Committee regarding the economic outlook, rather than the staff's forebodings.

Chairman Martin said he had been encouraged by the Committee's discussion today. Although the members were divided in their views, the discussion had been thoughtful and highly useful. The problem of formulating appropriate monetary policy at this juncture seemed to him to be an extremely difficult one. In his judgment the difficulties were largely traceable to the long delay in introducing fiscal restraint and to the fact that monetary policy had moved toward restraint too slowly. He now thought that the discount rate should have been raised to the current 5-1/2 per cent level considerably earlier than it had been.

The Chairman remarked that July evidently was a good month for business and he was not as pessimistic as the staff was about the economic outlook for the rest of the year. Nevertheless, he thought that a correction at some point would have been inevitable even if fiscal restraint had not been introduced. While the correction might be fairly sharp he would hope it would not be extended. As he had indicated at the previous meeting, the objective should be disinflation without recession, but the line between the two was admittedly fine.

In general, Chairman Martin continued, he thought a movement toward a lower level of interest rates was desirable. He was as concerned as other members were about the high current rates of growth of bank credit and other manifestations of crosscurrents. But the System was faced with a technical market problem at the moment; as a result of expectations of greater monetary ease, short-term interest rates had been forced down to a point at which the discount rate was out of line. The problem had been compounded by the Treasury's decision not to include a short-term anchor issue in its current refunding. To a certain extent System officials, including himself, might have contributed to the expectations that had developed. In the process of working hard for fiscal restraint, both System and Administration officials might at times have overstated the implications of fiscal restraint for interest rates.

If he were acting on his own, the Chairman said, he would want to reduce the discount rate promptly to 5 per cent without large injections of reserves. He did not think Mr. Sherrill's suggestion for a two-stage approach was feasible, given the state of expectations. Obviously, it was a matter of judgment as to whether a 1/2 point cut in the discount rate would stabilize the situation or whether it would create new expectations of another 1/2 point cut soon, but he personally would expect such an action to have a stabilizing effect. As to timing, unless the discount rate were reduced promptly there would be good arguments for delaying action for a month or six weeks. He did not think it would be feasible to wait that long, however, in light of various considerations, including the state of market psychology.

The Chairman concluded by saying that no one could be certain of the most practical means for dealing with problems of market psychology. Perhaps it would be best for the Committee to discuss the matter further at this point. From the go-around it appeared that a majority favored alternative A for the directive.

Mr. Galusha said it seemed to him--assuming that the upward rate pressures of the last few days persisted--that it would be necessary to begin injecting reserves in fairly significant volume to get interest rates back down. Accordingly, operations under alternative A might be much like those that would be pursued under alternative B.

Mr. Holmes remarked that, as he understood it, under alternative B the Desk would be instructed to ease money market conditions promptly in order to prevent a further rise in bill rates, without waiting for evidence that the rise was occurring. Under alternative A, however, there would be no move toward ease unless bill rates moved up further--perhaps to the neighborhood of 5.20 per cent. In that event, the Federal funds rate would be brought closer to 6 per cent and, if the bill rate pressures continued, below that level. It was possible that the money market conditions that would then develop would be similar to those called for under alternative B, but they would come about only if it proved necessary to resist bill rate increases. Such operations would no doubt suggest to the market that the System did not want rates to rise very much. If bill rates subsequently came under downward pressure, under alternative A the Committee presumably would expect the Desk to let day-to-day money market rates move back up again.

Mr. Galusha said he gathered that if alternative B were adopted it would be expected that the bill rate would be pushed below 5.10 per cent. Assuming upward rate pressures continued, that evidently would require overt action on a scale large enough to create a climate of a substantial move toward ease, for which there seemed to be little if any sentiment today.

Mr. Mitchell, referring to the Chairman's comments about the discount rate, said that the market's expectations of a 1/2 point cut seemed to him to have an aura of unreality; such a move by the System would be too much in too little time. If the Committee was going to focus on the bill rate and if the Chairman's views on the need for a prompt discount rate reduction were correct, he (Mr. Mitchell) would favor a cut of only 1/4 point.

Chairman Martin remarked that it was a matter of judgment whether a 1/4 point reduction would not simply lead the market to anticipate another similar step soon.

Mr. Mitchell agreed. However, he said, with a 1/4 point cut in the discount rate some market participants would undoubtedly be under pressure to reduce positions they had built up in the expectation of making profits on the basis of a 1/2 point cut.

