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, June 28, 1966, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Bopp
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Hickman
Mr. Irons
Mr. Maisel
Mr. Mitchell

Messrs. Treiber, Wayne, Scanlon, Francis, and Swan, Alternate Members of the Federal Open Market Committee

Messrs. Ellis and Galusha, Presidents of the Federal Reserve Banks of Boston and Minneapolis, respectively

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Hexter, Assistant General Counsel
Mr. Brill, Economist
Messrs. Eastburn, Garvy, Green, Koch, Mann, Partee, Solomon, Tow, and Young, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Hersey, Adviser, Division of International Finance, Board of Governors
Messrs. Axilrod and Gramley, Associate Advisers, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors
Mr. Forrestal, Senior Attorney, Legal Division, Board of Governors

Mr. Kimbrel, First Vice President, Federal Reserve Bank of Atlanta
Messrs. Willis, Ratchford, Taylor, Baughman, Jones, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, Chicago, St. Louis, and San Francisco, respectively
Messrs. MacLaury and Scheld, Assistant Vice Presidents of the Federal Reserve Banks of New York and Chicago, respectively
Mr. Nelson, Director of Research, Federal Reserve Bank of Minneapolis
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 7, 1966 were approved.

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 June 7 through 22, 1966, and a supplemental report for June 23 through 27, 1966. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury reported that the Treasury gold stock would remain unchanged this week following the decline of $100 million last week. Reserve gains by France this month appeared to be more than $100 million, so that another purchase, at least equal to the $75 million taken in June,

could almost certainly be counted on in July, and consequently another drop in the gold stock at approximately the same time. In the London market, the price of gold moved up from $35.13 earlier in June to $35.17-1/2 in the last few days. Supplies coming on the market from new production had been substantially diminished by the rebuilding of South Africa's gold reserves, and in the face of sustained demand the pool had gone $64 million further into deficit in this month alone. That acceleration in the amount of gold supplied by the pool was cause for real concern; the pool began the year with a surplus of some $40 million and was now nearly $120 million in deficit, so that official losses through the pool totaled approximately $160 million for the year to date.

Without doubt, Mr. MacLaury said, the pressures on sterling during the past month had contributed to the uneasiness in the gold market, and there were rumors last week that China might again be a buyer, although there was no confirmation of that. The sizable Russian purchase of wheat from Canada announced last week led to some hope that Russia might at last come into the market with its long-anticipated sales of gold. As yet there had been no evidence of such sales, however; and he understood that, contrary to initial impressions, the rate of Russian wheat purchases from Canada during the next three years would be only about half that of previous years.

Altogether, the outlook in the gold market was not encouraging, as Mr. Coombs had been stressing at recent meetings of the Committee.

Sterling had had a very rocky time this month, Mr. MacLaury continued. At the beginning of the month--between June 3 and June 7--the Bank of England had to provide some $350 million of support in the spot and forward markets as holders of sterling first reacted to the announcement of the $100 million U.K. reserve decline for May, and then to the prolongation of the British maritime strike and to the devaluation of the Indian rupee. The actual cost to the reserves during that four-day period was limited to about $200 million by shifting part of the original spot losses into the forward market.

Another brief burst of selling occurred on Friday, June 10, when the losses amounted to about $60 million, Mr. MacLaury observed. In the following week, however, there was a sharp turnaround in the market as those who had sold sterling short the previous week rushed to cover their positions on the announcement of renewed international assistance for the pound. The Committee would recall that on Monday, June 13, the Bank of England announced that the international credit facilities first extended in September 1965 by seven European central banks, Japan, Canada, and the Bank for International Settlements had been renewed, that related facilities with the United States were still in force, and that the Bank of France this time was participat-ing in the arrangements. The renewal was initially reported in the

press as a completely new package, and on the strength of those somewhat exaggerated press stories, substantial buying of sterling carried through most of that week. The Bank of England was able to recoup most of the previous week's spot losses, regaining about $220 million of the earlier $260 million loss.

Since in fact that recovery was not based on any fundamental change in the British situation itself, and particularly in the strike, one could not expect the buying to be long sustained, Mr. MacLaury noted. It was perhaps only natural that sterling should again come under pressure last week, when another weekend had passed with no news of a strike settlement and when the market had had more time to assess closely the implications of the renewal of the September arrangements. But, on that occasion, the pressure was compounded by an extreme squeeze for funds that developed in the Euro-dollar market as mid-year approached; quotations for short maturities rose more than 1/4 per cent to 6 per cent or higher. The pull of the Euro-dollar market drew funds out of sterling, and on Monday, June 20, the Bank of England had to provide some $140 million to hold the spot rate at $2.7890. Since much of the selling that day reflected covered movements of funds out of sterling, forward sterling rates strengthened sharply; for example, one-month sterling rose to a premium for the first time since late 1963. With U.S. Treasury bill yields also slipping, the covered incentive on three-month bills

jumped from less than .40 per cent to .70 per cent per annum in favor of London, while London's incentive on one-month bills advanced to approximately 1-1/4 per cent per annum. Despite the generally tight money market conditions in this country, there was a distinct possibility that covered incentives of that magnitude could pull private funds from the U.S. To reduce the potential for such an outflow, and at the same time to relieve exchange market pressures resulting from the dollar squeeze and to provide support for spot sterling, in the afternoon of June 20 the New York Bank began to engage in market swaps--purchasing sterling spot against one-month forward sale, thereby widening the discounts for forward delivery. By the close of business that day, a total of almost $50 million equivalent of swaps had been undertaken, half for System account and half for Treasury account. As a result of that intervention the net incentive on one-month bills was reduced to about 0.90 per cent per annum. The operation had, of course, been discussed in advance with the Bank of England and it was welcomed by them in the full knowledge that the market would have to reabsorb the sterling purchases when the forwards came due in July. On Tuesday, June 20, the Bank of England again had to provide sizable support--$55 million--to counter brief but heavy selling just after the opening in London. With the forwards still narrow and the incentive in favor of London on one-month bills still nearly one per cent, the New York Bank continued to engage in swaps

on Tuesday and Thursday, though on a much smaller scale. Altogether, during the three days of such operations, a total of $67 million of sterling was purchased on a covered basis, half for System account.

Mr. MacLaury went on to say that although the operations indirectly helped to offset part of the pressures on U.K. reserves arising from the technical dollar squeeze--without the adverse effects on the U.S. balance of payments that would have accompanied interest-induced private outflows from this country--the British authorities nevertheless were facing a pretty bleak picture on reserves this month. The net result of the Bank of England's very sizable intervention, its repayment of the $100 million credit from the U.S. Treasury over last month-end, and the maturing of a sizable amount of previous forward contracts left U.K. reserves down nearly $550 million.[1/]

A published loss approximately double last month's figures--i.e., about $200

1/ Two sentences have been deleted at this point for one of the reasons cited in the preface. The deleted material reported further comments by Mr. MacLaury on recent and prospective activities of the Bank of England.

million--seemed reasonable under the difficult circumstances, even though a decline of that magnitude clearly involved a calculated risk of speculative repercussions. If that reasoning was accepted by the U.K. authorities, the U.S. would have to be prepared to put up the remaining $200 million necessary to cover the $550 reserve decline. Half probably would be provided by the Treasury and half through a drawing under the swap line with the Federal Reserve.

Mr. MacLaury remarked that there had been considerable activity in other currencies during the month, with France and Italy continuing to take in dollars as a result of payments surpluses, Switzerland and Germany experiencing sizable repatriations of funds in connection with tight domestic money markets and mid-year positioning, and the Canadian dollar benefiting from the announcement of Russian wheat purchases. He would not go into detail on those developments, however, because they had not involved any System operations. Sterling remained the real focus of concern. In that connection, he noted that there had been no substantive changes in the sterling balance arrangements finally agreed upon at the last Basle meeting from the draft agreement circulated to the Committee by Mr. Coombs.

Mr. Daane asked about the dates on which the British would publish figures for June on their reserves and on their trade balance. He suspected that the first-quarter payments figures to be announced

soon would not be good, and he was concerned about the possible effect on the sterling market of the conjuncture of poor payments figures and data showing large reserve losses.

Mr. MacLaury replied that the reserve figures for a month customarily were published two business days after the end of the month, and the June trade figures could be expected about the middle of July.[1/]

In response to another question by Mr. Daane, Mr. MacLaury said that the British preferred not to draw on the new credit package because they were not certain they could prove there had been a net decline in foreign sterling balances since the end-of-February base period specified under the formula contained in the agreement. Although foreign balances had been run down in June, they had increased in April and May.

Mr. Brimmer asked what reason the British would have for not showing a June reserve loss larger than the $200 million[2/]

1/ Two sentences have been deleted at this point for one of the reasons cited in the preface. The deleted material reported further comments by Mr. MacLaury on the British reserve situation.

2/ Part of a sentence has been deleted at this point for one of the reasons cited in the preface. The deleted material related to the $200 million figure under discussion.

Mr. MacLaury responded that they would be concerned about the risk of setting off a cycle of speculation against sterling. A loss of $200 million was large for a single month; in the three preceding months the British had shown losses of about $75 million, $50 million, and $100 million, respectively.

In reply to questions by Mr. Mitchell, Mr. MacLaury said that the three figures he had just mentioned reflected the actual reserve declines the British had experienced but, of course, a $200 million figure for June would not. In the past the British had always announced the fact of recourse to their U.S. credit facilities, but had not made known the amounts involved.[1/]

Mr. Mitchell said that he, for one, felt the British would achieve the results they sought faster if they reported their reserve position accurately than if they attempted to conceal their true position.[2/]

1/ Two sentences have been deleted at this point for one of the reasons cited in the preface. The deleted material reported a comment by Mr. Hayes regarding a recent conversation of his with an official of the Bank of England.

2/ A sentence has been deleted at this point for one of the reasons cited in the preface. The sentence reported a further comment by Mr. MacLaury on the British reserve situation.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period June 7 through 27, 1966, were approved, ratified, and confirmed.

Mr. MacLaury then recommended renewal of six standby swap arrangements that would mature soon. They were a $50 million arrangement with the Bank of Sweden, having a term of 12 months, and maturing on July 19; a $150 million arrangement with the Swiss National Bank, having a term of 6 months, and maturing on July 20; two $150 million arrangements with the BIS--one for System drawings in Swiss francs and one for System drawings in other European currencies--having terms of 6 months and maturing on July 20; a $50 million arrangement with the Austrian National Bank, having a twelve-month term, and maturing on July 26; and a $250 million arrangement with the Bank of Japan, also with a twelve-month term, and maturing on July 29.

Renewals of the six standby swap arrangements, as recommended by Mr. MacLaury, were approved unanimously.

Mr. MacLaury then noted that he had one remaining matter to report for the information of the Committee. At the preceding meeting the Committee had noted without objection the renewal of the $50

million drawing on the National Bank of Belgium that represented the portion of the swap arrangement with that Bank that was always fully drawn. As in the past, the Belgians had asked that the interest rate on the drawing be adjusted to current market levels and, with the concurrence of the U.S. Treasury, the rate was increased from 4-3/8 per cent to 4-1/2 per cent. The rate on the standby portion of the arrangement remained unchanged at 4-1/4 per cent, and no use was being made currently of either portion of the arrangement.

Chairman Martin then invited Mr. Daane to report on the meeting of the Deputies of the Group of Ten he had recently attended.

Mr. Daane said that the Deupties meeting was held in Frankfurt, Germany, on Wednesday through Friday of last week (June 22-24). His own assessment was that it represented a significant setback in the negotiations of the Ten. As a backdrop to the meeting there had been increasingly serious concern abroad with the U.S. balance of payments position, as Chairman Martin and he had reported at the previous meeting of the Committee. Skepticism was growing about the real objective of the U.S. in the negotiations, with the question raised as to whether the U.S. was seeking some additional financing that would enable it to avoid the monetary discipline the members of the Group of Ten felt it should observe.

A more specific backdrop to the meeting, Mr. Daane continued, was the discussion at an immediately preceding meeting of the Ministers and Governors of the European Economic Community. In that

discussion apparently the French Finance Minister had capitalized on the concern about the U.S. payments balance, and had persuaded his colleagues to adopt a considerably firmer position on three points. The first, and most important, was that the six members of the EEC were now solidly of the view that the decision-making process on any new asset creation should rest with the Group of Ten, even if the assets were created through the IMF. Moreover, some of the Deputies made it perfectly clear that that position had been taken at the cabinet level. Thus, they had definitely hardened their positions on the matter of decision-making. Secondly, they had firmed even further their positions with regard to preconditions for asset creation, most significantly in setting as a precondition the restoration of equilibrium in both the U.S. and U.K. balance of payments. They also called for stronger rules on the adjustment process and for strengthened multilateral surveillance. Third, they had coalesced around the idea of a simple unit plan.

Those apparent developments at the EEC meeting, Mr. Daane continued, filtered through to the subsequent deliberations in Frankfurt of the Group of Ten Deputies, where some of the previously discussed substantive matters relating to reserve asset creation, such as the question of a gold link, were submerged. The discussion focused almost entirely on the question of the decision-making process, particularly as it related to moving into a second stage.

The questions were: Was there now to be a second stage? If so, how should it be entered, and how organized? As a further backdrop to what was an unsuccessful and incomplete discussion among the Ten, the International Monetary Fund Executive Board had held extended discussions of a U.S. proposal for creation of an Advisory Committee of Governors to carry on second-stage discussions. The Fund Executive Board had reacted negatively, and quite strongly. It had concluded by endorsing a proposal of the Managing Director for a compromise involving second-stage deliberations by the Executive Board and the Group of Ten Deputies sitting together. There had been discussions between Messrs. Schweitzer and Emminger and a cross-fertilization of the ideas of the Fund and the Group of Ten. As he understood the outcome, the proposal was for separate, parallel efforts by both the Fund Board and the Ten, with regularly-scheduled combined meetings, perhaps four times a year.

Those, Mr. Daane thought, were the key points at the meeting last week. The Deputies did consider parts of the draft of their report itself, but such discussion was secondary to the issue of decision-making. A substantial degree of agreement was reached on the language of the introduction and of the second chapter concerning improvements in the international payments system. Consideration of the third chapter, dealing with elements of various proposals for the creation of reserve assets, was postponed to the next meeting,

and the discussion bogged down when Chapter 4, involving a vertical analysis of the various proposals, was considered. The current thinking was that the substance of Chapter 4 should be included in an appendix. As far as the draft report was concerned, the focus was mainly on the fifth chapter, Conclusions and Recommendations. The French position, while basically unchanged, had hardened; they were now willing to say very early in the concluding chapter that they had abstained even from participating in the discussion and drafting of all those passages of the report relating to the elements of contingency planning. They indicated that they would hold firmly to their position until the U.S. achieved equilibrium in its balance of payments. It was possible to get agreement among the other nine members of the Group on the desirability of contingency planning, but the French would certainly stand strongly on their position.

The Deputies would meet in Paris on July 6 to put their report in final form, Mr. Daane said. The report would then be considered by the Ministers and Governors of the Ten at The Hague on July 25-26.

Mr. Daane concluded by noting that Mr. Solomon, in addition to attending recent meetings of the Deputies, had been a member of a four-man drafting group that had held sessions between the Paris and Frankfurt meetings. He thus had been extensively exposed to the thinking of the Europeans and might have some comments.

