

MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, April 2, 1968, at 9:30 a.m.

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

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

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

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

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

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

By unanimous vote, the minutes of
actions taken at the meeting of the Federal
Open Market Committee held on March 5, 1968,
were approved.

The memorandum of discussion for the
meeting of the Federal Open Market Committee
held on March 5, 1968, was accepted.

By unanimous vote, the actions taken by
members of the Federal Open Market Committee
on March 16 and 17, 1968, authorizing the
Special Manager to undertake negotiations
looking toward increases in System swap
arrangements with (1) the German Federal
Bank, from \$750 million to \$1,000 million
equivalent, and (2) the Bank of England,
from \$1,500 million to \$2,000 million equiv-
alent, to become effective, along with

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corresponding amendments to paragraph 2 of the authorization for System foreign currency operations, upon determinations by Chairman Martin that such increases were in the national interest, were ratified.

By unanimous vote, the action taken on March 6, 1968, under paragraph 3 of the authorization for System foreign currency operations, by the Subcommittee designated in paragraph 6 of the authorization, approving a purchase from the Swiss National Bank of \$50 million equivalent of Swiss francs at a rate other than the prevailing market rate, was ratified.

In connection with the preceding item, Chairman Martin noted that a memorandum from the Special Manager, entitled "Recent purchase of Swiss francs at rate other than market rate," had been distributed to the Committee under date of March 27, 1968.^{1/}

By unanimous vote, the action taken by members of the Committee on March 19, 1968, approving revised procedures with respect to allocations of securities in the System Open Market Account, effective March 21, 1968, was ratified. The revised procedures were as follows:

1. Securities in the System Open Market Account shall be reallocated on the last business day of each month by means of adjustments proportionate to the adjustments that would have been required to equalize approximately the average ratios of gold holdings to note liabilities of the 12 Federal Reserve Banks based on the ratios of gold to notes for the most recent five business days.

^{1/} A copy of this memorandum has been placed in the files of the Committee.

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2. Until the next reallocation the Account shall be apportioned on the basis of the ratios determined in paragraph 1.

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

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 March 5 through March 27, 1968, and a supplemental report covering the period March 28 through April 1, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said the Treasury gold stock would remain unchanged this week. After taking account of orders in process, the Stabilization Fund had roughly \$175 million on hand.

Mr. Coombs reported that nearly final figures were now available on the cost of the gold pool operation from Saturday, November 18, the date of the sterling devaluation, through Thursday, March 17, the day before the London gold market was closed. During that four-month period, the pool sold \$3 billion of gold in the London market. Of that total, the U.S. share

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amounted to \$2.2 billion; both Italy and Belgium had replenished their share of pool losses during March by buying gold from the U.S. Treasury. The gold rush also sparked a number of gold purchase orders by small central banks around the world, including former members of the sterling area. However, as fears of a change in the U.S. official price or of a gold embargo had at least temporarily subsided, new orders to buy gold had fallen off abruptly during the past week or so.

The breakdown of the gold pool was, of course, a major defeat for the central banks and governments involved, Mr. Coombs observed. He thought it fair to say that the system was now considerably more vulnerable than before. The so-called two-tier gold price system and related measures introduced after the gold pool meeting in Washington a little over two weeks ago (March 16 and 17) was a damage-control operation of still uncertain effectiveness but more likely to be effective in the short than in the long run. He thought the major increases in the swap lines negotiated at the Frankfurt meeting in November and again in Washington a few weeks ago had helped to reassure the market that the central banks were prepared to deal with abnormally heavy flows of hot money across the exchanges. The recent further increase in central bank credit facilities available to the Bank of England had had a further stabilizing effect. Even more important, however, had been the

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reaffirmation at the Washington meeting, against the background of worldwide fears that the United States was about to impose a gold embargo, that this country would continue to buy and sell gold at the official price of \$35 per ounce in transactions with monetary authorities. While the credibility of that assurance might again come under speculative attack, for the moment at least the markets seemed satisfied that the pledge was valid and so another breathing space had been gained. A very important technical factor in the gold and foreign exchange markets at the moment was the huge overhang of gold bought for short-run speculative purposes. That overhang had held the free market price within the \$37 to \$40 range and had greatly reduced the speculative effects of the discontinuance of pool operations.

Mr. Coombs commented that the technical advantage now enjoyed in the gold market might for brief periods bring the price down close to the \$35 parity, especially if South Africa or Russia resumed sizable sales in the free market. Unfortunately, he thought the technical advantage would dissipate in due course, although opinions would probably differ widely as to how long it might take for the gold now held for speculative purposes to move on into firm holdings of the investment type. He personally was inclined to think that there might not be more than a few months' time before uncertainties connected with the U.S. election would

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bring new speculative pressure on the free market price of gold. With London now reopened as the major market center, the free market price would become a highly visible and widely accepted barometer of confidence in the dollar and in the international monetary system generally. If, as he thought quite possible, the London price should move up to the \$50 range by late summer, there could be a serious problem not only in the form of central bank gold purchases but more generally in the form of speculation against the present parity network, with heavy movements of funds from the weaker to the stronger currencies.

As clearly the weakest of the major currencies, Mr. Coombs continued, sterling would be particularly vulnerable. Before the sterling devaluation, he had mentioned several times to the Committee that sterling and the gold market could be compared to two time bombs, with every likelihood that the explosion of one would set off the other. The sterling devaluation had immediately ignited massive speculation in the gold market; now he thought the risk was of the reverse situation, in which a sharply rising London gold price would tend to excite new speculative pressures against sterling. Despite the major effort made by the British government to produce a strong budget, the market remained suspicious of the viability of the new \$2.40 parity for sterling. And it was virtually convinced that if the United States were to increase the official gold price or to declare a gold embargo, there would be a realignment of the

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present currency parities with sterling depreciating against the others. British financial officials now talked quite openly at international meetings of the alleged drag imposed on the recovery of sterling as a result of the uncertainty with respect to the outlook in the gold area. Whatever might be the reason, sterling remained more or less on dead center with few signs as yet of the long-awaited return flow of funds. In light of the volume of Britain's debt, that was a dangerous situation.

In March the Bank of England again suffered heavy reserve losses, Mr. Coombs noted. Those losses, which partly reflected speculative pressures associated with the gold rush as well as continuing attrition on forward contracts, had been largely covered by central bank credits totaling \$1,140 million. The System had contributed only \$50 million to that total; during the course of the month he had encouraged the Bank of England to borrow from other creditors. He was hopeful that in April the British would draw the full amount of their \$1.4 billion standby facility with the International Monetary Fund and use the bulk of the proceeds to repay their debt to the System. That would be in accordance with the "first-in-first-out" principle, since the Federal Reserve credits had been outstanding considerably longer than the credits from continental central banks. Most of the latter had been extended after the devaluation, whereas in another month or so the bulk of the Federal Reserve credits would be beyond the six-month mark.