Mr. Daane remarked that, as he had indicated earlier, he would like to minimize reserve injections to the extent possible. If a modest reduction in the level of net borrowed reserves would keep the bill rate about where it was at present, he would prefer that course to action on the discount rate. Like Mr. Robertson, he would be willing to lower the discount rate if necessary; but he was not completely convinced that it was necessary at this juncture.

Chairman Martin said that Mr. Daane's comment went to the heart of the problem. He also would prefer not to change the discount rate, but he did not believe such a course was feasible. As he had indicated, it was a matter of judgment.

Mr. Brimmer said he shared the Chairman's judgment and, unlike Mr. Mitchell, he did not think a 1/4 point cut would suffice. For one thing, the market probably would not conclude that that was as far as the System was prepared to go for the time being. For another, it was clear that a lower structure of interest rates would be required over the next year in view of the economic outlook and that the discount rate would have to be reduced further at some point. He would favor a 1/2 point reduction now not only on economic grounds but also to remove the System to the extent possible from the arena of the public debate on economic policy that probably lay ahead. Accordingly, he hoped that the Committee would agree today that open market operations should assume a supporting role in the expectation that the Reserve Banks and the Board would act to reduce the discount rate by 1/2 point.

Mr. Coldwell said he suspected that if the bill rate had remained within the expected range in recent weeks rather than declining sharply there would have been little sentiment today for a 5 per cent discount rate. He thought a 1/2 point reduction would represent overreaction by the System to unexpected developments that already were in process of correction.

Mr. Galusha remarked that while much of the discussion today had focused on the bill rate, that rate was significant mainly because it was viewed in the market as symptomatic of Federal Reserve policy. The basic problem for the System was that posed by the large overhang of positions; and he believed that in dealing with the problem the method that was likely to prove least expensive in terms of reserve provision was a 1/2 point cut in the discount rate.

Mr. Brill said he was concerned about the procedural problem of interpreting the proviso clause when the assumptions underlying the blue book projections of bank credit did not encompass policy actions subsequently decided upon. Such a problem had arisen in the recent interval in connection with the reduction in the RP rate to 5-1/2 per cent, an action that had contributed importantly to the market expectations that had depressed bill rates and boosted bank credit growth. Although it was by no means certain that the staff would have correctly anticipated the effects of that action on bank credit, the fact was that no allowance for it had been made in the blue book. He was concerned that the problem of the appropriate interpretation of the proviso clause would arise now if the discount rate were reduced by 1/4 or 1/2 point, since no discount rate action had been assumed in making the latest projections. The problem would be more acute if the acceptable range of variation around the projections was narrowed by deleting the word "significantly" from the proviso clause.

Chairman Martin said that Mr. Brill had made a valid point. The Chairman then noted that during the past week he had been giving thought to the question Mr. Coldwell had raised today. Were it not for the circumstances that had arisen as a result of the long delay in getting the needed fiscal and monetary restraint, he would agree completely with Mr. Coldwell that for the System to cut the discount rate by 1/2 point now would be to overreact to an unanticipated decline in interest rates. But under the circumstances actually prevailing, he thought the Desk would have great difficulty in coping with the effects of shifting expectations unless the discount rate were reduced. A discount rate cut would not necessarily resolve the problem. But he hoped it would reduce the volume of reserves that would have to be injected and help stabilize conditions in a period when interest rates were adapting to the evolving economic situation.

Mr. Swan noted that the settlement date for the August refunding was Thursday of this week. While one could not be sure how long the distribution process would take, even keel considerations would seem to militate against a discount rate change before next week.

Chairman Martin remarked that the refunding was, of course, a relevant matter. In general, however, he thought the System should not consider itself bound to maintain an even keel for any specific number of days after the payment date in a financing. Moreover, even keel considerations had a somewhat different character when the policy change under consideration involved less rather than more restraint.

Mr. Sherrill said his position was much closer to that of the Chairman than his earlier remarks might have suggested. Only if short-term rates started to move sharply downward again would he be opposed to a discount rate reduction.

Mr. Bopp asked whether a reduction in the large inventories of dealers would necessarily tend to lower the rate of bank credit growth.

Mr. Maisel commented that liquidation of dealer positions should tend to reduce outstanding bank credit to the extent the securities were sold to non-bank investors who financed them by means other than borrowing from banks. The approach he favored was to reduce the discount rate while supplying reserves at a pace calculated to keep day-to-day money market rates relatively high, in order to maintain pressure on dealers to reduce their inventories. If the discount rate were not reduced, the dealers were likely to conclude that they had been misled about the System's policy intentions, and they might attempt to dump their inventories on the market. In the first case the liquidation would proceed in an orderly fashion; in the second case it would not.