Mr. Solomon said he would make two points. First, he thought the hardening of views by the Europeans on the question of decision-making reflected what was close to a suspicion on their part that, if a scheme for creating reserve assets through the Fund were adopted, the U.S. would team up with the rest of the world to force creation of new assets that would end up in their own reserves. At the moment they felt strongly enough on the point to insist on conditions that would prevent that from happening. Secondly, the present confusion regarding alternative proposals for procedures in the second stage also reflected the hardening of the Europeans' position and their reluctance to move into that stage. They would prefer procedures that were less than clear-cut, and that in general would involve continuing work in the area by the Group of Ten while paying some lip service to the idea of a second stage.

Mr. Daane remarked that he subscribed fully to Mr. Solomon's observations.

Mr. Galusha asked whether Mr. Schweitzer's recent strongly worded criticism of the limitation of the current dialogue to the Ten had resulted in any significant strain.

Mr. Daane replied that, as far as the U.S. view was concerned, there would inevitably be a second stage whether or not the Ten were willing to accept it. While the Group had fended off the participation of other countries thus far, they were aware of the need to

bring in the rest of the world at some point and in his view Mr. Schweitzer's statement was overly critical of the Ten. The Group probably would not be able to resist for any length of time the strong feeling in the Fund and in the countries that were not participating, and in due course there was likely to be parallel consideration by the Fund and the Group, and perhaps some form of merger. The question would then arise whether that would constitute a real second stage of negotiation.

Chairman Martin noted that Mr. Hayes recently had spent some time in Europe. He invited Mr. Hayes to report any observations of interest to the Committee.

Mr. Hayes said that he had met with the Governors of a number of European central banks, and while the discussions were lengthy and intimate they did not involve any specific business. He would report a few of his general conclusions. First, one pattern of thinking that seemed common to many countries was an acute fear of inflation, a feeling that monetary policy was able to do something in that regard but not everything, and a feeling of frustration with respect to fiscal policy. That pattern was clearly evident, for example, at the Bundesbank and the Netherlands Bank. Of course, recent experience in those countries was parallel in some respects to that of the U.S.

Secondly, Mr. Hayes said, he fully agreed with Mr. Daane about the growing concern and worry in Europe with respect to the U.S. balance of payments. That concern had not yet taken the form of an acute distrust of the dollar but the seeds of such distrust were being sown and were finding fertile ground. That, in turn, was a cause for real concern on the part of the Committee. The Europeans were skeptical about the will of the U.S. to do what had to be done to bring its payments into balance. He was not sure of the extent to which the effects of the Vietnam hostilities were recognized. They probably were not fully recognized, but even to the extent they were the matter was clouded by the lack of sympathy in Europe with respect to U.S. objectives in Vietnam. In his talks with people concerned with financial matters he had not found any widespread sympathy with the U.S. position on Vietnam nor any particular feeling that the hostilities were an acceptable reason for the failure of the U.S. to achieve the balance of payments goal it had announced earlier.

Mr. Hayes thought that U.S. balance of payments developments were beginning to affect the thinking of some of the nation's best friends in Europe on the subject of gold and dollar holdings. Specifically, in his discussions with Governor Carli of the Bank of Italy he had found a greater preoccupation with the gold ratio than ever before, which Governor Carli attributed to pressures from

his own Parliament and from the European Economic Community. That did not bode well for the System's defensive efforts; the swap arrangements provided an exchange guarantee but not a gold guarantee. Even in Germany, which had been a strong friend of the U.S., there was a good deal of worry. From time to time the Bundesbank had considered the desirability of enlarging its swap arrangement with the System. However, there were divided views at the Bundesbank and in some views the arrangement with the System was regarded with a certain degree of suspicion in the absence of any visible trend toward improvement in the U.S. payments balance.

As to the sterling question, Mr. Hayes said, he could not recall a time at which there was as much profound worry as now--not only on the continent but also in the London financial community. The maritime strike was a bitter blow at a time when it had been thought that Britain was making a reasonable degree of progress in recovering from the crisis. The general feeling was that the strike should not have occurred and no one seemed to know what could be done about it.

Mr. Hayes remarked that the way in which the succession at the Bank of England had been worked out was widely approved in the London financial community.[1/]

1/ A sentence has been deleted at this point for one of the reasons cited in the preface. The sentence reported a further comment by Mr. Hayes on reactions to the succession at the Bank of England.

In concluding, Mr. Hayes noted that he had joined Mr. Shepardson, and Mr. David Hayes of the Board's staff, at the recent 150th anniversary celebration of the Bank of Norway in Oslo. Their reception had been a cordial one and the affair on the whole was a pleasant experience.

Chairman Martin noted that Mr. Bopp recently had attended the International Monetary Conference in Madrid and the Annual Meeting of the Bank for International Settlements, and had visited the Bundesbank, the Bank of France, and the Bank of England. The Chairman invited Mr. Bopp to comment.

Mr. Bopp said he had nothing new or encouraging to report but that he was able to confirm on the basis of personal contacts the reports that System members had been bringing to the Committee for some time.

There was widespread agreement that inflationary pressures existed throughout the Western World, Mr. Bopp observed. In Europe and particularly on the continent construction was rampant. There was a widespread view on the continent that the United States and the United Kingdom were primarily responsible for those developments. Mr. Holtrop, Chairman of the Bank for International Settlements, was particularly emphatic that the inflation had been exported from the United States to the continent. He (Mr. Bopp) had responded to that line of argument by saying that until just

recently the United States had had relatively large unutilized resources and stable prices. In short, the U.S. had not until recently had inflation and it was not convincing to blame a country which did not have inflation for exporting it elsewhere.[1]

There was also widespread feeling, Mr. Bopp continued, that too much of the burden of restraining inflation was being placed on monetary policy and that no central bank was receiving adequate support from fiscal policy. He had indicated that credit conditions in the United States were significantly tighter than was evidenced by looking merely at the discount rate. The scarcity of funds was reflected more in the Federal funds rate which at times was as much as one per cent above the discount rate.

Mr. Bopp had found the greatest sympathy and understanding of the American position in the United Kingdom which historically had assisted other parts of the world and, therefore, appreciated the American efforts to reconstruct Europe after the War.

Mr. Blessing had commented to Mr. Bopp that Germany now had about 1,300,000 foreign workers, mostly from Spain and Italy and some from Turkey and North Africa. Recently there were seven to eight vacancies for each unemployed person. Mr. Blessing

1/ A sentence has been deleted at this point for one of the reasons cited in the preface. The sentence reported a further comment by Mr. Bopp on international discussion of the problem of inflation.

had indicated that he had no fear at all that tight credit would create unemployment of German workers.[1]

Chairman Martin then noted that Mr. Young recently had participated in a mission to Vietnam to help that country deal with its financial problems, and he asked Mr. Young to tell the Committee about the negotiations.

Mr. Young said the mission was for the purpose of working with the Vietnamese Government in developing a reasonable stabilization program. The mission consisted of a team from the International Monetary Fund going at the request of the Vietnamese Government; a group of three persons from the White House, State Department, and the Treasury to work on the problem from the U.S. point of view; and finally, himself, participating in the capacity of adviser to the Governor of the central bank. As matters turned out, his own role was largely that of mediator between the IMF and U.S. Government groups.

1/ Two sentences have been deleted at this point for one of the reasons cited in the preface. The deleted material reported certain further observations by Mr. Bopp on conditions in one of the countries he had visited.

The mission could hardly have been launched under less promising circumstances, Mr. Young continued. Vietnam was on the brink of civil war, the army had been withdrawn from active combat to deal with the internal situation, and military developments were not going well. There was extreme discouragement among U.S. personnel in the field and in Washington; the Vietnamese inflation appeared to have gotten out of hand, and there was no agreement among the various agencies as to what kind of approach to a solution of the problem would make sense.

The Vietnamese inflation was being propelled by rapid monetary expansion, Mr. Young said, and was rendered more acute by inadequate port facilities and harbor congestion, interdiction of major highways by the Viet Cong--so that cargoes moving by truck were either confiscated or subject to high tribute--and disorganization of agricultural production. The rapid monetary creation resulted partly from the deficits of the Vietnamese Government, primarily in connection with military outlays, and partly from expenditures by the U.S. embassy for various activities, including military and civilian construction. Expenditures by U.S. personnel in Vietnamese currency, on the order of $100-$150 million a year, added to the problem. All told, the pace of monetary expansion last year was about 74 per cent and the best estimate he was able to obtain for this year was something over 100 per cent. Prices

were rising at an accelerating pace in Saigon, and probably even more rapidly in the rest of the country although price indexes were available only for the capital.

In sum, Mr. Young continued, the situation was one of inadequate supply and extreme excess liquidity, with additional liquidity being pumped in at a rapid rate. At the outset the situation appeared virtually hopeless, but the mission was able to move forward when the Government was found to be interested in considering a program for financial stability and capable of reaching decisions on the subject. Three alternative proposals were advanced, of which one was a scheme for extinguishing money by financing capital flight. That alternative appealed to some members of the cabinet but was rejected by Premier Ky on the ground that it was morally wrong. The second proposal, which involved a partial devaluation, was the one finally accepted. It introduced simplification of the exchange system, improvement in import tax procedures, some fiscal measures that would add to the Government revenues but would not cover the inflationary gap entirely, and, finally, action to limit the expansion of private bank credit. In addition, the Vietnamese proposed to extinguish some liquidity by sales of gold from their own stock. The third alternative, which the Government thought too difficult, would have involved a more severe devaluation,

the establishment of a single rate throughout the exchange system, and a rigorous control of the creation of money through Government borrowing.

At one stage in the discussions, Mr. Young said, the Vietnamese appeared prepared to accept the second alternative, but the situation was not completely clear because there was a strong division in the cabinet and Premier Ky had not made up his mind. He finally did so in the mission's last week. Mr. Young was impressed by the fact that the Premier found time to consider the problem in view of the many other pressing problems facing him. In the end it was pointed out to Premier Ky that the operation was likely to be a painful one; that the partial devaluation proposed would increase prices by some uncertain amount in the range from 5 to 25 per cent, and that the additional inflationary jolt might be severe enough to result in overthrow of the Government. The Premier responded that if his Government was not strong enough to carry out a program of value to the people his cabinet should be overthrown. Members of the mission were quite impressed by his decision.

Mr. Young concluded by noting that the program had been announced about a week ago and it had not had quite as drastic effects as some had predicted. Some prices had advanced sharply but others only a little, so that the average increase might well turn out to be reasonably moderate. The mission was hopeful that

the program would go forward as proposed. If carried out as planned, some further upward price adjustments would occur for about three months. Money creation then would be stopped for about twelve months, with accompanying restraint on further price pressure from the monetary side, after which it would again resume. If the monetary program was reasonably successful, if port facilities were expanded and imports increased, and if highway traffic was opened to the north, it should prove possible to stabilize prices in Vietnam for most of next year. Another look at the program would then be in order.

Chairman Martin commented that Mr. Young's report was hopeful, indicating as it did that the U.S. might not lose the war behind the lines.

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 open market operations in U.S. Government securities and bankers' acceptances for the period June 7 through 22, 1966, and a supplemental report for June 23 through 27, 1966. 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 financial markets exhibited a great deal of strength and resiliency over much of the period since the Committee last met with a generally confident tone predominating. The corporate and municipal markets handled

an exceptionally large volume of new issues at high though generally stable rates, while an unprecedented volume of Federal agency financing was distributed at the higher interest rates that had emerged. In the Government securities market, where there was no pressure of new supply, prices of notes and bonds rose appreciably while Treasury bill rates moved sharply lower. By late last week, however, market sentiment appeared to be again shifting. And although the demand in the capital markets is expected to be less in July than June, considerable uncertainty is developing about the future course of both long- and short-term interest rates.

Commercial banks remained under pressure throughout the period, with Federal funds and dealer loan rates pushing into new high ground and with some prime banks offering as much as 5-1/2 per cent for 30-day CD money. The high cost of money has brought about considerable discussion of a possible increase in the prime rate. At the close of business last night dealers raised bankers' acceptance rates by 1/8 per cent to 5-5/8 per cent bid on 90-day acceptances and to 5-3/4 per cent on longer maturities. The markets are now awaiting the outcome of the midyear interest and dividend payment period of the thrift institutions and the implications of that outcome for the mortgage market. Rate developments at some savings and loan associations and mutual savings banks just before and after the weekend have also raised questions of a new round of rate competition among the savings institutions. Against this background the markets had become quite cautious and are currently in process of assessing the implications of the Board's actions announced late yesterday.

Developments in the market for Treasury bills led to a further sharp rate decline, bringing quotations to the lowest levels for the year and extending further the already wide gap between bills and other money market instruments. Contributing to this unusual degree of strength were various special demand factors, coupled with the reduction in supply associated with the redemption of $4.5 billion June tax anticipation bills. As a result of these developments dealers' inventories were picked bare, with scarcities evident throughout the whole maturity range. In fact, total dealer positions in Treasury bills due in three-months dropped to less than $100 million by last Friday, and the latest outstanding 91-day issue closed last night at 4.33

per cent. To be sure, a degree of caution has emerged in recent days as market participants questioned the tenability of current rate levels, and despite the scarcities of supply dealers, in particular, have approached recent Treasury bill auctions with mixed emotions. In last Thursday's auction of new one-year bills, for example, tenders were spread over a very wide price range, with the average issuing rate just under 4.70 per cent and some awards at rates as high as 4.79 per cent. Market rates, particularly for long bills, temporarily adjusted higher by about 10 basis points in the wake of that auction, and a cautious atmosphere was again in evidence yesterday as the regular weekly bill auction approached. Average issuing rates for the three- and six-month bills were set at about 4.44 and 4.60 per cent, respectively, with the weight of demand on the three-month issue as banks bid to build up positions in advance of the June 30 statement publishing date. It is generally expected that the available supply of bills will increase in the period ahead as banks reverse their midyear window dressing operations.

As far as the aggregate reserve measures are concerned, bank credit expansion appeared to be lagging behind expectations during the first part of the period, but then accelerated in the statement week ended June 22 in the light of loan demand related to the tax date and to the speedup of Treasury collection of withheld income taxes from business firms. Thus, on June 16, both the Board and the New York Bank staff projections of average bank credit expansion in June were only about 3-1/2 per cent. By last Thursday, however, the projections had been raised to a 5-6 per cent range, but were still below the 6-1/2 per cent estimate made at the time of the last Committee meeting.

The rise in net borrowed reserves to $417 million in the statement week ended June 22 was partly related to the stronger than anticipated expansion in required reserves and bank credit. However, country banks ran down their excess reserves in the second week of their settlement period so that member bank borrowing from the Reserve Banks actually fell. Moreover, the sharp downward movement of Treasury bill rates and the strong sentiment then existing in the securities markets generally permitted a somewhat greater swing in the net borrowed reserve figures with little risk of signaling any change in monetary policy. I believe it would be desirable to condition the market to wider swings in the net borrowed reserve figures in response to changing patterns of credit

expansion or reserve distribution, but given the tender state of expectations in recent weeks there have been obvious risks of market misinterpretations of the implication of such swings for the discount rate or Regulation Q ceilings. I should note, in this respect, that there is normally an unusually wide swing in country bank excess reserve positions between the second and third week in July. In the past two years country banks have built up their excess reserves to about $500 million in the second week of July (the first week of their settlement period), and then let them run down to $200 million or less in the third week. We believe that this pattern is related to unusually heavy calls by the Treasury on tax and loan account balances at small- and medium-sized banks at that time of the year. In any event, assuming the pattern is repeated this year and other things being equal, it would seem desirable to let net borrowed reserves run lower than usual as reserves become immobilized in excess reserves at country banks, and then run higher as these excesses come into the reserve stream at the end of the country bank settlement period. The market should not find it difficult to understand this sort of variation of net borrowed reserves.

