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, May 28, 1968, at 9:45 a.m.

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

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

Messrs. 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. Hexter, Assistant General Counsel
Mr. Brill, Economist
Messrs. Axilrod, Hersey, Kareken, Mann, Partee, Solomon, and Taylor, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Cardon, Assistant to the Board of Governors

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

Messrs. Eisenmenger, Eastburn, Parthemos, Baughman, Andersen, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Richmond, Chicago, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York
Mr. Duprey, Economist, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee held on April 19 and 30, 1968, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee held on April 19 and 30, 1968, were 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 April 30 through May 22, 1968, and a supplemental report covering the period May 23 through 27, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the present atmosphere in the gold and foreign exchange markets was the worst that he could recall. Governmental policy failings, both here and abroad, had now so overstrained the machinery of international finance that the market sensed that technical operations by the central banks might no longer suffice to keep the situation from slipping out of control. Market distrust of national currencies had become general, and for the moment that was perhaps the only saving grace of the situation; that is, uncertainty was now so pervasive as to have an almost paralyzing effect on market judgments as to what currency realignments might result from a general breakdown. Any new dramatic event, however, might immediately galvanize the market into taking a strong view in favor of or against any one of a dozen major currencies, and so bring about heavy flows of hot money across the exchanges.

As the Committee knew, Mr. Coombs continued, the Treasury gold stock was reduced by $100 million last week, to a new low of $10,380 million. That had suggested to the market that the breathing space that had occurred since March was now over. As of today, the Stabilization Fund had only $33 million on hand, and if it became necessary to reduce the gold stock again next week--which

seemed all too likely--foreign central bank demand for gold might quickly snowball. As had been feared, the rise in the London free market price had panicked a lot of small central banks into buying gold from the United States. Within a matter of a few months, if not weeks, those continuing drains of gold to countries that were relatively small and unimportant in terms of world trade and finance would bring the gold stock down to the critical $10 billion level.

On the free gold market, Mr. Coombs said, the London price was providing financial markets and central bank governors throughout the world with a reading twice a day on the health of the international financial system. That price was accepted as reflecting the "insiders' view" and was having an exaggerated effect on attitudes in financial centers away from the main stream. Over the past month, the readings had shown a steadily rising temperature, reflecting further delays on the tax bill, the weakening of sterling, the general strike in France, and other disturbing developments. In response to a question at a Committee meeting several months ago, he had suggested that an uncontrolled breakout of the London price would have disastrous effects, and he had found no reason to change that view. The very fact that the London gold price could rise to $42.60 last week, despite the $3 billion of official gold that had been poured into the market between November and March, provided a fairly ominous indication of what was likely to happen as soon

as the present overhang of speculative gold holdings became absorbed in longer-term investment portfolios. There had been a time last December when it might have been possible, by joint action, to insulate the international currency system, and particularly the dollar, against the threat posed by the London gold price. Perhaps that opportunity would come again if, as he thought likely, the London gold price became a wildly disruptive influence not only in the exchange markets but in domestic financial markets as well.

Turning to the exchange markets, Mr. Coombs said he would defer his comments on the sterling situation until he presented his recommendations. The most spectacular event during the period, of course, had been the general strike in France, which had brought about the closing of the Bank of France and purely nominal quotations on the French franc in most markets. In New York, the Reserve Bank had been intervening for the Bank of France at a rate only slightly above the floor. Thus far the New York Bank had bought about $30 million of francs for the Bank of France, and he would not be surprised if it acquired another $20 or $25 million today. With a reopening of the French banks, he would expect to see continuing selling pressure on the franc. Over the longer run inflationary developments and rising imports in France would redound to the benefit of sterling and the dollar. In the short run, however, he thought little solace could be drawn from the

weakness in the French situation, since it would probably result in additional pressure on the gold market and through the gold market on sterling. Nor could one hope in the short run to see the French disgorging any significant amount of their gold stock. He would assume that if the Bank of France did have to intervene in sizable volume on the market the French would draw down not only their sizable dollar holdings but also their super gold tranche and gold tranche position in the Fund, amounting to $880 million, before selling any gold. Finally, the weakening of the French position increased the risk that any breakdown of the sterling parity might be followed immediately by corresponding action by the French Government.

Mainly reflecting pervasive market uncertainty, Mr. Coombs observed, there had not been much money moving across the exchanges and no further Federal Reserve drawings on the swap lines had been necessary. Since the preceding meeting of the Committee it had been possible to take advantage of a Canadian loan in Germany to supplement the System's existing holdings of German marks and pay down its mark debt from $275 to $225 million. Meanwhile, he had also been negotiating with both the U.S. Treasury and the Swiss National Bank regarding a shift to Treasury account of the System's present Swiss franc debt of $132 million. The Treasury had agreed

readily, but the negotiations with the Swiss had run into a number of difficulties. Yesterday he had arranged a swap through the Bank for International Settlements of $55 million of Treasury holdings of guaranteed sterling for Swiss francs, which would be used to pay down the System's Swiss franc debt. But the BIS had shown resistance to acquiring more guaranteed sterling on the grounds that they had more than enough sterling already. The Swiss were resistant to taking any more franc-denominated bonds from the Treasury. He thought it was ominous that, with the Swiss franc approaching its ceiling and with the hazards that lay ahead, the Swiss were becoming increasingly reluctant to accept what previously had been routine techniques for funding debts.

By unanimous vote, the System open market transactions in foreign currencies during the period April 30 through May 27, 1968, were approved, ratified, and confirmed.

Chairman Martin then said that he would report briefly on his recent foreign trip. Along with Mr. Coombs, he had attended the BIS meeting in Amsterdam on May 10 and 11. A morning session lasting about three hours had been devoted to the sterling balance problem, but that discussion had not been encouraging. The afternoon was devoted to the gold situation. That discussion also was not particularly encouraging, mainly because of unrest about the decisions that had been taken at the Washington meeting of gold pool

participants in mid-March. There was a great deal of discussion about the position of South Africa, and it was obvious that a number of the central banks represented at the BIS meeting would like to buy gold from that country. Most of the dissatisfaction was with the idea that a permanently binding treaty was entailed in the Washington agreement, but it was made clear that there had been no desire for a binding treaty--that the need was for continued cooperation in a workable approach to the gold exchange standard. Obviously, the other central banks were as anxious as the Federal Reserve to maintain the present system as long as it was viable. Thus, the discussion of gold policy was concluded in a reasonably satisfactory manner. Certainly no changes in the present arrangements were contemplated in the immediate future.

From Amsterdam, Chairman Martin continued, he went to Stockholm to participate in the celebration of the three-hundredth anniversary of the central bank of Sweden. Mr. Hayes also attended that celebration. He and Mr. Hayes then traveled to Puerto Rico for the Monetary Conference of the American Bankers Association, which was also attended by Messrs. Mitchell, Daane, and Ellis from the System. He thought it was fair to say that there was a great deal of unrest in evidence at that meeting and little hope about the outlook. That statement should be tempered, however, by the

fact that hopes would be bolstered and the outlook brightened considerably if there were a tax increase and an improved budgetary situation in the United States.

The Chairman then asked whether the others who had attended the ABA conference would care to comment.

Mr. Hayes remarked that he shared the Chairman's impression that there was pessimism in Puerto Rico with respect to the financial outlook, not only for sterling but also for U.S. affairs. Such a feeling seemed to be general among both foreign commercial bankers and central bankers. It was true that a ray of hope was seen in the possibility of fiscal action in the United States, but a statement he had heard repeatedly was that time was running out.

Mr. Daane said he had been asked by a reporter on the last day of the week-long conference whether he shared the view that only one story had emerged--the need for fiscal action in the United States--and had replied affirmatively. Secretary Fowler's final speech at the meeting represented a stirring call for fiscal action.

Mr. Mitchell observed that he agreed with the Chairman's comment on the conference. A great deal--more than he thought warranted--was riding on the tax bill, especially in the eyes of foreigners. They had made it a symbol transcending its real importance. The more perceptive foreigners were able to visualize

a situation in which the tax bill was not enacted, and they were prepared to live with the present situation until there was a new administration that might produce a change in fiscal policy. But they obviously would rather see the tax increase enacted now.

Mr. Mitchell added that he had found the remarks at the meeting of Professor Harry Johnson to be entertaining and enlightening. He suggested that copies be distributed to the Committee.

Mr. Ellis said he had heard a report that an administration head-count of Congressmen favoring fiscal action had yielded moderately pessimistic results. He asked whether the Chairman had any personal feeling as to how the vote might go.

Chairman Martin replied that while he had not made a head count and would consider doing so inappropriate for an official of the System, he was cautiously optimistic.

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

Mr. Coombs said he would begin with some comments on sterling. He thought that thus far the devaluation of last November had to be regarded as a failure. During the six months since devaluation the British had had to draw $2.6 billion of short-term credits, as compared with $2.2 billion in the six months up to the day before devaluation. While exports had responded to

improved profit possibilities, imports had continued to run at an unusually high level, apparently reflecting a lack of control over demand. The resultant continuing deficit had been further aggravated by consequences of the withdrawal of the Bank of England from the forward market and by the lack of any action to restrain the liquidation of sterling balances. Earlier predictions of a shift in the British position into surplus during 1968 were now being revised to forecasts of another sizable deficit. In short, the Committee faced a situation in which further provision of Federal Reserve credit to the Bank of England carried with it no real promise of reversibility. He was not making any recommendation as to whether or not the credit should be granted; his purpose was simply to give his estimate of the outlook.

Mr. Coombs recalled that at the Committee's meeting four weeks ago he had strongly urged that the British move immediately to draw the $1.4 billion standby available to them from the International Monetary Fund. Despite the repeated urgings of System representatives, negotiations between the U.S. Treasury and the British Treasury had continued to run into delays. The British would not make their request to the Fund until Friday, May 31, according to the latest information, and the mere mechanical process of collecting the money would take another ten days or two weeks. Meanwhile, France might well decline to put up its share of funds

committed through the General Arrangements to Borrow to finance the standby, which might result in further delay and probably in a fair amount of bad publicity.

As a result of all the time that had been lost in connection with the British drawing on the Fund, Mr. Coombs observed, the System had been placed in a seriously exposed position. If the British called on the Federal Reserve for financing all of their further reserve losses over the next two or three weeks, it was quite possible that the remaining $800 million under their swap line with the System could be fully exhausted. Even worse, if the swap line were to be exhausted before the British actually got the Fund drawing, the Committee would immediately be faced with the question of whether to increase the swap line still further or, alternatively, to risk a British decision to go onto a floating exchange rate. In the latter case the Fund standby might disappear--not to mention various other unpleasant consequences. He understood from Bank of England spokesmen that the British still intended to live up to their commitment to devote at least half of the proceeds of a Fund drawing to repaying debt to the System. But they might try to exact assurances that whatever margin under the swap line might be reconstituted by such repayment would remain unconditionally available for future use. Since such problems might come to a head between now and the next meeting, and since

the Account Management might well be confronted from day to day with British requests for further drawings on the swap line, it would be helpful if the Committee would provide guidance to the Desk.

Mr. Coombs said it was the view of the Desk that there was little assurance that further System credits to the Bank of England would be reversed within the span of time appropriate to central bank credits. There was a major risk that they might become frozen indefinitely. He was citing risks rather than making predictions, but he saw a very great risk here.

In evaluating possible courses of action, Mr. Coombs continued, one might note that the System was not compelled to assume such risks simply because it had entered into a standby swap arrangement. The System was in no way committed, morally or otherwise, to permit drawings on the standby unless it was satisfied that such drawings represented an appropriate use of central bank credit. As he had mentioned in his memorandum of May 20, 1968, to the Committee,[1/] not only the Bank of France but a number of other foreign banks had refused at times to permit the Federal Reserve to draw on its swap lines with them, indicating that they preferred

1/ A copy of this memorandum, entitled "Present Sterling Position," has been placed in the Committee's files.

alternative actions, such as a sale of gold or a U.S. drawing on the Fund. It was fully understood by all of the System's partners in the swap network, including the British, that the Federal Reserve retained the same discretion in extending credits. If at this meeting, or subsequently because of pressure from the British Government, the Committee were to introduce the concept of complete unconditionality for British drawings on the swap line, it would be making a basic change in the original concept of those facilities. It also would be creating an asymmetrical situation, in which the System would be extending credit on an unconditional basis while being able to secure credit only on a conditional basis.

Mr. Coombs observed that during the next few weeks the Committee might well have to exercise a judgment as to whether the Bank of England should continue to draw on the swap line. There were two major types of circumstances under which the Committee might wish to take a negative view. First, if there were further delays in the British drawing on the Fund, or other evidence of an effort by the British to shift the responsibility for defending sterling to the System, the Committee might conclude that a refusal to permit drawings was appropriate. Secondly, such a conclusion might be reached if there were some sudden new disruptive event--such as a spread of the current French disturbances to Britain or a new dock strike--that would so strain the British position as to make further defense of the $2.40 parity hopeless. In his judgment

the British situation had come very close to being hopeless last week, and it was entirely possible that with all the tinder lying around, a further spark might set off an explosion in the next week or so.

In seeking ways and means of relieving the harshness of the dilemma now facing the System, Mr. Coombs said, he had been able to develop only one new approach which might hold some promise. As he had mentioned in his memorandum of May 20, the British were practically out of cash in the form of dollars or other foreign exchange balances. They had, however, been holding untouched a last-ditch gold reserve which might amount to as much as $750 million free and clear of any pledges. He had tentatively raised with Bank of England officials the possibility of liquidating part of that gold reserve in order to meet their current market requirements. The reply had been that the British Government regarded that gold reserve as essential protection against their gold-value liabilities to the International Monetary Fund and consequently would be reluctant to sell it off, particularly since they might subsequently encounter resistance to repurchasing it from the U.S. Treasury. The System could, of course, press the Bank of England and the British Government to match any further drawings on the swap line by sales of gold to the U.S. Treasury. A debate on that score might

be quickly overtaken by events, however, and he was inclined to think that it might be the safer course, if the British had to pay out a sizable further volume of reserves, to offer gold loan facilities to the Bank of England. The one major advantage he saw in such gold loans would be in holding down British recourse to the System's swap line and so preserving the possibility of their completely clearing up the swap line through a combination of a Fund drawing and U.S. acquisition of guaranteed sterling. It might still be possible then to get the favorable psychological effect that had been hoped for from an announcement of full clearance of the swap line.

To this point, Mr. Coombs continued, he had been discussing the question of Britain's day-to-day cash needs. In addition, however, they had the problem of their month-end reserve report. As the Committee knew, the British recently had engaged in month-end window dressing operations, including funds received through overnight credits in their reported reserves. The U.S. Treasury had provided month-end overnight credits in amounts that had built up by the end of April to $700 million. As a result of developments in May Britain's needs would be considerably enlarged. At the same time, the U.S. Treasury probably would have to cut back its credits over the end of May, perhaps to $550 million. All told, Britain's

net need then might easily run to $350 million, and since it had about exhausted its European facilities, the System appeared to be the only remaining source. In the past a number of members of the Committee had indicated that they were averse to accommodating such window dressing, but in the present emergency circumstances the Committee might be willing to do so.