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By unanimous vote, the System open market transactions in foreign currencies during the period March 5 through April 1, 1968, were approved, ratified, and confirmed.

Mr. Coombs then noted that at the meeting of the Committee on June 7, 1966, he had reported on what had come to be known as the "sterling balance credit package," involving credits of roughly \$1 billion, of which the U.S. share was \$310 million. The U.S. contribution to the package did not involve new money. Rather, it represented an earmarking of part of the facilities already existing in the form of the System's swap line with the Bank of England and System and Treasury guaranteed sterling authorizations. The British had since utilized the full facilities provided under the package by the continental central banks and practically all of the facilities earmarked by the System and the Treasury.

At the time the agreement was negotiated, Mr. Coombs said, the continental creditors had insisted that as a backstop the British agree to make a negative pledge of \$750 million of their drawing rights in the IMF as a direct means of funding debts under the credit package, with the U.S. monetary authorities having a pro rata share of the \$750 million. At the time of the negotiations the U.S. representatives thought such a pledge was unnecessary. Indeed, they considered it undesirable because it tended to give priority to refinancing through the Fund of debts incurred under

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the sterling balance credit package.. In view of the importance of a successful conclusion to the negotiations, however, the arrangement was accepted with the hope that the continental central banks subsequently would agree to dropping the negative pledge requirement. That, in fact, had happened; at the March Basle meeting the Europeans had indicated their willingness to do away with the pledge. When he had reported on the matter to the Committee in June 1966, no objection had been made to the terms of the credit package. He hoped that there would be no objection now to dropping the negative pledge.

Dropping Britain's "negative pledge" of \$750 million of its drawing rights in the International Monetary Fund for backing to the sterling balance credit package was noted without objection.

Mr. Coombs then recalled that at the meeting of the Committee on January 9, 1968 he had expressed the view that the System was coming to the end of the line with respect to its technical forward lire commitments, and had suggested that if those commitments did not prove reversible soon the Treasury be asked to take them over. It had been agreed that he should discuss the matter with the Treasury, and on doing so he had been advised that the Treasury was prepared to have the commitments transferred. Accordingly, if the Committee had no objection he would arrange for the transfer to the Treasury of the System's forward lire commitments within the next few days.

The transfer to the Treasury of the System's forward lire commitments was noted without objection.

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The transfer to the Treasury of the System's forward lire commitments was noted without objection.

Mr. Coombs then said he would recommend renewal of a number of drawings under the System's swap lines, both drawings by the System and by other central banks, as well as certain System forward market commitments that would mature soon. He was disturbed by the fact that most of the drawings and some of the forward commitments would involve second renewals. On the other hand, the international monetary system had just come through a major emergency which perhaps justified a more flexible approach than might otherwise be desirable. As he saw it, the main hope for repayment of some of the drawings that had been outstanding for more than six months lay in a British drawing on its \$1.4 billion standby facility with the Fund. Such a Fund drawing should not only permit the Bank of England to repay its swap debt to the System, but also might permit the System to purchase some of the foreign currencies the British drew from the Fund to repay swap debts of its own.

Specifically, Mr. Coombs first recommended renewal for further periods of three months of four System drawings. These were a \$2 million drawing on the Belgian National Bank, maturing April 16, 1968; a \$25 million drawing on the Bank of Italy, maturing April 17; a \$100 million drawing on the Bank of Italy, maturing May 2; and a \$5 million drawing on the Netherlands Bank, maturing May 9. All four would be second renewals.

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Renewal of the System's drawings on the Belgian National Bank, the Bank of Italy, and the Netherlands Bank was noted without objection.

Mr. Coombs then recommended renewal, if requested by the other central bank involved, of four drawings on the System for further periods of three months. These were a \$250 million drawing by the Bank of Canada that would mature for the first time on April 30, and three drawings by the Bank of England, each of which had already matured once. The latter included drawings of \$50 million and \$100 million that would mature April 16, and a drawing of \$50 million that would mature May 8.

Renewal of the drawings on the System by the Bank of Canada and the Bank of England was noted without objection.

Finally, with respect to forward market commitments, Mr. Coombs recommended second renewals of two such commitments in Swiss francs, of \$5 million, maturing April 19, and \$1.5 million, maturing April 22; and first renewals of a \$15 million Swiss franc commitment maturing April 22, and of a \$12.84 million Dutch guilder commitment maturing April 17.

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

Chairman Martin then asked Mr. Solomon to report on the significant international financial developments that had occurred since the preceding meeting of the Committee.

Mr. Solomon presented the following statement:

During the recent weeks of turmoil in the international monetary system, two meetings of major importance have been held: the Washington meeting of the active gold pool members and last week's Stockholm meeting of the Group of Ten. Taken together these two meetings may turn out to have marked a turning point in world monetary history. What I shall try to do this morning is to place these meetings in perspective and sketch out for the Committee two alternative scenarios for the period ahead. One scenario involves a return to international monetary stability based on returning confidence that the existing price of gold will be maintained; the other scenario involves a recurrence of instability based on a failure to correct the U.S. balance of payments problem.

The Washington meeting of two weeks ago was called in a crisis atmosphere in which the policy of keeping the London price of gold at \$35 per ounce had become untenable. The gold pool policy had earlier been adopted and had been continued through the upheaval set off by the devaluation of sterling for one reason and one reason only: to maintain confidence in the official price of gold. It was thought that a substantial increase in the free market price of gold would undermine the credibility of the official price and would lead central banks to cash in their dollars for gold. In other words, the gold pool supplied gold to private speculators in order to forestall a run on the dollar by official holders of dollars. But the gold pool policy--designed to maintain credibility in the official price of gold--itself lost credibility, for the market came to doubt that the pool would continue in the face of heavy losses. And thus pool losses fed on themselves.

The Washington meeting terminated this policy and established the two-tier system--which was described in the paper circulated to the Committee last week.^{1/}

^{1/} A copy of this paper, entitled "The Two-Market System for Gold" and dated March 28, 1968, has been placed in the files of the Committee.

In the circumstances in which pool sales were terminated--with a multilateral reaffirmation of the official price of gold and a heavy overhang of private speculative gold holdings--the free market price rose relatively little. The principles enunciated in the Washington communique, if adhered to, should maintain downward pressure on the market price.

But the Washington meeting did much more than terminate pool sales. In my view, the most important sentence in the Washington communique is the one that says: "Moreover, as the existing stock of monetary gold is sufficient in view of the prospective establishment of the facility for Special Drawing Rights, [the Governors] no longer feel it necessary to buy gold from the market."