Mr. Mitchell expressed the view that a 1/2 point reduction in the discount rate would lead dealers to expect lower financing costs and encourage them to hold on to their inventories.

Mr. Holmes said that discount rate action would bring about some fall in dealer financing costs but that dealers would still have an incentive to sell if pressure was kept on day-to-day rates.

Mr. Daane remarked that while he thought the discount rate should be reduced if necessary, he saw some real risks in moving too quickly. He asked whether the Manager thought it was clear that the discount rate would have to be reduced before the September 10 meeting of the Committee if a massive injection of reserves was to be avoided.

Mr. Holmes said that it was likely to be quite difficult through open market operations to lower day-to-day rates enough to keep dealers from wanting to dump their inventories and to maintain their willingness to engage in two-way trading. He would not want to say it was an impossible task; but clearly from a technical point of view somewhat lower dealer lending and Federal funds rates would make the task of open market operations much easier in the month ahead. The objective presumably was to get dealer inventories down but in an orderly fashion. In the event of a change in the discount rate, the Desk could resist any overly rapid decline in interest rates if expectations of still further discount rate reductions developed.

In reply to questions by Mr. Mitchell, Mr. Holmes said that dealer positions had nearly doubled in the past month. Dealers had made very good progress through last Friday in distributing the new 6-year notes, but he suspected that that process had slowed down yesterday. Dealers were more than willing to reduce their inventories; the problem was that buyers were holding back. He agreed with Mr. Mitchell that lower day-to-day rates would reduce the incentive for dealers to draw down their positions, but thought that many nevertheless would probably be willing to take presently available profits. If day-to-day rates remained high, the effect of dealer efforts to unload would be to push rates up rapidly.

Mr. Brimmer commented that in his conversations with market participants over the last few weeks he had not detected a general expectation that the System planned to dismantle monetary restraint rapidly. The expectation, rather, was that the move toward ease would be gradual. He asked whether the Manager had the same impression.

Mr. Holmes replied that he had heard various views. Some observers expected the System to ease quickly; others were convinced that some measure of restraint would be retained.

Mr. Robertson remarked that the recent run-up in speculative positions suggested that the former view was widespread.

Mr. Swan commented that the materials recently released in connection with the System's study of the discount mechanism had emphasized the desirability of smaller and more frequent changes in the discount rate. Against that background, a 1/2 point cut in the discount rate now would be particularly likely to be interpreted as a major step toward ease rather than a moderate move.

Mr. Daane remarked that the magnitude of the reaction to the 1/8 point reduction in the RP rate suggested that a 1/2 point cut in the discount rate was hardly likely to be dismissed as a technical move.

Mr. Brimmer said he did not think the Committee had intended the cut in the RP rate to be interpreted as a purely technical move. Rather, it was expected to be viewed as a "mini-policy" action. In his judgment a 1/2 point reduction in the discount rate could be considered as a moderate move in the existing environment.

Chairman Martin noted that no Reserve Bank had acted thus far to change the discount rate. He suggested that the Committee move on to the matter of the directive, on the understanding that the Board would stand ready to review any discount rate actions Reserve Banks might take. He then asked whether the Secretary had directive language to propose in light of the comments made today on the staff's drafts.

Mr. Holland remarked that, as recommended by Mr. Coldwell, the word "suggests" in the opening sentence of the first paragraph might be replaced by "indicates." With respect to the second sentence, the problem at which Mr. Coldwell's proposed revision was directed--that the outlook described reflected staff projections about the likelihood of which Committee members had varying views--might be dealt with most simply by modifying the language to read, "Expansion in over-all activity, however, is projected to slow considerably in coming months . . . ." As to the second paragraph, the consensus appeared to be for alternative A with the word "significantly" deleted from the proviso clause. The specifications associated with the second paragraph presumably would be those given for alternative A in the blue book, including those providing for somewhat lower day-to-day rates and net borrowed reserves if bill rates remained under upward pressure. It was also his presumption that the Committee would want to reconsider the directive if changes were made in Reserve Bank discount rates.

Mr. Hickman noted that the directive would call for firming if the credit proxy appeared to be exceeding the rate projected in the blue book.

Mr. Maisel remarked that he did not think such a directive would serve for the full period until the September 10 meeting of the Committee, particularly if firming action was required under the proviso clause. It was his hope that discount rate action would be taken within a few days, and that the Committee would revise the directive promptly thereafter.

Mr. Robertson said he thought it would be a mistake to delete the word "significantly" from the proviso clause. Such a qualification customarily had been included to permit small deviations from the projections before implementing the proviso, and he thought it would be appropriate to permit such deviations now.