In conclusion, Mr. Coombs said he could find only one ray of hope in the sterling situation. The trade figures to be announced next month might show a turn for the better. If so, the Bank of England might be able to reinforce the resulting lift to confidence if it were to re-enter the forward market to create incentives for moving funds into rather than out of London. If, in addition, the British were to take some positive steps to resolve the sterling balance problem, there would be a possibility of bringing about a shift in favor of sterling. But too many "ifs" were involved to rely on such a turn of the tide. The more prudent course was to make the assumption for the short run that sterling might experience further serious problems.

Chairman Martin agreed that sterling was in a difficult situation and might well experience more trouble. On the other hand, there were some hopeful signs suggesting that the British might make progress.

The Chairman then asked Mr. Solomon to give the Committee his views on the British situation.

Mr. Solomon made the following statement:

The Committee has received Mr. Coombs' memorandum on the sterling situation and has heard his further comments today on this problem. There are two issues raised in Mr. Coombs' presentation on which I would like to comment to the Committee--presenting a somewhat different view from Mr. Coombs. The points have to do with the viability of the present sterling exchange rate of $2.40 and with the desirability of permitting additional drawings by the Bank of England on its swap line of $2 billion.

First let me say that the Board's staff in no way disagrees with Mr. Coombs on the desirability of a U.K. drawing on the Fund--the proceeds to be used insofar as possible to repay short-term debts, including those on the swap line.

Now as to the present exchange rate. Mr. Coombs notes that there are widespread expectations in the market that the present $2.40 parity will prove untenable. He states that he has "increasingly come to share the view of the market." I regard it as my duty to say to the Committee as forcefully as I can that it would be a serious mistake to accept and act upon the view that the present parity is untenable. Britain devalued almost 15 per cent six months ago and few countries followed. She adopted a powerfully deflationary budget in March--too late but certainly not too little. And she has just enacted a strengthened incomes policy.

Thus the preconditions exist for a sizable and sustained improvement in Britain's trade. What Britain needs is a little more time to let this improvement show itself. In my view it would be a tragic mistake to let bearish market sentiment override these objective facts. It is simply premature to judge the existing parity as untenable.

This leads me to a second issue raised by Mr. Coombs' memorandum--whether the Federal Reserve ought to discourage further drawings by the Bank of England on the swap line. I do not wish to dispute Mr. Coombs' view that swap facilities are not fully automatic and unconditional. What I do wish to say is that, in my view, it would be a serious error for the Committee to tell the Bank of England that the remainder of the $2 billion is not

available. It would be unfortunate if the U.K. authorities were to come to believe that the FOMC thinks that the present exchange rate is not viable. Beyond this risk, we must face the consequences of denying further use of the swap to the British. If the British were forced onto a floating exchange rate while a substantial portion of the swap remained unused, the Committee would have to be prepared to bear the responsibility for the chaos into which the international monetary system would be thrown. A run on the dollar by foreign central banks would undoubtedly follow. While this is a danger we are facing in any event, it is not a process that the FOMC itself would wish to precipitate.

While there may be a risk that the System will be stuck for a while with what Mr. Coombs refers to as a frozen asset, it is necessary in the present situation to balance one risk against another. The risk of international monetary chaos with a round of competitive devaluations must be balanced against the risks to the quantity of the System assets.

In fact, the dangers to the international monetary system are sufficiently grave that present circumstances can certainly be labeled as "exceptional circumstances"--that is, circumstances in which the Committee could agree to a delay in swap repayment beyond one year, if that should prove necessary.

It is perfectly proper for the Special Manager to bring to the Committee's attention the dangers he sees to the liquidity of the System's claims under the swap network. What the Committee needs to do is to weigh these dangers against the dangers to the entire monetary system.

I stress these problems today even though we now expect the United Kingdom to draw on the Fund and repay a substantial portion of the swap because the Committee ought to give Mr. Coombs guidance on U.K. use of the reconstituted swap line. After a part or all of the present outstandings are repaid, should the Bank of England be discouraged from further use of the swap? It seems to me that we ought to apply to the Bank of England what we do ourselves with our drawings on swaps; when we repay them via Fund drawings, gold payments or otherwise, we expect to be able to use them again.

Chairman Martin said he might report at this point on the status of the negotiations with the U.S. Treasury and the British that the Committee had authorized at its preceding meeting. An agreement had been worked out with the British under which they would repay their swap debt to the System in its entirety if they drew the $1.4 billion available to them under their Fund standby. In a telephone conversation shortly before today's meeting Governor O'Brien of the Bank of England had told him that they were prepared to repay the $1.2 billion currently outstanding on the swap line, assuming there was not a run on sterling later this week.

As the members would recall, Chairman Martin continued, at the preceding meeting the Committee had increased from $200 million to $250 million the limit on System holdings of guaranteed sterling. On May 10, he and Mr. Robertson and Mr. Holland had met with Under Secretary of the Treasury Deming and had urged Mr. Deming to press toward a resolution of the remaining difficulty in the Treasury's negotiations with the British, having to do with U.S. credits against U.K. military procurement. It was agreed that he (Chairman Martin) would suggest to the Committee that it authorize another $50 million in System holdings of guaranteed sterling, and that the Treasury would seek authority from the President to increase the Treasury's maximum holdings by $100 million. He would ask Mr. Holland to set forth the various figures relating to guaranteed

sterling holdings, which the members should have in mind. But the essence of the matter was that agreement in principle had been reached with the Treasury and if the Committee authorized another $50 million increase in System holdings of guaranteed sterling, the U.S. authorities would be in a position to conclude the negotiations with the British.

Mr. Holland said that at the time of the negotiations the System held $93 million equivalent of guaranteed sterling under an authorization for maximum holdings that had been increased from $200 million to $250 million at the Committee's April 30 meeting. The Treasury had holdings of $168 million under a maximum authorization of $300 million. The proposal was to raise the combined total of the U.S. authorizations to $700 million and then to acquire an additional $400 million of guaranteed sterling, for a combined Treasury and Federal Reserve total of $661 million. The increase of $400 million in U.S. holdings of guaranteed sterling would, in effect, provide the British with the funds to pay off their full debt under the Federal Reserve swap line, which then was $1.1 billion, on the assumption that the British would apply $700 million of their drawing on the Fund to that purpose.

Chairman Martin remarked that Governor O'Brien was fully aware of the importance the System attached to confining the use of the swap network to short-term obligations and was in complete agreement with that position.

Reverting to the question Mr. Ellis had raised earlier, the Chairman said present indications were that there would be a test vote in the House tomorrow on a tax increase coupled with a $4 billion reduction in budgeted expenditures for fiscal 1969. If that bill was not approved--and it probably would not be--it was likely, but not certain, that a bill calling for a tax increase and a $6 billion expenditure cut would be brought to a vote in a week or so. Chairman Mills probably would be reluctant to bring the bill to the floor unless he felt that it was likely to pass. After talking with Mr. Mills he (Chairman Martin) thought there was a good chance that the bill would be brought to the floor.

Chairman Martin went on to say that the present situation represented an exercise in "brinksmanship" much like that of mid-March. As the members would recall, the bill removing the gold cover requirement against Federal Reserve notes passed the Senate with a margin of only two votes at a time when the System's gold certificate reserves were only a shade above the 25 per cent requirement. If that bill had not passed there would have been no purpose in holding the Washington meeting of central bank governors on March 16 and 17. And if the tax bill failed now the difficulties would be great.

The Chairman said he thought it was quite possible that sterling would weather the current storm, although the disturbances

in France added another uncertainty. Indeed all of Europe seemed to be in a turmoil. Mr. Coombs had wisely pointed out the risks the Committee was facing, and his forthrightness was helpful. Nevertheless, he (Chairman Martin) agreed with Mr. Solomon that, having gone this far, the System did not want to push the British over the brink. Despite the hazards, he was clearly in favor of going the last mile with the British rather than tightening up at this juncture and saying the System would go no further down the road with them. Sterling had a chance; there was at least divided opinion as to whether the $2.40 parity could survive. If the British were forced onto a floating exchange rate, additional problems would be posed for the United States. Fiscal action in this country would certainly buttress the position of the pound. In fact, one reason the British had delayed drawing on the Fund was that they hoped to be able to tie that action to a change in U.S. fiscal policy.

In sum, the Chairman said, he would favor giving the Special Manager the authority, for the time being, to permit the British to draw on the remaining $800 million under the swap line, with full understanding by the Committee that the debt could become frozen. He would like to see the Committee move ahead at this juncture in the hope that the fiscal action needed would be taken and that it would prove possible to weather the storm. He would

also favor increasing the limit on System holdings of guaranteed sterling by an additional $50 million, to $300 million, on the same basis as the Committee had approved the increase from $200 to $250 million on April 30--namely, that he would be empowered to negotiate regarding the use of that authorization and the related question of a British Fund drawing. The increase would be made in the expectation that the Treasury would seek the approval of the President for a $100 million increase in their authorization. When negotiations were under way on May 10 it was understood that the Federal Reserve would warehouse part of the Treasury's acquisitions, pending today's meeting of the Committee. But the meeting date had arrived before the arrangements had been completed and he thought it better not to undertake warehousing operations at this point, but rather to increase the System's own authorization.

In a final remark Chairman Martin said Governor O'Brien had indicated that for internal reasons the British authorities were holding their plans with respect to a Fund drawing in the closest confidence. Accordingly he (the Chairman) asked that everyone present at today's meeting treat that information as highly confidential. The Chairman then called for discussion of System policy with respect to sterling.

Mr. Hayes observed that the Committee was greatly indebted to both Messrs. Coombs and Solomon for excellent presentations of

the essential issues, and he certainly would not challenge either presentation. He thought there was a real risk that System credits to the British would become frozen and he understood the Special Manager's reluctance to have the Bank of England make further drawings without a full understanding of the hazards on the part of the Committee.

At the same time, Mr. Hayes shared the Chairman's view, which coincided with that of Mr. Solomon, on the basic issue. He personally thought the $2.40 parity for the pound was probably viable. The problem was a psychological one of an irrational but strong speculation against sterling. That speculation was a market fact and the Special Manager was quite right in indicating that it could continue and might well become overwhelming. But since the lack of confidence in sterling was largely irrational--in view of the steps the British had taken--the rate was likely to prove viable if sterling could survive the current pressures. Moreover, the risk that System credits to the Bank of England might become frozen--with all that that would entail--had to be weighed against the risk that refusing to extend further credit might be the factor that pushed sterling off the precipice. In his judgment the latter was the greater risk; he would not want the System to take any action that would bring the crisis to a head. Assuming that the British went ahead with their planned

drawing on the Fund, he thought the course the Chairman had suggested was the correct one. If for some reason the Fund drawing was not made, the Committee might wish to review the situation again, perhaps in a telephone meeting.

Mr. Robertson said that in his judgment it was essential that the Committee approve the addition of $50 million to the limit on System holdings of guaranteed sterling. He thought it would be fortunate if it proved possible to work out a way for holding the line for the time being. He then submitted the following supplementary statement for inclusion in the record:

> With respect to British use of the swap line, I think in this field we have to be especially careful in distinguishing between what is and is not fair, wise, and equitable to all parties concerned. I recognize we may have to face up to the fundamental question of how much moré credit we are willing to authorize for the British, and that some very basic policy issues are wrapped up in that question. But, however much we may question the wisdom of _increasing_ the $2 billion swap line, I think further drawings--up to substantially the $2 billion market if needed--ought to be permitted if necessary and if requested in conformity with the usual "rules of the game" for swap line use. There is a degree of "moral commitment" involved in the $2 billion maximum level earlier established for the swap, and the Committee having agreed to such a policy limit, I think we should not then try to dictate British policy, by insisting that added restraints or conditions be attached to any further drawings under the existing swap.

Mr. Daane said he would support the increase of $50 million in authorized System holdings of guaranteed sterling. On the basic question, he thought the Special Manager had done the Committee a

service in outlining the risks in permitting further British drawings. He had a great deal of respect for Mr. Coombs' assessment of the situation, particularly since such assessments had been proved correct so often in the past. But he shared Mr. Hayes' view that the opposing risk, of precipitating a crisis by not permitting drawings, was the greater. Accordingly, he would favor permitting further British use of the swap line despite the fact that their debt to the System might become frozen. He expected the British to go forward with their Fund drawing and to repay all or most of their current debt to the System. If they did so, he thought it would be unwise to impose new conditions on their further use of the swap line. Once the line was cleared it should be available for future use on the same basis as in the past.

Mr. Mitchell asked whether Mr. Coombs would amplify on the risks he foresaw in connection with British drawings. In particular, was he concerned about the possibility that the credits might never be repaid, or only that repayment would be late?

Mr. Coombs replied that one could not say how long it would take, if ever, for the credits to be repaid. It should be remembered that the British were indebted not only to the System but also to the U.S. Treasury and to other central banks, for an over-all total of perhaps $5 billion. Conceivably, they might need as much as 30 to 40 years to repay debts of that magnitude.

Mr. Coombs stressed that he was not recommending any particular course of action to the Committee. Rather, he was indicating some possible courses and cataloging risks. The risk that repayment would be delayed for as much as 30 years was a serious one, and there also was some risk of complete default.

In reply to a further question by Mr. Mitchell, Mr. Coombs said the System was not exposed to an exchange risk under the terms of the contract embodying the swap arrangement, but parties to contracts were not always able to honor them.

Mr. Hickman remarked that he favored increasing the limit on guaranteed sterling holdings by $50 million. He also favored permitting the Bank of England to draw on the unutilized portion of the swap line if necessary; he did not see how the Committee could follow any other course at this point.

Mr. Brimmer said that from checks he had made recently he understood that Britain's total debt was between $5 billion and $6 billion, and that overseas sterling balances amounted to about $7 billion, of which $4 billion was officially held and the rest was in private hands. The magnitude of those sums suggested to him that there was not much prospect of Britain's earning enough to repay its debts in the foreseeable future, even if the trend of international payments shifted in its favor. He thought the issues might best be handled on a government-to-government basis rather than between central banks. If it was the decision of the

U.S. Government to continue to assist Britain he would favor having the System support that decision--recognizing that it would at best be a holding operation and that a substantial amount of System credit to the British was likely to be frozen for a long time.

Mr. Brimmer went on to say that at its meeting on November 14, 1967, the Committee had been presented with a generally optimistic view of the possibility of maintaining the sterling parity at $2.80. It subsequently was learned that by that date there was relatively little support remaining within the British Government itself for trying to maintain that rate. At present he had the impression that the determination of the British Government to maintain the $2.40 parity was weakening. Although he might be mistaken he suspected that if put to the test the British would shift to a floating rate. Accordingly, it might be well to give serious thought to the implications for the United States of a floating rate for sterling. In addition, it appeared that the continental Europeans were becoming less and less willing to help maintain the present sterling parity. He was particularly disturbed by the apparent attitude of the Swiss.