Between now and the July 4 weekend the System will have to supply around $1 billion in reserves, reflecting the cash needs of the public over the holiday, in order to keep net borrowed reserves near current levels. Given the market scarcity of Treasury bills, we have been giving a good deal of thought at the Trading Desk to how these reserves might be supplied. At the present moment, with at least some improvement in the availability of Treasury bills likely, and with the prices of Treasury coupon issues declining--in sharp contrast to the situation a week ago--the prospect of supplying reserves through normal channels does not appear as difficult as it did earlier. A combination of outright purchases of Treasury bills and other Treasury issues in the market and from foreign accounts, repurchase agreements on both Government securities and acceptances, and some decline in Treasury balances at the Reserve Banks may be enough to do the job. Given all the uncertainties, however, in face of the large reserve need, I would like to outline to the Committee an alternative approach which we might follow if market scarcities of Treasury issues persist in the weeks just ahead.

As the Committee knows, repurchase agreements against Government securities are based on dealer financing needs at the moment. Dealer financing needs lately have been

minimal because of the heavy demand for Treasury bills and high dealer financing costs, and the repurchase agreement has not therefore been a feasible means of reserve supply. However, we are quite certain if dealers were told in advance that repurchase agreements were available, they would be able to find the necessary collateral by arranging back-to-back repurchase agreements with either banks or other holders of Government securities who were looking for cash over a period of expected money stringency. This approach would not involve any change in the repurchase instrument. It would involve a change from our usual practice of relating repurchase agreements to dealer inventories to a use of the dealers as a channel to those holders of Government securities who have temporary cash needs and who would prefer not to sell Treasury bills or other Government securities outright. In order to give maximum flexibility to such a repurchase agreement approach, I recommend that the Committee waive the requirement that repurchase agreements be limited to Government securities maturing in 24 months or less for any agreements entered into until the next meeting of the Committee. Let me reiterate that such a departure from normal practices may well not be needed, but in light of recent market scarcities of Treasury bills I believe we should do our contingency planning now.

As you know, the Treasury will end the fiscal year in a strong cash position and will not actually need new money until some time in August. Although no decisions have been made, some sentiment exists for selling tax bills in July. If this should be decided on, the announcement would probably have to come before the middle of the month in order to get the auction out of the way before the regular one-year bill auction. Towards the end of July the Treasury will meet with its ABA and IBA borrowing committees to consider the terms of its August refunding, with an announcement likely on July 27.

Chairman Martin called for discussion of Mr. Holmes' proposal that the Committee temporarily waive the requirement that repurchase agreements be limited to Government securities maturing in 24 months or less, first asking for Mr. Hackley's views.

Mr. Hackley noted that the requirement in question was contained in paragraph 1(c) of the Committee's continuing authority directive. If the Committee acted on the subject he would recommend that it do so by amending the directive rather than by waiving the requirement. The substantive effect would be the same but in his opinion an amendment would be the more appropriate form of action.

In response to Mr. Brimmer's question about the specific time period in which he might use the proposed authority, Mr. Holmes said that if used at all it would be in the period of reserve need immediately ahead; thus, an authorization that remained in effect until the next meeting of the Committee would be satisfactory. The authorization would be used only in an emergency situation, and it was unlikely that the need for it would arise. In his judgment, however, there was enough uncertainty on the question to warrant advance preparation.

Mr. Daane thought that granting the additional authority for the period until the next meeting of the Committee would be appropriate in light of the many uncertainties ahead, including those related to the reactions to the Board's reserve requirement action of yesterday.

Mr. Galusha asked what differential would be available to the dealers in the "back-to-back" repurchase agreements in which they would engage.

Mr. Holmes replied that he would contemplate making the RP's with dealers at the customary rate--the discount rate--and let market competition set the rates at which dealers made RP's with others.

Mr. Galusha then inquired if Mr. Holmes thought there was any possibility of criticism to the effect that the System was offering dealers the opportunity to make windfall profits, and Mr. Holmes said that such a possibility did exist.

Mr. Brimmer asked whether the proposed arrangements would be restricted to nonbank dealers.

Mr. Holmes replied affirmatively, adding that there might well be some criticism from bank dealers, who had expressed a desire for the Deak to make RP's with them in the past. He would not be overly concerned with such criticism, however, because the arrangements would be made only if an emergency situation arose. Presumably banks would be among those that the nonbank dealers would get in touch with immediately regarding their RP's, so that the funds would be available to the bank dealers indirectly.

Mr. Brimmer then commented that he had recently attended one of the discussions being held currently with dealers as part of the Federal Reserve-Treasury dealer-market study. The dealer involved in the discussion had made the point strongly that the Desk did not engage in a sufficiently broad go-around when it traded in coupon issues; some dealers were left out and others appeared to have

special access to the Desk. He assumed the Manager would not exclude any nonbank dealers in the operation now under discussion.

Mr. Holmes replied that the Desk would contact all nonbank dealers, and would distribute the RP's among them about in proportion to the amount of business the Desk had done with each in the past six months, both in outright transactions and through repurchase agreements.

Chairman Martin noted that he thought granting the proposed authority would be appropriate. He suggested that the Committee amend the continuing authority directive today and plan on rescinding the action at its next meeting.

Thereupon, upon motion duly made and seconded, and by unanimous vote, paragraph 1(c) of the continuing authority directive to the Federal Reserve Bank of New York was amended to read as follows:

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

Mr. Mitchell asked what level of net borrowed reserves the Manager thought would be consistent with the increase in reserve requirements of $400 million, assuming that the change in requirements was a monetary policy action intended to result in tightening. In other words, what level of net borrowed reserves would be appropriate when the increase in requirements became effective?

Mr. Holmes replied that the answer would depend on the Committee's own policy decision. If the Committee chose not to offset any part of the increase in requirements, as a matter of mechanical calculation net borrowed reserves should be increased by $400 million.

Mr. Maisel commented that the question appeared to be one of timing. He assumed that the Committee would not want the full adjustment of $400 million to take place during the next four weeks.

Mr. Daane remarked that the Manager's reply made sense to him; whatever change occurred in net borrowed reserves should reflect the decision of the Committee. There were many other factors to be taken into account in deciding on operations, and he did not think one could or should say that net borrowed reserves should be deepened by any precise figure, such as $400 million.

Mr. Scanlon asked what level of net borrowed reserves the Manager thought the Committee should call for if it was to implement the Board's objective in raising reserve requirements as described

in yesterday's press statement--namely, that it "would serve to apply a moderate additional measure of restraint upon the expansion of banks' loanable funds."

Mr. Daane said that Mr. Scanlon's question might be sharpened if "a moderate additional measure of restraint" was defined as the amount of further reduction in net reserve availability possible without creating pressures that would require an increase in the discount rate.

Mr. Holmes replied that the answer would depend on the nature of other developments. For example, the answer would be different if there were a change in the prime rate at banks.

Mr. Hayes asked whether the psychological effect of the reserve requirement increase might not in itself exert some moderate restraint, even if there were no change in net borrowed reserves.

Mr. Holmes replied he thought that would be the case but, again, it was necessary to wait to see how the market reacted.

Mr. Daane commented that the Board's action in fact had had an immediate announcement effect, but that effect might or might not taper off quickly.

Chairman Martin remarked that it was generally recognized that time deposit funds would now cost more to the larger banks.

Mr. Ellis commented that he found some difficulty in accepting the notion that net borrowed reserves should be held at $400 million. Required reserves had been increasing more or less steadily and if that level of net borrowed reserves was maintained the Committee would continue to supply all of the reserves demanded. At the other extreme, to deepen net borrowed reserves to $800 million would represent a large change that would exert substantial pressure on the aggregates.

Mr. Swan observed that the fact remained that reserve requirements would increase by $400 million on the effective date of the action. The Committee's choice was between offsetting some or all of that increase or having the aggregates fully reflect the increased requirements.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period June 7 through 27, 1966, were approved, ratified, and confirmed.

The staff economic and financial report at this meeting was in the form of a visual-auditory presentation. (Copies of the charts have been placed in the files of the Committee.)

The introductory portion of the review, presented by Mr. Brill, was as follows:

> This has been a rough year for forecasters; the economy has come up with a number of surprises. The first-quarter pace was more rapid than any of the forecasting profession expected at the beginning of the year. And just when sights

were being revised upward, the economy stumbled a bit and produced a slower second quarter than expected.

These jerky movements in the pace of economic activity make life interesting--and hazardous--for forecasters. At the same time, they underscore the necessity of looking for longer-term underlying trends, rather than at shorter-term oscillations. Undaunted by the prospect that the economy in the months ahead will continue to move less evenly than forecasters' smooth lines, we have once more girded our loins and faced up to the necessity of exploring prospective economic and financial developments and their possible interactions with policy decisions. Our analysis this morning will focus on the basic trends in activity and finance likely to emerge over the remainder of this year and into 1967. But first we will begin with a review of developments thus far in 1966.

Mr. Gramley then commented on economic and financial developments through the first half of 1966, as follows:

Economic activity since mid-1965 has been stimulated vigorously by increased defense spending. Outlays for defense have risen $8 billion--or 16 per cent--in the past year. The backlog of defense orders is up 26 per cent, and production of defense equipment 27 per cent. The current annual rate of defense spending already exceeds the amount budgeted for fiscal 1967, and further expansion seems clearly in prospect.

The defense build-up, occurring at a time of high resource use, heightened pressures on capacity and encouraged further expansion in business fixed investment. On a GNP basis, business fixed investment has increased 13 per cent over the past year, and now accounts for more than 10-1/2 per cent of GNP. Business inventory demands also have been strong, as firms have sought to maintain adequate stocks to meet rapidly advancing demands.

GNP in current dollars increased between $16 and $17 billion in both the fourth and first quarters, but growth then slackened in the second quarter of this year. The fast pace of GNP during the winter months reflected a sharp upsurge in consumption expenditures adding to the thrust of rising defense and business investment outlays. In 1958 dollars, the first-quarter rise in GNP was at nearly a 6 per cent annual rate, exceeding the large 5-1/2 per cent advance for all of 1965.

The rise in consumption slackened in the second quarter, as auto sales fell from record first-quarter levels. Larger tax payments retarded the growth of disposable income, and helped to moderate consumer purchases in the period.

Responding to strong demands, nonagricultural employment rose very rapidly from October through March. Employment gains substantially exceeded growth in the labor force, and the unemployment rate fell below 4 per cent this spring. With experienced workers in short supply and labor turnover rising, employers lengthened the workweek further, hired younger workers, and accelerated in-plant training programs. Employment gains moderated in the second quarter, partly because of strikes, and cutbacks in auto production. The total unemployment rate rose to 4 per cent in May, as teen-agers entered the labor market early for summer jobs. But the unemployment rate for adult men fell to 2.1 per cent in April and May--about as low as during the Korean conflict.

A tighter labor market has led to wage increases above the guidepost in both high- and low-wage nonmanufacturing industries, especially those engaged in local area bargaining. Wage gains in these industries have been about 4-1/2 per cent or more per year--considerably higher than the increases in manufacturing. With wages rising faster than productivity, higher labor costs, along with demand pressures, have been reflected in rising prices for construction and services.

In manufacturing, wage gains last year were still in line with increased productivity, and unit labor costs remained stable. Average hourly compensation has begun to rise somewhat faster, however, and unit labor costs in manufacturing have increased moderately since last fall.

With demands intensifying and labor costs firming, the rise in prices of industrial commodities accelerated to an annual rate of 3-1/2 per cent in the first half of this year--up from the 1-1/2 per cent of last year. Despite this acceleration, the total wholesale index has been stable since February, when the earlier sharp rise in food-stuffs was reversed.

Sensitive materials have made a larger contribution to the rise in industrial commodities this year than last--reflecting heightened demands for copper and aluminum, and supply problems in hides and lumber.

For other, less sensitive, materials, price increases have become more numerous, though not yet large. One reason is that steel prices--under the influence of foreign

competition and public pressures--have increased little. The three-year labor contract in steel signed last September called for wage increases about in line with the guidepost.

The price rise for producers' equipment picked up speed early this year, as electrical equipment turned up and non-electrical machinery continued to rise. For consumer goods, the rise in wholesale prices has remained relatively slow--despite increases for shoes and apparel, tires, cigarettes, whiskey, and furniture. Consumer durables, apart from furniture, generally have been stable.

The rise in consumer prices accelerated early this year, mainly because of a further sharp increase in foods, and a faster rise in services, especially medical care. Among other consumer goods, prices of clothing and other nondurables have increased, while durables, on the average, have been stable.

The substantial growth of GNP in the first half was accompanied by large demands for credit. Total funds raised over the first six months of this year, estimated at $83 billion, annual rate, were 15 per cent above the full year 1965. Federal borrowing (including sales of participation certificates) rose appreciably. Private borrowing was 12 per cent above the rate for all of last year, with large security flotations accounting for most of the increase. Foreign borrowing remained below the high levels of previous years, reflecting both the effects of the voluntary restraint program and tightening in domestic credit markets.

Expansion of bank loans excluding mortgages continued at the high 1965 pace, and banks added to their mortgage holdings in volume. The increase in total bank credit declined, however, to not far above the 1964 rate of advance.

To meet these large loan demands, banks liquidated investments. Federal securities, measured here to include agency issues, declined at nearly a $7 billion annual rate. Net acquisitions of municipals remained close to the 1965 pace.

The impact of monetary policy has moderated the growth of money and time deposits. Growth of money and time deposits together has receded appreciably from the unusually high rates late last year, and recently has been running between 7 and 8 per cent, annual rates, on a three-month moving average basis.

The slowdown has been especially evident in time deposits, which on average have been growing at about an 11 per cent annual rate recently, compared with much higher rates early

and late last year. This slackened pace has occurred despite marked increases in interest rates on time deposits paid by banks.

Growth in money, on a moving average basis, also has declined from the high rates sustained through late 1965. Nonetheless, with the money stock increasing sharply in April, and also in June, the effect of monetary restraint on banks has been reflected principally in time deposits.

The effects of monetary restraint, together with regulatory actions, have influenced greatly the inflows of savings to nonbank intermediaries, as well as to banks. Banks, over the first five months of this year, recorded gains in total time and savings deposits equal to a 10 per cent annual rate, down from 15 per cent a year earlier. Seasonally adjusted inflows to savings and loan associations fell sharply further, to less than a 4 per cent annual rate.

At mutual savings banks, the inflow fell to about a 2 per cent annual rate, well below accretions from the crediting of interest to existing deposit accounts.

With deposit inflows moderated, while total funds supplied increased, the share of the total supplied by financial institutions declined appreciably. For banks, the drop was to 28 per cent of the total; the share for nonbank intermediaries also fell to 28 per cent. On the other hand, funds supplied directly to credit markets by the nonfinancial public--that is, by individuals, businesses, and State and local governments--increased substantially, in response to sharply higher rates of interest on market securities.

Yields on long-term corporate new issues rose abruptly in the first quarter when the supply of new securities was unusually large. The market rally that developed in mid-March lost steam within a few weeks, and new issue rates have since moved up to around the early March peaks.

