

MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held on Monday, August 19, 1968, at 11:10 a.m., at the call of Vice Chairman Hayes. This was a telephone conference meeting, and each individual was in Washington, D. C., except as otherwise indicated in parentheses in the following list of those participating:

PARTICIPATING: Mr. Hayes, Vice Chairman, presiding (New York)
Mr. Brimmer
Mr. Daane
Mr. Galusha (Minneapolis)
Mr. Hickman (Wheeling, W. Virginia)
Mr. Kimbrel (Atlanta)
Mr. Maisel
Mr. Robertson
Mr. Sherrill
Mr. Bopp, Alternate (Philadelphia)

Mr. Treiber, Alternate Member of the
Federal Open Market Committee (New York)

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Hexter, Assistant General Counsel
Messrs. Partee, Solomon, and Taylor
(Atlanta), Associate Economists

Mr. Forrestal, Assistant Secretary, Office
of the Secretary, Board of Governors
Mr. Cardon, Assistant to the 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
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Mr. Bernard, Special Assistant, Office
of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat
Assistant, Office of the Secretary,
Board of Governors
Messrs. Baker and Beck, Economists,
Division of Research and Statistics,
Board of Governors

Messrs. Bilby, MacLaury, and Sternlight,
Vice Presidents of the Federal
Reserve Bank of New York (New York)

Mr. Hayes noted that this meeting had been called to consider a possible revision of the Committee's current economic policy directive in light of the reductions from 5-1/2 to 5-1/4 per cent in the discount rates of the Federal Reserve Banks of Minneapolis and Richmond, effective August 16 and 19, respectively. At the outset, he would call on Mr. Sternlight for a review of developments in domestic financial markets since the Board's announcement late on Thursday (August 15) of the reduction in the Minneapolis Bank's discount rate.

Mr. Sternlight said that initial reaction in domestic financial markets to the Board's announcement had been quite moderate. Early on Friday, prices of some Treasury coupon issues had advanced by up to 10/32 or 12/32, but by the end of the day gains on most issues had been shaded to about 1/32 to 6/32. For example, the new 6-year, 5-5/8 per cent note recently issued by the Treasury at a price of 99-20/32, which had closed at 99-25/32

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on Thursday, rose to 100-6/32 early on Friday but then drifted down to 99-31/32. The downward adjustment in Treasury bill rates on Friday also was rather mild, ranging from 4 to 10 basis points. At the close, the three- and six-month bills were bid at 5.11 and 5.25 per cent, down 6 and 7 basis points, respectively, on the day.

This morning, Mr. Sternlight continued, prices of Treasury notes and bonds were generally steady. The Treasury bill market had a steady to firm tone, with yields unchanged on shorter-term bills, including the three-month bill, and down slightly on longer-term bills. With respect to the rates that would be set in today's weekly bill auctions, the thinking in the market was presently centering around 5.10 to 5.12 per cent for the three-month bill, compared with a 5.08 per cent average in last week's auction; and around 5.22 to 5.25 per cent for the six-month bill, compared with a 5.27 per cent average a week ago. There had been no significant change in rates on Federal funds, which had been trading mainly in a 6 to 6-1/4 per cent range before the discount rate announcement. On Friday the effective rate was set at 6-1/8 per cent, and today, following a few early transactions at 6 per cent, trading was taking place again at 6-1/8 per cent.

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Mr. Sternlight noted that preliminary reports on dealer positions in U.S. Government securities showed a decline on Friday of \$190 million to a level of \$4,861 million. The decline was more than accounted for by a reduction in inventories of bills, as dealers continued to make good progress in distributing bills. There was a partially offsetting increase in dealer holdings of coupon issues. The data received this morning indicated that dealer positions in notes and bonds maturing in more than five years had risen by \$89 million on Friday to a level of \$1,021 million. He suspected, however, that the figure might be in error, since conversations with dealers on Friday had not suggested an increase of that size in their holdings of longer-term issues.

Secretary's note: Revised data received following the meeting indicated that dealer positions in notes and bonds maturing in more than five years had increased by only \$14 million on Friday, August 16, 1968.