Mr. Maisel said he agreed with Chairman Martin with respect to the appropriate course for the System. He then summarized the following statement which he submitted for inclusion in the record:

I feel that the comments of the Special Manager and Mr. Solomon have been extremely useful. In the light of the prior comments, I would oppose the idea that the Federal Reserve ought to take a strong stand which would indicate in any way that we were unwilling to swap with the British up to the full limit of our $2 billion swap line, whether or not they draw first on the Fund. I would urge granting of credit while recognizing that we were taking a risk of having this line tied up for a considerable period. Any banker in making a loan takes such a risk. The problem is what is gained or lost by doing so. The question is what are the real costs if everything goes wrong. I don't see large risks in having a frozen asset, except psychologically, while I do see large risks to the United States in cutting off swap credit at the point when it is needed and desired by the borrower. It seems to me such a precedent would be extremely detrimental to our future. Recognizing that discretion can clearly be used, a policy of minimum discretion would be to our advantage.

I might note that I now urge allowing the swap line to be used even though formerly I did not favor the way it was expanded. Even though one can argue that everybody had his eyes wide open, I don't believe in sawing off a limb after having given someone every aid and support (if not urging) to go out on the limb. I felt and made clear in our meetings that I did not think the British were wise (even though it was to our benefit and that of other lenders by helping to maintain the existing system) in using as much credit as they did in attempting to maintain an over-valued pound and urged extreme caution in expanding the swaps. The credit was granted, however. From the Special Manager's account it is clear that paying off the forwards has been expensive. Most of what has been reported appears to be mainly an accounting shift in the form of the liabilities. It is not a sign of additional weakness. Now that the pound is obviously less over-valued and perhaps not over-valued at all, they should certainly not be told that the credit is not available except under special conditions. It seems to me that a lender should always try to put himself in the seat of the borrower to see what terms appear fair and logical. It seems to me that after weighing our relative risks it would be most prudent to keep our conditions at a minimum.

Mr. Sherrill remarked that he also favored proceeding along the lines the Chairman had suggested. He did not think the System should back off at this point.

Mr. Swan agreed. He then referred to Mr. Coombs' comment that the French might not be willing to put up the funds they had committed through the GAB to help finance the British Fund drawing, and asked whether such action would raise the possibility that the drawing could not be made.

Chairman Martin said he thought there was some question as to whether the French could opt out, even though they might well want to do so in light of recent developments in France.

Mr. Solomon agreed, noting that the only acceptable grounds for a French refusal to participate would be balance of payments problems which did not exist at this point. If they declined to participate anyway, in his opinion their share would be taken up by other members of the GAB. Thus, he doubted that the British drawing would fail to go through because of any action by the French.

Mr. Daane said that was his understanding also. The other members of the Common Market presumably would put considerable pressure on the French to get them to participate, but if those efforts were unsuccessful it was his impression that France's share would be redistributed.

Mr. Hayes said he would dissent strongly from Mr. Maisel's view that it had been a mistake for the British to try to defend the $2.80 parity last fall. It seemed to him that subsequent developments had lent support to two principles. First, devaluation was not a panacea in a situation such as that the British had then been in; it had created new problems, and had underscored the need for cooperative international action. Secondly, the very fact of devaluation set in motion enormous waves of speculation and undermined confidence in general. Accordingly, in his judgment all the efforts that had been made last fall to avoid the devaluation of sterling had been worthwhile.

Mr. Coombs remarked that it was highly comforting to the Account Manager to have the members of the Committee take the position they had today. He wanted to make it clear that the Desk had never recommended that the Committee shut off all credit to the British, and in effect, push sterling over the cliff. Its main concern had been to alert the Committee to the risks in the present situation, and to suggest that if there was a new run on sterling the Committee might wish to review its position and not simply leave it to the Desk to pour out funds. The speed with which the British could lose reserves was illustrated by the fact that they had drawn $500 million on the swap line on the last day of the $2.80 parity.

Mr. Coombs then asked whether he should interpret the Committee's discussion today to mean he was authorized to permit the British to draw any amount on the swap line up to the full $800 million presently unutilized.

Chairman Martin said he thought it was clearly the decision of the Committee to go forward on that basis. Of course, circumstances might arise that would require a further review by the Committee, and the members would rely on the Special Manager to advise them if that was the case.

Mr. Robertson said it should be crystal clear that the Committee did not intend to change the rules of the game with respect to swap drawings. If the pressures became too heavy Mr. Coombs presumably would call for further instructions from the Committee.

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

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

The Committee considered the matter of possible month-end overnight drawings on the swap line by the Bank of England that Mr. Coombs had mentioned earlier. In response to questions by Messrs. Scanlon and Mitchell, Mr. Coombs said that information on any such credits, along with all other drawings under the System's

swap network, would be included routinely in his published semiannual report. After further discussion it was agreed that overnight System credits to the Bank of England would be appropriate in the current emergency circumstances.

Chairman Martin asked Mr. Coombs to present his further recommendations.

Mr. Coombs reported that the $100 million standby swap arrangement with the Bank of France would mature on June 28, 1968. He recommended its renewal for a further term of three months.

> By unanimous vote, renewal for a further period of three months of the $100 million swap arrangement with Bank of France, maturing June 28, 1968, was approved.

Mr. Coombs recommended renewal for a further period of six months of the $50 million fully drawn portion of the swap arrangement with the National Bank of Belgium, which would mature on June 24, 1968.

In response to questions, Mr. Coombs said that the System's total facility of $225 million with the National Bank of Belgium consisted of this $50 million fully drawn portion and a standby facility of $175 million. The fully drawn facility had been established at the initiative of the Belgians for reasons relating to their domestic financial situation. It was the only such facility in the System's entire network, and he had suggested repeatedly to the Belgians that the full $225 million line be put

on a standby basis. However, they preferred the present form of the arrangement. No part of the $50 million facility was in active use at present.

> By unanimous vote, renewal for a further period of six months of the $50 million fully drawn portion of the swap arrangement with the National Bank of Belgium, maturing June 24, 1968, was approved.

Mr. Coombs then reported that two drawings under the standby portion of the swap arrangement with the National Bank of Belgium, of $35 million and $10.6 million, respectively, would mature on June 12 and June 19, 1968. He recommended their renewal for further periods of three months, observing that both would be first renewals. However, as he had noted at the previous meeting, the standby portion of the Belgium swap line had been in active use since July 26, 1967, so that if the drawings in question remained outstanding for another two months the line would have been in active use for over a year. He hoped it would be possible to acquire the Belgium francs needed to repay the System's debt either through the issuance by the Treasury of a franc-denominated bond or as a result of the British drawing on the Fund.

> By unanimous vote, renewal for further periods of three months of two System drawings on the National Bank of Belgium, maturing June 12 and June 19, 1968, respectively, was authorized.

Mr. Coombs recommended renewal for a further period of three months of a $225 million drawing on the German Federal Bank that matured on June 21, 1968.

Renewal of the drawing on the German Federal Bank was noted without objection.

Mr. Coombs then reported that two System drawings of Swiss francs would reach the end of their second three-month terms soon. One was a $77 million drawing on the Swiss National Bank that matured on June 18, 1968; the other was a $55 million drawing on the BIS that matured on June 21. As he had mentioned earlier, arrangements had been made with the Treasury and the BIS to clear up the $55 million drawing, but he would recommend renewal of that drawing in case some difficulty developed. He would also recommend renewal of the drawing on the Swiss National Bank. The System's two Swiss franc swap lines had been in active use since June 2, 1967 and hence the one-year mark would be reached in a few days.

By unanimous vote, renewal for further periods of three months of the System's Swiss franc drawings on the Swiss National Bank and the Bank for International Settlements, maturing June 18 and June 21, 1968, respectively, was authorized.

Mr. Coombs then remarked that the Swiss franc drawings raised the question of Treasury backstop facilities for System swap debts in general.

Chairman Martin noted that the Committee had planned to discuss the question of backstop facilities at today's meeting, in the expectation that a memorandum from the Treasury on the subject would have been available earlier for study by the members. However, a rough draft of the memorandum had been received from the Treasury only this morning; because of the press of other duties, Mr. Deming had not been able to turn to the matter as early as he had hoped. Rather than holding a Committee discussion of the current draft, he (Chairman Martin) might undertake to discuss its content with Mr. Deming, in the expectation that a revised version would be distributed to the Committee before the next meeting and placed on the agenda for consideration then.

There were no objections to the procedure the Chairman had suggested.

Mr. Coombs reported that two Bank of England drawings would mature soon--one for $50 million on June 11, 1968, and the other for $300 million on June 28. The latter had already been renewed once. As he had noted at the previous meeting, the Bank of England had been making active use of the swap line since June 28, 1967, so that the one-year period would be reached in a month. In light of the discussion earlier today he presumed that the Committee would authorize renewal of the two drawings in question.

By unanimous vote, renewal for further periods of three months of two drawings by the Bank of England, maturing June 11 and June 28, respectively, was authorized.

Finally, Mr. Coombs said he would recommend renewal of certain System forward commitments that matured soon. These were commitments for $5.345 million in Dutch guilders that matured for the first time on June 13, 1968; for $13 million in Swiss francs that matured for the first time on June 20; and for $21.25 million in Swiss francs that matured for the second time in the period June 19-24, 1968.

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

In conclusion, Mr. Coombs noted that System drawings on the Bank of Italy had been initiated in September 1967 and that the lire debt now outstanding amounted to $500 million. There was little prospect in the next few months of acquiring through market transactions the lire needed to repay that debt, since the Bank of Italy was likely to be accumulating dollars during the summer tourist season. If the British made a drawing on the Fund it might be possible for the System to obtain a moderate amount of lire from them. However, it was not likely that the System's lire debt could be fully cleared up unless the Treasury made a drawing of lire on the Fund. Accordingly, he thought there was a strong case for urging the Treasury to do so.

In response to a question, Mr. Coombs said the System had not made any drawings on the Bank of Italy during the past month. It was likely that further drawings would be necessary during the tourist season, however.

Chairman Martin said that if there were no objections, it would be recommended to the Treasury that it move in the direction Mr. Coombs had suggested. No objections were voiced.

Chairman Martin then asked Mr. Holland to comment on the memorandum from the Secretariat dated May 24, 1968, and entitled "Proposed revision of foreign currency directive."[1/]

Mr. Holland noted that, as Chairman Martin had mentioned earlier, it had been contemplated in the course of the recent negotiations with the Treasury that the System would warehouse some of the Treasury's holdings of guaranteed sterling. On November 14, 1967 the Committee had amended paragraph 1C(1) of the authorization for System foreign currency operations for the purpose of enabling the Desk to warehouse such sterling for the Treasury. The Committee had subsequently permitted the revision to stand although in fact no warehousing operations had been carried out thus far. Recently it had been noticed that the Committee's action of November 14 was not complete. Specifically, a conforming change in paragraph 4 of the foreign currency directive, which listed the purposes for which

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

forward transactions could be made, was required if the Desk was to be authorized to warehouse sterling for the Treasury. The Secretariat recommended that this be done by adding at the end of clause (iv) of paragraph 4 of the directive the phrase "and to facilitate operations of the Stabilization Fund."

> By unanimous vote, paragraph 4 of the foreign currency directive was amended, effective immediately, to read as follows:

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

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period April 30 through May 22, 1968, and a supplemental report covering May 23 through 27, 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 saw financial markets reach the depths of despair about the willingness and ability of Congress and the Administration to take needed action on taxes and Government spending. Interest rates, as the regular written reports to the Committee and the blue book[1] spell out in some detail, rose sharply in all maturity areas, with key Treasury bill rates reaching new trading highs. The Treasury was forced to support what had appeared to be an attractive new intermediate issue in the secondary market. In the corporate market a new double-A rated utility issue was marketed at 7 per cent while two small high-grade Canadian issues were placed at 8 per cent. And the municipal market was quite generally--and properly--described as a disaster area. If ever markets were speaking directly and forcibly about the need for fiscal action, this was the time, and I trust the message was heeded in the proper places. A considerably better tone has prevailed in the past few days as hopes for fiscal action have revived, but although some new corporate and municipal issues were postponed, the calendar of new issues has been rising, and the period of peak Treasury needs is near at hand.

The situation is not beyond retrieval--as I believe the markets have been saying. But the process of delay has brought the general level of interest rates to the point where the small leeway that commercial banks had under the new Regulation Q ceilings has evaporated and competition from market instruments will be felt by all financial institutions. Even though prompt action on fiscal policy could bring some further declines in short rates, it is questionable whether--in light of Treasury needs--some degree of disintermediation can be avoided.

Market developments provided a complicated backdrop for the Treasury's May refunding, which, as you know, included a cash offering that raised about $2 billion. The announcement--the day after the Committee last met--that the Treasury would offer two 6 per cent issues was very well received by the market. In fact, there were some early fears that excessive speculative interest

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

might develop. However, the President's statement on Friday of the same week that a $6 billion spending cut was unacceptable quickly put a wet blanket on this ebullient atmosphere, and there was a risk that the over-all financing would be a complete failure. The situation was saved, a few minutes before 1 p.m. on Monday, May 6, when the House Ways and Means Committee announced it was prepared to go along with the fiscal package endorsed by the joint House-Senate Conference Committee. Actually, the exchange for a new 7-year note was better than had generally been expected, and the 28 per cent allotment of the 15-month note fell at the lower end of market expectations.

By May 15, however, the settlement date for the new issues, another sharp shift in expectations about fiscal policy action demoralized the market, and the new 7-year note fell to a discount of as much as a full point. In this atmosphere the Treasury was justifiably concerned about the capital losses inflicted on the underwriters of the new issues and purchases, in two separate operations, about $300 million of the new longer-term note and other intermediate-term Treasury securities. It should be noted that the Treasury did not intervene with an interest rate objective in mind but in order to reduce sizable dealer inventories. It was hoped that a better technical market position would help dealers absorb securities being offered by private investors and at the same time sustain dealer capacity as underwriters of Treasury securities.

Given shifting market expectations, it is not surprising that the pattern of money market conditions that emerged over the period was not precisely the one anticipated at the time of the last Committee meeting. Early in the period, the 3-month Treasury bill rate appeared stuck at or below the lower end of the range expected at that meeting. The Federal funds rate, on the other hand, persisted above 6 per cent, and, in fact, touched a new high effective rate of 6-1/2 per cent even though net borrowed reserves were not very much changed. It appears that banks, feeling the cumulative impact of tight money, became more willing to pay up for funds--partly to preserve their use of the discount window for later on when they anticipated a rise in credit demand and a squeeze on CD's over the June tax date. This expectation of tightness was strengthened by concern that Federal Reserve policy would become even more stringent.

The taut money market--reflected quickly in dealer borrowing costs--began to exert a modest upward pressure on interest rates. But the temporary abandonment of hope for fiscal policy action was the basic force that drove the bill rate well above the upper end of the range considered by the Committee four weeks ago. This occurred even though the Federal funds rate had receded by that time from the high level that had prevailed. By last Friday the general pattern of money market conditions had generally come into line with earlier expectations, but how long this will last is anybody's guess. It should be noted that in yesterday's Treasury bill auction, average rates of 5.69 and 5.87 per cent were set, respectively, on 3- and 6-month bills. These rates are 19 and 26 basis points above those established in the auction four weeks ago, but 23 and 22 basis points below the interim peak levels.