In the short-term area, the bill market has been sheltered from the full impact of rate pressures, as bill rates have receded from earlier highs. By contrast, other short-term rates have continued to rise. For example, rates on finance company paper are now a full percentage point above early December levels, and far above earlier postwar peaks.

Mr. Koch continued the presentation, focusing on prospects for economic activity and prices over the next year. He commented as follows:

Looking ahead, there appears to be little prospect for relief of pressures on resources and prices. Our current projection anticipates a $14 billion growth in GNP in each of the third and fourth quarters, with continuing rapid expansion through the middle of 1967. In current dollars, GNP in the next year is projected to increase 7.5 per cent, nearly as much as in the previous 12 months. But with prices increasing somewhat faster, growth in GNP in constant dollars would be about 4.5 per cent.

Defense expenditures are a dominant factor in the outlook. We have no official basis for projecting these outlays, but recent statements by the Administration, together with rising order backlogs for defense goods, continuing high draft calls, and a military pay raise, all point to a large further expansion. Our projection assumes a $7.5 billion increase by mid-1967, with the largest part of the rise coming before the end of 1966.

Continued gains in business fixed investment will also contribute to growth in total spending. Major determinants of investment--high profits and intensive utilization of industrial capacity--remain expansive. Our projection calls for an increase consistent with the 17 per cent rise for 1966 anticipated in the Commerce-SEC survey. With the pace of business fixed investment exceeding the growth in GNP, the share in GNP would rise still further, to over 11 per cent by the middle of 1967.

While defense and business investment provide the underlying strength, resumption of large gains in consumer spending accounts for the more rapid growth of GNP after midyear. Consumer outlays are scheduled to increase on the average about $9 billion a quarter over the next year, even though the saving rate is projected to rise from the low second-quarter level. Disposable income is expected to advance substantially, especially in the third quarter, with faster growth in private wages and salaries, a Federal pay increase, and a large rise in "transfer payments" arising from Medicare and other Federal programs.

The projected level of consumer demand would likely be realized only if auto sales rise from the May level. Recent consumer surveys do suggest strong underlying demand, and early-June figures already show some recovery. We are projecting a moderate rise in new car sales to an annual rate of 8.5 million units for the new model year. In the third quarter, part of the stimulating effect of higher auto sales on GNP will be tempered by a large runoff in auto stocks.

The weak factor in the over-all economic outlook is residential construction. In line with recent developments, housing starts are projected to decline to about 1.2 million units by the fourth quarter, and to fall somewhat further early next year. Limitations on funds for home financing is the primary factor, and single-family starts may be reduced somewhat more than for multi-family units.

Although sharp, the expected drop in housing starts is not unprecedented. Declines about as steep occurred between 1955 and early 1957, and also from 1959 to 1960.

Despite the weakness in residential construction, growth in GNP is sufficient to keep the capacity utilization rate high. The projection calls for substantial expansion in manufacturing capacity--on the order of 8 per cent over the coming year. But with industrial output and sales expanding rapidly, the utilization rate would remain close to 92 per cent, declining only slightly in the first half of 1967.

Manpower demands would also continue very strong, with nonfarm employment and the armed forces projected to increase further. Unemployment is projected to decline to 3.5 per cent, and experienced workers will continue in short supply. The unemployment rate for adult men is not likely to rise above the low frictional level of 2 per cent.

With profits high and gains in real earnings reduced by rising prices, unions have been pressing for wage increases well above the guidepost. Their demands may largely be realized in major negotiations over the next year. Increases in hourly compensation in manufacturing, at an annual rate of 3.6 per cent in the first half of 1966, could accelerate to more than 4.5 per cent in the first half of 1967.

In nonmanufacturing, wage gains have already been averaging about 4.5 per cent and could rise even faster. Early next year, the minimum wage will be increased and coverage will be extended substantially, especially in the trade and service areas. With productivity gains slowing, unit labor costs are projected to rise, putting pressure on consumer as well as industrial prices.

For many industrial materials and also for finished products, higher costs and rising demands suggest an acceleration of the price rise later this year or early in 1967. However, prices of sensitive materials, which contributed so much to the recent rise, are likely to increase less rapidly. For example, upward price pressures may moderate in markets for nonferrous metals. Lumber prices have turned down and curtailment in residential construction may provoke further declines. Prices of hides have soared into a range where the elasticity of demand is high and will inhibit further increase.

Altogether, the rise in industrial prices may remain close to the recent annual rate of 3-1/2 per cent through the second half, and could pick up additional speed thereafter. Prices of foodstuffs probably will decline somewhat through the balance of this year as supplies expand. Consequently, the index for all commodities may increase little. Early next year, however, food prices may no longer be declining, and the total index would then be rising again.

Prospective developments in commodity markets point to a slowing in the rate of increase in the consumer price index over the next six to eight months, but an acceleration again thereafter. Food prices turned down in May, and should be lower by early next year. Also, elimination of heavy 1966 auto stocks may require large seasonal discounts this summer. But by early 1967, average prices of other goods may rise somewhat faster in response to increasing labor and materials costs. For services, additional increases are to be expected, as strong demands pull wage rates up in many of these relatively low-wage industries.

Mr. Hersey continued the presentation, discussing balance of payments developments and prospects, as follows:

In the U.S. balance of payments, the central development in recent months has been a further shrinkage in the merchandise export surplus, back to levels comparable with 1958. From peaks around $7 billion in 1964, the trade surplus first fell off sharply in early 1965. This year the export surplus has declined further, to average about a $4 billion rate in the first five months and even less in April and May.

Easing of demand pressures in various foreign countries in 1964 and early 1965 had its main adverse impact on our exports during the first half of 1965. In the past 12 months

expansionary forces abroad have heightened again. U.S. exports rose briskly for a while, but from the second half of 1965 to the first five months of 1966 the rise has been at a rate of only five per cent a year. Intensified demand pressure in the United States may have contributed to this disturbingly poor export performance. It has certainly been the main factor in the steep rise in imports, by 18 per cent between the second halves of 1964 and 1965 and by 16 per cent at an annual rate since then.

Imports of materials and supplies--including quota-restricted petroleum imports--rose 15 per cent further from the second half of 1964 to the second half of last year. Imports of final manufacturers, which have had an average growth rate of almost 15 per cent over the past decade, rose by nearly 30 per cent. Food imports also rose more than usual.

Imports of materials excluding petroleum rose 17 per cent between the second halves of 1964 and 1965. This increase bore the same general relation to the 8 per cent rise in U.S. industrial production of materials over the same period as we have seen at previous times of unsustainably rapid expansion, as in 1955. The growth trend in use of materials is steeper now than in the 1950's, but the departures from trend, then as now, have been greater for imported than for domestically produced materials. The slower rise in these imports in early 1966 reflected the tailing off of last year's large steel imports, and Government stockpile sales also held imports down.

The shrinkage of the merchandise trade surplus has been accompanied recently by other unfavorable developments in the current account. Growth in U.S. receipts of direct investment income has slowed, partly because oil companies are experiencing lower prices and higher taxes in the Middle East. The burden on the balance of payments of our military expenditures abroad stopped shrinking last year because of the Vietnam war. By the first quarter of 1966 these expenditures, net of military sales, had increased to more than $2-1/2 billion, annual rate.

Consequently, the balance of goods and services--"net exports" in the GNP accounts--was down to $6 billion, annual rate, in the first quarter and is falling lower in the second quarter. Outflows of U.S. private capital were relatively stable in total from mid-1965 through the first quarter.

With these and other developments, the over-all balance on the liquidity basis has been a deficit near $2 billion annual rate so far this year. This deficit would have been substantially larger but for shifts of foreign official and international institution funds into technically nonliquid assets. The amount of these shifts in the second quarter has been large enough to make the deficit figure, whatever it may turn out to be, a potentially misleading indicator of recent trends. On the official reserves transactions basis, the deficit has fluctuated widely, with an average rate of $1-1/2 billion since mid-1965.

Given the outlook for expanding domestic demands, high profits, and upward pressures on costs, few cheery signs can be found for the balance of payments. Further reduction of the net outflow of U.S. private capital looks unlikely. The recent rate of about $3 billion a year--after adjustment to exclude amounts financed by U.S. corporations' borrowings abroad--is low, matched in recent years only briefly in 1962 when foreign demand for U.S. bank credit was small.

Direct investment outflows are likely to be at least at the recent $2-1/2 billion rate, not counting either borrowings abroad or reinvestment of foreign earnings, because U.S. corporations' plans for plant and equipment expenditures abroad are very large and still growing.

Net U.S. purchases of foreign securities have been sustained by Canadian new issues in this country. The net outflow may remain near the $1 billion rate of the six months through March.

In that recent period bank-reported claims declined, as U.S. banks were getting net repayments of short-term credits and were still reducing foreign liquid asset holdings of their own or their customers. They were also reducing outstanding term loans to foreigners, under the impact of the IET, the voluntary restraint program, and monetary tightness. Recently, however, there have been net outflows of bank credit in some months. With the present stance of monetary policy, it is by no means certain that net reflows of bank-reported claims on foreigners will continue.

With U.S. private capital outflows perhaps more unfavorable, the projection made here of an over-all rate of liquidity deficit later this year around $3 billion in the absence of official window dressing assumes no further deterioration of the goods and services balance beyond the first half of this year. Further increases in military

expenditures abroad may be about offset by gains from investment income and other services. Merchandise exports are expected to rise strongly, helped by resumption of raw cotton exports at a reduced price. But imports seem certain to increase rapidly, too, preventing any improvement in the merchandise trade surplus.

The concluding part of the staff presentation, given by Mr. Brill, was as follows:

The GNP projection presented this morning is, I believe, a conservative estimate of the underlying strength of economic activity. Increases in GNP are projected at $14 billion or more per quarter in the last half of this year, and only slightly less thereafter. But defense spending could easily accelerate faster than we can presently anticipate, given recent trends in defense orders, in draft calls, and in apparent target levels for the Armed Forces.

Even without such a defense acceleration, the projected rate of increase in GNP is well beyond what the economy can produce with available resources, and still maintain stable costs and prices. Capacity utilization rates remain high, and the over-all unemployment rate is likely to decline somewhat further over the balance of the year. In consequence, wage rate increases are projected to spread and to accelerate. Since productivity growth would be at a slower rate, unit labor costs are expected to rise and industrial commodity prices are projected to increase at about a 3-1/2 per cent annual rate.

For balance of payments reasons, among others, these demand and price pressures indicate a need for additional restraint on spending. The projection implies an expansion of imports continuing to exceed the longer-run trend, and the export surplus would remain close to the recent low level. The balance of payments deficit will be large. Cooling off the domestic economy would provide some immediate relief by moderating the rising tide of imports. More importantly, it would reduce the likelihood of a longer-run erosion of our competitive position in international markets.

In the absence of additional restraint on spending, we would expect a continued high rate of credit expansion. Funds raised in the second half of this year would match the high rate we saw in the first half. The total for the first

six months of 1967 would be moderated by reduced Federal borrowing, made possible by tax receipts in excess of accruals. But the rate of private credit expansion in that six-month period would be fully as high as the average for the two halves of 1966.

An immediate and across-the-broad increase in income taxes would be the most certain--and the most general--method of tempering the advance of spending between now and the end of the year. Unfortunately, present prospects are for near-term fiscal stimulation. Our projection implies that the Federal budget, on a national income and product account basis, will shift to a significant deficit in the third quarter, and remain in deficit through the remainder of fiscal 1967.

If inflationary pressures are to be constrained, it appears then that monetary policy would need to move further toward restraining growth in bank deposits and credit. Month-to-month swings in financial variables are large, and it is hard to be certain about the target to shoot for. But an average growth rate for money and time deposits together of between six and seven per cent--somewhat below recent rates--would, in my judgment, be a reasonable next step in generating additional restraint on spending.

With such a target, time deposit growth would likely be smaller than the average for recent months--perhaps about nine per cent. The growth of money balances consistent with this--between 4.5 and 5 per cent--would be a modest rate of increase in light of the underlying strength of demands for goods and services.

Interest rates can be expected to respond briskly to evidence of additional monetary restraint. Apart from the Treasury bill market, financial markets are still taut. The calendar of new long-term security offerings for July is modest, but that for August is already large. Consequently, interest rates on new issues are likely to adjust quickly to higher levels. While we have not tried to forecast precisely how much change in interest rates might occur, we would not be surprised to see new issue rates on high-grade corporates approaching six per cent before--possibly well before--the end of the year.

Rising market rates would raise questions about the viability of the CD market. The highest rates quoted by prime New York banks on 3- to 6-month maturities are now at Regulation Q ceilings. Indeed, very recently rates of

5-1/2 per cent have been paid for around one-month maturities. Persistent upward pressure on market interest rates, with present Regulation Q ceilings, would force larger banks into significant portfolio adjustments if they persisted in meeting customer loan demands.

We must also keep in mind that rising market rates might also aggravate the problems of nonbank intermediaries. We are on the eve of a period that might witness sizable shifts of assets affecting financial institutions. Judgments as to the magnitude of the problem are hazardous, and aggressive rate increases by mutual savings banks and savings and loan associations in the past few days, together with the Board's action of yesterday, add additional unknowns to an already cloudy situation.

Nevertheless--with more courage than confidence--we have attempted to spell out some of the market consequences of implementing, in open market operations, moves to additional restraint such as the reserve requirements increase ordered yesterday. Technical factors--including System buying over the July 4 holiday and low dealer inventories--would probably cushion the impact of restraint in the bill market. The bill rate, however, would most likely begin to move back into closer touch with money market conditions. Thus, bill rates might be expected to rise from 10 to 20 basis points over the next four weeks. Other short-term rates--represented here by the yield on three-month Federal agency issues--might increase somewhat more, perhaps from 15 to 25 basis points.

Long-term rates are likely to respond promptly to upward pressures on short rates, with yields on long-term Governments increasing perhaps 5 to 10 basis points over the four weeks, and yields on other long-term instruments rising somewhat faster.

The net borrowed reserve figure consistent with this behavior of market rates is exceedingly difficult to specify in the present fluid situation. There are many specific as well as general uncertainties, including possible sharp seasonal swings in country bank reserve flows, and the unknown potential for borrowing by mutual savings banks in connection with deposit drains if the System adopts the proposal to act as a lender of last resort for this group of intermediaries. As the roughest of guesses, we show here a band ranging from $400 to $450 million, but perhaps a somewhat deeper marginal reserve target might be needed over the longer run to sustain the interest rate levels pictured here.

> *In implementing a policy of additional restraint*, open market operations should smooth the transition to tauter financial markets. Further increases in market rates of interest should be welcomed, and indeed encouraged, but credit market conditions cannot be allowed to tighten too abruptly. Indeed, market conditions may need to take precedence over marginal reserve measures as operating targets. On the other hand, cushioning actions should not be allowed to offset fully the move to increase required reserves. It will be difficult to guide the ship of policy between these two reefs.

In reply to a question by Mr. Swan, Mr. Brill said that the staff had not attempted a projection for the Federal funds rate.

Mr. Mitchell asked what probability the staff attached to its projection for GNP.

Mr. Brill replied that the projection described the outcome that the staff considered most likely, given the estimates for defense spending. By coincidence, it was not greatly different from some other forecasts being made in Washington currently. There were some differences, mainly relating to the expected distribution of auto sales between the third and fourth quarters, but the estimates for the fourth quarter nevertheless were quite close. Of course, the levels of defense expenditures assumed were critical in all of the projections.