Mr. Sternlight reported that projections of net borrowed reserves by the New York Reserve Bank staff were \$305 million for the current statement week, and \$420 million, \$753 million, and \$910 million for the weeks ending August 28, September 4,

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and September 11, respectively. Board staff projections were almost the same for the current week but were progressively deeper for the three subsequent weeks.

With respect to operations today, Mr. Sternlight said, the Desk contemplated making roughly \$200 million of repurchase agreements with dealers at a rate of 5-1/4 per cent, the same rate as had been used on Friday. In the weekly bill auctions this afternoon, the Desk planned on bidding to roll over System holdings of about \$796 million maturing bills.

In reply to a question by Mr. Hickman, Mr. Sternlight said that information for the country bank sample--which, as the members knew, was used to refine preliminary bank reserve estimates--would not be available until tomorrow. At the moment, he was not able to predict the probable effect of the sample on the projection of net borrowed reserves for this week.

Mr. Hayes then asked Mr. MacLaury to summarize foreign reactions to the discount rate reductions.

Mr. MacLaury said his remarks could be brief because there had not been much exchange market reaction or foreign comment. The dollar had remained firm against all continental currencies except the Swiss franc, and it was well off the floor against that currency. In the Euro-dollar market there had been a slight

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decline in yields for some maturities. Canadian and British bill rates had declined slightly further on Friday. The gold market had been quiet, with trading at prices just above \$39. Most of the comments he had heard suggested that while the discount rate action had not been anticipated, it was being interpreted as a technical adjustment and it was not expected to trigger discount rate changes abroad. There had been some speculation in recent weeks that the British Bank rate might be reduced, but he had heard nothing to suggest that the Federal Reserve action had increased the possibility of such a reduction.

Mr. Hayes then noted that the Board's staff, after consultation with the staff of the New York Bank, had distributed a draft current economic policy directive for consideration by the Committee today. He asked Mr. Holland to comment.

Mr. Holland indicated that the draft directive consisted of a single paragraph concerning open market operations; as in the directives the Committee had adopted at other recent interim meetings following discount rate actions, the customary first paragraph had been omitted. The draft read as follows:

System open market operations until the next meeting of the Committee shall be conducted with a view to facilitating orderly adjustments in money market conditions to reductions in Federal Reserve Bank discount rates; provided, however, that operations shall be modified if bank credit appears to be significantly exceeding projections.

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Mr. Holland added that the draft directive had been accompanied by a note regarding the projections referred to in the proviso clause. The note indicated that the Board's staff saw no reason for projecting growth rates higher than those shown in the blue book^{1/} prepared for the Committee meeting of August 13, 1968, even in an atmosphere of somewhat easier day-to-day money market rates evolving in the wake of the recent discount rate actions. In that blue book the bank credit proxy had been projected to grow at annual rates of 16 to 18 per cent in August and 5 to 7 per cent in September.

Mr. Hayes asked Mr. Sternlight to comment on how he would interpret the proposed directive operationally.

Mr. Sternlight said that if the Committee adopted the proposed directive he presumed that it would want open market operations to be directed largely at keeping the market response to the discount rate change moderate and orderly, as befitted a discount rate action that was more a market-following than a market-leading move. He would regard as still of key importance two considerations that had been emphasized in the discussion at the August 13 meeting of the Committee. The first was the

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

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desirability of keeping short-term rates, notably bill rates, in their recent range of movement--roughly 4.90 to 5.20 per cent for three-month bills. The second--and he did not mean to be setting priorities for the Committee here--was concern about the need to avoid excessive bank credit growth. He believed that continuation of the July-August growth pace in the proxy--which presently was estimated at an average annual rate of about 15 per cent, after allowance for Euro-dollar borrowings of U.S. banks--would not be acceptable to the Committee. The outlook was for slower growth in September but, consistent with other objectives, the Desk would react to any signs of excessive growth as it had in the past several weeks, by shading its operations toward somewhat greater firmness than would have been done otherwise.