After several members had expressed similar views, it was agreed that the word "significantly" should be retained.

> 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 some elements of economic activity continued to expand vigorously in early summer. Expansion in overall activity, however, is projected to slow considerably in coming months as a result of the new fiscal restraint measures and a marked reduction in inventory accumulation. Industrial prices have been increasing less rapidly in recent months, but consumer prices have continued to rise substantially. Wage pressures remain strong, and the recent wage settlement in the steel industry was followed by announcements of steel price increases. Both short- and long-term interest rates have declined considerably, in large part as a result of expectations of easier credit conditions. Bank time and savings deposits, particularly large-denomination CD's, have expanded sharply in early summer; growth in the money supply has continued large as U.S. Government deposits have been drawn down further on average; and growth in total bank credit has been unusually rapid. Although the U.S. balance of payments has recently shown a marked improvement, the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of 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 maintaining, on balance, about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be significantly exceeding current projections.

Chairman Martin then noted that memoranda from the Account Manager and from the Secretariat, both entitled "System lending of U.S. Government securities," had been distributed to the Committee on August 6 and 7, respectively.[1/] He asked Mr. Holmes to comment.

Mr. Holmes observed that on July 11, 1967, in a paper captioned "Policy Issues #4," the Steering Committee of the Treasury-Federal Reserve Study of the Government Securities Market had recommended adoption of a proposal for System lending of portions of its holdings of U.S. Government securities to dealers and to nondealer banks participating in the clearing arrangement operated by the Federal Reserve Bank of New York. That proposal had been scheduled for discussion at the Committee meeting of September 12, 1967, but had been held over to provide more opportunity for study by Committee Counsel. On July 10, 1968, there had been distributed a memorandum from the Committee's Counsel entitled "Legality of plan for lending of Government securities by Federal Reserve Banks," in which Mr. Hackley expressed

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1/ Copies of these documents and those subsequently referred to by Mr. Holmes have been placed in the Committee's files.

the opinion that "it is doubtful whether the Reserve Banks have authority under the law to lend Government securities in the manner proposed." Attached to Mr. Hackley's memorandum was a memorandum prepared by Mr. Sloane, Assistant General Counsel at the New York Reserve Bank, which concluded that Federal Reserve Banks "are authorized to lend securities in aid of open market operations."

Thus, Mr. Holmes continued, the Committee had before it two opinions. He obviously was not qualified to comment on the legal questions, and would hope that Mr. Hackley would do so. He could report that after a further review last month, the Steering Committee had unanimously concluded that the legal questions were not sufficiently serious to make undesirable Committee consideration of the proposal on its merits. The Steering Committee had also reaffirmed its earlier position that the proposal would offer advantages to the market and hence to the System and the Treasury.

Mr. Holmes went on to say that the two purposes for which it was contemplated that System securities would be lent were to enable dealers to avoid delivery failures and to facilitate the securities clearing arrangement of the New York Federal Reserve Bank. It was expected that most of the lending activity would arise in connection with the first purpose and that there would be only a negligible amount in connection with the clearing arrangement.

His memorandum of August 6 concluded with two recommendations, Mr. Holmes observed. The first was that the Committee amend the continuing authority directive to authorize lending of securities from the System Open Market Account under terms and conditions to be established from time to time by the Committee. The Secretariat's memorandum of August 7 proposed a specific amendment to the directive for consideration by the Committee if it approved that recommendation. His second recommendation was that the Committee establish the terms and conditions outlined in his memorandum as those under which the System would lend Government securities, on the understanding that any substantial changes that might be indicated by discussions with dealers would be submitted for the consideration of the Committee. The dollar limits included among the recommended terms and conditions were clearly experimental, and he might want to propose changes in them at a later time.

Mr. Holmes noted that there were three attachments to his August 6 memorandum: a draft of a letter for Mr. Hayes' signature to the Presidents of the other Federal Reserve Banks, requesting that they authorize the Federal Reserve Bank of New York to lend securities from the System Open Market Account in accordance with the directions of the Open Market Committee; and two proposed forms of contracts--for lending securities overnight and for lending securities for more than one day. He would propose one change in the draft of the letter from Mr. Hayes, to delete the words "equal or" from the sentence reading "Loans of Government securities would be secured by Government securities of equal or greater market value."