Mr. Mitchell then asked what implications the kind of monetary policy Mr. Brill recommended would have for the GNP projection.

Mr. Brill replied that in his judgment a policy of limiting the growth in money and time deposits to a rate between 6 and 7 per

cent would produce a significant slowing in GNP in the fourth quarter--perhaps not down to a $10 billion growth rate, but in that direction. He recommended such a monetary policy for the longer run; for the short run he would advise caution because of the great uncertainties associated with flows of funds among financial institutions. As a first step he would suggest not offsetting fully the effect on nonborrowed reserves of the increase in reserve requirements; and then, if there were no adverse reaction, pushing cautiously further to achieve a slowdown in deposit growth.

Mr. Mitchell commented that he was disturbed by the possibility of overly generous wage settlements if the economy was ebullient at the beginning of 1967. He asked whether the policy Mr. Brill advocated was a counsel of futility, involving holding the line as best possible, or whether it was likely to prove corrective.

Mr. Brill replied that the recommended policy was intended to be corrective. At the same time, he did not think enough was known to say that a 6 or 7 per cent growth rate in money and time deposits would cut back the expansion in GNP to some particular figure, such as $10 or $11 billion per quarter.

Mr. Hickman asked what level of net borrowed reserves Mr. Brill would recommend for the short run, in view of the pressures expected at savings and loan associations and mutual savings banks in the next few weeks.

Mr. Brill replied that his short-run prescription was to keep net borrowed reserves somewhat above the $400 million level, but to watch closely the markets' reaction and the flows at financial institutions. In effect, he recommended a short-run policy of cautious probing, recognizing the uncertainties about flows at intermediaries in the coming period, and recognizing that later it might prove necessary to deepen net borrowed reserves considerably further. The Committee was tentatively scheduled to meet again on July 26, and it could then decide whether to move more aggressively, depending on, among other things, what new information was available on defense spending.

Mr. Hickman commented that he would expect pressures at the discount window to increase as net borrowed reserves deepened, the present discount rate to become untenable, and present Regulation Q ceilings to be out of line with market rates. In effect, there would be a general upward ratcheting of interest rates.

Mr. Brill observed in response that maintaining the existing Regulation Q ceilings in a period of rising rates would in itself provide a measure of restraint.

Mr. Koch made two observations with reference to the preceding discussion. First, he noted that the staff projected housing starts to fall to a rate of 1.2 million by the fourth

quarter of 1966, and that the projection would have to be lowered if policy was tightened further. However, the level of 1.2 million starts in itself was below other estimates currently being made in Washington, and those other estimates already were giving rise to concern. Secondly, he confessed to being somewhat puzzled by the discussion of the reserve requirement increase. As he interpreted that action, its main effects were to increase costs to large banks and to decrease their liquidity slightly; any other tightening would have to come through open market operations.

Mr. Hickman commented he was highly disturbed by the projections for defense spending presented today, of which there had been no inkling in the Cleveland District. Personally, he had vacillated on the subject of taxes but if the defense projections were correct a tax increase was clearly needed since monetary policy could not do the job alone. He concluded that the System should bring as much pressure as possible on the Administration to act on taxes.

Chairman Martin then noted that copies of a staff memorandum addressed to the Board, entitled "Emergency credit facilities for mutual savings banks," had been distributed to all Reserve Bank Presidents on June 27. Copies of a related document prepared at the New York Reserve Bank also had been distributed.[1/] Chairman Martin

1/ Copies of the documents referred to have been placed in the files of the Committee.

invited Mr. Treiber to open the discussion of the subject of the documents.

Mr. Treiber made the following statement:

> The Board of Governors of the Federal Reserve System and all the Reserve Banks have been furnished with copies of a document prepared by the Federal Reserve Bank of New York under date of June 22, 1966, entitled "Plan to Assist Savings Banks in Meeting Extraordinary Withdrawals." Three exhibits are attached to the plan. These papers were prepared in the light of intense discussions with the heads of large savings banks and Savings Banks Trust Company, and, also, a large member bank.
>
> The Board of Governors has approved the making by the Federal Reserve Bank of New York of advances to member banks on the Collateral Trust Notes of Savings Banks Trust Company referred to on page 3 of Exhibit B.
>
> The plan is designed to meet an emergency situation that may never arise. Indeed, we think that the Federal Reserve Bank of New York is unlikely to be asked to lend directly to a savings bank or to Savings Banks Trust Company, or to lend indirectly to the Trust Company through a conduit loan as described in Exhibit B. But it is important to have the machinery in working order. We believe that the machinery is in good order.
>
> In working out the plan it was the view of all involved in the negotiations that publicity should be avoided. Withdrawals by depositors of savings banks could be accentuated greatly if there were wide discussion of a fear of a run. It seemed wise to keep the discussions to a limited group. It seemed unwise, for example, to suggest that all, or even the principal, savings banks have their directors adopt resolutions authorizing their officers to borrow directly from the Reserve Bank. It also seemed unwise to bring a large number of savings banks into discussions of minutiae.
>
> We think that the brunt of the demand of savings banks for credit accommodation to pay their depositors will fall on the commercial banks which have over $1 billion of credit lines to the New York savings banks. Member bank access to the discount window will continue to be subject to the usual disciplines.

Only in the event of vast withdrawals by savings bank depositors would the special arrangements come into play. We expect to be in continuing close contact with Savings Banks Trust Company, the heads of large savings banks, and the head of the member bank with which the Trust Company has its principal relations. We would also be in frequent contact with the heads of the other principal member banks in New York.

We would be prepared to lend directly to the larger savings banks on direct obligations of the United States. Presumably these would be savings banks in New York City. In the normal course of events the smaller savings banks, and the out-of-town banks, would seek emergency accommodation in the first instance from Savings Banks Trust Company. We would be prepared to lend directly to the Trust Company on direct obligations of the United States, but it is questionable whether the Trust Company would have such obligations available as collateral.

The conduit arrangement under which the Reserve Bank would make a loan under section 10(b) of the Federal Reserve Act to a cooperating member bank on the Trust Company's Collateral Trust Notes would be invoked only after consultation between the Trust Company, its principal member bank, and the Reserve Bank.

We understand that savings banks hold a negligible amount of assets that would qualify as "eligible paper" available for discounting under the third paragraph of section 13. We think it would not be worthwhile to try to use such paper. We would consider it unwise in an emergency situation to introduce the additional complicating factors that would be involved in the use of such paper.

It must be apparent that in an emergency situation, with a severe run on savings banks, speed is of the essence. Judgments will have to be made quickly on the basis of facts available at the time. We would have one of our own men in the Trust Company to see developments at firsthand and to help assure that administration of the Trust Company's lending policies are in accord with the approach which has been agreed upon in our discussions with the Trust Company.

All in all, we think we have a workable arrangement. Each borrowing case must be administered flexibly and on its own merits. This observation applies both to the extension of the credit and to the arrangements for paying it off.

Mr. Daane asked whether there were any important differences between the procedures Mr. Treiber had outlined and those suggested in the Board's staff memorandum.

Mr. Partee said he thought the staff plan completely accommodated the plan of the New York Bank. The staff plan was developed in response to the need for a more general approach than New York's--one that could be used in other Federal Reserve Districts and in connection with institutions other than mutual savings banks. He then briefly summarized the staff plan, as set forth in the memorandum.

Mr. Treiber indicated that the New York Bank was basically in accord with the approach recommended by the Board staff.

Mr. Ellis observed that while the Reserve Bank was prepared to adopt emergency measures to assist mutual savings banks in the Boston District, his appraisal suggested that such measures were not likely to be necessary. In the past month District savings banks had "freshened up" their credit lines with correspondent commercial banks, which Mr. Ellis estimated at a total of about $200 million. The large commercial banks had reassured the savings banks that their lines would be honored and knew that they in turn could borrow at the Reserve Bank if necessary. Deposit losses at savings banks had not been of great magnitude in April. The banks

had been alerted to the possibility of losses in July and had been preparing for it, so they were not likely to be caught short.

Mr. Ellis said he agreed with the general tone and specific proposals of the staff memorandum. He asked, however, whether it might not be desirable for the Board to issue a statement to the effect that the Federal Reserve would make funds available to mutual savings banks if necessary, so that all such banks would be informed and possible misunderstandings avoided. He agreed that it would be undesirable to suggest a sense of urgency on the matter, but at the same time it would be useful to let all mutuals know that liquidity would be provided as needed.

Mr. Bopp said that three of the largest savings institutions in Philadelphia had reported no accelerated outflows of funds in June. They did not expect much outflow in July and thought that their liquidity positions were adequate at present. More generally, the Reserve Bank had heard no expressions of concern on the part of District institutions. He had not yet had a chance to study the staff memorandum, but he shared the view Mr. Ellis had expressed.

Mr. Wayne said that the only mutual savings banks in the Fifth District were located in the Baltimore area. Those banks had expressed no concern about anticipated losses; their concern was with a possible slowdown in inflows against large forward commitments.

He would concur with the staff proposals and proceed as necessary, but he did not anticipate a problem in the District.

In subsequent discussion of Mr. Ellis' proposal it was agreed that giving general publicity to the emergency program was likely to create more problems than it would solve, by stimulating concern on the part of depositors. It was suggested that the Reserve Banks inform savings banks in their Districts of the program directly. In those Districts where the number of such banks was too large for such a course to be feasible, it was suggested that those known to be anticipating problems should be contacted.

Mr. Brimmer said it was not clear to him whether the emergency program was to be restricted to savings banks. He expressed interest in hearing the views of the Presidents on that question.

Mr. Treiber noted that the Federal Home Loan Bank System provided a mechanism for meeting the needs of savings and loan associations. Moreover, he understood that a few individual savings and loan associations had lines of credit with member banks in New York, and he had no doubt that those banks would extend credit under the lines in question. In general, there did not appear to be any need for making additional provision for savings and loan associations in the Second District.

Mr. Brimmer noted that the Board staff memorandum included the following statement on page three: "Emergency needs for credit, if any, seem most likely to develop among mutual savings banks although it is conceivable that sizable deposit outflows might also be experienced by a relatively few credit unions, nonmember banks, and savings and loan associations not having access to Federal Home Loan Bank credit, where assistance would be indicated." He suggested that if it was clear that the System would not be called on as a lender of last resort by such institutions the matter could be laid aside. If that was not clear, however, some decision should be reached regarding them.

Mr. Swan concurred, and drew attention to the following statement on page two of the staff memorandum: "The staff believes that the posture of the System should be to prevent to the best of its ability any depositary-type financial institution from failing during this period due to lack of liquidity." With respect to savings and loan associations, Under Secretary of the Treasury Barr had met in San Francisco last Friday (June 24) with some commercial bankers, and had indicated that about $5 billion was available for the assistance of the associations, including funds recently raised by the Home Loan Bank System, funds of the Federal Savings and Loan Insurance Corporation, and some $2 billion that the Treasury was prepared to deposit directly in the Home Loan Banks. Mr. Barr

thought that that sum would be adequate to deal with the situation. If it was not, however, the System would be faced with the question of whether it should channel credit through the commercial banks to the savings and loan associations. He assumed that the System would do so if the need arose.

Mr. Irons said that that was his assumption also. He observed that there were some savings and loan associations in the Eleventh District that were not affiliated with the Federal Home Loan Bank, and as he read the staff memorandum it was contemplated that the System would act as lender of last resort for them.

Mr. Brimmer noted that at the present point the staff memorandum did not reflect an official System position.

After further discussion, Chairman Martin suggested that the substance of the staff memorandum be approved by the members of the Board and the Reserve Bank Presidents as a general statement of System policy, and there was no disagreement.

Chairman Martin then called for the go-around of comments and views on economic conditions and monetary policy. Mr. Hayes submitted the following statement for the record, after summarizing it orally:

> Business activity in May was stronger than in April, in spite of a drop in automobile sales and residential construction, and some decline in steel production. Capital spending plans remain strong. Government spending is rising. While there are some signs of lessening pressures on capacity, labor

resources, and prices, the over-all situation is still characterized by excess demand. Slackening of pressures should be welcomed rather than interpreted as pointing to a business downturn. There is no indication so far that this has gone far enough to eliminate our concern over inflation, much less to be interpreted as foreshadowing a decline in business activity. The uncertainties in Vietnam are ever present, but at this point we do not envisage any fundamental change in the economic outlook.

Returning from a trip which offered wide opportunities to take informal soundings, I am impressed by the new wave of skepticism as to our will to handle our balance of payments problems. The heavier-than-expected foreign costs of the war in Vietnam explain only to a limited extent the disappointing developments in our balance of payments. And even if these costs may be an important contributing factor, they do not constitute a valid excuse, in the eyes of foreign observers, for inaction with respect to remedial policies. Efforts to improve the statistical picture through a rearrangement of maturities of our liabilities cannot hide the fact that, instead of moving toward equilibrium, we are backsliding. I am particularly disturbed by the deterioration of the trade surplus, on which so much reliance has been placed to achieve balance.

In the last two weeks, the banking system has handled smoothly large flows of funds and has accommodated a large volume of tax-related borrowing. The banking system has taken the June 15 tax date in stride, but unexpectedly heavy borrowing developed in the following week in connection with the forward shifting of withholding tax payments. Bank liquidity positions have declined further, and loan-deposit ratios are at record levels. Banks are willing to pay the maximum permissible rates on the shortest-term certificates of deposit to attract or hold funds.

The early June credit data, which do not fully reflect heavy tax borrowing, appear to be consistent with the moderate slowing down of total bank credit expansion so far this year. But credit demands remain strong, and the pace of loan expansion is likely to quicken in July.

Financial markets have been buffeted by peace rumors and conflicting interpretations of recent business news, including views that a topping out of the boom may lie

ahead. As a result, the stock market has been listless and the volume of transactions moderate. In recent weeks, a relatively large flow of corporate and municipal offerings, including some large issues, has been absorbed surprisingly well. However, over the past few days a change in sentiment has been developing, which could well lead to further upward pressures on yields despite the relatively light calendar immediately ahead.

The impact of the midyear interest payment date on the savings and loan associations and mutual savings banks is now the next hurdle to get over. While I have the impression that some of the apprehension is exaggerated, we must of course do everything in our power to avoid a liquidity crisis. I have a good deal of confidence that the various arrangements made to cushion any undesirable developments will prove to be fully adequate.

After an absence of five weeks, I am impressed by two developments--first, a slackening of very strong inflationary expectations; second, growing evidence that our increasingly restrictive monetary policy is having pervasive effects in all financial markets. Credit availability and the willingness to make forward commitments have been reduced significantly, and credit costs have risen. Financial intermediaries are under intensified pressure from a reduced inflow of funds and increased demands.

The modest slackening of inflationary expectations in no way alters the need for further restraint through appropriate public policies. On the contrary, the strong basic outlook still calls, in my judgment, for an effective assist from fiscal policy in the form of a tax rise. On the other hand, the reduction, for the time being at least, in the intensity of the pressures in some sectors of private demand permits us to give full weight to the need for a cautious monetary policy in a period when thrift institutions could be subject to significant deposit drains. Depending on how the market reacts to yesterday's announcement, we may not have much leeway to deepen net borrowed reserves, without calling into question the current discount rate and the related Regulation Q ceilings. Net borrowed reserves in the range of $350-$400 million seem appropriate, with borrowings averaging in the neighborhood of $650-$700 million. These ranges may have to be modified in the light of unusual liquidity pressures or of an unexpected burgeoning of credit demands.