That pronouncement, together with the Stockholm agreement on Special Drawing Rights, can be interpreted as constituting a demonetization of gold at the margin. In other words, what is being said is that the monetary authorities of the world--taken as a group--are not dependent on an increasing stock of gold. Their need for growing reserves in the future can be satisfied mainly by Special Drawing Rights.

Thus as far as monetary reserve needs are concerned, the present official price of gold need not be questioned. And neither private parties nor central banks need speculate on, nor protect themselves against, an increase in the official price of gold.

Both the Washington and the Stockholm communiques reaffirmed the existing price of gold. But the actions of the Stockholm meeting spoke much louder than its words. At that meeting, the Common Market countries openly and courageously broke with France and by doing so turned their backs on the gold standard prescription being offered by France.

France could not go along with the SDR plan because it had become clear that although France had won the battle of semantics at London last August, she had lost the battle of substance. Despite the terminology, SDR's would be, it had become evident, a form of international money that could substitute for gold at the margin.

If along with the results of these two meetings, one takes account of the U.K. budget and its wage restraint policy and of the improvement in the outlook for the Canadian dollar, and if one could assume an improving

U.S. balance of payments, one could picture a very favorable scenario. In this scenario, the world would be seen to have adjusted to the U.K. devaluation and to the U.S. balance of payments program. The countries of continental Europe, experiencing more rapid expansion than in 1966-67, would stand still for decreasing surpluses and in some cases over-all deficits. And doubts about the stability of the system would disappear and we would witness the evolution of a multilaterally-managed international monetary system in which the role of gold would diminish steadily.

The alternative and much less happy scenario assumes that inflation continues in the United States and that the benefits from the January 1 balance of payments program are offset by a deterioration in the trade balance.

This worsening of the trade balance has already occurred: the trade surplus fell from an average annual rate of \$4.3 billion in the first 9 months of 1967 to \$1 or \$1.5 billion in recent months. Some part of this worsening is explainable by special factors such as the copper strike and the precautionary build up of steel stocks. But even apart from these special factors, imports have surged in recent months. Unless the import surge can be dampened, the outlook for the balance of payments is very bleak.

In this unhappy scenario, the world begins to believe that the U.S. balance of payments deficit cannot be reduced without drastic measures involving either a change in the relationship between the dollar and gold or a change in the relationship between the dollar and European currencies, or both. And, with a continuing large U.S. deficit, the world begins to doubt that the SDR scheme will be activated. Thus for one reason or another doubts about the official price of gold reappear and foreign central banks convert dollars into gold--not only existing official dollar balances but new dollar balances accruing to European central banks as a result of currency speculation against the dollar.

Where this chain of events would ultimately lead is not easy to say. An increase in the price of gold would be no solution to this problem--which is a balance of payments and not a liquidity problem. Yet a change in the U.S. exchange rate without an increase in the price of gold is extremely difficult to engineer.

What would be most likely is a suspension of gold payments by the United States and, as the most hopeful outcome, an agreed appreciation of European currencies. But whether this could be brought about without monetary chaos and severe disruption in world trade is not at all evident.

The moral of the story is clear. To prevent monetary chaos and to assure the more favorable evolution sketched out in the first scenario, the United States must improve its trade balance. Fortunately, the policies necessary for this result are called for on domestic grounds in any event. We are not facing conflicting domestic and international objectives. From both points of view a decisive move toward fiscal restraint is needed. But if this is not forthcoming, both domestic and international considerations call for restrictive monetary policy. Insofar as monetary policy can substitute for fiscal policy in restraining domestic demand, it will have roughly similar effects on the trade balance. But restrictive monetary policy brings an added benefit, albeit of short term, to the balance of payments: it does more than fiscal policy to swing capital flows--including Euro-dollar flows from branches to head offices--in favor of the United States.

Chairman Martin said he would add a few observations to Mr. Solomon's excellent summary. The last three or four weeks had witnessed exciting developments in the monetary area, beginning with the Basle meeting in the early part of March that he had attended along with Messrs. Solomon and Coombs. He had left the United States on March 7, and on the following day there had been a serious run on the London gold market. The pool had lost over \$180 million of gold that day and the atmosphere in Basle was one of heavy gloom. During the meetings on the following two days the participants arrived at the view that it would be desirable

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to try to continue the operations of the gold pool. However, by Thursday of the following week (March 14) the pool was virtually out of business. The Committee held its telephone conference meeting on that day, and effective the next day the Federal Reserve discount rate was raised from 4-1/2 to 5 per cent. On Saturday and Sunday, March 16 and 17, the governors of the central banks participating in the pool had met in Washington with results reflected in the communique and discussed in the staff paper to which Mr. Solomon had referred. That meeting had been called on the preceding Thursday, and the Board's staff had performed quite well in arranging for the necessary facilities on very short notice.

The subsequent Stockholm meeting might well prove to have been a historic one, Chairman Martin continued. He thought Secretary Fowler had performed splendidly as the leader of the U.S. delegation. It was a traumatic experience for the other Common Market countries to break away from the French. They had expected to be able to cajole the French into joining the agreement and were rather shaken by France's refusal to do so. In his judgment Secretary Fowler had been wise in deciding to go the last mile with the Common Market countries in their attempt to give France every opportunity to join. It was significant that the French had not walked out of the meeting and had left the door

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open for their possible later participation. He thought the Committee members would want to read the statement made at the meeting by Mr. Debre, the French Finance Minister, and he asked the staff to distribute copies of that statement and of the communique issued by the Group of Ten.^{1/}

Basically, the Chairman said, the French appeared to be trying to keep their own options open while reaffirming their conviction that the United States was headed in the direction the British had recently traveled. They expected the two-tier price system for gold to collapse because of an unwillingness of the United States to put its balance of payments situation in order. It was up to this country to prove them wrong, and the agreement at Stockholm provided the time to make the necessary adjustments. The French had been defeated at Stockholm in the sense that the other participants reached agreement. At the same time, they had scored a success in focusing the question on whether the United States was capable of handling its own affairs.

On the whole, Chairman Martin concluded, the Stockholm meeting was dramatic and significant. It was one of the most interesting meetings he had ever attended, partly because of the obvious undercurrents of feeling that the end of an era was at

^{1/} These documents were distributed on April 3, 1968 and copies have been placed in the Committee's files.

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hand, and that it would now be seen whether it was possible to demonetize gold at the margin and to make it a supplementary rather than a central element in the system of international payments.

The Chairman then noted that Mr. Daane had also attended the Stockholm meeting and invited him to comment further.