As the written reports indicate, System open market operations over the interval were largely directed to countering the tendency towards undue tightness in the money market. Repurchase agreements--at 5-3/4 per cent--totaled $2.8 billion over the period, although none were on the books at the close. As noted earlier, the Federal funds rate tended to run higher than reserve levels indicated was necessary, and when the funds rate tended to decline at the close of statement weeks, no effort was made to offset the momentarily easier conditions. Late in the period the state of the securities markets became a cause for increased concern, but reserve objectives did not have to be set aside. On May 16, when the Treasury made market purchases of the new 7-year note, the System also bought outright $300 million Treasury bills early in the morning. And last Wednesday--when rates were again rising rapidly in a demoralized market--the System bought Treasury bills and coupon issues for regular delivery in anticipation of reserve needs in the current statement week.

Looking to the period immediately ahead, it appeared late last week that there would be a modest need to supply reserves over the next two statement weeks, but the actual outcome will depend heavily on the British situation described by Mr. Coombs. Current swap drawings are likely to provide most of the reserves that will be needed, while swap repayments out of the proceeds of an IMF drawing would--later on--create a substantial reserve need. Thus, domestic open market operations are apt to be affected even more than usually by developments on the international side.

As far as money market conditions and interest rates are concerned, I have little to add to the blue book discussion of likely developments in the period ahead. Markets are certainly likely to be sensitive to both domestic and international developments, and as a result the various market indicators, collectively or individually, may be subject to abrupt and unexpected movements. Certainly, prospects for fiscal restraint are critical for interest rates and for the market's evaluation of the likely direction of monetary policy. The recent and prospective sluggish behavior of the bank credit proxy reflects the impact of the competition of market rates on bank time deposits. Mid-June will provide a test for the banking system and the markets, but how serious a test depends heavily on the state of expectations--and interest rate levels--at the time. The market has regained a fair measure of confidence in the past few days, and interest rates have moved down sharply from their recent peaks, but all this is subject to change on short notice. Congressional failure to act on the restraint package could quickly put the market on the ropes again.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period April 30 through May 27, 1968, were approved, ratified, and confirmed.

Chairman Martin noted that two memoranda dealing with System repurchase agreements had recently been distributed to the Committee. The first was a memorandum from the Manager dated May 22, 1968, and entitled "An Examination of Competitive Repurchase Agreements;" the second, prepared by Mr. Keir of the Board's staff, was dated May 27, 1968, and entitled "Pros and Cons of an RP Rate Independent of the Discount Rate."1/ The Chairman suggested that although the

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

Committee had planned to consider this matter at today's meeting, the discussion be deferred until the next meeting so that the members could have further opportunity to study the memoranda.

There were no objections to the Chairman's suggestion.

Chairman Martin then called for the staff economic and financial reports, supplementing the written reports that had been distributed prior to the meeting, copies of which have been placed in the files of the Committee. At this meeting the staff reports were in the form of a visual-auditory presentation and copies of the charts have been placed in the files of the Committee.

Mr. Brill made the following introductory statement:

> Our presentation this morning centers once again on the implications of fiscal restraint for the economy and for monetary policy. This will be the fifth time in about a year and a half that the staff has come forth with a model--live and in color--of the economy operating under a tighter fiscal rein. The reason for this morning's rerun is not only that the latest shift in Congressional sentiment appears to raise the odds that a tax bill will pass. More importantly, it is because if the Conference Committee bill were passed, the country would be in for a very large dose of fiscal restraint, and the System would undoubtedly want promptly to reconsider its policy stance.
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> For purposes of today's presentation, we have assumed that the Conference Committee bill would be passed by early June, so that higher withholding rates for individuals would start by July 1. We program into the model, along with the 10 per cent tax increase, $6 billion in expenditure cuts--allowing, as the bill does, for some overage in Vietnam outlays and in other areas exempted in the bill.
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> Given the severity of this fiscal restraint, and given the time lags in seeing the results of a change in monetary conditions, we have assumed a prompt but moderate shift in monetary policy, one that would permit Treasury bill rates to drop rapidly to about the 5 per cent level,

and then drift off further to about 4-1/2 per cent before year-end. This would be consistent with a resumption in the growth of bank credit to a pace averaging about 8-1/2 per cent during the second half of this year.

Perhaps just a word is in order, before turning to the details of the model, as to why so prompt an easing of monetary policy was assumed in this exercise.

The answer is found quite clearly in our projection of the high employment budget. According to our calculations, the next year would witness a net swing in this budget of $24 billion toward surplus. By comparison, the movement in the 1958-60 period, often assigned a major role in the recession of 1960, looks relatively mild. And although our economy is larger now than in 1960, it could scarcely take this degree of fiscal restraint--together with the present degree of monetary restraint--without heading into a recession.

Mr. Wernick then discussed the projection of nonfinancial developments:

The path of GNP growth thus far in 1968 points clearly to the urgent need for fiscal restraint. Our projection for the second quarter implies an even larger dollar increase than the record first-quarter gain. In real terms, growth this quarter is projected at a 7 per cent rate, with the deflator rising at a 4 per cent rate.

Fiscal restraint is expected to slow the growth of GNP promptly. In the second half, the quarterly increase should drop to an average of under $13 billion--with further deceleration expected in the first half of 1969, when the full effects of the fiscal restraint package are felt. Real GNP growth is projected to decline sharply from the recent excessive pace to an annual rate of only about 1-1/2 per cent by early 1969.

The shift in the Federal budget is the critical factor slowing economic growth. Higher tax rates lift receipts substantially. With increased withholdings assumed to start July 1, receipts rise rapidly in the third quarter, and then accelerate again early in 1969, reflecting large final settlements of 1968 tax obligations and increased Social Security taxes. And as projected

Government expenditures level off and then decline, the Federal budget position changes dramatically.

The NIA deficit--at a $10 billion annual rate in the second quarter of this year--is sharply curtailed by the last quarter of 1968, and shifts to a surplus of $8 billion by the second quarter of 1969--a swing of $18 billion in just a year. And as Mr. Brill mentioned earlier, the change in the high employment budget deficit is even larger.

While the restraining effects of the fiscal package would come initially from higher taxes, the course of Federal expenditures would also change dramatically. The assumed budget cuts would probably have little early impact on GNP growth because of the momentum of outlays already in train and the scheduled increases in civilian and military pay on July 1. But total purchases are projected to level off in the fourth quarter and to decline by next year, with about half the budget cut coming in non-Vietnam defense outlays. Meanwhile, budgetary reductions in grants-in-aid, transfer payments, and other items would halt the growth in other NIA expenditures after the third quarter, and these expenditures would then taper off.

The restraint from the tax side of the package works mainly through its effect on consumer disposable income. Largely as a result of higher taxes, the change in disposable income in the third quarter would be less than one-third as much as in the current quarter. Income growth slows again early in 1969, as employment gains are reduced sharply, as Social Security taxes rise, and as the impact of retroactive income taxes is felt.

Consumer buying should be moderated by the smaller growth in spendable incomes, although a projected decline in the saving rate would help cushion the impact on consumer expenditures. Durable goods spending would be most heavily affected. Sales of autos are projected to decline from an 8-1/2 million annual rate in the second quarter to a 7-3/4 million rate a year later. But there would also be considerable slowing in the rise of nondurable goods sales.

Nonetheless, these are relatively large increases in consumer expenditures, considering the size of the tax increase. We assume a sharp drop in the saving rate, reflecting the effect of smaller gains in income. We also assume that consumers anticipate an end to the higher tax rates and a rise in their spendable income after

mid-year 1969, when the surcharge would expire. By the second quarter of 1969, the projected saving rate is down from the high 7 per cent of recent quarters to about 5-1/2 per cent--the average of 1963-66.

The growth in final sales would thus be reduced by the accumulating weakness in Federal spending and consumer demand. And with prices rising, the projected rate of increase in final sales is well below the amount necessary to utilize the expansion in physical and manpower resources.

In this context, inventory investment could be expected to provide only moderate further stimulus through the remainder of this year. Indeed, part of the projected fourth-quarter increase would be involuntary because of the marked slowdown in final sales. And rising stock-sales ratios during the first half of 1969 should limit any further increase in the desired rate of inventory accumulation.

Fiscal restraint would also alter substantially the outlook for residential construction. While the increased monetary restraint to date is expected to reduce starts and construction outlays in the months ahead, activity is projected to pick up after year-end in response to easing supplies of mortgage money. By mid-1969, starts are projected to return to an annual rate of over 1.5 million units, and construction expenditures should also regain their present dollar volume--after falling about 7 per cent in the last half of this year. Building costs are expected to continue to be rising fairly rapidly, but the effect on expenditures should in part be offset by a further shift to multi-unit structures.

Business fixed investment is not expected to provide much stimulus during the projection period. Although expenditure levels should rise gradually--in part because of increasing prices--declining profits and low rates of capacity utilization should dampen any new resurgence of investment demand.

New plant and equipment outlays would be sufficient to lift manufacturing capacity by about 5 per cent over the next year. But, manufacturing output rises considerably less than this, and the rate of capacity utilization would decline, to about 82 per cent in the first half of 1969. This additional unused capacity should act as an important deterrent to passing cost increases through to higher prices.

The effects of a declining capacity utilization rate, pressures on costs, and relatively weak product markets

should have a marked effect on corporate profits. Profits before taxes are presently rising rapidly and are likely to total over $95 billion at an annual rate this quarter. By the second quarter of next year, profits before taxes are projected to dip by more than 10 per cent, to about the level in the final quarter of last year. After-tax profits would decline to about the levels that prevailed during the slow growth in the first half of 1967.

From the second quarter of 1967 to the second quarter of 1968, large demands for labor increased both employment and the civilian labor force substantially, following a 12-month period of relatively temperate expansion in these two variables. But in the year ahead, employment gains are projected to moderate again, in line with the anticipated reduction in the growth of real output. Since demands for manpower are diminishing, growth in the civilian labor force is also expected to fall below normal. The rise in the labor force, however, is likely to out-pace employment gains, and unemployment is expected to rise to close to a 4-1/2 per cent rate by the second quarter of next year, the highest since late 1965.

Easing in the demand for labor and resistance to increased costs in the private economy should begin to lay the basis for some dampening of the rate of growth of hourly compensation, but probably not until early 1969. Any significant reduction in these pressures takes time. Large wage gains granted in recent long-term contracts will continue to limit the response of average wages to slower output growth. Upcoming wage settlements in the important aluminum, shipbuilding, apparel, and steel industries will still take their cue from recently negotiated settlements in the 6 to 7 per cent range.

Advances in unit labor costs are projected to be only a little less than in the recent past. Easing in wage gains would be partly offset by slower growth in productivity, since the lower rate of growth of output indicated over the next year would mean less efficient use of labor and lower capacity utilization.

Since upward cost pressures remain strong, the rise in industrial prices is likely to pick up again soon following some recent easing. But the rise in industrial commodity prices could slacken considerably as fiscal restraint cools off business and consumer demands. And with the slow growth projected for industrial activity and the dip in capacity utilization, the more volatile sensitive materials prices would likely decline substantially by early next year.

For consumer prices, on the other hand, continued upward cost pressures at the retail level, together with lagged effects of earlier wholesale price increases, are likely to keep the total CPI moving up at a fast pace in the near future. We should see some moderation in the rate of rise by the end of this year, however, and in the first half of 1969 the rise in the CPI could slow a little further.

To sum up, the fiscal package would curtail the rate of growth in real GNP appreciably. Substantially slower growth in output, the rise in unused capacity, and the accumulation of relatively high inventories in relation to sales should moderate price rises. This pattern of price response was clearly evident in the first half of 1967, when the rise in the GNP deflator slowed along with a sharp decline in real GNP growth. Our past experience, however, clearly indicates that our real growth rate moves through much wider swings than the deflator. Since the response of prices to changes in the pace of economic activity is sluggish, the projected decline in the growth rate of the deflator from a 4 per cent annual rate currently to a little under 3 per cent a year from now is the most we probably can expect in so short a period. Nevertheless, it would be a significant first step in the easing of domestic inflationary pressures

Mr. Gramley continued the presentation, commenting on financial developments as follows:

As Mr. Brill noted in his opening remarks, the GNP projection assumes that monetary policy moves toward ease promptly following passage of the Conference Committee bill. Our discussion of financial market developments, therefore, might appropriately begin with some consideration of the shifts needed in financial markets to cushion the effects of the fiscal restraint package on demands for goods and services.

The projected housing pattern provides the main clue as to the extent and timing of monetary ease incorporated into the model. While we recognize that easier money has direct implications for other types of spending, the financial market requirements of the GNP model are most readily characterized by focusing on the housing sector.

The near-term outlook for the mortgage market suggests that housing will soon come under heavy downward

pressure, as the precursors of a sharp curtailment of commitments for construction are already in evidence. Thus, to realize the housing pattern shown for the year ahead, a quick turnaround will be needed in the flow of commitments in order to increase substantially the availability of credit for homebuilding.

Inflows into nonbank savings accounts are the most critical linkage in the housing picture. Net inflows for the first half of 1968--at less than a 6 per cent annual rate--have not yet shown the full effect of current high market interest rates. Yet, to obtain the necessary funds for housing, net inflows would have to rise to an annual growth rate of about 8 per cent during the second half of this year. And the upswing would have to occur soon. The present outlook for the June-July interest-crediting period is bleak, and the institutions will need assurance at that time that better days are immediately ahead if they are to continue committing funds to the mortgage market in volume.

The increase in savings inflows projected here would have to depend mainly on declining market interest rates, since aggregate personal savings are expected to fall with the tax increase.

To achieve the projected turnabout in savings inflows, short-term interest rates would have to decline quickly. We estimate that the yield on 3-month bills would have to be reduced to about 5 per cent in the third quarter, and to 4-1/2 per cent by the fourth. Short-term rates might drift down further in the spring of 1969, when the Federal budget is in surplus.

A decline in short-term rates of the magnitude projected would, of course, bring long-term rates down also. To be consistent with the movement of bill rates, the corporate AAA new issue rate would probably fall to about 6 per cent by the end of this year. The new issue rate might drop even lower, if the slower pace of GNP projected led investors to expect a further easing of monetary policy.

The immediate problem for monetary policy, however, would be to encourage rates to decline in the face of large Federal borrowing. Total Federal borrowing, including that of all agencies and Government-sponsored enterprises, should amount to more than $10 billion in the last half of this year, even with a tax increase. Though much less than in the last half of 1967, borrowing requirements of this magnitude--even though partly seasonal--would make it somewhat more difficult for monetary policy

to push interest rates down. To some extent, of course, interest rate expectations would be working on the side of easier money once the tax bill passed, but we could not count on expectations alone to do the job.

By the first half of 1969, on the other hand, the Treasury will be repaying debt in volume. Then, the problem for monetary policy might be to keep interest rates from declining too far, given the possibility that the fiscal restraint incorporated into the Conference Committee bill may terminate at mid-year 1969.

In contrast to Federal borrowing, household and business borrowing is projected to rise more in the first half of 1969 than in the last half of this year. The general rise in borrowing in the private sector partly reflects an increase in private expenditures. But the tax increase, together with ready availability of credit, should result in a rise in household and business borrowing relative to net investment. The projected ratio of borrowing to net investment, however, does not rise above the average we saw in 1961-65. In effect, we assume that the sustainment of private spending relative to income is partly financed by increased private borrowing and partly by a reduction in demand for financial assets.