In response to the Chairman's request for comment, Mr. Hackley said it was quite obvious that the legal questions were debatable. Basically, he had concluded that it was doubtful whether the Reserve Banks had incidental powers to lend Government securities in the manner proposed because it did not seem at all clear to him that that activity was reasonably necessary for carrying out their express powers. He had great difficulty with the argument that the Reserve Banks had legal authority to engage in any activity not prohibited by law that would aid in the discharge of their statutory responsibilities. On the basis of that argument, it would not have been necessary for the Board to recommend legislation specifically authorizing the Reserve Banks to invest foreign currency balances in foreign Government securities, but the Board had so recommended.

Mr. Hackley added that he had reviewed the several documents to which Mr. Holmes had referred and concluded that if the Committee approved the proposal those documents would be adequate from the legal point of view. It might be well, however, to make clear that the securities to be lent would not be those required to be held as collateral against Federal Reserve notes.

Mr. Holmes agreed that that point should be clarified.

Chairman Martin commented that the matter under discussion was an important one. While the Steering Committee had recommended favorable action, a decision could be postponed until a later meeting if the Committee members thought that would be desirable.

Mr. Mitchell noted that the proposal had been pending for over a year. He would be prepared to vote favorably on it today.

Mr. Brimmer remarked that the Steering Committee's favorable recommendation would carry great weight in his thinking.

Mr. Bopp said he thought there were real hazards in proceeding on the assumption that the proposed activity was authorized under the System's incidental powers. He would prefer to seek specific enabling legislation.

Mr. Hickman said he would like to have the matter held over so that he could have an opportunity to discuss the legal questions with the general counsel of his Bank.

Mr. Heflin remarked that he concurred in Mr. Hackley's views on the question.

It was then agreed that the Manager's recommendations regarding System lending of Government securities should be considered further at a later meeting of the Committee.

It was agreed the next meeting of the Committee would be held on September 10, 1968, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

August 12, 1968

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on August 13, 1968

FIRST PARAGRAPH

The information reviewed at this meeting suggests that some elements of economic activity continued to expand vigorously in early summer. Expansion in over-all activity, however, is likely to slow considerably in coming months as a result of the new fiscal restraint measures and a marked reduction in inventory accumulation. Industrial prices have been increasing less rapidly in recent months, but consumer prices have continued to rise substantially. Wage pressures remain strong, and the recent wage settlement in the steel industry was followed by announcements of steel price increases. Both short- and long-term interest rates have declined considerably, in large part as a result of expectations of easier credit conditions. Bank time and savings deposits, particularly large-denomination CD's, have expanded sharply in early summer; growth in the money supply has continued large as U.S. Government deposits have been drawn down further on average; and growth in total bank credit has been unusually rapid. Although the U.S. balance of payments has recently shown a marked improvement, the foreign trade balance and underlying payments position continue to be matters of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of 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, on balance, about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be significantly exceeding current projections.

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 less firm conditions in the money market; provided, however, that operations shall be modified if bank credit appears to be significantly exceeding current projections.

ATTACHMENT B

CONTRIBUTION OF "PROXIMATE" DETERMINANTS TO RATES OF CHANGE IN THE MONEY SUPPLY

Monthly Averages of Daily Figures - Seasonally Adjusted

	Annual Rate of Change in Money Stock *		
	Dec. 1967 June 1968	Dec. 1967 Mar. 1968	Mar. 1968 June 1968
1. Banking System			
Borrowing from Reserve Banks	3.4	8.5	- 2.1
Excess Reserves	- 0.5	- 1.7	0.7
Bank Structure 1/	1.1	2.4	- 0.2
Other Banking 2/	0.5	0.2	0.6
Total Banking	4.5	9.4	- 1.0
2. Public			
Currency Held	- 9.9	- 9.1	- 10.8
Time Deposits at Member Banks	- 0.4	- 0.8	- 0.1
Total Public	- 10.3	- 9.9	- 10.9
3. Government			
Demand Deposits at Member Banks	2.0	- 1.7	5.6
4. Other Reserve Factors 3/	- 6.0	- 9.7	- 1.9
5. Total of 1, 2, 3, and 4	- 9.8	- 11.9	- 8.2
6. Federal Reserve			
Federal Reserve Portfolio	22.0	27.2	16.8
Reserve Requirement Changes	- 5.3	- 10.5	0.0
Total Federal Reserve	16.7	16.7	16.8
7. Rate of Change in Money Stock	6.9	4.8	8.6

1/ Shifts in deposits among classes of member banks.

2/ Net of member bank demand balances "due to" and "due from" banks, and nonmember bank demand deposit component of money.

3/ Factors determining total member bank reserves other than Federal Reserve Holdings of U.S. Government securities, member bank borrowing from Reserve Banks, and currency held by the public.

* June data are preliminary.

Federal Reserve Bank of St. Louis
August 9, 1968