Mr. Daane said he would comment briefly on some of the remaining technical issues discussed at the Stockholm meeting, relating both to special drawing rights and to proposals for reform of the IMF. By the time of the meeting those issues had become inextricably interrelated in the negotiations. Roughly speaking, there were six issues remaining in each category. Three issues on IMF reform were so highly technical as to be considered inappropriate for discussion by the Ministers and Governors, and they were referred back to the Executive Directors of the Fund for resolution. Other reform issues included proposals to raise from 80 to 85 per cent the voting majorities required for approving changes in IMF quotas, uniform changes in par values, and waiver of the maintenance of value of IMF assets. Affirmative decisions were reached on those proposals, although IMF member countries outside the Group of Ten had taken a strong position against the first, and had proposed linking such action to the initial activation of SDR's. At the Stockholm meeting the United States originally had supported the position of the

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non-10 countries, but it finally conceded on the matter in the interest of arriving at an outcome that would be acceptable to the Common Market countries. Another reform issue, relating to procedures for interpretation of the Fund's Articles of Agreement, was resolved satisfactorily with a proviso that kept the final decision-process within the voting framework of the Fund.

The most important technical question relating to SDR's, Mr. Daane said, concerned a possible provision for a country's "opting out"; that is, permitting a country participating in the scheme to reserve the right to refuse to join in and accept the new assets when they were first activated by an 85 per cent majority decision, and subsequently, with majority approval, to opt back in again. Again, in an effort to arrive at a package acceptable to all countries, the United States went along with the Common Market countries--a number of which also had strong reservations about the desirability of permitting opting out--in accepting such a provision, in the hope that doing so would enable the French to come in. All countries finally agreed on the opting out provision.

In the interest of time, Mr. Daane observed, he would not comment on the remaining technical issues regarding SDR's that were considered in Stockholm. He would note, however, that in agreeing on the conditions for activation of the SDR's the Group went back to the Hague communique of July 1966, which in

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part referred in general terms to special considerations with regard to the attainment of better equilibrium in the balance of payments of participating countries.

Mr. Brimmer asked whether those attending the meeting in Stockholm had gained any impression of the Europeans' attitude about the proper role of the Federal Reserve in putting the nation's house in order. He gathered that the Europeans thought the key issue concerned the U.S. balance of payments, and he would agree with that judgment. But it was not clear to him how the Europeans felt about monetary policy. It was his personal impression that they did not appreciate the full extent of the shift toward monetary restraint since last fall. For example, a foreign visitor had commented to him that the recent half-point increase in the discount rate represented a half-use of monetary policy.

Chairman Martin said he thought the views of Europeans on the question varied widely. In his judgment, however, most of the Europeans at the meeting did have an appreciation of the extent to which the System had moved toward tighter monetary conditions, and they were not anxious to see much more tightening. They realized that the heart of that problem lay in the adjustment process; that by some means the United States had to make an adjustment in its large and persistent deficit in relation to

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their large and persistent surpluses. Differences in views on how the adjustment process would work would be the subject of continuous study and discussion over the next several years. They questioned whether U.S. monetary policy alone could do the necessary job, although they believed it had a part to play. They were aware of this country's problem of inflation. On the whole, they were a highly sophisticated group. With respect to the question of whether the half-point increase in the discount rate was adequate, one found the same differences of judgment among the Europeans as existed within the Federal Reserve. That was a perfectly normal and proper situation.

The Chairman then asked whether Mr. Daane or Mr. Solomon had anything to add on the subject.

Mr. Daane said he might comment with respect to the attitude of the Europeans as reflected at the meeting a few weeks ago of the Economic Policy Committee of the OECD, where U.S. stabilization policies were subjected to a specific examination. He thought it was fair to say that there had been an incomplete awareness of what the System had done, and in particular of the rapidity with which it had shifted the stance of its open market policy. Partly as a result of comments by the U.S. representatives at that meeting, however, he thought a much better understanding had emerged of what the System had accomplished.

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With respect to future U.S. stabilization policies, Mr. Daane continued, the European attitudes at that meeting were somewhat ambivalent. The U.S. representatives had indicated that if fiscal restraint was not forthcoming monetary policy could and would do the job, although with an eye on the possible effects on the domestic financial structure and on international rate relationships. But when the question arose as to what should be said in the report of the chairman of the EPC, there was quite a bit of questioning on the part of the Europeans of the desirability of trying to substitute monetary for fiscal policy. He thought the Europeans would like to see the United States get its house in order by use of fiscal policy, and in the absence of fiscal restraint they leaned toward the use of monetary policy; but they were somewhat concerned about the potential impact on their countries of further marked tightening of U.S. monetary policy.

Mr. Solomon concurred in the comments of Chairman Martin and Mr. Daane. There was no doubt that the Europeans were ambivalent on the subject. For years they had said that U.S. interest rates should be much higher than they were. In the early 1960's that notion had been resisted in this country because of the need then to encourage expansion of the domestic economy. Now that there was no longer any conflict between domestic needs

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and those of the balance of payments, the Europeans were trying to encourage expansion of their own economies and were no longer sure they wanted to see U.S. interest rates rise. That was understandable. It was his feeling that although they would not be happy about it they would accept further firming of U.S. monetary policy without reacting in kind.

Chairman Martin added that the Europeans in question were quite aware of the political problems involved and did not want to be in the position of trying to tell the United States how to run its affairs. They had heard about complaints by some members of Congress that European bankers were trying to influence U.S. affairs, and he understood that in the EPC meetings--which he did not attend but which Mr. Daane did attend--they were leaning over backward to avoid giving such an impression. Personally, he thought the give-and-take discussion at those meetings had been beneficial to everyone in broadening understanding of each country's problems. Unfortunately, the line between political and economic decisions had been almost obliterated, and that was causing a great deal of trouble in the general application of policy on a world-wide basis.

Mr. Mitchell remarked that Mr. Solomon had implied in his prepared statement that it would be desirable to attract Euro-dollars to the United States through foreign branches of

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U.S. banks; and in his later comments he had expressed the view that the Europeans would accept an increase in U.S. interest rates without reacting. By appropriate decisions on monetary policy and on Regulation Q, the System could provide the incentives for U.S. banks to make substantial demands on the Euro-dollar market. He asked whether Mr. Solomon thought it would be wise for the System to attempt to induce an inflow from the Euro-dollar market of, say, \$2 billion over a period of three months.

Mr. Solomon replied that an inflow at so high a rate would have a serious impact on European financial markets, and would probably lead the European monetary authorities to take actions that the United States would not like to see them take. In his judgment the Europeans would accept a steady, moderate inflow of Euro-dollars to the United States that was a natural byproduct of a firmer monetary policy in this country, but would react to a surge such as had occurred in the summer of 1966.

In response to another question by Mr. Mitchell, Mr. Solomon agreed that an inflow of around \$200 million per month might be tolerated by the Europeans.

Mr. Swan asked about the time schedule that was visualized for the activation of SDR's.