These patterns projected for public and private borrowing would imply a volume of total funds raised during the second half of this year about equal to the high first-half level. The total is then projected to decline in the first half of 1969, reflecting the swing in the Treasury's borrowing requirements. During that period, with GNP growing slowly and total credit demands declining, a further easing of monetary policy would not be required to achieve our projected interest rate levels. But until then, getting interest rates down in the face of a continued level of total borrowing of about $90 billion, annual rate, would require that the banking system supply a significantly larger share of funds raised than we have seen so far in 1968.

The estimate of bank credit growth consistent with both the projected total of funds raised and the pattern of interest rates noted earlier, amounts to an annual growth rate of $30 billion--or 8-1/2 per cent--during the latter half of this year. By the first half of 1969, the growth rate of bank credit could recede a bit, along with the total of funds raised, and still maintain easier conditions in the credit markets.

The projection suggests that the banking system should experience a moderate pick-up in loan demands during the next year, relative to the average for the first half of 1968. Business external financing requirements would be increased by higher taxes, and banks are assumed to have sufficient funds available to supply these needs readily. But nothing very dramatic is projected, mainly because inventory building in the GNP model remains at modest levels. Consequently, banks would also have funds to purchase securities, especially State and local obligations, and their liquidity positions would improve somewhat. By the first half of 1969, however, our projection calls for banks to liquidate a modest amount of Treasury securities--during the period when the Treasury is retiring debt.

The projected upturn in the growth rate of bank credit during the second half of 1968 would likely be accompanied by a significant increase in time deposit expansion. The effect of declining market interest rates during this period would increase the willingness of the public to acquire time deposits, and it would also provide the banks with elbow room in the market for CD's. Time deposit expansion would perhaps slow up a bit in the first half of next year, when the saving rate falls further, and after the effects of changing yield relationships on transfers of existing asset stocks to time deposits have worn off.

For the money stock, recent rates of expansion have been unusually high--higher than we had plugged into our projection a few weeks ago. The recent experience seems to reflect the unusually high rate of GNP growth occurring in the second quarter, uncertainties about prospective developments in credit markets, and a marked decline taking place in the Treasury balance. We expect a reduction in the growth rate of money during the second half of 1968, as these temporary influences wear off. A further tailing off of growth in money balances in the first half of 1969 is projected, because moderated growth of income would temper the public's demand for money.

These projected rates of expansion in money and time deposits--which would require about a 6-1/2 per cent expansion in reserves over the next year--would represent a return to a substantially easier monetary policy than we have seen in recent months. But the growth rates projected would be well below those we saw in early 1967,

when monetary policy was much more expansive than projected for the year ahead. What we programmed into the model was the minimum amount of monetary expansion thought to be consistent with the chain of events described earlier--from expanded supplies of bank funds to lower interest rates, increased inflows to nonbank savings institutions, and the revival in housing that cushions the effect of sharply higher taxes and reduced Federal spending on the growth rate of GNP.

Mr. Hersey then presented an analysis of the balance of payments, as follows:

The enactment of the income tax surcharge may increase the chances of getting prompt ratifications of the SDR plan, and thereby help to strengthen the will of the sponsors of the March 17 communique not to buy newly mined gold. And if the fiscal action leads to improvement in the balance of payments, an early activation of paper gold may become more likely. The chances would then be reduced of further outbreaks of gold speculation such as that which pushed the gold price above $42 last week. With gold markets calmer, balance of payments improvement would surely diminish the possibility that foreign central banks would switch their dollars into gold.

This chain of pleasant ideas depends heavily on the view that the tax action would indeed lead toward significant reduction of the U.S. balance of payments deficit without too great a lag. What are the grounds for thinking so?

On capital account one might look for shrinkage of speculative outflows--except that there is little evidence up to now of any outflows, or failures of inflow, ascribable to doubts of the future value of the dollar. Apart from that, given our assumption that monetary policy would ease once the fiscal action were taken, no new improvement could be expected. Some worsening later this year is probably inevitable in those parts of the capital account that are subject to voluntary or compulsory restraint programs, which exerted strong effects in the first quarter. After the large reflow of U.S. bank-reported credit in the first quarter, net bank credit flows in either direction should

be small on balance over the rest of this calendar year, with or without changes in policy.

With respect to borrowings of Euro-dollars by U.S. banks through their branches and other placements of liquid funds in the United States by banks abroad, any easing of U.S. monetary policy would be expected--other things being equal--to result in less inflow of funds and accordingly in a larger deficit to be financed by official reserve transactions. However, these flows are notoriously difficult to predict. The inflow of funds from American bank branches in the first quarter this year, which accelerated in April and May, stood in sharp contrast with the outflow in the early part of 1967. This contrast reflects not only the change since then in U.S. monetary conditions, but also the shift in attitudes of holders of sterling from a temporary revival of confidence early last year to this year's persistent pessimism. This year's unexpectedly large inflow has been made possible by the flight from sterling--which has been pulled into dollars rather than into marks or Swiss francs by the much higher interest rates on dollar deposits--and has been accompanied by a heavy drain on U.K. reserves.

Through April, last November's devaluation of sterling had not yet worked through Britain's new export orders and deliveries sufficiently to have a visible effect on the trade balance. In large part the persistent deficit has been due to British imports swollen by restocking of materials and by a pre-Budget bulge in consumer buying. However, in March and April the real volume of imports may have begun to diminish.

Just as concern about the dollar and gold has been adversely affecting confidence in sterling, so an improvement in the U.K.'s basic balance and in confidence in sterling could be helpful for confidence in the dollar, even if it meant less intake of Euro-dollars by U.S. banks.

To return to the U.S. balance of payments--if the growth of GNP now slows as projected, there should be a slowing in the growth of imports, too. This is the main way in which the fiscal action can be expected to help the balance of payments in the short run of a year or so. Even sooner, the cessation of abnormal copper and steel imports will be helping.

The catastrophically low net export balance of goods and services in the first quarter reflected not only the import bulge but also the delays in exports occasioned by a port strike at the end of March. A year from now, if exports of goods increase by about 6 per cent, we may look for a merchandise trade balance of $3 billion annual rate in the first half of 1969, with the goods and services balance at about a $5 billion rate. This would still be far below the $8 or $10 billion we may need for a viable equilibrium without capital controls.

Though fiscal action would reduce the danger of disorderly conditions in the markets for gold and for dollars, the problems of financing the deficit a year from now look almost as difficult as ever. Over the past four quarters, with a net increase of $2.6 billion in U.S. liabilities to commercial banks abroad, the deficit on the reserve transactions basis before special transactions was $1.6 billion.

Because of the U.K. portfolio liquidation and massive Federal Reserve and Treasury Stabilization Fund financing of British reserve drains, the potential flow of dollars into foreign reserves was larger, amounting to $4.6 billion. However, $2-1/2 billion of this was absorbed by U.S. gold sales, partly to central banks and partly, through gold pool operations, to private persons whose purchases cost their central banks dollars. On balance, therefore, foreign reserve holders' claims on the United States increased by $2.1 billion. The major part of this increase was given exchange value guarantees through our swap operations or was financed with foreign currency debts. Central banks added only $600 million to their holdings of uncovered dollars.

Lasting adjustment of the balance of payments cannot be expected from cyclical variations in demand here and abroad. Even with the help we may eventually get from a cessation of fighting in Vietnam, we are likely to need a more favorable alignment of relative costs and prices than now exists. Relative to German equipment prices, the adverse shift from 1965 to 1967 is going farther this year. Whatever else may be done here or abroad to alter price and cost relationships, we cannot escape the necessity of checking excessive price rise in the United States. The longer-run significance of fiscal action for the balance of payments lies in the help it would give in checking inflation.

To underscore the difficulty of the adjustment problem that lies ahead, it may be worthwhile to recall the time, nine or ten years ago, when we were beginning to see what harm the price and cost inflation of the middle 1950's had done to our ability to expand exports. From 1956, when price advances were most rapid, on into 1959 the efforts of monetary and fiscal policy had been bent most of the time toward checking inflation. In 1959, with the cost-of-living rise slowing, with industrial commodity prices stabilizing, and with the country in the grip of a long steel strike, the rise in average hourly earnings in manufacturing slowed.

During the next several years prices were relatively stable, both as compared with earlier years and as compared with Europe's. Wages, too, rose more slowly than before. This was the period of improvement in our trade balance. Since late 1965 we have been in another period of excessive increases in prices and money incomes, with imports rising sharply and the trade balance again worsening. The slowing of the wage rise in the year ahead will be only gradual.

Unit cost increases result from the partial offsetting of wage increases by productivity gains. There is no prospect ahead of the kind of rapid productivity gains that helped to hold costs stable all through the early 1960's. And already unit labor costs in manufacturing are 9 per cent above the level maintained from 1959 to 1965.

We saw earlier the German prices of producers' equipment, an important index of competitiveness in international trade in manufacturers, were nearly stable from 1965 through 1967. Ours are now 9 per cent higher than in 1965. Given the upward shift that has occurred in our entire cost and price level, the restoration of a competitive position comparable to that of 1965 is no simple task. But clearly one essential element for any solution of this problem is a damping of domestic demand pressures.

Mr. Brill concluded the presentation with the following remarks:

The package of tax and expenditure adjustments put together in the Conference Committee bill would provide

fiscal restraint with a vengeance. The swing from deficit to surplus in the Federal budget is exceptionally swift and large. Of course, it may be that some of the proposed expenditure cuts or tax increases will be rescinded before the end of the fiscal year--after a new Administration comes into office--so that the degree of fiscal restraint actually resulting might be less than that implied by the bill. But on the other hand, the impact of higher taxes on private spending could well be greater than we have projected. Our estimates depend heavily on a willingness of consumers and businesses to accept the tax as a temporary levy, and to maintain high spending propensities. The probabilities of a stronger economy than our model portrays, therefore, can't be assumed to outweigh the possibilities of a weaker one.

Given the problems of inflation and the worsening of our balance of payments situation that have resulted from the excessive pace of activity, there can be no question that fiscal restraint is needed. But given the amount of restraint in the pending bill, the economy would skate perilously close to the brink of economic recession, with real growth declining abruptly to a very slow pace, and substantial slack developing in labor and plant resources in the first half of next year. From the standpoint of prices, we would be beginning to turn inflationary pressures around. With the continued cost pressures likely in the months ahead, however, the deflator would come down slowly, not dropping below a 3 per cent annual rate, according to our estimates, until next spring. In view of this sluggish price response, some may question whether monetary policy should seek to put the economy through a still tighter wringer.

The most urgent need for doing so would be associated with our international financial problems. We do expect the fiscal restraint package built into our model to provide a basis for improvement in our balance on goods and services, largely because it would reduce the growth of imports. But the longer-run problem of restoring competitiveness in our international trading position would remain. In the short-run, our main hope for keeping the glue in place on existing international financial arrangements lies in the possibility that measures of restraint here will convince other countries that we are serious about our intentions to curb inflation. That means we must see that the effects of fiscal restraint

are not fully offset by monetary ease. But our international position is not likely to be helped in the longer-run, either, by adoption of policies leading to economic overkill.

Maintenance of the present posture of monetary policy in addition to the proposed fiscal restraint would, in our judgment, result in overkill. We are already seeing in all financial variables the cumulative impact of the credit restraint put in train since last fall, and this is in process of being transmitted to the real economy. Credit flows through banks and other institutions have been sharply contracted, and the costs of borrowing funds at both short- and long-term have risen to exceptionally high levels.

Assuming passage of the Conference Committee bill, I am convinced that to avoid a recession next year the current tautness in financial markets would have to ease promptly. The degree of ease needed is by no means unusually large. Looked at from the vantage point of interest rate levels, we would be returning by the fourth quarter of this year to a posture of policy about like that prevailing in the early fall months of 1967.

A comparable picture of moderate monetary ease also emerges from the projected growth rates of money and time deposits. For both types of liquid assets, and especially for time deposits, the projected growth rates in the year ahead are well below the high levels we saw through most of 1967. It should be noted, of course, that the moderate rates of expansion expected in these variables partly reflect, in addition to Federal Reserve policy, the moderation in the public's demands for these assets coming from slower growth in incomes and the projected decline in the saving rate. All things considered, however, these rates of expansion in money and time deposits do not seem excessive in an economy reined in tightly by fiscal policies.

The problem for monetary policy in realizing the model we have outlined would lie less in the amount of monetary ease needed than in the speed with which it has to be accomplished. An increase in depositary-type inflows at the nonbank savings institutions, as well as at banks, must begin soon if monetary ease is to have the desired effects on construction and other activities by early next year. Passage of the Conference Committee bill, even by early June, would provide very little time

to get the job done. While the likely change in market attitudes would help, it might not help enough, or soon enough, if uncertainty over the stance of the monetary authorities persists. And we do have to keep in mind that within a few weeks, thrift institutions have to gird themselves for a major dividend and interest crediting period; banks have to face the loan and deposit pressures attendant on a corporate tax payment period; and the Treasury will have to begin massive financing operations. These are big hurdles to surmount.

Of course, in the absence of fiscal action, our problem in the weeks ahead may well be that of preserving the orderly functioning of the financial system. Even though bill rates have backed off from their recent peak, there is precious little leeway remaining between market rates, on an investment yield basis, and the ceilings on 90 to 179 day CD's. Indeed, most banks are about priced out of the CD market now all along the maturity range.

The consequence has been an inability of banks to recover their attrition in outstanding CD's over the April tax and dividend period; by mid-May, outstandings were still below the early April levels. And outstandings in New York in the latest week fell by another $34 million. The CD runoff would likely accelerate unless money market rates come down a bit further.

The staff estimates that if bill rates hold to the lower end of a 5-5/8 to 6 per cent range, the CD runoff in June could be kept to about $1 billion, or about $500 million more than seasonal. If rates tend to return close to the upper end of the range, the runoff could easily be twice as large.

As the tax and dividend period approaches, keeping bill rates toward the lower end of the projected range will likely require some generosity in dealing with developing pressures on bank reserves. This might mean permitting the Federal funds rate to stay in the lower end of the 6 to 6-1/4 per cent band over the next three weeks.

For net borrowed reserves, the figure might have to hover between $300 and $450 million. And even these money market conditions might prove too restrictive to hold bill rates in the range specified, if the Treasury were to announce sizable additional bill offerings in the next few weeks.

> Given the many uncertainties affecting the money market conditions projected and the consequences of alternative developments on CD flows, the band estimated for the credit proxy is specified with more hesitancy than usual--at from -1 to -4 per cent, annual rate. But in any event, the proxy seems relatively sure to record negative figures in June, barring some action by the System to improve the ability of banks to bid for CD's and other time deposits. The further contraction in bank credit will undoubtedly reflect bank liquidation of security portfolios, adding to pressures on long-term securities markets.
>
> In sum, so long as the fiscal package remains in a state of suspended animation, the System will have to guard against a resurgence of excessive tensions in financial markets, particularly as the tax payment date approaches. If it should become clear that fiscal action is not forthcoming, we might well have to cope with disorderly markets, at least in the short run. And if it becomes clear that the blessing of fiscal action is at last going to be bestowed on us, we will have to move promptly to ensure that financial conditions this summer cushion some of the impact of excessive fiscal restraint next winter.