As for holding short-term market rates in their recent range, Mr. Sternlight thought the 5-1/4 per cent discount rates should be helpful. Also, there continued to be market expectations in the background that credit conditions would tend to be easier later on. At the moment, however, dealer financing costs were still quite high relative to current market rates, and that could tend to push bill rates up. With Federal funds at 6 per cent or a shade more and dealer financing costs somewhat higher, it was expensive to carry bills at their current yields. Even a Federal

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funds rate somewhat under 6 per cent--say, 5-3/4 per cent--would be associated with financing costs that kept some upward pressure on present bill rate levels, although the resulting pattern would be more viable than the existing one.

However, Mr. Sternlight remarked, a crash program to pull down the Federal funds rate and financing costs would risk flooding the money market with reserves to an extent that could fan expectations of much greater easing; and along with that, credit growth could bulge further instead of decelerating as was now projected. In carrying out Committee intentions, it would seem preferable to encourage a gradual decline in the Federal funds rate to below 6 per cent. That might well follow as additional Reserve Banks moved to a 5-1/4 per cent discount rate and as dealers made further progress in distributing their large inventories of securities and hence lessened their demands on money market banks. But the progress in reducing inventories could be slow.

Mr. Sternlight said the range of net borrowed reserves that would accomplish Committee objectives was not easy to predict. There seemed to be a particular need for flexibility at this time. In his discussions with Board staff members a range for net borrowed reserves of \$150 to \$350 million had been suggested; such a range seemed reasonable as best he could judge the situation now.

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In response to a question by Mr. Galusha, Mr. Sternlight noted that he did not sense any aggressive efforts by dealers to reduce their positions. One major dealer had worked down his holdings substantially in recent days and some other dealers apparently were moving toward trimming their inventories. He was not persuaded, however, that that was a universal tendency, or that the reductions in aggregate dealer positions would proceed at a pace that might be desirable from the Committee's point of view.

Mr. Hayes then called for a go-around of comments on policy and the proposed directive, beginning with Mr. Galusha.

Mr. Galusha expressed the view that the proposed directive was appropriate.

Mr. Hickman indicated that he would attach a lower priority to keeping the bill rate in a 4.90 to 5.20 per cent range than Mr. Sternlight had implied and would give greater weight to reserve availability. In particular, he would want to offset any tendency for bank credit to expand at rates above the projections the Committee had considered at its previous meeting. He was very much concerned about the risk that in retrospect it would be concluded that monetary policy had swung too far toward ease in this period.

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Mr. Kimbrel said he agreed that the System should not move too rapidly toward ease. He thought some small decline in interest rates might be desirable, but he would certainly be opposed to any massive injection of reserves at this time. On that basis, he was prepared to vote for the proposed directive.

Mr. Bopp remarked that he agreed with Mr. Kimbrel.

Mr. Robertson said he found the draft directive acceptable and concurred in Mr. Sternlight's proposals for implementing it.

Mr. Daane indicated that he too found acceptable both the draft directive and the Desk's views concerning its implementation.

Mr. Maisel said he thought it was important for the Committee not to focus on the bulge in bank credit that had already occurred. According to one estimate the rise in the credit proxy which had already occurred would mean that the expansion rate for August would be over 17 per cent. Rather consideration of policy ought to be based on the rate of growth in prospect for the remainder of August and for September which was all that could be influenced by today's decision. In his judgment the directive should contain a two-way proviso clause, rather than the one-way clause shown in the draft, to guard against the possibility that bank credit would be significantly weaker in the period ahead than implied by the projections. There was a real risk, he thought, that bank loans

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and deposits would be considerably less strong than the staff expected. He suggested a proviso clause reading: "provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections."

Mr. Brimmer said he inferred from Mr. Sternlight's comments that implementation of the proposed directive would be somewhat easier if additional Reserve Banks were to reduce their discount rates from 5-1/2 to 5-1/4 per cent. He (Mr. Brimmer) would be disturbed about the implications for operations if those reductions were not made as soon as was feasible, given the dates at which Reserve Bank directors' meetings were scheduled. He thought continuation of a 5-1/2 per cent discount rate at a number of Reserve Banks would be counterproductive, since it was likely to place the Desk in the position of having to supply a large volume of reserves to keep the bill rate in its recent range.