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Mr. Daane replied that the Executive Directors of the Fund were now putting the amendment to the Articles of Agreement in final form, and probably would complete that work within a short time, perhaps one or two weeks. Together with a report, the amendment would then be transmitted to the IMF governors for approval. That was done by mail in some cases, and under normal procedures might require up to a month's time. The amendment would then be submitted for ratification to the parliaments and legislatures of the various member countries, including the United States. Once ratified by three-fifths of the member countries having 80 per cent of the votes in the Fund, it would be in place as a piece of machinery but it could be activated only under an agreed procedure requiring favorable votes of countries having 85 per cent of the votes of all participating countries. One could only guess how long the process of ratification would take. In that connection, the U.S. Treasury had indicated yesterday that the proposal would definitely be submitted to Congress at this session. On the most optimistic appraisal, one might look for the machinery to be in place in early 1969. The date of subsequent activation would depend on the needs for the new assets and the willingness of the participants to move ahead in creating them.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System

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Open Market Account covering domestic open market operations for the period March 5 through 27, 1968, and a supplemental report covering March 28 through April 1, 1968. Copies of both reports have been placed in the files of the Committee.

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

Open market operations since the Committee met on March 5 were conducted in an atmosphere of market uncertainty generated by gold losses and concern about the international financial system, by confusion about the prospects of a more realistic fiscal policy, and by both market expectations of a tighter monetary policy and the actual progressive development of distinctly firmer conditions in the money market. A new set of factors was introduced by President Johnson's week-end message--with the initial market reaction strongly on the plus side.

By March 14--at the height of the disorder in the gold markets--domestic financial markets were also in a state of considerable disarray. Interest rates had adjusted sharply higher, with the 3-month bill rate reaching 5.45 per cent--up nearly 1/2 per cent from the rate prevailing at the time of the March 5 meeting--while longer-term rates were also sharply higher. Expectations of an increase in the discount rate were widespread, and indeed, the market appeared to have pretty well discounted a full 1 point increase in that rate. With an actual discount rate increase of 1/2 point announced that evening, the decision to close the London gold market, and the decision to hold an international conference in Washington over the week-end, the markets breathed a sigh of relief. Subsequent international developments were viewed as moderately encouraging, at least for the short run, but continued concern over the future course of monetary policy and Congressional indecision on fiscal policy tended to produce an air of caution in long-term markets, with irregular price changes developing as sentiment about fiscal policy and about Vietnam waxed and waned.

After March 14, Treasury bill rates moved sharply lower in response to strong seasonal demand and supply pressures and to the demand for liquidity that arose with growing uncertainty in the capital markets. Over the period as a whole, the 3-month bill rate rose by about 17 basis points to close Friday night at 5.17 per cent. In yesterday's auction, average rates of 5.15 per cent and 5.27 per cent were set on 3- and 6-month bills, respectively, up 15 and 10 basis points from the auction held the day before the Committee's March 5 meeting.

Intermediate- and long-term Government bonds and notes closed on Friday with yields $1/8$ to $1/4$ per cent above those prevailing at the time of the early March meeting, while both corporate and municipal bond yields moved into new high ground. The municipal market has, of course, been considerably disturbed by uncertainty over the future of tax-exempt industrial revenue bonds in the light of Treasury suspension of the exemption privilege and conflicting action within Congress on the exemption status of such issues. Over the period investor response to new corporate and municipal issues was generally lackluster despite higher yields. On the other hand, the new Federal National Mortgage Association participation certificates--bearing rates of 6.45 per cent on both the 5- and 20-year maturity--were very well received and, indeed, raised the spectre of disintermediation at thrift institutions. Yesterday, of course, prices of long-term securities moved sharply higher on the President's message, and it is obvious that the market will need some time to evaluate the new situation.

Open market operations were directed towards achieving firmer conditions in the money market, and then, after the Committee adopted a new directive at the March 14 telephone meeting, towards confirming the still tighter policy position that was signaled by the increase in the discount rate. Operations had to take into account the abnormal drain on reserves that came from the \$1.4 billion decline in the gold stock, a very large volume of foreign operations, and the unusual reserve impact of a large merger transaction. If at times operations appeared a bit on the schizophrenic side, this was a reflection of the over-all atmosphere--including a high degree of uncertainty about the reserve outlook--

in which operations had to be conducted. In spite of the need to supply a substantial volume of reserves, market purchases of Treasury bills were undertaken on only two occasions; early on March 14, when bill rates were in the process of adjusting upward by 25 basis points and the market for Government securities was generally unsettled, and again on March 27, after the Federal funds rate had touched as high as 6-3/8 per cent. Sales in the market and redemption of bills at maturity actually exceeded market purchases, and, together with our purchases of about \$220 million of coupon issues and the use of repurchase agreements late in the period, provided some resistance to the strong downward pressure on the Treasury bill rate.

As the blue book^{1/} notes, the bank credit proxy in March grew at only a 4 per cent annual rate--below the 5 - 7 per cent rate projected at the time of the March 5 meeting, although with a set of money market conditions less firm than actually achieved. It should be noted that at the very outset of the period it appeared that the proxy might be exceeding expectations, and this was a marginal factor in producing the very sharp change in net borrowed reserves and money market conditions that developed early in the period. It would be comforting to think that the shortfall in the March proxy from projections and the absence of growth in the April projections reflected a quick response of the banking System to the firmer System policy. Perhaps this is partly so, but I fear that some good luck may be involved, including the absence of strong private loan demand and of Treasury borrowing. The eagerness of Government security dealers to reduce their inventories--and hence their bank borrowing--can, however, be directly attributed to their fulfilled expectations of tighter money.

Predicting the future course of interest rates and credit demands is certainly no easier now than it ever is, and I have little to add to the blue book discussion. Certainly the impact of the limitation of bombing in Vietnam, the reaction in Congress to the

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

President's speech of Sunday night with respect to fiscal policy, and international financial considerations generally are all highly uncertain and of the utmost importance to financial markets. I suspect that the seasonal downward pressure on Treasury bill rates--barring unexpected developments--will be quite strong this month, and that this will tend to avoid extreme pressure on the CD position of banks. But as the blue book notes the margin is small, and the Regulation Q ceiling may become a matter of increasing concern.

As far as even keel is concerned, the Treasury will be meeting with its IBA and ABA committees at the time of the next FOMC meeting, and will announce the terms of its May refunding the day after the Committee meets. In addition, the Treasury will have to raise cash before mid-June and could do so as part of the May refunding operations, although it may also raise some cash before that time. One possibility would be to add to the six-month bill cycle--an operation that would not invoke even keel considerations.

There are two housekeeping matters that I would like to mention. As you know, on March 18, the President signed legislation removing the 25 per cent gold reserve cover, and as a result we have shifted to the method of allocating the System Open Market Account that was noted at the last meeting and approved by the Committee by wire on March 19. The bill was signed none too soon, for the System reserve ratio had fallen by the time the bill was signed to 25.0084 per cent, and there was only \$3.5 million in free gold left.