The time may come fairly soon to consider an increase in the discount rate, especially if the rising cost of money to banks should trigger a prime rate increase--and I would not rule out the possible need, under those circumstances, for consideration of further changes in Regulation Q ceilings. However, I believe that right now we ought to tread cautiously in view of the sensitivity of this midyear period--even though we will enter a period of Treasury financing by late July and possibly sooner. Alternative A seems quite acceptable for the second paragraph of the directive, although I would suggest breaking up the very long sentence into two sentences.[1/]

With regard to the telegram[2/] requesting comments on commercial bank promotional activities to attract savings funds as the interest payment date approaches, we find that in our District advertising of bank "savings bonds" and savings certificates, while not as extensive as three months ago, is spirited and aggressive. A few banks are engaged now in active advertising campaigns, using advertisements, frequently of a very large size, and offering a variety of such instruments with characteristics designed to attract different categories of deposits. They invariably stress the higher interest rates offered. These banks, which include three of the largest banks located on Long Island, have been advertising in the New York Times, which has a national circulation.

However, we have found only limited evidence that commercial banks in general are stepping up their promotional activities in an unusual degree to attract time and savings deposits around the end of June. It is problematical whether the recent rate increases of several New York savings banks will tend to set off a new wave of competitive rate moves.

1/ The draft directives submitted by the staff for consideration by the Committee are appended to these minutes as Attachment A.

2/ Under date of June 22, 1966, Mr. Sherman had sent the following telegram to the Reserve Bank Presidents: "In connection with go-around at Open Market meeting June 28, Board members would appreciate having Presidents include comments on question of whether commercial banks are now increasing or are planning to increase advertising or other promotional activities to attract time and savings deposits around end of June. It is not intended that you make a general survey but that comments be based on what you have observed or heard or may learn from spot checks."

Mr. Francis said that impressions received from a few spot checks and from other contacts with bankers were that outside of the St. Louis metropolitan area there were very few new advertising or other promotional campaigns in the Eighth District directed primarily to attracting time and savings deposits around the end of June. In the St. Louis area, where competition for savings was especially keen, bank advertising expenditures had been accelerated recently, but he did not expect any difficult liquidity problems in savings and loan associations to result.

Mr. Francis reported that the St. Louis Reserve Bank had just completed a series of meetings throughout the District with member bankers and representative groups of businessmen. It had found accelerating demand for products, for materials, and for labor. So great were the demands that shortages were prevalent; equipment shortages, materials shortages, and labor shortages. The demand for highway trucks exceeded supply. The great demand for copper, along with the limited supply, was creating bottlenecks. Here, price controls were preventing an allocation of supplies to the most useful purposes. Copper was generally utilized for pots and pans and spouting while inadequate amounts were available for the production of electric motors.

As a result of the vigorous demand, Mr. Francis said, prices of products, of materials, and of labor were being pushed

up rapidly. Manifold inefficiencies of production arose as dollar demand exceeded practical efficient production. Wages were increasing more than appeared, as less efficient labor was applied to particular jobs. The rate of inflation of prices was more than the indexes showed, as discounts had disappeared, premiums were paid, and less efficient mixes of resources were necessitated.

That inflation-creating excessive demand was being fostered by rapid bank credit expansion, Mr. Francis said. In the Eighth District business loans of reporting member banks had been expanding at a 25 per cent annual rate since December. In the nation, according to the Reserve Bank's figures, the supply of money was continuing to increase at a rate of about 6 per cent per annum, although in light of the inflation and higher alternative costs of holding cash, the demand for cash balances relative to GNP was continuing to decline.

As Mr. Francis saw it, the great total demand for goods and services, fostered by the stimulative fiscal stance and rapid monetary expansion, was pushing up prices of goods and services and also demand for investment funds. The excessive demand for funds, in turn, was pushing up interest rates and possibly was distorting the institutional pattern of flow of investment funds.

Mr. Francis urged a limitation on the rate of monetary expansion. In the absence of appropriate fiscal restraint--namely, a large budget surplus--the necessary monetary restraint would

probably raise interest rates. But if total demand were adequately restricted, demand for investment funds also would be limited, and the basic forces pushing interest rates up would be kept in bounds. If total demand was not limited by those or other means, and price inflation continued, interest rates would be increasingly bid up, as they had been in other periods of inflation. The Committee did not and could not keep a rein on interest rates, under present conditions, with bank reserves, bank credit, and money expanding more rapidly than the productive capacity of the country.

Indeed, Mr. Francis continued, while it was generally believed that interest rates had been rising in a restrictive manner during the past year, they had, in a very real sense, not done so. The cost of money to the borrower and the return to the saver were affected by changes in the value of the dollar. When one adjusted market interest rates for the decline of the value of the dollar as measured by the implicit price deflator, one found that interest costs had not risen at all in the past year and that the real return to the saver had not increased. Hence, during the year market interest rate increases had provided no restriction to the excessive total demand either through discouraging spending or encouraging saving.

If limitation of expansion of bank reserves, bank credit, and money resulted in further increases in interest rates, Mr. Francis

said, institutional dislocations such as those connected with savings and loan associations and mutual savings banks would be augmented. But if the choice lay between further facilitating and possibly accelerating inflation, on the one hand, and having to face up to some institutional problems, on the other, he thought the welfare of the nation clearly required the latter. As indicated in the staff memorandum discussed earlier, the System had the means, or could devise the means, to provide savings banks and savings and loan associations with enough liquidity to prevent inordinate financial dislocations while at the same time not supplying the economy with the liquidity which would contribute to excessive total demand.

During most of the past year, Mr. Francis observed, the Committee's directives had provided that the growth of bank reserves, bank credit, and money should be moderate, and since April they had called for restricting growth in those magnitudes. Nevertheless, bank reserves had grown at a rate of 5 per cent, bank credit 9 per cent, and the money supply about 6 per cent. In a period of excessive total demand those rates, high by all historic standards, had not been moderate or restricted. He believed that the Committee should now take those words of the directive seriously and literally, and do what was necessary at the Desk over the next few months to make them effective. He favored alternative B of the draft directives.

Mr. Kimbrel reported that, although the general level of economic activity remained high in the Sixth District, several signs of a slowdown in the rate of expansion were being found. Total nonfarm employment had been almost stable since January, and average weekly hours worked in manufacturing had been trending downward since February. Retail sales in May, according to the Reserve Bank's estimates, dropped 3 per cent on a seasonally adjusted basis from April, a somewhat greater decline than nationally. In part the drop might reflect the slower gain in District personal income that had characterized the past few months. But a large part might be attributed to slower auto sales. In turn, lower automobile sales had been reflected in a 4.5 per cent decline in April from March in the volume of new consumer instalment loans extended by District banks. The lower rate of credit extensions did not seem to reflect a stiffening of standards, according to various lenders contacted.

Latest information on construction for the District, Mr. Kimbrel continued, suggested that, although there had been no dramatic change, total contracts had been drifting downward, and construction employment was probably over 5 per cent lower on a seasonally adjusted basis than in January. Moreover, there might be a greater decline in the future if the results of the Atlanta Bank's regular quarterly tabulation of the dollar volume on new and expanded manufacturing plants announced for future construction

in the District was any indication. Preliminary figures for the second quarter of 1966 showed a dramatic decline from those of the first quarter, although in interpreting the figures it was well to remember that the first-quarter figures were unusually high. Nevertheless, the second-quarter dollar volume was considerably below that of the same quarter of last year.

Continuing, Mr. Kimbrel reported that partial data for May indicated that the net flow of funds to savings and loan associations improved slightly and that some investors from outside the District had returned to the market for FHA and VA loans. Nevertheless, those changes had not been great enough to affect terms or to lower rates.

Thus far, Mr. Kimbrel observed, the emergence of new competition by commercial banks for time deposits by offering higher rates seemed to be confined to the Miami area. At least three of the smaller banks there, according to advertisements, were offering savings-type certificates at rates between 5-1/4 and 5-1/2 per cent. Terms were very diverse, with one bank offering 5-1/4 per cent with a six months' maturity on a minimum of $2,500 and another 5-1/2 per cent for three years with a $1,000 minimum. Although bank advertising continued heavy elsewhere, as yet there had been no general increase in promotional activities and in rates. However, it was rumored that some banks were planning to alter their promotional activities in response to new savings and loan rate competition.

Savings and loan associations in Atlanta had announced 5 per cent rates generally associated with a minimum time and amount.

The apparently slower rate of expansion in District economic activity had not been paralleled by a slowdown in bank credit, Mr. Kimbrel commented. During the first three weeks of June, according to data from weekly reporting banks, loan growth continued. The bank lending practices survey just completed showed either stronger loan demand than in March or loan demand that was unchanged from the previously strong position.

If economic conditions in the Sixth District could be considered typical of those throughout the nation, Mr. Kimbrel concluded, they suggested to him that one should take any further restrictive actions with considerable caution.

Mr. Bopp remarked that a principal problem at present was the lack of harmony between over-all flows of money and credit and the allocation of funds among different lenders and different sectors of the economy. Restraint had been felt markedly in the housing and mortgage-lending industries; meanwhile, bank credit and the money supply had grown more rapidly than was desirable at the current fast pace of business.

In the Third District, Mr. Bopp said, the mortgage market had become increasingly tight. FHA discounts continued to deepen in the past three weeks. Current "prime" FHA mortgages were now

discounted from 5-1/2 to 7-1/2 points; the average had been 3 points in April and 4-1/2 in May. Lesser quality FHA's were now discounted from 7-1/2 to 12 points. Those tight conditions had prompted a local "builders' holiday"--a rally called for today aimed at protesting market conditions.

With regard to the Board's query on commercial bank advertising, Mr. Bopp reported that most of the large Philadelphia banks had already shifted the emphasis of their copy to attracting savings. One large bank, for example, had doubled the amount of space and time devoted to savings, while a smaller and somewhat less aggressive institution increased savings copy from 25 per cent to about 35 per cent. The others fell in that range. The shift was not new, however; it had been going on for at least two months. Moreover, none of the banks contacted planned "all out" campaigns for the end of June and early July. Nor had any advertising and promotion budgets been increased significantly in recent months. One bank, in fact, reported that it was waiting to see what form interest ceiling legilsation would take before changing promotion activities.

A few savings and loan associations had responded to the increased competition by raising dividend rates, effective July 1, Mr. Bopp continued. At least six relatively large Philadelphia associations raised their dividend to 4-1/2 per cent in June, and two others raised the rate earlier. His over-all impression, based

on a spot check, was that savings institutions were not overly concerned about the expected withdrawals early in July. Some estimated that withdrawals would run 15 to 25 per cent greater than normal. Certainly no liquidity crisis was forecast.

Mr. Bopp reported that during the past week Reserve Bank personnel had spoken with senior officials of several banks regarding their policies in allocating credit. Construction loans were being rationed more than consumer loans. Practically all of the banks were either refusing or discouraging loans to finance mergers and shifts of ownership, and they were avoiding loans to finance inventory in anticipation of future needs, to purchase land for speculative purposes, or to speculate in securities.

Turning from the problems of credit allocation to over-all flows, Mr. Bopp was still concerned over the rapid rate of growth of money and credit. Just what money market conditions were needed to slow that growth was, of course, a difficult question to answer, especially given the action taken yesterday on reserve requirements. He would be inclined to maintain the current policy posture for the next four weeks unless growth in required reserves suggested a resumption of the rapid spurt in money and credit, in which case he would favor some further movement toward restraint. Alternative A of the draft directives would best serve that purpose.

Mr. Hickman said that a spot check of bankers and newspapers in the Cleveland, Pittsburgh, and Cincinnati areas suggested that few if any planned to increase promotional activity for savings at the end of June. There was no evidence of plans to change rates or other savings terms, and little change in advertising space was anticipated.

Mr. Hickman then submitted the following statement for the record, after summarizing it orally:

> Evidence is accumulating that the pace of economic activity is moderating. Recently, such series as housing starts, new orders for durable goods, personal income, employment, retail sales, and consumer prices have either declined or increased less than the average for the first quarter. Nevertheless, defense spending and business outlays for capital goods are large, and aggregate demand is pressing upon capacity. Thus, despite recent tendencies toward moderation, the balance could be easily tilted once again toward overheating if, say, a new surge of defense spending were to be imposed on the economy.
>
> Some insights into the current business situation and outlook were provided at the regular quarterly meeting of Fourth District business economists held at our Bank on June 17. The highlight of the meeting was a lessening of the extreme bullishness that had characterized the two previous meetings. Most of the group believe that the pace of the economy is moderating, and a majority do not anticipate an acceleration in activity in the second half. Most also feel that the economy has passed the crest of inflationary danger. They were, of course, not informed of the Board staff's projections for defense spending.
>
> Despite the general theme of moderation, the group's individual forecasts of industrial production were strong for the remainder of the year, but a few of the economists thought that the index would decline sometime during the first half of 1967. The median projection of GNP for 1966 of $731.5 billion was somewhat less optimistic than the "standard" forecast of $735 billion. Quarter-to-quarter increases in the median forecast for GNP were $12 billion

for the second and third quarters of 1966, $10 billion for both the fourth quarter and the first quarter of 1967, and $8 billion for the second quarter of 1967. The group's median forecast for auto production for 1966 was 8.6 million cars, with total sales, including imports, projected at 9.2 million. The median forecast for steel output was 134 million ingot tons.

A few specific items reported at the meeting may be of interest to the Committee. Reports on the nonferrous metals industries showed distinctly less price pressures than in earlier meetings, particularly in zinc and lead. On the other hand, continuing supply problems were reported for manpower generally, for equipment (especially machine tools), and for some materials (specifically sulphuric acid and copper).

Before the meeting, we surveyed, on a confidential basis, the credit situation as seen by the corporations represented by our Fourth District business economists. The general view was that bank credit is readily available for the large, top-quality companies but at higher prices (including the effects of larger compensating balances). A few companies reported active solicitation by banks wanting to extend credit. In many cases, increased capital spending and expansion of accounts receivable financing had enlarged the companies' demands for credit. The expansion of accounts receivable financing reflects the fact that smaller and marginal companies are turning to their suppliers for funds, when denied credit by banks.

Turning to policy, I feel there is no need for any major shift at this time. Yet, the staff's projection of a considerable expansion in money supply for June is disquieting. Some accommodation of money and credit expansion perhaps can be justified by the mid-month clustering of tax and dividend payments and CD runoffs, but the tone of the money market suggests to me, at least, that we may have been a bit too easy. We should avoid at all cost inflationary monetary expansion such as occurred in December and April.

Mr. Hickman added that he had come to the meeting prepared to vote for alternative A of the draft directives, but in view of the staff's projections for defense spending he now favored alternative B. However, he would prefer very moderate further

restraint until the early-July period of special pressures on nonbank financial intermediaries was passed.

Mr. Brimmer said that he had planned to comment today on various developments in connection with the U.S. balance of payments but because the hour was late he would turn directly to the subject of the Committee's directive and its background instructions to the Manager. In light of the Board's action of yesterday he believed the Committee should be especially careful in formulating its instructions. First, he thought it should be recognized that the recent net borrowed reserve figures were slightly shallower than those the Committee had intended to achieve; discounting the $417 million figure for the latest week, which would be revised downward if the pattern of the past few weeks continued, net borrowed reserves had been running somewhat less than $400 million. Thus, room existed for a further deepening of net borrowed reserves, although he did not advocate deepening them to $800 million.