In that connection, Mr. Brimmer continued, he shared the concern others had expressed about flooding the banking system with reserves. At the same time, he would not favor permitting the three-month bill rate to rise beyond 5.20 per cent. That was close to the upper end of the range that various Committee members had suggested as appropriate at the August 13 meeting, before any Reserve Banks had reduced their discount rates. Indeed, he hoped

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the Desk would begin to resist any upward pressures on the bill rate well before it reached 5.20 per cent. As to the directive, he wanted to reflect further before expressing a view on Mr. Maisel's proposed change.

Mr. Sherrill remarked that he would consider it highly regrettable if the three-month bill rate rose above 5.20 per cent, partly because such a development might confuse market participants about the System's policy intentions. He hoped that it would not prove necessary to supply a large volume of reserves, but in any event, he would favor a 5.20 per cent upper limit for the bill rate. To some degree he concurred in Mr. Maisel's view that the possibility of a shortfall in the growth of bank credit made a two-way proviso clause desirable, but he thought the proviso should not come into effect on the downside unless bank credit growth fell considerably below the projections.

Mr. Hayes said the proposed directive was acceptable to him. To some extent, he shared Mr. Hickman's views about priorities; he was more concerned about the possibility that bank credit would continue to expand at an excessive rate than about the risk that short-term interest rates might rise unduly, although both considerations were important. Accordingly, he was inclined to retain the type of one-way proviso that had been included in other

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recent directives rather than to introduce a two-way proviso clause today. On the subject of the discount rate, he could report that when the directors of the New York Reserve Bank had considered the matter at their meeting last week they were strongly of the view that a reduction at that time would have been a mistake. Their major concern, which he shared, was with the continuing strong inflationary pressures in the economy.

Mr. Hayes then said that the only significant point of disagreement today appeared to be whether the proviso clause should be one-way or two-way. He thought it would be appropriate for the members of the Committee who had not yet spoken on that issue to express their views.

Mr. Bopp indicated that he would favor a one-way proviso clause under current circumstances.

Mr. Robertson remarked that as a matter of general principle he thought two-way proviso clauses were much to be preferred, and he would favor such a clause today. He did not feel strongly on the matter, however, because in his judgment there was a greater need at the moment to guard against excessive bank credit growth than against a shortfall.

Mr. Hickman commented that, given the rapid rate of bank credit growth in July and projected for August, a zero

growth rate in September would bring the rate for the third quarter as a whole down only to about 10 per cent. Accordingly, if a two-way proviso clause were used he would favor having it activated on the downside only if the growth rate in September appeared to be below zero.

Mr. Maisel remarked that such an approach would seem to him to be inconsistent with the basic purpose of the proviso clause. The rapid increase in bank credit to which Mr. Hickman had referred reflected developments that had already taken place; the Committee should now be concerned with the growth rate that would be appropriate in the future.

Mr. Brimmer indicated that, having had an opportunity to consider the issue, he favored a two-way proviso clause.

Mr. Hayes remarked that there was a question in his mind about the desirability of shifting to a two-way proviso clause at a time when the Committee's major reason for issuing a new directive was to take account of discount rate reductions, and when there appeared to have been no developments that indicated a need for revising the bank credit projections prepared for the previous meeting of the Committee. He wondered how a move from a one-way to a two-way proviso clause would be interpreted in retrospect in the absence of some evident reason for the change.

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Mr. Daane said his position was similar to that of Mr. Hayes. He (Mr. Daane) would have no strong objections to a two-way proviso if it were realistically required in terms of the projections. However, he thought a one-way proviso might be more appropriate for the current directive, since the bank credit projection had not been changed. Moreover, it would seem preferable to wait until the Committee made a significant policy move before introducing a two-way proviso.

Mr. Kimbrel said he doubted that a two-way proviso clause was needed at this point. In general, he shared the views expressed by Mr. Daane.

Mr. Hickman remarked that the Committee might deal with the problem that concerned Mr. Maisel by planning to hold another telephone conference meeting if bank credit appeared to be markedly weaker than was now expected.

Mr. Hayes then asked for the staff's judgment on the likelihood of a major change in the outlook for bank credit.