Following the presentation Mr. Ellis asked if the staff would elaborate on the patterns projected for Vietnam and other defense spending in connection with the assumption that Federal spending would be reduced by $6 billion in fiscal 1969, and whether it would give its assessment of the likelihood that the $6 billion cut would actually be achieved.

Mr. Brill said he would ask Mr. Wernick to comment on the first question. As to the second, the Administration presumably would propose specific budget cuts totaling $6 billion, but the actual reductions made would depend in part on the willingness of

the Congressional appropriation committees to go along with the Administration's recommendations.

Mr. Wernick noted that the President had indicated at the end of March that expenditures for Vietnam would exceed estimates presented in the January budget document by $2.5 billion in fiscal 1968 and by $2.6 billion in fiscal 1969. Those increases had been incorporated in the budget totals given in the presentation. The $6 billion reduction projected for fiscal 1969 was assumed to consist of $3 billion in defense expenditures not related to Vietnam and $3 billion in nondefense expenditures. Thus, in the fiscal years 1968 and 1969 taken together, defense spending would be about $2 billion higher than the Administration had estimated in January.

Mr. Mitchell said he had two questions relating to possible monetary policy actions in the next three or four weeks if fiscal action were taken in early June. First, he gathered that the staff thought it was necessary to have a change in the attitudes of managers of thrift institutions before the midyear interest and dividend crediting period. It was not clear to him, however, whether the staff expected such a change to come about the easy way--through declines in market interest rates as a result of the impact of fiscal action on expectations--or whether it foresaw a need for intervention by the System; and if the latter, what degree of

intervention the staff expected to be required. Secondly, he would be interested in hearing the staff's views on the desirability of increasing Regulation Q ceilings in order to make interest rates on time deposits more competitive with other rates.

In reply to the first question, Mr. Brill said he could not specify in advance how strongly the market would respond to fiscal action. He suspected that there might be some hesitancy as market participants waited for clues to the System's intentions. If interest rates remained high for a protracted period--particularly through the entire interest crediting period, which might be considered to run from June 26 through July 10--an important opportunity to modify attitudes at, inflows to, thrift institutions might have been lost. Accordingly, he would recommend that the System stand ready to act, by whatever means appeared appropriate, to foster declines in interest rates to levels that would encourage increased willingness to commit funds to mortgage lending.

With respect to the second question, Mr. Brill said a need for an increase in Regulation Q ceilings was most likely to arise if fiscal action had not been taken by the time the interest crediting period began. But such action might create problems for some nonbank institutions--such as California savings and loan associations and New York State mutual savings banks--which might not be able

to afford an increase in the rates they paid on savings funds, unless the increases were made only for certain categories of their deposits.

Mr. Mitchell remarked that a strong, overt move toward greater monetary ease following fiscal action might well defeat the international objectives of the latter. Thus, unless market interest rates declined sufficiently of their own accord, the System was likely to find itself faced with a serious conflict of objectives.

Mr. Brill responded by noting that, as Mr. Mitchell had suggested earlier, the international community looked upon U.S. fiscal action as the _sine qua non_ of this country's financial integrity. Presumably fiscal action would provide enough reassurance abroad to give the System some latitude with respect to monetary policy. Certainly a recession in the United States next winter would not have a favorable effect on the attitudes of foreign holders of dollars.

Mr. Hayes said that to some extent he shared Mr. Mitchell's concern regarding the possible foreign reaction to an immediate marked easing of monetary policy after fiscal action was taken. Such an easing might well vitiate some of the effect on foreign confidence in the dollar expected from the change in fiscal policy, and that would be regrettable. He was not sure at the moment how

he would weigh that risk against the cost of putting somewhat more pressure on thrift institutions over the interest crediting period. He certainly did not feel that the conclusion was foregone.

Mr. Daane shared that view. It seemed to him that Mr. Mitchell's point was valid, and he hoped that the market reaction would suffice. In light of the general attitudes in Europe he was quite certain that it would be unwise for the System to rush to ease monetary policy immediately after enactment of the fiscal package.

Mr. Brimmer asked how the staff's projection of growth in real GNP might be revised if the assumption of prompt monetary easing was replaced by an assumption that the System delayed taking action for, say, three months after the fiscal package was passed.

Mr. Brill replied that while the staff had not made a formal projection on the basis of that assumption, the work that had been done suggested that the growth rate in the first half of 1969 would be considerably below the 1.5 per cent annual rate given in today's presentation. In that connection he might cite an econometric analysis recently made at the Office of Business Economics in which the fiscal policy assumption was the same as in today's presentation, but the monetary policy assumption involved no easing until the second quarter of 1969--at which time it was assumed that the discount rate would be lowered to 5 per cent. That monetary policy assumption was extreme and he would not necessarily agree with

other aspects of the analysis. Nevertheless, he found significant the conclusion that there would be no increase in real GNP in the fourth quarter of 1968 and declines in the first and second quarters of 1969.

Mr. Brill went on to say that one consequence of a delay in monetary easing would be to reduce the possibility of a timely revival in housing activity, which the Board's staff had projected would involve an increase in residential construction outlays of $2 billion, annual rate, between the fourth quarter of 1968 and the second quarter of 1969. Perhaps more important was the fact that in some respects the staff's projection of real growth in the first half of 1969 at a 1-1/2 per cent annual rate might be considered as optimistic. That growth rate was predicated heavily on the willingness of business to accumulate inventories at a modest rate; if, as projected in most other models, there was no increase in inventories, GNP growth could be lowered by $6 or $7 billion. The growth projected also was predicated on the willingness of consumers to adjust their saving rate to a level below what might be regarded as the long-term average. Both factors were likely to be quite important in sustaining the momentum of the economy, and it was questionable whether the momentum would be maintained if it became clear that monetary easing was to be delayed.

In reply to another question by Mr. Brimmer, Mr. Brill said he would expect the unemployment rate to rise to 5 per cent or more in the first half of 1969 if the growth rate in real GNP then was zero.

Mr. Hickman said he hoped the staff would explore the possibility of making an alternative projection based on the assumption of slightly less easing of monetary policy than assumed in today's presentation. He was disturbed by the fact that under the projection the GNP deflator would still be rising at a relatively high annual rate--2.8 per cent--in the second quarter of 1969 despite slow growth in real GNP. Public knowledge that the Committee was following a policy course under which average prices were expected to be rising at nearly a 3 per cent rate next year might well shake international confidence in the dollar, particularly since the fiscal policy package called for the higher taxes to be in effect only through the end of the 1969 fiscal year.

Mr. Hickman then asked if Mr. Hersey would indicate what effect the decline in the rate of increase in the deflator shown in the projection--from 4.0 to 2.8 per cent between the second quarters of 1968 and 1969--would have on the U.S. trade balance.

Mr. Hersey replied that he would find it extremely hard to make any quantitative judgment as to the effects of relatively small price changes on exports and imports in particular periods.

The difficulties were magnified by the fact that marked changes in international competitive relations could occur--for example, through the development of new products--independently of changes in price and cost measures. In general, he thought that over the period ahead U.S. foreign trade should be benefiting from cyclical expansion in Europe, with the benefits offset in part by less rapid growth in Japan and Canada. In the recent period domestic imports had been swollen by inventory accumulation and the copper strike, and import growth should tend to level off in the next several quarters. Thus, even in the absence of changes in price relations, he would expect considerable recovery in the trade balance from the low level to which it had fallen. But a number of years were likely to be required before the trade surplus recovered to the point at which the nation's balance of payments problem was resolved.

Chairman Martin commented that the staff's presentation today had pointed up well the problems with which the members should be concerned. The Chairman then noted the lateness of the hour and asked whether the Committee should not plan on continuing its meeting into the afternoon in order to complete the go-around of views on policy and to reach a decision on a directive.

Mr. Hayes said he thought the Committee would have relatively little difficulty in agreeing on policy today. If each member made a relatively brief presentation--submitting the text of any remarks

he had prepared for inclusion in the record--it should be possible to complete the agenda before lunch.

There was general agreement with Mr. Hayes' suggestion.

Mr. Hayes then summarized the following statement:

Even though statistical indicators turned somewhat mixed in April, the economy has not lost any of its exuberance. There is excess demand in all major sectors, and even residential construction is still moving on a high plateau rather than declining. Tight labor markets, mounting order backlogs, and declining inventory--sales ratios are familiar characteristics of an economy in which pressures of demand operate against limitations set by real factors. Pervasive inflationary pressures affect more and more the thinking and actions of businessmen and consumers.

In this environment, the procrastination of Congress in acting on the tax bill and the shadow-boxing on the precise dollar amount of the associated spending cuts have had serious destabilizing effects on financial markets. The financial markets have been buffeted by changing expectations and have undergone substantial rate adjustments. The banking system has come under greater liquidity pressure. Disintermediation has begun to add pressure on resources available to commercial banks as well as on thrift institutions as rates on money market instruments have moved up. An increasing portion of the growing volume of credit absorbed by the economy bypasses institutional channels.

In the meantime, our balance of payments is weakening in spite of first-quarter results that turned out somewhat better than expected, in part due to official operations. But the current quarter is likely to show a dramatic deterioration, and the outlook for the year as a whole is most discouraging.

The threats in the international area are by no means limited to the prospect for another year of large deficits in our foreign accounts highlighted by a sharply worsening trade account. Sterling remains weak. The events in France have been upsetting for many reasons, including the implications which they carry with regard to political stability in Europe.

All this has been occurring at a time when international confidence in the dollar has been strained by the long delays in obtaining appropriate fiscal action from Congress. Last week in Dorado Beach some of us had an opportunity for informal conversations with a number of bankers and officials from Western Europe. There were a great many comments to the effect that time is running out for the United States.

The period since our last meeting has been particularly trying. The fear of another credit crunch has been a major psychological element in financial markets, although it has given way to some feeling of euphoria in the last couple of days. None of us can predict the ultimate fate of the tax bill, but we can only hope that its future course will be less unnerving to the market than in the recent past. Prospects for a near-term end of hostilities remain as elusive as ever, and in the meantime defense spending continues to rise.

We are thus in a most difficult domestic and international situation. The overexuberance of the economy suggests the need for reduced availability of credit. In fact, however, we have achieved a considerable degree of firmness already. At times, we had to relieve some of the pressure coming from market forces rather than to push harder in order to achieve our aims. In the immediate future, the cumulative effect of our past actions and the approaching period of large-scale Treasury borrowing are likely to reinforce pressures on financial markets.

I do not see how the cause of internal and external stability could be served at this point by a further overt move on our part. If there is no fiscal action, however, another increase in the discount rate, and perhaps also, or alternatively, an increase in reserve requirements might become necessary in the not too distant future. For the time being, I would be content to leave the burden of maintaining firm credit conditions to open market operations. Maximum rates set under Regulation Q will bring banks under increased pressure which is likely to become very strong by the time of the mid-June tax payment date. Ultimately, interest ceilings may have to be raised again, but I would favor doing so only when disintermediation becomes a severe problem.

Our main objective should be to maintain continuously firm but orderly markets and to convey to the market clearly our wish to achieve only a moderate growth of

bank credit over a period of months. The path between a liquidity crisis, that can easily result if banks begin to lose funds rapidly, and the kind of sustained firmness that I have in mind is admittedly narrow. In view of the recent experience with rapidly shifting relationships among the various reserve and rate indicators, I would be reluctant today to be quite as specific as we normally try to be, although I have no particular quarrel with the ranges mentioned in the blue book.[1] In any event we must be prepared to let rates, as well as other market indicators, swing widely in response to day-to-day shifts in expectations.

The staff's draft directive[2] seems to me quite appropriate.

Mr. Francis submitted the following statement for the record:

Total demand for goods and services continues to rise excessively, adding to domestic inflation and intensifying our balance of payments problems with other nations. An examination of the record indicates that the expansionary fiscal and monetary developments in 1967 were in great measure responsible for today's excessive demands.

Since late last year, both fiscal and monetary actions appear to have become slightly less stimulative. Reflecting a slowdown in the growth rate of defense purchases, the high employment budget deficit is estimated to be about $10 billion in the first half of 1968 compared with over $12 billion in the second and third quarters last year. In the monetary sector, new member bank reserves have been supplied less rapidly since late last year, interest rates have risen, growth in bank credit has slowed markedly, and the increase in the money stock has gone down from a 7 per cent annual rate to about a 5 per cent rate.

A case can be made that these actions are still excessively expansionary. With the exception of last year and a brief period during the Korean War, the Government's

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1/ These ranges were as follows: The three-month bill rate, 5.65 to 6.00 per cent; the Federal funds rate, 6 to 6-1/4 per cent; net borrowed reserves, $300 million to $450 million; and member bank borrowings, around $650 million to $700 million.

2/ Appended to this memorandum as Attachment A.

high-employment deficit currently exceeds that in every period since World War II. Money has risen faster since January than it has in 85 per cent of all possible four-month periods since early 1948. When an economy has strong inflationary pressures and is finding foreign competition increasingly formidable, fiscal and monetary actions, according to traditional beliefs, should be relatively restrictive--not relatively stimulative.

On the other hand, a case might be made that recent actions have been in the appropriate direction and near the proper amount. For one thing, policy makers should avoid the greatly unsettling stop and go actions of recent years. With the advantage of hindsight, most of us can agree that restraint of excesses became too severe in 1966 and that stimulation during 1967 was too vigorous. Now that the country is experiencing the results of the excesses of last year, there could be a temptation to move too rapidly to restraint.

In view of the strong inflationary pressures and imbalances in the economy, what is an appropriate policy? Over the long-run GNP probably should rise at about a 5 per cent annual rate to provide for full employment and maximum growth with little inflation. If fiscal and monetary actions were sufficiently restrictive to keep GNP from rising at more than a 5 per cent annual rate during the rest of the year, however, substantial unemployment and declines in production could occur. Cost-push forces and inflationary expectations will almost inevitably continue to force prices up for some time, and so a sudden slowing in spending is apt to be largely reflected in production initially. It may be preferable for us, as policy makers, to recognize that these undesirable forces do exist and not attempt to eliminate them too quickly.

Hence, one might well conclude that the rather slow progress made so far this year in reducing the underlying causes of the excessive demands has been appropriate. Yet, if inflationary pressures are to be eliminated in a reasonable time, the underlying causes must be steadily and gradually withdrawn. For this reason we feel that now is the appropriate time for this Committee to take another small step toward less monetary expansion. To quantify the type of move we have in mind, open market operations in the near future might provide only enough reserves to reduce the growth rate of money from the recent 5 per cent annual rate to about a 3 per cent rate.

> For a while, this may result in somewhat higher interest rates, but as inflationary pressures are gradually reduced interest rates are likely to move lower.