The second matter is of somewhat greater importance, involving the interest rate on repurchase agreements. As you may recall, during the tight money period of 1966 several members of the Committee expressed a concern--which we at the Trading Desk shared--about the fact that the repurchase agreement rate had gotten badly out of line with money market rates. Despite this joint concern, expectational and other factors always seemed to work in such a way as to prevent our moving to a repurchase agreement rate above the discount rate. With Federal funds now trading about 1/2 per cent above the discount rate and New York dealer loan rates higher than that, our 5 per cent repurchase agreement rate is already getting

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out of line--and the disparity could increase under the pressure of future Treasury financing, or if the Committee decides to push further towards restraint. In my view, it would be desirable to break away from our tradition of a repurchase agreement rate no higher than the discount rate now, rather than waiting until pressures increase. Expectational responses will admittedly be hard to avoid, but they should be minimal at this time. No change is required in the continuing authority directive to introduce a greater degree of flexibility in setting the repurchase agreement rate on the upward side, but in due course the Committee might want to provide for greater flexibility on the down side as well. I have no rigid formula to propose and do not believe it would be desirable to adopt one. But, unless the Committee feels differently, I would propose to experiment with a repurchase agreement rate that would be more closely related to market rates on Treasury bills and the Federal funds rate. The period immediately ahead is well suited to such an experiment since there is a large temporary reserve need in the next statement week and RP's would be a natural choice of operating instrument.

Mr. Daane asked whether experimentation with a higher rate on RP's at this time would be likely to reinforce market expectations of another increase in the discount rate.

Mr. Holmes replied that he did not think it would, particularly if the RP rate was set only modestly above the discount rate--say, by one-eighth of a point. He added that such a step now would reduce the likelihood of a repetition in coming months of the 1966 experience, when the RP rate was so far out of line that the Desk had hesitated to use RP's at all.

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Mr. Daane then asked whether many people in the market now appeared to expect another discount rate increase.

Mr. Holmes responded that very little attention of any sort was now being paid to the discount rate because of the market's preoccupation with other developments.

Mr. Brimmer asked whether the Manager would simply post an RP rate at one-eighth of a point above the discount rate for the time being, or whether he would plan on adjusting the RP rate from day to day.

Mr. Holmes replied that he would propose to introduce flexibility in the RP rate, adjusting it in light of market developments. Under certain circumstances the RP rate might well be one-fourth of a point or more above the discount rate. For a time in 1966, he noted, the Federal funds rate had been 1-1/2 points above the discount rate, and the dealer loan rate had been higher still.

Mr. Brimmer said he was disturbed by the suggestion that the level of the RP rate should be left to the discretion of the Manager. If that were done the market might mistakenly begin to interpret changes in the RP rate as conveying messages about System views on appropriate rate levels in general. The risk of such mistaken interpretations would be reduced if the RP rate

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were tied to some market rate, so that changes in it would be purely mechanical. He thought the Committee should weigh the matter carefully before approving the proposal.

Mr. Mitchell commented that the discussion in the blue book seemed to suggest that adoption of alternative B for the directive^{1/} probably would lead to sufficiently large changes in the monetary environment as to make an increase in Regulation Q ceilings necessary. He asked whether the Manager thought adoption of alternative B would make action on the Q ceiling inevitable.

Mr. Holmes replied that the matter was hard to judge. Seasonal forces normally would be putting downward pressure on short-term interest rates between now and the end of the month, but it was not clear whether the usual seasonal pressures would develop this year. He agreed that there was likely to be some surge in loan demands at banks around the middle of the month. On the whole, he did not disagree with the blue book assessment.

Mr. Mitchell then remarked that a policy course between those implied by alternatives A and B for the directive would reduce the likelihood that a change in Regulation Q would be necessary, and Mr. Holmes concurred.

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

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Mr. Ellis referred to the Manager's comment regarding even keel constraints, and asked what the prospects for such constraints were with respect to the month of June.

Mr. Holmes replied that after the May refunding the Treasury would probably engage in a large cash financing in June. More generally, he thought even keel considerations would be important in the whole period from the end of April through the end of the calendar year, although there probably would be intervals within that period in which they were absent.

Mr. Hickman noted that the Committee had not developed a consensus on the Manager's proposal regarding the RP rate, and proposed that the subject be pursued.

Mr. Hayes said he saw a great deal of force in the Manager's suggestion that there would be real advantages in a mild increase in the RP rate at this time. Because similar action was not taken early enough in 1966, the spread between the RP rate and money market rates grew so large that the former could not be increased to restore a desirable relation without attracting a good deal of attention and affecting expectations. Under those circumstances the Committee had been reluctant to have the RP rate raised, even though it was clear that Federal Reserve credit was being provided through repurchase agreements

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at much too low an interest rate. He favored the Manager's proposal for cautious experimentation with a higher RP rate. He doubted that it would be feasible to link the rate mechanically to some market rate.

Messrs. Daane and Hickman said they also favored giving the Manager flexibility with respect to the RP rate, on the understanding that he would use it in a cautious manner.

Mr. Brimmer remarked that the discount rate was accepted as the basic rate at which Federal Reserve credit was provided. If some different rate were to be established on RP's he thought it should be set in a systematic and predictable manner. He did not favor leaving decisions on the RP rate to the discretion of the Manager.

Chairman Martin said he thought it was desirable to experiment occasionally with operating techniques. Although the Committee had discouraged the Manager from setting an RP rate above the discount rate when the possibility was considered in 1966, he did not think any harm would be done by an experimental operation of that type now. Circumstances under which a higher RP rate would be considered were relatively infrequent; if they were more common, he would be inclined to agree with Mr. Brimmer.

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Mr. Maisel said he also favored proceeding as the Manager had suggested, on an experimental basis. At the same time, he shared the view that there would be advantages in relating the RP rate to some other rate, and he thought the possibilities for doing so should be pursued.

Mr. Holmes noted that the average bill rate set in Monday's auction was close to 5-1/8 per cent and an RP rate initially set at that level could be related to that auction rate. It was not certain, however, that the auction average would continue to be appropriate as the basis for determining the RP rate.

Mr. Mitchell said there was a disadvantage in leaving the RP rate to the Manager's discretion in that it would expose him to the criticism that he was acting in an arbitrary fashion. A link with some market rate would obviate such mistaken criticism. The real solution to the present problem, however, would be to move the discount rate into line with market rates.

Mr. Brimmer remarked that if the Reserve Banks and the Board became convinced that the discount rate was out of line they should proceed to change it. In his judgment the RP rate should not be used as a proxy for the discount rate.