Secondly, Mr. Brimmer continued, the Board's action of yesterday should be interpreted as precisely as possible. It was a monetary action, intended to reduce the availability of reserves, and he hoped the Committee would not act to offset it completely. While he thought it would be helpful to ease the market adjustment, by no means would he fully offset the action. It was important, he thought, to let the market--and especially the larger banks--know

that the Committee did not subscribe to a pattern of activity in which those banks competed actively for funds to relend to their customers. He would assume that net borrowed reserves would be deepened well beyond $400 million, and that while the Manager would ease the adjustment and play by ear over the early-July period, he would lean as far as possible in the direction of further tightness. A figure around $350 million would constitute backsliding. There would be more room to maneuver if, as now seemed likely, midyear drains from nonbank institutions would be less than anticipated because more institutions were raising their deposit rates.

Mr. Brimmer said that he had considered expressing a preference for alternative B for the directive, but would vote for alternative A with a strong recommendation for the course he had outlined. If the Committee did not take the present opportunity to tighten it was likely to find itself constrained by Treasury financing activity later and thus to be less able to act.

Mr. Maisel agreed with Mr. Brimmer that the Committee had to act to give the Desk specific instructions on what to do about reserve creation in the space between now and the next Committee meeting. Required reserves would increase $400 million as a result of the Board's action of yesterday and the specific question that had to be faced was whether or not the Committee was going to attempt to offset that action by furnishing additional reserves to partially

or completely reduce the restraining influence of the Board action. It seemed to him that in giving those instructions the Committee had to be concerned with what would be happening in total reserves and nonborrowed reserves, and not in net borrowed reserves. The blue book[1/] showed a projected increase in total reserves of $160 million for the four-week reserve period ending July 20. That included normal growth but excluded the impact of any special loans to thrift institutions or of the change in reserve ratios.

If one assumed that no reserves beyond the $160 million projected were to be furnished in that period, Mr. Maisel said, the entire effect of the Board's action in raising reserve requirements would have to be absorbed by member banks through a slower expansion of credit. Total deposits and loans would not expand as much during the period as they otherwise would. If the Desk made all projected reserves available in the coming week, banks could expand deposits sharply. However, as Government deposits fell during the next two weeks, banks would not be able to expand private deposits as much as the blue book projected and they would have to cut back the amount of credit outstanding by more than normal.

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

After an examination of reserve movements, credit expansion, and changes in the money supply since last December, Mr. Maisel believed that if in this period there was no additional expansion of total reserves beyond the $160 million projected, the Committee would be closer to the proper reserve target needed to meet its general monetary goals than it was now. That, therefore, should be the target for policy: not to allow total reserves to grow by more than $160 million through the week ending July 20.

However, Mr. Maisel continued, it might be that the adjustment to the higher reserve requirement would have to be spread over a somewhat longer period than the next three weeks. If, as the situation developed, a six-week period appeared more logical, that would mean according to the staff projections that total reserves in the week ending August 10 should be at about the same level as they were in the week ending June 22. He would have no objection to that extended target. If that also turned out in the course of the period to be too rapid a halt in credit expansion, even though it meant no cutback; the Committee might allow any additional expansion to come only through borrowing. That would mean as a minimum insuring that nonborrowed reserves were no higher than now in the week ending August 10.

To meet that goal, Mr. Maisel would allow the level of borrowings and of net borrowed reserves to rise as sharply as

needed to hold nonborrowed reserves level for that period. He would hope that an immediate start could be made in holding back on reserve creation. The smaller the increase in reserves in the coming week, the smaller would be the amount that had to be absorbed over the next month. The added borrowings should, hopefully, cause the banks to slow their credit expansion.

Mr. Maisel thought the Committee should not be surprised if banks attempted to gain their additional reserve requirements in the period through added discounting. An expansion of reserves through the window, offset by open market sales, should not be feared. It would offer the opportunity to discuss with banks the need to constrain loans rather than adjusting through the sales of securities. It would also provide an opportunity to make it clear that the System intended to hold the present Q ceilings as an aid to restraint. Pressure at the window should be allowed for a considerable period before any consideration was given to a discount rate change.

He obviously would avoid a panic in the money market, Mr. Maisel continued, but he would not be afraid of fairly sizable increases in interest rates. Almost all market interest rates, but especially bill rates, were far below the levels which the staff projected at the start of the year. The present appeared to be a rather light period for financing and therefore a favorable period for action.

In Mr. Maisel's judgment the Committee had been extremely slow in meeting any logical goal for the rate of credit expansion. Now was a proper time to adjust to a target for reserves, credit, and monetary expansion. The present opportunity should be seized by aiming at finding total reserves at the present level at the end of the next six weeks even though reserve requirements would have gone up in the interim. That level of reserves would mean the Committee was then on a proper path--that being to continue to increase reserves at the annual rate of expansion experienced between December 1 and August 10 under the projections.

At the moment, Mr. Maisel did not feel the Committee should look beyond cutting back beneath that rate of growth. That might be all that monetary policy could do. The Committee should not look forward to doing more than it could; but it could continue on that path. Further delay in getting on target would increase the danger of continuing to tighten for too long. If the Committee moved to a proper growth path now, it could then hope to stay with it.

Mr. Maisel said that clearly he would support alternative B, but with the understanding that any increase in total reserves over the next six weeks would be a sign that they were increasing more than expected. As a result, such increases would show that greater restraint was necessary and net borrowed reserves would be allowed to rise as much as needed.

Mr. Daane remarked that in the interest of time he would simply say that his own appraisal of the continuing underlying strength of the economy, of price developments, of the impending addition of cost-push inflation--foreshadowed in the staff's chart on unit labor costs--to the demand-pull inflation being experienced, of the lack of cheer in the balance of payments outlook--all led him to the desirability of somewhat greater monetary restraint. Under the current uncertainties, it was difficult to be precise with respect to any of the monetary variables and, therefore, he would favor giving the Manager maximum latitude in the expectation he would take advantage of any opportunity to bring about the somewhat greater restraint envisaged perhaps more clearly in alternative B.

At the same time, Mr. Daane said, he did not detect any great difference between the language of alternative A calling for some further gradual reduction in reserve availability "if" liquidity pressures were not unusually strong, and that of alternative B which similarly called for some gradual reduction in net availability "while taking account of" any unusual liquidity pressures. Accordingly, he could accept either alternative for the directive.

Mr. Mitchell favored alternative B on the grounds that the staff review pointed distinctly to tightening and the Board's action of yesterday also pointed in that direction. For a guideline, he

would suggest keeping total member bank deposits--the bank credit proxy--from rising above its estimated June average level of $245 billion. He would like to see the money supply come back down after its large rise in June. Like Mr. Maisel, he thought an immediate start should be made in restraining reserve creation.

Mr. Mitchell favored deepening net borrowed reserves to the $450-$550 million range before the effective date of the reserve requirement action. If that did not provide effective restraint and the proviso clause of alternative B became operative, he would favor net reserves in the $550-$600 million range. His basic objective was to tranquilize growth in bank credit.

Mr. Wayne reported that evidence of a slower rate of growth in Fifth District business continued to multiply. The Richmond Bank's latest survey indicated that the downtrend in new construction business, evident in earlier statistics, continued in June. On balance, the survey of manufacturers showed declines in new orders and backlogs for the first time in nearly a year and for only the second time since January 1964.

Demand for business loans at District banks remained strong, Mr. Wayne said. The position of member banks in the District seemed to have eased a little recently, however, as indicated by a considerable reduction in borrowing at the discount window and a fairly large swing from net purchases to net sales of Federal funds. Nonetheless,

some of the District's larger banks apparently planned to step up promotional activities in the savings competition. There was evidence that at least a few large banks in Virginia and North Carolina would intensify advertising of savings-type certificates in the week of June 27. All of those banks, however, emphasized that the intensity of their promotional activities was geared, as a matter of normal practice, to interest-payment dates at other institutions and that promotional plans for the next few weeks were quite normal. One large bank, however, reported that it would avoid any step-up of its efforts in that regard for fear that it would antagonize many good savings and loan association customers.

In the policy area, it seemed to Mr. Wayne that the important question at the moment concerned the dimensions of the current slowdown in the economy's rate of advance. The green book[1/] and the staff presentation this morning appeared to resolve the balance between weakness and strength on the side of significant acceleration in the rate of improvement in the coming quarter. But he was skeptical respecting the staff's projections, and accordingly was reluctant to take the policy position which they seemed to imply.

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

On the whole, he was not convinced that any significant acceleration in the rate of expansion in the next month or two could be expected. For the present, maintenance of the present posture appeared to him to be the safer course.

So far as instructions to the Desk were concerned, Mr. Wayne favored alternative A, which he interpreted as a vote for no significant change in the present degree of restraint.

Mr. Clay reported that while some Tenth District commercial banks obviously had increased their promotional efforts for time deposits in late June, the more typical was a continuation of the efforts of recent weeks which in itself represented an intensive campaign for funds by most city banks. It seemed only realistic to assume that bankers were conscious of the July 1 savings and loan dividend date as a potential for acquiring time deposits. In private conversations, a limited number of bankers had given that as a reason for their expanded publicity drive. With the recent increase in savings and loan dividend rates and the accompanying promotional drives by those organizations, bankers also had expressed some reservations as to the volume of funds that they might acquire. In one District city in which a banker freely gave the savings and loan funds as the goal of the expanded effort by the banks, the savings and loan associations had lifted their divident rate to 5 per cent,

the same as the banks' interest rate on savings certificates, and had expanded their promotional efforts fully as much as had the banks.

At this juncture, Mr. Clay felt that monetary policy probably should remain essentially unchanged, with policy actions continuing to apply about the present degree of pressure on the commercial banks and the financial markets. While pressure on resources continued and price inflation remained a problem, the economic situation appeared to permit such an approach to policy for the present. In view of the uncertainties in the period ahead, particularly those arising from possible developments associated with the flow of funds, the financial situation called for an avoidance of further credit tightening at this time.

Thus, Mr. Clay continued, the Committee should aim for money market conditions and net reserve availability about in line with the last two weeks. It still should be the Committee's aim to apply added restraint if bank credit expansion was much in excess of what was expected, insofar as such action was not precluded by the flow of funds problem and its associated developments and by the need to avoid precipitating a discount rate action. The Manager might require more than the usual degree of leeway in meeting the Committee's guidelines in the period ahead. The draft policy directive with alternative A as the second paragraph appeared satisfactory to Mr. Clay.

Mr. Scanlon reported that a sampling of Seventh District opinions indicated the current trend of economic activity was extremely vigorous despite cutbacks in autos and home building. In the District it was generally expected also that Vietnam would require an increasing volume of the nation's resources, that tax rates would not be raised soon, that interest rates would not decline significantly in the next few months, and that the general price level would rise further, but at a moderate pace. Capital goods producers continued to anticipate that output would rise well into 1967.

Mr. Scanlon commented that he had nothing significant to add on the subject of commercial bank advertising and promotional activities.

As to policy, Mr. Scanlon shared Mr. Daane's view that in the period immediately ahead the Manager should have more than the usual amount of latitude in which to operate, but he would urge the Manager to move to a posture of greater restraint whenever he could do so. Mr. Scanlon favored alternative B of the draft directives.

Mr. Galusha submitted the following statement for the record after summarizing it orally:

> My statement today will be confined to food production developments in the Ninth District and consumer spending patterns as they are developing in the recreation areas of the west.

In a survey of opinion of various leaders around the midwest and northwest in the livestock industry, the following points were developed. Producers are generally continuing optimistic even though there are a number of major drought pockets, principally along a line through eastern Washington, eastern Oregon, central Idaho, southwestern Montana, and then broadening through Wyoming and extending southward along the eastern slopes of the Rockies. Marketings of cows and heifers have increased substantially, partly as a result of this, and partly as a result of the inversion currently obtaining in the cattle markets. Cows had been selling at $150-$160 per head, which is $20-$25 above the price level warranted by the fat cattle market. This market has been laid at the door of the U.S. Department of Agriculture and the Administration, which have been unusually confused and contradictory. This curtailment of breeding stock may have supply implications for next year if it continues at present rates.

Feeders are unhappy. Current price levels have put them into loss positions generally vis-a-vis their present inventories. However, bumper corn prospects plus an unusually favorable spread between present contrasting levels for fall delivery of feeders and the February-April futures market should cheer them up. Financing is no major problem yet, although the Production Credit Associations generally are bracing themselves, particularly in the drought areas.

Wholesalers are pessimistic, but the grocery chains are doing very well in their meat operations. The major packer visited is optimistic and although they expect fat cattle prices to edge up perhaps $1.00 by fall, they expect to maintain their margins.

The wheat situation is due for basic readjustments. Criticism of the Agriculture Department's policy is mounting. The belief was expressed by one man who is particularly knowledgeable in the world markets that the increase in acreage is only the first that will be necessary if the carryover a year from now is to be prevented from dropping below 300 million bushels. Approximately 50 per cent of the salable Canadian crop has been committed to the present Communist bloc contracts. While this is less than last year, the Canadian wheat supply is going to be very tight partly because of the limits of handling capacity and partly because of the

pressure felt by non-Communist markets to cover their positions. It is expected that prices will continue to edge up, placing increasing pressure on the Department of Agriculture because of their unrealistic mix of social, political, and economic policies in wheat pricing and production. PL 480 commitments will be switched to coarse grains if possible but both price and acreage movements upward are thought inevitable.

The general atmosphere of foreboding here today has no reflection in American spending habits this vacation season. A general question of where are the American people spending the money they are not spending on durables can be answered, in substantial measure, by saying that they are spending it on the road. These are a few statistics gathered from the principal concessioners in the four big western parks: Yellowstone reservations up 42 per cent; paid reservations up 24 per cent; and May travel reservations up 59 per cent. There is less criticism of pricing, with fringe services such as boat rentals and saddle horses being bought to capacity. Yosemite reservations are up 15 per cent as are Sequoia reservations; Grand Canyon is up only 10 per cent, but revenue is up 15 per cent. The variation from Yellowstone for May is attributable in large part to seasonal and weather factors.

Labor is tight on the professional side, and boys are in short supply. Vietnam pressures, direct and indirect, are blamed. Girls are now 4 to 1 in the work force generally.

Prices are up slightly, but a significant downturn in all food costs except canned goods has taken off the pressure.

In response to the Board's wire, we were unable to find any substantial number of bankers planning to increase advertising efforts. In one instance it was noticed that a major Twin City correspondent was attempting to redress some of its earlier wrongs by publicly advertising that the local bank be consulted if the listener was located outside the Twin Cities.

The word had gone out quietly from the Farm Credit Board to the Federal Intermediate Credit Banks to encourage PCA's to follow a four point program: (1) avoid speculative financing, (2) avoid loans for undue expansion, (3) concentrate on production loans, and (4) cease the aggressive hard sell of their services.

> What does all this add up to in terms of monetary policy? It seems to me that, if it is not presently going on, a quiet but directed dialogue should be started on the consequences of a discount shift upwards before too long, so that if it becomes necessary--as it may well be--the Board's peers will not be caught totally unprepared. My preference is for alternative A.