Mr. Kimbrel observed that he hoped the measures of fiscal restraint would be adopted and that he was prepared to accept the draft directive. He submitted the following statement for the record:

> There is not much to report about economic developments in the Sixth District since the last meeting of this Committee that differs very much from national changes. Employment continues to push against the available labor supply, producing an unemployment rate of around 3.6 per cent. Although there are signs of a possible future slowdown in residential construction because of a shortage of mortgage funds, current activity remains high.
>
> Loans continue to increase at our large banks, although not at the explosive rate of early April. Outstandings of large CD's increased further. Business loans advanced moderately, with lending to construction and service firms accounting for much of the increase. About half of the banks reporting so far in the lending practices survey expect loan demands to remain unchanged; and about 40 per cent expect them to be moderately stronger.
>
> At the last meeting of this Committee, I suggested that further restraint was required by the overheated state of the economy even though we might be forestalled from moving because of Treasury financing. Economic news since then, it seems to me, continues to point to the need for applying the brakes.
>
> Determining just what shape a policy of further restraint should take or if monetary policy has done all it can be expected to do are hard questions, of course. Looking solely at the behavior of money market conditions and the recent rate of change in bank credit, one could conclude that the System has done about all it can be legitimately expected to do. Given time, one could argue, the effects of this firming will show up in the behavior of the economy. Thus, merely holding to the present posture will do the job.

I should like to think that this was the case and that we can avoid making any decision now. With the need for making decisions in the near future about the discount rate, the support of Treasury financing, and interest rate ceilings facing the System, any reduction of decision-making would be most welcome.

Although I am not wholly convinced that this will turn out to be the case, I found the discussion in the blue book and the staff presentation today pushing me in that direction, especially if fiscal restraint finally comes into the picture. Certainly, I want to avoid an overdose of restraint. If, as the discussion develops further today, it turns out that continuing the present taut conditions will be likely to further restrain the economy, I can accept the draft directive as given.

Mr. Bopp said the draft directive was acceptable to him. He submitted the following statement for the record:

Over the past several months, monetary policy has been able to slow the growth of bank credit while avoiding disorderly markets. In the period immediately ahead, market pressures are likely to present continuing difficult problems. We have in mind that market rates on negotiable CD's are at or above the recently revised ceilings; that banks have been cutting back purchases of municipals while the 30-day visible supply is climbing; and that the market is aware that Treasury financing, even with a tax increase, will be heavy.

A further squeeze is developing at the level of bank lending, at least in the Third District. Commercial banks report a strengthening in loan demand which they expect to continue at least into the next quarter. Some indicate a decreased willingness to lend.

In the mortgage market, telephone interviews with a few local mortgage bankers indicate a belief that the market in Philadelphia will become extremely tight. Despite the new 6-3/4 per cent rate on FHA and VA mortgages, prime residential mortgages are going at a five-point discount. Mortgage bankers find it increasingly difficult to place mortgages with ultimate lenders. In addition, because of higher rates in the Southeast and Far West, some of them feel that the Federal National Mortgage Association no longer can be considered a lender of last resort to them.

In short, pressures on financial markets will be great even if the present degree of monetary restraint is merely maintained.

The need for restraint is still evident in the real sector of the economy. The unchanged level of industrial production and the decline in retail sales in April do not indicate to us any fundamental slowing of the economy. Indeed, the downward revision of inventories and the upward revision of consumer spending for the first quarter suggest to us greater pressure on resources during the second half of the year than was originally thought.

Given the stresses likely to be at work in the money and capital markets, the Desk may need to be particularly alert to the possibility of disorderly conditions, but in view of the longer-term need to restrain inflationary forces no easing in the basic posture of policy is called for. On the other hand, inasmuch as a significant slowdown in bank credit has been achieved, and there remains hope of a tax increase in June, we would not move to further tightening.

Mr. Hickman said the draft directive was acceptable to him. He then summarized the following statement:

The current quarter will show excessive rates of advance in aggregate demand and prices, but there are signs in the Fourth District and elsewhere of moderating tendencies after midyear. Over-all gains in consumer spending are slowing, the recent behavior of major leading indicators lacks ebullience, and increased inventory investment in autos and steel is expected to slacken soon.

Moderating tendencies in the economy were generally forecast at a meeting of 40 business and financial economists held at our Bank on May 17. Most of the participants assumed a program of fiscal restraint effective around midyear. The median forecast of the group is for a sharp further advance in GNP in the second quarter, followed by modest increases of $10 billion in the third quarter and $12 billion in the fourth quarter. Rising prices are expected to account for two-thirds or more of the increase in GNP in the second half, which suggests that inflation will continue to be a serious

problem in the months ahead and that little real growth can be expected.

Once a fiscal program is enacted, if indeed it is enacted, this Committee will have to face up to the fundamental policy question of whether we should continue to fight inflation or renew efforts to promote growth. Whatever our conclusion may be then, the appropriate stance now is to check inflation, restore balance in the domestic economy, improve our foreign trade position, and protect the dollar. Toward these ends, I would continue a policy that keeps a tight rein on the banking system and financial markets, and that maintains money market conditions about as they are at present.

The reserve aggregates in May will be somewhat below and interest rates somewhat above the projections specified in the blue book of April 26 as being consistent with the directive adopted at our last meeting. Nevertheless, recent policy seems to have been just about right, and I see no reason to make a further move today. My own preference is similar to that expressed in the current blue book; that is, net borrowed reserves and borrowings about where they are and the bill rate in a range of 5-5/8 to 6 per cent. The general objective should be to allow banks in the aggregate to hold most, if not all, of the CD's they now have, but to prevent any further expansion or sharp contraction. In view of recent strained conditions at deposit-type financial institutions and in some segments of the money and capital markets, I would be prepared to provide reserves quickly if severe liquidity pressures develop before the next meeting, but would not favor a change in the discount rate or in Q ceilings. Hopefully, by the time of the next meeting, there will have been action on a program of fiscal restraint, and we will then be in a better position to reevaluate the stance of monetary policy.

Mr. Sherrill said he was prepared to vote for the draft directive. He would be highly concerned, however, if money market rates moved toward the upper ends of the ranges given in the blue book. Such a development would increase the pressure on thrift institutions and the amount of disintermediation at banks and

might result in a need to raise the Regulation Q ceilings--an action he would consider unproductive and contrary to monetary policy goals at present. Consequently, he would hope the Desk would try to keep money market rates in the lower part of the indicated ranges.

Mr. Brimmer said the draft directive was acceptable to him. If nonbank financial institutions came under heavy pressure he would hope that the Board would reinstate the emergency credit facilities it had established in the summer of 1966. Such a course might be preferable to asking the Manager to deal with the pressures by providing increased reserves, since the needs were likely to be selective.

Mr. Brimmer then noted that if fiscal policy action was not taken in the next few weeks it might be desirable for the Committee to meet, perhaps by telephone, to reconsider its policy. At the same time, if the tax bill was passed he would be concerned about the combined impact of fiscal and monetary restraint and would hope that the System would not delay in moving toward greater monetary ease.

Mr. Maisel summarized the following statement:

> If I were to assume that there were to be no vote up or down on the tax measure in the next month, I would be concerned with the current stance of policy. Whether because the rates on Federal funds and Treasury bills were above those expected at the last meeting, or

because we usually tend to underestimate the degree of firmness carried through to rates of change in bank credit in periods of contraction, in this last period we experienced flows at the bottom of our range of estimates.

More important, we are experiencing flows below those which should be sustained. The estimate for the rate of increase in the bank credit proxy is minus one per cent for the six months March-August 1968, and negative even for the credit proxy plus Euro-dollars for this period. This compares with a plus 5 per cent for the second and third quarters of 1966, or plus 6.6 per cent for that period when Euro-dollars are included. Clearly we can stand somewhat lower flows for a period compared to 1966 because we entered this current period with higher liquidity. This liquidity, however, is now being used up rapidly. In addition, we must remember we are dealing with actions that will affect the financial markets and the economy with considerable lags.

As a result, I feel that if we were to assume no final decision on the tax bill, we would have to increase the expected flows to avoid major dangers to our financial system. This also means that logically, while awaiting the votes, we should make certain we avoid tightening further. This should mean that until the tax votes we ought to have the Federal funds rate fluctuating closer to 6 per cent and more frequently below that rate than in the past three weeks, with the three-month bill rate below 5.75 per cent. These targets should be maintained even if it means a lower level of borrowings and net borrowed reserves. For the same reason, the proviso should clearly allow a greater increase than predicted for the bank credit proxy. Some positive increase in the credit proxy would be proper.

Assuming the tax bill is voted down or there is a sterling crisis, I believe the important factor again would be to furnish sufficient reserves to avoid disorderly markets--defined in this case to include a sharp run-up in rates. We should still desire an adequate increase in the bank credit proxy in the vicinity of 3 to 5 per cent for the next several quarters. As a result, we should not fear its rising even somewhat above this rate under the reactions of a semi-crisis.

I gave my prescription for the case if the tax bill passes at the preceding meeting: Namely, don't fight the fall in rates. Flows would probably drop as demand shifted down.

Mr. Daane said the draft directive was acceptable to him. It provided the Manager with the flexibility necessary in view of the uncertainties in the period ahead.

Mr. Mitchell remarked that while he could accept the draft directive, he was disturbed by the use of the word "firm," without elaboration, to specify the kinds of money market conditions desired. He asked whether Mr. Holmes could suggest some means for making the Committee's intent clearer.

Mr. Holmes noted that the text of the policy record prepared for each meeting often amplified on the Committee's intent in adopting particular language for the directive.

Mr. Mitchell then said he hoped that would be done in the policy record for today's meeting.

Mr. Heflin submitted the following statement for the record:

> There is little that I can add to the economic discussion presented here today apart from noting that Fifth District business generally parallels the current trends described in the green book. 1/ It seems clear that the national economy continues to expand at an excessive rate. The large second-quarter gain in GNP projected in the green book promises additional pressure on labor markets, with further increases in wages and prices. Coupled with the increasingly discouraging situation in international financial markets, this outlook clearly calls for more effective restraining action than has been forthcoming thus far.
>
> Over the past few days prospects for early passage of a compromise fiscal package appear to have improved

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

substantially. This, of course, is a welcome development. Nonetheless, I believe it raises some important questions for our deliberations today, as early enactment of a tax surcharge and a spending cutback would, in my view, give us a brand new ball game in the credit policy arena. As of the moment, there would appear to be some likelihood that we will get action before the date of our next meeting. In that case, it may be appropriate to have a special meeting of the Committee to revise whatever instructions may be issued to the Desk today.

In any event, it seems to me that the problem we will face over the next few days will vary, and probably sharply, with the prospects for the fiscal package. If these prospects continue to brighten and early passage becomes a virtual certainty, we can be sure that the general improvement in market tone that began last week will continue and that market rates will drift downward. The question then would become one of the extent to which we should resist any decline in rates that may develop from this source. In my view, the clear need for more restraint on aggregate demand growth argues strongly against accepting any substantial decline in rates on the strength of mere prospects of fiscal action. Accordingly, I would be inclined to resist any tendency of the 90-day bill rate to fall more than 10 or 15 basis points below current levels until the proposed fiscal curbs are actually enacted into law, at which time I would be prepared to reopen the question.

But I think it is necessary for us to consider also the situation we would confront if action on the tax package is delayed further. In such an eventuality, both domestic and international markets are very likely to weaken again and to resume the extremely nervous tone with which we have become familiar over the past few months. I believe that an overt move toward a further tightening of credit in that kind of atmosphere would involve an unacceptable risk of precipitating a crisis in both domestic and foreign markets. Indeed, it seems to me that disappointment of hopes for fiscal action might well leave us with the primary job of maintaining orderly conditions in financial markets.

For the moment, I am assuming that prospects for fiscal action will continue to improve. Accordingly, I am inclined to instruct the Desk to maintain the same degree of market restraint that has existed over the past few days but to resolve doubts on the restrictive side. In particular, I would resist any tendency for the 90-day bill rate to fall

> much below about 5.60 per cent and would be prepared to see deeper net borrowed reserve figures, a higher level of borrowings, and a further reduction in bank credit growth if these are required to resist any downdrift in rates that may develop.

Mr. Clay observed that the draft economic policy directive appeared quite satisfactory. In view of the projection that the bank credit proxy would decline in June at an annual rate in the range of 1 to 4 per cent, he thought it would be appropriate to modify the application of the two-way proviso clause so as to tolerate a larger deviation on the up side than on the down side before implementing the proviso. He then submitted the following statement for the record:

> The problems facing public economic policy appear to be intensified rather than relieved. Domestic economic expansion, already at an unsustainable pace, is accelerating at the present time. The terms of wage settlements are increasing and complicating the existing severe wage-price spiral, and price inflation adds to the economic difficulties on both the domestic and international fronts. The international balance of payments situation continues seriously adverse, along with the accompanying problems of the balance of trade, currency exchange instability, and the price of gold.
>
> The need for public policies of economic restraint is increasing. Yet the necessary action on fiscal restraint has not materialized. Meanwhile, monetary policy has moved a long way and is operating in a very tight and sensitive financial situation, complicated by the uncertainties of fiscal action and the related effects on monetary policy and domestic and international economic developments.
>
> In the light of this situation, monetary policy should seek to hold firm to its recent goal of monetary restraint without taking action to tighten further at this time. The full impact of monetary actions already

taken is not yet known, and a decision on the fiscal restraint package presumably is near at hand. In view of these circumstances and the extreme sensitivity of the financial markets, it also would be unwise to aggravate an already potentially severe financial disintermediation problem. Pursuit of such a policy of monetary restraint would appear to be generally consistent with the monetary specifications listed in the blue book, although it is difficult to specify interest rate conditions because of the sensitivity of the financial markets to existing uncertainties, as has been apparent in recent weeks.

Mr. Scanlon said the draft directive was acceptable to him, although the Committee might want to consider a modification of the final sentence of the first paragraph. Specifically, the clause reading "while taking account of the potential for severe pressures in financial markets if fiscal restraint is not forthcoming," might be modified to read "while taking account of the potential for even more severe pressures . . ." He then submitted the following statement for the record:

A further rise in business activity in the Seventh District is indicated, at least until the August 1 steel strike deadline. Employment in most District centers is expected to rise more than seasonally in May and June. Congressional inaction on the fiscal restraint package, together with the continued advance of interest rates to unprecedented levels, is causing uneasiness and may be holding back some investment.

New claims for unemployment compensation have been far below last year's levels in all District states in recent weeks, but are somewhat above the levels of two years ago. Employment in trade and State and local government is at record highs and continues to increase. Employment in manufacturing is below last year and average weekly hours are appreciably below the levels of two years ago. Employment and weekly hours have

declined substantially in the farm and construction machinery and the television industries.

Half of the 24 major labor market areas in the District are classified in group B (less than 3 per cent unemployment) compared to only one-third for the United States. These low unemployment centers include most of the largest ones--Chicago, Milwaukee, Indianapolis, Flint, Rockford, Peoria, and Des Moines. With the recent improvement in Kenosha, none of the District centers is classified as having "substantial" unemployment. Surveys of small centers, where unemployment appears relatively large, invariably show that the job seekers are not willing to relocate. Attempts to hire the hard-core unemployed in the larger cities have hardened the conviction of many employers that there is no readily trainable reservoir of unused labor, and that efforts to train these people for steady employment will be difficult and costly.

A pattern of generous wage and salary increases (ranging from 5 to 10 per cent per year in most negotiated settlements) is firmly established for the next several months or until the current cycle is complete for major industries.

Except for steel, some components made principally of steel, and residential building materials, no important industries expect a decline in activity in the next several months. There has been some improvement recently in orders for construction machinery and for components for industrial equipment.