Mr. Hayes commented that there was no necessary connection between the rate the Federal Reserve Banks charged member banks

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borrowing at the discount window and the rate charged nonbank dealers on RP's. Under certain circumstances it might well be considered unwise to extend credit to nonbank dealers at the same rate at which credit was granted to banks.

Mr. Sherrill agreed that the RP rate need not necessarily be the same as the discount rate, and that flexibility in the latter would be useful. If possible, however, he would favor an effort to develop some criteria for determining the RP rate, perhaps involving a number of market rates.

Mr. Hayes suggested that if the Committee agreed on experimentation with a higher RP rate it might also ask the Manager to study the possibility of developing some objective criteria in terms of other market rates.

Mr. Robertson believed that Mr. Brimmer's concern was well founded. On the other hand, he (Mr. Robertson) thought it would prove necessary to experiment in order to develop appropriate objective criteria for the RP rate. He favored some mild experimentation.

Chairman Martin said it would be highly desirable, if the Committee approved the Manager's suggestion, to ask the latter to undertake the study Mr. Hayes had suggested and report on it at the next meeting. He thought it would be a mistake for the Committee to press ahead without such a study.

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Chairman Martin then proposed that the Manager be authorized to experiment in a mild way with a higher RP rate, and that the Committee plan on following developments in that area closely. No disagreement with the Chairman's proposal was voiced.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period March 5 through April 1, 1968, were approved, ratified, and confirmed.

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

Mr. Brill made the following statement on economic conditions:

Submerged in the more dramatic news announced by the President Sunday night was the firmest indication we've had yet of the extent to which Vietnam spending may exceed the amounts budgeted just two months ago. Unless the de-escalation promptly produces favorable results, defense outlays in the first half of this year will be much higher than indicated earlier, and the increase for fiscal year 1969 will be closer to \$6 billion than to the \$4-1/2 billion projected in the January budget.

Some of this boost in defense outlays will undoubtedly be offset by reductions in other Federal spending, and perhaps the whole impact will be more than offset by a tax increase, chances for which seem to have turned a bit more

auspicious. But the fate of fiscal restraint is still obscure, and it would be premature to establish monetary policy today on the so-often-dashed hope of fiscal restraint in the future.

Certainly, the current and immediately prospective economic picture doesn't provide a basis for letting up on monetary restraint. Not only is Government spending rising faster than projected, but consumer incomes are rising enough to permit sharp increases in spending while saving is still at historically high levels. Wage contracts are escalating, with very large first-year increases, and rising costs are being passed through--with substantial mark-up--at all levels of the price structure. For those who insist on categorizing economic developments, one can safely say that at the moment we are suffering from both cost-push and demand-pull inflation.

To be sure, some of the income increases in the first quarter were in the nature of one-shot adjustments to the income stream: the rise in minimum wages, the increase in social security benefits, and the effects of wage contracts signed last fall. But we are anticipating continued large increases in income. The full effect of higher social security benefits, which contributed to only one month of first-quarter incomes, will be more fully reflected in the rise in incomes in the second quarter. Also, strikes in several industries, which had some hampering effects on wage incomes in recent months, have ended or are in process of ending. And with retail sales rising rapidly while industrial production has been on a plateau, output should be picking up as producers begin to replenish distributors' inventories of consumer goods. Impetus to increasing output and inventories could also come from the acceleration in industrial commodity prices, which have been rising at a 4-1/2 per cent annual rate. Thus, even with a leveling off in business investment and residential construction outlays, we would expect another very large increase in GNP in the current quarter, which would continue to exert pressure on resources and on prices.

The question is whether Government stabilization policies already set in train have done enough to begin curbing inflationary pressures. I am sure that no one here feels that fiscal policy has done enough, even though the Federal deficit on income and product account has declined substantially, from close to a \$15 billion rate last spring to an estimated \$9 billion rate in the first quarter. This reduction in the deficit, however, is largely a reflection of, and not a curb on, inflation. Soaring profits and personal incomes--the results of inflationary wage settlements passed through in sharply rising prices--are swelling the tax base and resulting in a flow of tax receipts rising even more sharply than expenditures. But this sort of fiscal "drag" is proving a weak tool for cooling off an over-heated economy.

It's equally important to insure that we are not deluded by the available figures reflecting the impact to date of monetary stabilization efforts. Not that anyone would expect a policy of gradual intensification of monetary restraint, instituted less than four months ago, to be reflected so soon in a significant slowing in GNP. But there is the danger of our taking too much comfort from the fact that policy actions since November seem to be showing up rapidly and significantly in the volume of financial flows.

As the table in the blue book^{1/} indicates, a number of monetary quantities have recorded marked declines since the initial step toward restraint last fall. Our

^{1/} The table showed the following annual growth rates, with dates inclusive:

	<u>May '67 - Nov. '67</u>	<u>Dec. '67 - March '68</u>
Total reserves	9.6	6.3
Nonborrowed reserves	10.0	0.3
Bank credit proxy	11.3	5.4
Money supply	8.4	3.3
Time and savings		
deposits at banks	14.7	6.5
Savings accounts at		
thrift institutions	8.6	5.5 (Dec. '67- Feb. '68)

public relations image is improved, no doubt, by having succeeded in reducing the pace of bank credit expansion and the money supply to less than half the rates prevailing in the spring and summer of 1967. But the economics involved makes it a less convincing demonstration of monetary restraint.

The sharp reduction in bank credit growth with so little impact on credit costs has reflected both a reduction in total credit demands and a rise in the nonbank public's investible funds. While Treasury borrowing has continued high, corporate financing in capital markets has tapered off--a result of the jump in profits, the reduced pinch from tax acceleration, and a waning desire to improve liquidity by funding into longer-term debt. With the flow of private savings high and new-security issue volume significantly lower, banks have been able to let their holdings of Governments run down without putting much strain on markets.

Moreover, they've been able to sustain a faster loan expansion without much strain on their investment portfolios. Business loan growth has been at an 11 per cent rate in the December-March period--almost twice as rapid as in the May-November period--and consumer credit and mortgage lending have also accelerated. But banks have been able to continue adding to their holdings of municipals at a substantial pace, although somewhat slower than in the earlier period. While I'd hesitate to characterize the banking system's position as comfortable, it doesn't seem to me to have been very uncomfortable, and this has been reflected in some apathy or at least lack of aggression--up until recently--in soliciting CD funds.

We should not, therefore, take too much comfort from the decline in financing at banks and in the capital markets since our policy shift last November. The critical question is whether the borrowing costs and conditions that have developed recently are stringent enough to begin curtailing the rise in private expenditures, or whether monetary pressures have to be intensified even before an upsurge in financing demands develops.