Chairman Martin then noted that he understood Mr. Brill had some explanatory comments to make regarding the staff's projection of defense expenditures.

Mr. Brill said that he was somewhat disturbed by the impression that the Committee may have gotten from the chart presentation that the staff was privy to advance information on defense spending plans. The staff had no special private information on defense spending, and the estimates presented today were based entirely on its own analysis. The information that was publicly available on orders, draft calls, and so forth suggested to the staff that defense spending would rise in the third quarter at about the second-quarter rate, and then begin to taper off slowly--in contrast to the abrupt leveling off in the third quarter that was implied in the January Budget Document. The projections did not envisage an acceleration in spending from recent rates of increase, but it did envisage a higher level than did the Budget.

Mr. Swan noted that the green book indicated that California State-chartered savings and loan associations had an increase in share accounts in the first 17 days of June. Some further details of

interest were now available. There had been a loss in regular accounts at associations paying 4.85 per cent, a gain at those paying 5 per cent, almost no change in six-month certificates paying 5 per cent, and a quite substantial increase in the three-year minimum term accounts paying 5.35 to 5.50 per cent. He hoped those changes indicated that the reduced inflows reflected rate differentials and not a loss of confidence. If that were the case, there should be some response to further rate increases by the associations. As of Friday, one or two small institutions had increased their rates on regular accounts to 5-1/4 per cent, and he expected that increase to spread despite the fact that at the higher rate the associations would be subject to restrictions on borrowing from the Home Loan Bank for purposes of expansion. The associations were not concerned about such restrictions. On the other hand, there was a great deal of concern of other kinds, as evidenced by the fact that the Governor of California had called a confidential conference on June 22 to discuss the outlook for residential construction and mortgage capital. In the discussion on Friday with Under Secretary Barr, to which he had referred earlier, some of the large commercial banks indicated they already had some savings and loan association passbooks on hand for collection and deposit after the interest-crediting date. They indicated that they did not have large numbers of such passbooks, but it was unusual for them to have any noticeable numbers at all.

With respect to bank advertising, as of Friday Mr. Swan had noted no increases in activity and no plans for increases beyond what was normal for the beginning of any quarter. However, how the banks would react if the 5-1/4 per cent rate spread to many savings and loan associations remained to be seen; it would not be surprising if banks increased their advertising efforts.

Turning to policy, Mr. Swan felt that in view of the pressures on financial intermediaries and the uncertanties in credit markets--including the effects of the announcement of the Board's action of yesterday--the Committee should not tighten further, at least not in the first two weeks of July. He did not see how the Committee could anticipate at the moment the extent to which it should offset the reserve requirement increase. He would give due regard to the qualification in alternative A; in the language of the draft, if "liquidity pressures are not unusually strong and required reserve increases are larger than expected," he thought firming action would be called for. Barring those two developments, however, in the immediate future he would prefer to see the Committee's policy stay about where it was now.

Mr. Irons said he could briefly summarize the economic situation in the Eleventh District by indicating that activity was showing a somewhat slower rate of growth at a very high level. With regard to the Board's inquiry on bank advertising, a spot-check had

indicated no concerted advertising campaign among the District's larger banks. Some of the smaller banks in the Houston area were advertising heavily, but that was not a recent development; it reflected a competitive situation that had existed for some time.

Mr. Irons believed that developments in financial markets were reflecting the bite of recent monetary policy. He felt that it would be well for the Committee to exercise some caution in the period until its next meeting, and he did not favor further tightening on any significant scale. He also felt that there would be added pressure on the discount rate and certainly on the prime rate if short-term rates continued to push up as they had over the past few weeks, and he would not like to see that happen. The current relation between the discount rate and short-term market rates left little elbowroom in which to maneuver. He would add that the chart presentation this morning presented one of the clearest and strongest cases for fiscal policy action that he had seen.

Mr. Irons concluded that during the period until the next meeting the Committee should maintain about the situation that had prevailed over the past three weeks, with net borrowed reserves in the $350-$400 million range. With that thought in mind, he favored alternative A of the draft directives.

Mr. Ellis, in briefly summarizing New England economic conditions, reported that manufacturing output, construction, employment, the average workweek, personal income, and consumer spending had all increased in the most recent data, generally covering April-May changes. Individual highlights, such as the continuing strike of 11,000 workers at the General Electric plant in Lynn for higher pay for engine testers, merely confirmed the general impression of an economy operating at full capacity.

First District banks continued their search for funds to meet their continuing loan demand, Mr. Ellis said. Outstanding negotiable CD's on June 15 were almost identical with their May 11 level and showed a 23 per cent year-to-year gain. The remaining segment of other time deposits posted a 91 per cent year-to-year growth. Past patterns revealed that most of the CD's on the books of the smaller banks represented local funds, often from municipalities, rather than out-of-State funds. Those local contacts provided the smaller banks with assurance that they could continue to hold their deposits against the competition of larger banks in the reserve cities. For that reason he did not see in the District widespread concern by small banks as their bigger neighbors pushed CD rates closer to the Regulation Q ceiling.

While there continued to be a steady stream of commercial bank announcements of consumer-oriented savings plans in the District,

Mr. Ellis continued, no advertising programs had been observed that were designed especially to pull funds out of savings institutions at the time of dividend payments.

Mr. Ellis confessed to an uneasy feeling that the Committee had lost momentum during June in moving to resist the economy's pressure to expand credit and the money supply. The June projections of a 15 per cent annual rate of increase in private demand deposits, and of nearly 13 per cent in the money stock, differed so much from the 4.5 per cent growth rate in real GNP as almost to constitute a definition of inflationary pressures.

Mr. Ellis went on to say that the projections for the next few weeks--prepared before the change in reserve requirements--indicated a need to inject perhaps $1 billion reserves to meet seasonal requirements. In a bill market already laboring under pressures of strong demand and limited supply, it would be difficult to supply reserves by that route without further depressing bill rates. Those factors counseled a substantial reliance on RP's, as was suggested by the Manager's recommendation the Committee had approved earlier today. Perhaps a lagged provision of reserves should also be relied on to lend tightness to the feel of the market.

By the middle of July, Mr. Ellis continued, much of the present uncertainty concerning possible deposit losses by savings banks and savings and loan associations would have been dispelled.

His own intuition urged him to the view that the problem would be not nearly as serious as advance billing indicated. Accordingly, he anticipated that by the time of the Committee's next meeting near the end of July it would be possible to reappraise pressures on the discount window and to consider the desirability of discount rate increases without any change in the current Regulation Q ceilings.

For the present, Mr. Ellis said, the Committee in effect had three alternative courses suggested by the two draft directives. He would characterize alternative A, without the proviso clause, as standing firm in a passive sort of way, and alternative A with the proviso clause as active resistance if the rate of reserve growth accelerated. Alternative B called for a gradual tightening. His own preference for this particular time was alternative A with the proviso clause. It allowed some reaction against sharp reserve increases if they materialized and if market conditions permitted, and it left the initiative for further tightening with the market. He would consider it undesirable to ask the Manager to work with a target formulated in terms of total reserves rather than net borrowed reserves for the four-week period. He suggested a net borrowed reserves target in the $400-$500 million range, and he would expect borrowing fairly consistently to exceed $700 million.

Mr. Hayes said that he had understood from the comments around the table that others who had expressed a preference for alternative A also favored including the proviso.

Chairman Martin remarked that he did not think there was much difference among the various views on policy expressed by Committee members today. The majority appeared to prefer alternative A of the drafts of the second paragraph of the directive. In his own judgment nothing more was required at present. He favored giving the Manager as much latitude as was reasonable over the coming period.

Mr. Brimmer said he would find an answer to the following question helpful: How much, if at all, was the Committee asking the Manager to offset the effect of the Board's action of yesterday? To communicate adequately in present circumstances, he felt that some numerical indication was needed of the operating objectives the Committee had in mind.

Mr. Hayes said that, based on his experience with past changes in reserve requirements, it would be quite surprising if the full impact of the change in requirements was permitted to be reflected in the level of net borrowed reserves over any short period. An abrupt change of such a magnitude would be extremely upsetting to the market. It seemed obvious to him that the Desk would have to offset most of the effect in the short run, granting that the Committee intended to work toward a tighter position as that became feasible.

Mr. Brimmer noted that the reserve requirement change would be effective at reserve city banks about the middle of July and at country banks a week later. The Committee's next meeting was tentatively scheduled for four weeks from now, and he believed that over the four-week period there should be some bite from the Board's action.

Mr. Hayes agreed that the Board's action should be permitted to have some effect. However, a $400 million deepening in net borrowed reserves in a four-week period struck him as beyond any reasonable expectation.

Chairman Martin said he concurred in Mr. Hayes' point, and thought Mr. Maisel had had the same point in mind when he suggested that the adjustment might be spread over a six-week period. He (Chairman Martin) favored giving the Manager full latitude, as he had indicated earlier. If the Committee attempted to deal with the matter on a purely statistical basis it was likely to make difficulties for itself. At the same time it was clearly the Committee's intention to let the reserve requirement change have some bite.

Mr. Mitchell commented that he thought the Committee might be sweeping the matter under the rug and not facing up to the problem. In his judgment the members favoring alternative A in effect favored a sterilization of the tightening effect of the change in reserve requirements. He did not advocate deepening net borrowed reserves

by the full $400 million in a four-week period, but he did advocate letting a substantial part of the change in requirements--perhaps half--be effective in that period. The Manager should deepen net borrowed reserves as rapidly as he thought was feasible over the coming period.

Chairman Martin commented that while Mr. Mitchell's position was a legitimate one he personally did not think that targets of operations could be spelled out so specifically. The period in question was one in which thrift institutions would be under considerable pressure. Along with others he hoped those pressures would turn out to be less than had been anticipated, but the risk of severe repercussions to firming action had to be borne in mind. The Committee should not call for tightening credit regardless of how things worked out; a feel of the market was required, and that was why he favored giving considerable latitude to the Manager.

Mr. Maisel said the problem the Committee faced, as he saw it, was that of arriving at some measure of agreement on specific objectives.

Chairman Martin expressed doubt that the Committee could do so under current circumstances.

Mr. Brimmer agreed that it was necessary for the Committee to give the Desk flexibility, but it also had to give the Desk some guidance. He was as sensitive as anyone to the state of the

financial markets, but it was necessary to recognize that the Committee had not achieved the kind of control of the aggregate variables it had planned. While he did not favor abrupt action, he thought it should be made clear to the Desk that the Committee wanted to begin to achieve some real restraint.

Mr. Hayes commented that in his judgment the Committee faced a new set of circumstances as a result of the increase in reserve requirements. At all times the Committee's judgments had to be attuned to all relevant factors, and a $400 million increase in reserve requirements was one such factor. Personally, he could not conceive of letting net borrowed reserves increase by $400 million in a rather short period of time without cataclysmic results. It would take a considerable period to deepen net borrowed reserves from $400 million to $800 million if the Committee was to avoid precipitating a crisis.

Mr. Brimmer observed that he did not favor deepening net borrowed reserves to $800 million by the time of the next meeting, but he did think the figure should be deepened well beyond the $350-$400 million range.

Mr. Hayes indicated that his preference was for a target range of $350 to $400 million, with the proviso that the target should be deeper if there was a surge in credit demands and shallower

if the severity of liquidity pressures at financial institutions was great. He would give the Manager a considerable degree of latitude.

Mr. Daane said he did not detect any real difference in the positions various members were taking; in general, they seemed to favor some further gradual firming, if conditions permitted. He personally could not say at present by how much net borrowed reserves should be deepened, but he favored movement in that direction if and when the Manager thought it was feasible.

Mr. Mitchell thought that it would be appropriate to deepen the levels of net borrowed reserves in the period from the present to the time that the reserve requirement increase became effective, and then to shift to shallower levels. The objective would be to "wedge in" the impact of the change in requirements.

Chairman Martin remarked that the problem with which the Committee was struggling appeared to be that of avoiding inconsistency in policy.

Mr. Maisel observed that some members felt that the inconsistency lay in the fact that the Committee had been calling for a tighter policy but still had allowed bank credit to rise at a very rapid rate.

Mr. Holmes noted that in May the bank credit proxy had increased at only a 2-1/2 per cent annual rate. Before the last meeting the Board's staff projected a rise in June at about a 6-1/2 per cent annual rate. Around mid-June their estimate, and also that of the New York Bank, was a 3-1/2 per cent rate; and now the Board's projection was about 5 per cent and the New York Bank's about 6 per cent. For July the staff projections ranged from 9 to 13 per cent, with the increase reflecting the large rise from the middle to the end of June that resulted from tax payments, including the speed-up in payments of withholding taxes. If the Committee felt that an increase in July in the bank credit proxy on the order of 10 or 11 per cent was too great, it could call for activating the proviso in the directive and moving toward deeper net borrowed reserves.

Chairman Martin reiterated his view that an attempt to use statistical measures under present circumstances would lead to difficulties. He thought the Committee wanted the Manager to have latitude and that it would like to move towards firming if the opportunity presented itself. If there was no such opportunity it did not want the Manager to act in a way that would result in chaos in the market. In his judgment either alternative A or B could be interpreted within that framework.

Mr. Maisel said he favored the course suggested by Mr. Holmes' final remark--namely, that the Desk should operate to

prevent the bank credit proxy from rising at a rate as rapid as 10 or 11 per cent in July, if it could do so.

A number of members concurred in Mr. Maisel's statement.

Chairman Martin then asked whether there would be any objections to adoption of alternative A for the second paragraph of the directive, and none was heard.

Thereupon, upon motion duly made and seconded, and 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 economic and financial developments reviewed at this meeting indicate that, while there has been some reduction in automobile sales and residential construction, over-all domestic economic activity is continuing to expand, with industrial prices rising further. Mortgage market conditions remain tight and total credit demands continue strong. The foreign trade surplus has declined and the international payments deficit has increased. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current state of net reserve availability and related money market conditions, except as changes may be needed to moderate unusual liquidity pressures at financial institutions; provided, however, that if such liquidity pressures are not unusually strong and required reserve increases are larger than expected, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions.

It was agreed the next meeting of the Committee would be held on Tuesday, July 26, 1966, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

June 27, 1966

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 28, 1966.

First paragraph

The economic and financial developments reviewed at this meeting indicate that, while there has been some reduction in automobile sales and residential construction, over-all domestic economic activity is continuing to expand, with industrial prices rising further. Mortgage market conditions remain tight and total credit demands continue strong. The foreign trade surplus has declined and the international payments deficit has increased. In this situation, it is the Federal Open Market Committee's policy to resist inflationary pressures and to strengthen efforts to restore reasonable equilibrium in the country's balance of payments, by restricting the growth in the reserve base, bank credit, and the money supply.

Second paragraph

Alternative A (preserving current firmness, with qualifications)

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the current state of net reserve availability and related money market conditions, except as changes may be needed to moderate unusual liquidity pressures at financial institutions (; provided, however, that if such liquidity pressures are not unusually strong and required reserve increases are larger than expected, operations shall be conducted with a view to attaining some further gradual reduction in net reserve availability and firming of money market conditions).

Alternative B (firming, with degree conditioned by movement in required reserves

To implement this policy, while taking account of any unusual liquidity pressures at financial institutions, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining some further gradual reduction in net reserve availability and attendant firming of money market conditions, and to attaining somewhat greater restraint if required reserve increases are larger than expected.