Lead times on machinery and equipment have been reduced substantially in the last two years, and price competition has reappeared. Steel price reductions to meet import competition do not appear to have been significant in this region. Steel orders have drifted lower, but it is likely that output will be maintained near recent record levels until August 1.

Output of passenger cars in the second quarter apparently will approach 2.4 million, 10 per cent more than last year. Output for the 1968 model year is now indicated to approach 8.4 million units--up 9 per cent from the 1967 model year, but below the totals for the 1965 and 1966 model years. Inventories, relative to sales, are high but are not considered excessive. Production of 1969 models will begin early in August,

earlier than in most past years. Sales of trucks have been excellent and are almost certain to set a record for calendar 1968, well ahead of the previous high in 1966.

Retail sales are likely to continue strong for both hard and soft goods. Moves to de-escalate the war appear to be playing a role in boosting purchases.

Inventories of most consumer goods (autos and TV's excepted) appear modest by past standards, and attempts doubtless will be made to increase inventories in many lines. Sales, orders, and shipments for furniture and most types of appliances are at high levels. Sales of color televisions, on the other hand, seem to have hit another slow period after an excellent performance in the first quarter.

Construction contracts for the first quarter were 8 per cent above last year in the Midwest, and up 18 per cent for the United States. Residential construction contracts were at record highs in both the Midwest and in the nation, with apartment buildings especially strong. (Construction of manufacturing facilities has been at reduced levels in the region and nationally.) In view of reduced savings inflows to thrift institutions, it is virtually certain that credit availability for single family homes will be reduced substantially in the next several months. However, the heavy volume of both loans-in-process and commitments outstanding will help to maintain activity for some time to come. The situation remains much more favorable than in 1966.

In banking, there are signs of increasing nervousness about sources of funds to meet both current and expected loan demands, and considerable evidence that banks are tightening up in their loan policies. The pace of bank lending appears to have quickened recently although it is difficult to interpret the loan figures in view of developments that have affected seasonal patterns. Over all, credit developments at the weekly reporting banks seemed somewhat at odds with the declines in the past two months indicated by the credit proxy.

In the latest lending practices survey the majority of respondents in the Seventh District indicated that business loan demand has strengthened and that they have tightened their loan practices in varying degrees. Several said they were less willing to make term and mortgage loans.

Concern stems largely from the difficulties in acquiring funds to meet the prospective demands. Time deposit rates are again not competitive, and both large CD's and other time balances are declining. All of the large Chicago banks are substantial net buyers of Federal funds and a few have been making greater use of the discount window. Those in the Euro-dollar market have acquired greater amounts of funds from this source. The possibility of liquidating recently acquired Governments and loans to finance companies offers some flexibility in handling the surge in demands generally expected next month but not without an impact on financial markets. Meanwhile, the acquisition of municipal issues has virtually halted.

As to policy, current price and wage pressures and continued weakness in the balance of payments strongly indicate the need for additional economic restraint. At the same time, we appear to have achieved rather severe monetary restraint in recent months. With the exception of the continued peculiar behavior of the money supply, measures of financial aggregates show no growth. For the three months through May, total member bank reserves declined and member bank credit was substantially unchanged. (It has been difficult in recent months to reconcile the member bank credit proxy and the end-of-month credit series for all banks, which indicates continued growth of bank credit.)

If it were not for the strong expansion in the money supply and the prospective large volume of Treasury borrowing in July and August, I would urge that we act now to obtain a slow expansion in total reserves and bank credit. However, in light of these prospective developments, I believe we should maintain the current policy posture in the next few weeks--and in general terms, for the next few months, a policy designed to achieve an average expansion of total reserves of no more than 3 per cent. I would act to moderate abrupt changes in interest rates.

Mr. Galusha indicated that the draft directive was acceptable to him. He submitted the following statement for the record:

Let me begin with a few words about Ninth District agriculture. Last time I was rather optimistic, at least about total agricultural income. And, indeed, I am still

expecting an increase, year-over-year, in the total income of District ranchers. But the wheat outlook has changed. It now appears that wheat prices will decline. So I have changed my mind. I am now expecting that total District agricultural income--the total income, that is, of District ranchers and farmers--will be lower in 1968 than it was in 1967.

And evidently I am not alone in my judgment. To all appearances, District farmers and ranchers have become very reluctant spenders. Sales of tractors and other farm machinery and equipment have not been what manufacturers expected they would be. Inventories have increased sharply. There has even been some price cutting. And according to recent reports, District manufacturers of farm machinery and equipment are lowering production targets. One Minneapolis tractor manufacturer has indicated that production will likely be down 15 per cent from last year, and that coming weeks could well bring significant layoffs. (I received this information, I might add, with mixed feelings.)

It may seem paradoxical, what with farmers and ranchers having cut their spending plans, but I have come to believe that those who want loans are going to find getting them increasingly difficult. For one thing, the presidents of the Federal Intermediate Credit Banks have already been told they are not going to have large quantities of funds to lend. This is important, since the outstanding loans of the FICB's have lately been increasing sharply. Also, I have had numerous reports that our city banks are trimming country bank over-lines. Evidently they are beginning to feel the pinch.

Now, then, as to Committee policy: I am for "no change," although not because I have suddenly become optimistic about a surcharge being imposed. In my present mood, I will believe we are going to get the surcharge a week after Congress has imposed it. Attitudes about restraint are no less polarized than they were last fall. I do, however, sense that banks have begun to feel monetary restraint, and further that they are going to find it increasingly difficult to satisfy loan customers, even if this Committee simply maintains the present policy. So I would like to wait a bit, if only to get a somewhat better fix on the effects of past changes in policy.

There is a risk in waiting. The Treasury may belatedly decide to come to the market in June. I am willing, however, to take a gamble.

I do not know whether circumstances of recent weeks forced a change in Committee policy. But in defining "no change," I go back to last meeting's blue book. I have in mind a Federal funds rate averaging 6 per cent, and a bill rate in the 5.65 - 5.85 per cent range.

I would stress, if not for the first time, the desirability of having the Account Manager take as his first responsibility keeping the bill rate within the stated range. As we are all aware, last week provided an illustration of how the funds rate and the bill rate can diverge. The point, though, is that it may not be the wisest course to maintain a target funds rate, while letting the bill rate increase to a level which threatens widespread disintermediation.

Even with a bill rate in the 5.65 - 5.85 per cent range, banks are apparently going to experience a significant loss of CD's--quite enough of a loss to suit me. What I am fearful of is a very sharp decrease in CD liabilities. This is why I have specified a 5.65 - 5.85 per cent range for the bill rate. If another increase in CD rate ceilings were in the offing, I would find it easy enough to accept all the targets set out in the current blue book.

Mr. Swan said the draft directive was acceptable to him.

Mr. Coldwell observed that he was prepared to vote for the draft directive. He added that the heavy domestic and international pressures seemed to him to require some policy response. Hopefully, that would come through fiscal restraint, but reconsideration of monetary policy would be required if the fiscal package was not enacted.

Mr. Coldwell then submitted the following statement for the record:

Eleventh District conditions reflect high-level employment, production, income, and sales. Industrial production in Texas remained at the same near-record

level despite a further reduction in crude oil output, now down nearly 8 per cent from February and almost double that decline from the year-earlier Mid-East crisis level. However, recent lease sales for offshore Texas tracts brought accepted bids of $605 million, indicating an intense interest in drilling and exploration.

Employment conditions remain very tight, with virtually no employable males and with wages advancing rapidly. Recent settlements in construction provided for a 33 per cent wage increase over a three-year period. Retail sales are strong and auto sales are moving ahead quickly.

Agricultural conditions are good with an excellent moisture base in most areas. Agricultural credit supplies appear adequate except for the intermediate- and long-term demand.

Banking in the Eleventh District, as reflected by the weekly reporters, showed declines in deposits and loans but a small gain in investments. Borrowings from the Reserve Bank more than doubled but some of the increase is the usual seasonal demand.

Bankers with whom I have been in contact over the past few weeks report loan demand strong but the degree of tightness is very uneven. In fact, only a few banks could be said to be faced with a shortage of lendable funds. Most banks report marked increases in interest rates to customers and are worried by the threatened beginnings of disintermediation. Nevertheless, as a whole, the restraining influence of monetary policy does not seem to have had much of an impact as yet. The bankers report funds available to make loans to all normal borrowers. Unfortunately, too many banks have had enough funds and the willingness to make sizable loans to individuals speculating on silver. A recent visit to a bank revealed case after case of lock-box deposits full of silver coin or bullion. A few bankers have wondered why the Federal Reserve has not asked them to refrain from making speculative loans and to restrict lending operations as in a few other instances of credit restraint. I find myself wondering if this might not be a good move to bring home the seriousness of the situation, although I am not a believer in the long-term effectiveness of moral suasion.

> I will not take the Committee's time to review again all of the economic developments in the nation. These have been adequately covered by prior speakers. However, I will say that if the rate of growth approaches that discussed in the green book, the pace of inflation may quicken and, without fiscal restraint, could near the point of self generation. As I view the economy, it is being restrained by a lack of available workers and, to a minor extent, by credit policy. In my opinion the policy problem today is whether we can wait for the usual lag in effectiveness or must take action, consciously risking an overkill, in order to restore economic balance and dampen inflationary expectations before the situation becomes uncontrollable.

Mr. Ellis said he had found the staff presentation to be highly useful. While the draft directive was acceptable to him, he was concerned that if the ranges for money market variables given in the blue book were accepted as targets the Committee would be relaxing the degree of restraint somewhat. Thus, the current blue book specified a range of $300 to $450 million for net borrowed reserves, whereas the range given in the preceding blue book was $350 to $500 million. In his judgment it would be undesirable, particularly if the fiscal package were not adopted, to have to show in the record that the Committee had backed away from the earlier degree of firmness.

Mr. Maisel noted that the ranges given in the current blue book for the Federal funds rate and the bill rate were above those specified in the preceding blue book. He thought it would be a mistake to focus on one money market variable, such as net borrowed reserves, to the exclusion of others.

Mr. Ellis observed that while the target ranges now given for the Federal funds and bill rates were above those specified at the time of the meeting four weeks ago, they were below the ranges actually experienced since that meeting. Thus, in a meaningful sense acceptance of the proposed target ranges for those variables would imply a relaxation of restraint. He would hope that, absent tax action, the Desk would at least maintain the degree of restraint that had been achieved.

Mr. Mitchell remarked that money market conditions, as described by the Manager, had been close to disorderly at times in the recent period. He did not think the Committee would want to have that kind of situation persist.

Mr. Ellis replied that if the fiscal package were not enacted market conditions might well become disorderly. However, he was not prepared at this time to instruct the Manager to back away from the recent degree of restraint in light of that possibility.

Mr. Hayes then remarked that he disagreed with Mr. Sherrill's view that the Manager should aim for money market rates in the lower part of the ranges specified. In his judgment the target ranges should be treated in the customary fashion, with no effort to seek rates near either their lower or upper ends.

Mr. Hickman concurred in Mr. Hayes' statement.

Mr. Robertson said that he would submit his prepared statement for the record. He added that the draft directive was acceptable to him. In his judgment it specified the appropriate course for monetary policy pending fiscal action--namely, to keep money market conditions as tight as was consistent with the need to avoid a drastic degree of disintermediation.

Chairman Martin commented that that also would be his interpretation of the draft directive.

Mr. Robertson's prepared statement read as follows:

> A. With all the conflicting considerations that we have to bear in mind this morning, I am convinced that we ought to vote for no letup in monetary restraint at this moment. The prospect of a belated move toward fiscal restraint continues to hang tantalizingly just ahead of us, and we have seen in today's chart show how helpful its enactment would be in dealing with our deep-seated domestic and international problems. I realize opinions on the subject can vary, but I am satisfied that a package of fiscal restraints will be passed--and soon. But I do not believe it would be either wise or appropriate for us to let up on the only presently operable policy restraint on inflationary pressures before the time at which alternative policy restraints are clearly in place for all to see.
>
> Pending that time, I favor keeping monetary policy just as tight as we can without producing a drastic and irreversible wave of disintermediation at banks and other savings institutions alike. A certain amount of disintermediation I regard as tolerable--and indeed even as a constructive element in keeping loan policies under restraint. Obviously, one cannot be dogmatic about what money market and reserve conditions will produce precisely this credit result, given the delicate balance of rate relationships and possibilities for new developments that might overturn market attitudes. I would be willing to

have the Manager begin with a view to maintaining about the money market conditions specified in the blue book. But he will need to be prepared to shift from those if flows or rates shift too sharply, and for that reason I am glad to see the extended proviso clause suggested for the directive. I am prepared to vote in favor of the draft submitted by the staff.

B. With respect to use of repurchase agreements over the period ahead, I would accept--somewhat regretfully--the Manager's view that market practices make the use of matched purchase-sale agreements an impractical alternative now to repurchase agreements. The other competitive bidding alternative posed by the Manager has its appealing side. Although I do not share the Manager's reservations in full, it does not seem desirable to innovate with such a proposal now. In fact, it is not at all clear to me that the Open Market Desk should be in the business of lending to dealers on a regular basis. However, without raising that issue again--except to note my preference for more outright and fewer repurchase transactions--I would conclude from the material before us on the subject and from the experience to date that any repurchase agreements the Desk makes should be made at the discount rate.

Enough events have occurred to obscure the market impact of repurchase rates above the discount rate so that no one can say with certainty that money market conditions would have been more or less to our liking without such rates. But the very sensitivity of markets in such times as these seems to me to be a very good reason for ceasing innovation, since the best will in the world will not avert unintended announcement effects in rumor-prone markets. Unfortunately, it is going to be difficult to move the repurchase rate back to the discount rate without that itself being construed as an announcement of an easier policy. Even so, I advocate that such a move be taken at such time as it can be done with the least undesirable announcement effect. Once we manage to put the repurchase rate back at the discount rate, we should leave it there, at least until further consideration is given to the philosophic and financial impact of these operations and until we have the benefit of considering other measures that might affect dealers as might be proposed in the U.S. Government securities market study.

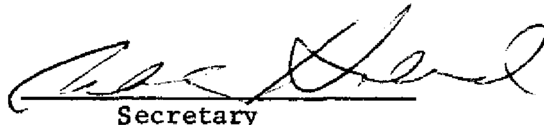
By unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The information reviewed at this meeting indicates that the very rapid increase in over-all economic activity is being accompanied by persisting inflationary pressures. There has been little or no growth on average in bank credit and time and savings deposits over the past two months, although the money supply has expanded considerably as U.S. Government deposits have declined. In recent weeks both short- and long-term interest rates have risen sharply on balance from their earlier advanced levels, partly in reaction to shifting expectations with regard to the likelihood of fiscal restraint. There has been some revival of speculative activity in the private gold market and in foreign exchange markets. The U.S. foreign trade balance and over-all payments position continue to be a matter of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and attainment of reasonable equilibrium in the country's balance of payments, while taking account of the potential for severe pressures in financial markets if fiscal restraint is not forthcoming.

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

It was agreed that the next meeting of the Committee would be held on Tuesday, June 18, 1968, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

May 27, 1968

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on May 28, 1968

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