Mr. Partee observed that, as Mr. Holland had noted earlier, the staff saw no reason to alter in any significant way the bank credit projections for August and September it had made about a week ago. The latest data from reporting banks indicated that required reserves had increased substantially on Friday, August 16, apparently reflecting larger than

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anticipated bank acquisitions of the new Treasury issues in the August refunding and/or larger than expected loans to dealers who were financing holdings of such issues. In consequence, it currently appeared somewhat more likely that growth in bank credit would turn out on the high side rather than on the low side of the range that had been projected. It had been anticipated in the projection that business loan demand would be relatively weak through August and that dealer loans would be running off at a moderate pace. It was conceivable, of course, that substantially greater weakness could develop in both categories of loan demand than was currently anticipated. One problem that made it quite difficult to forecast business loan demands at the moment was the lack of information on the rate at which loans were being repaid in connection with the liquidation of steel inventories now under way.

In sum, Mr. Partee said, at the moment the staff thought it was unlikely that growth in the credit proxy would slacken significantly below the rates indicated by the projections, and that the greater threat appeared to be the possibility of larger than expected expansion.

Mr. Hayes, noting that the Committee members appeared to be fairly evenly divided on the issue of the proviso clause, suggested that the Secretary poll the Committee on the question.

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In the poll, Messrs. Hayes, Daane, Hickman, Kimbrel, and Bopp expressed a preference for the one-way proviso shown in the staff's draft of the directive and Messrs. Brimmer, Galusha, Maisel, Robertson, and Sherrill expressed a preference for the two-way proviso proposed by Mr. Maisel.

Mr. Hayes then suggested that the Committee adopt a two-way proviso clause on the understanding that it would become operative on the downside only if bank credit growth appeared to be falling considerably short of the projections.

Messrs. Bopp, Daane, and Hickman indicated that they concurred in that suggestion.

Mr. Maisel said he would be concerned about how the credit proxy was behaving in relation to the Federal funds rate and the Treasury bill rate. If the Federal funds rate remained at 6 per cent or higher, and dealer lending rates and the bill rate also continued high, he would prefer to see the proviso clause implemented on the downside before the growth rate fell very much below the projections. If the Federal funds rate was reduced to around 5-3/4 per cent and the bill rate to below 5 per cent, he could accept a sizable shortfall in the proxy before the proviso was implemented. Finally, if the Federal

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funds rate was around 6 per cent and the bill rate in a 5.00 to 5.10 per cent range, he would favor a normal deviation below the projections before the proviso clause triggered a change in Desk operations.

Mr. Hayes remarked that each member presumably had his own views on the specifics for implementing the proviso clause, and perhaps it might be best for the Committee to agree on the general kind of understanding that he had suggested. As always, of course, the Committee could expect the Desk to take account of all elements of market conditions in making operating decisions under the Committee's directive.

Mr. Daane agreed that a general understanding to the effect that downward deviations should be quite deep before the proviso clause was implemented would serve the Committee's purposes. As had been suggested earlier, the Committee could hold another telephone meeting if problems arose under such an approach to operations.

Mr. Brimmer said he would like to return to the question he had raised in the go-around. If several Reserve Banks were to lower their discount rates to 5-1/4 per cent in the near future, the Federal funds rate might well be reduced to around 5-3/4 per cent and the bill rate to around 5 per cent. In that event, the differences of view as to when the proviso clause should be implemented on the downside would be minimized.

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Mr. Hayes remarked that the Committee could not anticipate the actions other Reserve Banks might take on discount rates in formulating its instructions to the Manager. It was true, of course, that discount rate reductions by additional Reserve Banks would ease the Desk's problems in coping with interest rate developments.

Mr. Hayes then suggested that the Committee vote on a directive incorporating a two-way proviso clause on the understanding that that clause would be implemented on the downside only if bank credit growth appeared to be falling considerably below the projections.

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

System open market operations until the next meeting of the Committee shall be conducted with a view to facilitating orderly adjustments in money market conditions to reductions in Federal Reserve Bank discount rates; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

It was agreed that the next meeting of the Committee would be held on September 10, 1968.

Thereupon the meeting adjourned.


Secretary