Given the state of the art, this is a delicately balanced decision to make. I'm not sure it can be made in the context of the staff projection presented

at the March 5 meeting, which suggested a complex of financial conditions and fund flows that would have-- in our estimation at that time--achieved a gradual and steadily increasing constraint on spending. Some of these conditions have already been met, at least in the area of long-term interest rates, and some of the conditions have been exceeded. Bank credit expansion so far seems to be below the projected rate for the first half-year--although I must hasten to emphasize that we still don't know enough about monthly variations to determine whether any one month's showing is on or off a longer-range target.

But the basic problem we are trying to tackle has become greater than it appeared in late February. Our international payments position is more precarious, and inflation is proceeding more rapidly than we had estimated even just a month ago. In February, we projected the deflator for the first quarter at a 3-1/2 per cent annual rate; now we've had to raise our estimate to 4 per cent. And as was noted earlier, consumers appear to be spending a bit more freely than projected earlier, Government spending is rising faster, business inventories are leaner, and profits are substantially higher than in the March 1 projection--all of which could easily lead to a faster-than-projected rise in business spending.

It seems to me, therefore, that we would be warranted in changing our sights on what is required of monetary policy. Considering also that we will be locked in at the next meeting by even keel considerations--and possibly also at the meeting after that--there seems to be a sufficiently strong economic argument for turning the monetary screw a bit more at this time.

There are deterrents, though. Prospects for a reduction in hostilities have improved, and should be even clearer in a few weeks. Moreover, the next turn of the screw will mean a painful confrontation with the issue of Regulation Q and thrift institution ceiling rates. Prudence might therefore dictate a willingness to "wait and see" for several weeks longer, while maintaining as much pressure as possible on financial markets to keep market rates at but not beyond the disintermediation threshold. Perhaps this is more timidity than prudence; my colleagues call this the posture of a "chicken" hawk.

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Mr. Axilrod made the following statement regarding financial developments:

The added pressures on financial markets resulting from the rise in the Federal Reserve discount rate and the firming of open market operations have led to interest rate increases all along the maturity spectrum and in all market sectors--although I hasten to add that Sunday's Presidential address has inserted a new element into the picture and caused interest rates yesterday to back off from their recent highs. Even so, interest rates in the three-month maturity area and out are back relatively near to, and in some cases above, where they were around year-end, when interest rate levels reflected anticipations of tight credit conditions, fears of disintermediation, and uncertainties with respect to international exchange and Euro-dollar markets.

There are some interesting differences among interest rates when levels currently in force are compared with those around year-end, and these differences seem to me to point to a state of expectations that is, for one reason or another--and rightly or wrongly--less fearful than earlier. Probably the principal evidence for this is that it has taken a \$450 million swing toward net borrowed reserves and a rise of about 75 to 100 basis points in the interest cost of day-to-day money in Federal funds and dealer loans to achieve a 10 - 15 basis point rise in the three-month bill rate. And longer-term bill rates have risen not at all since year-end, in fact declining around 25 - 30 basis points on balance. Of course, there have been strong downward seasonal pressures on bill rates--as you have been hearing for some time now--but the narrower spread in yield of longer-term over shorter-term bills indicates some calming in upward interest rate expectations. Or to put it another way, it indicates that the actual restraining posture of monetary policy has moved relatively closer to market expectations. But it also reflects less fear about gold and international exchange markets and about escalation in Vietnam.

Yields in long-term markets on new high-grade corporate issues, on outstanding Treasury issues, and on outstanding municipal issues have moved back to, and in some cases above, year-end levels, as monetary policy has continued to tighten. But only in the case of municipals are they above levels just prior to the mid-November devaluation of the pound. The behavior of these yields, too, seems to me to indicate that, in the main, monetary policy has about caught up with market expectations--with the direct restraint of policy showing up most clearly in the municipal market, in which banks have made somewhat smaller net purchases during the past four months in view of the slower growth in bank reserves.

By stressing the extent to which policy has caught up with the market, I do not at all mean to be implying stability in interest rates over the next few months. Yesterday's experience abundantly illustrates the tenuousness of any market equilibrium in these rather surprising times. Fiscal policy will clearly influence rates in the future, as will the response to the President's offer of peace negotiations in Vietnam. Moreover, we are now in the spring quarterly re-investment period affecting individuals' time and savings accounts at banks and nonbank financial institutions. Unlike December, the institutions are not in deep gloom in anticipation; but at the moment it does not look as if their actual experience could be much, if any, better than at year-end. Thus it would appear that mortgage yields and terms are likely to stiffen somewhat further.

Another uncertainty overhanging the interest rate structure is the extent of business loan demands on banks. There were signs of some pick-up in such demands in March, but even so--and even with the rise in short-term interest rates making it more difficult for banks to roll-over maturing CD's--banks did not come to feel themselves under much additional pressure. In fact, a few major banks found that they had over-prepared for loan demand and were more liquid than they preferred after mid-March.

In an effort to obtain some information on loan commitments at banks and on whether banks feel they are or are not in a position to cope with existing commitments, the System Research Advisory Committee has undertaken an

exploratory survey of such commitments. A preliminary pass at the responses indicates that the great bulk of banks feel that their loan commitments (in late February to mid-March) were about, or only somewhat above, normal for that time of year, and that they anticipated little trouble in accommodating the unused portion of these commitments. It is not clear what banks were assuming about Regulation Q ceilings, but one or two banks did indicate that in their evaluation they were assuming no disintermediation.

While the loan commitments indicated in our exploratory survey may indicate somewhat less potential loan pressure than might have been expected, the survey also indicates somewhat more complacency on the part of banks than appears judicious. The recent policy moves have brought banks and nonbank savings institutions to the threshold of disintermediation. And the current equilibrium in short- and long-term credit markets is a precarious one, particularly since prospective Treasury cash financings later in spring and in early summer are likely to exert fairly substantial upward interest rate pressures. In this situation, any further move toward monetary restraint, given existing Regulation Q ceilings, would need to be quite cautious if it is to avoid springing loose sharp cumulative upward interest rate pressures that could be generated as market participants lose confidence in their current appraisal of the market outlook.

In fact, I would tend to advance the view that the Committee at this meeting might undertake to go little further than maintaining over-all pressure on short-term markets, but interpreting that to include making reasonable efforts to keep upward pressure on the three-month bill rate. Adding considerably to short-term market pressures poses the danger of too strong a reaction on long-term markets and on the housing industry, so long as current ceiling rates on time and savings accounts at banks and nonbank savings institutions are maintained; and existing tightness in mortgage markets already presages a cut in residential construction by summer. But it clearly seems desirable to keep pressure on bank lending terms to consumers and businesses and on interest costs of finance company and commercial paper, and thereby help to moderate, at the margin, prospective consumer spending and the rate of business inventory accumulation.

It might be argued, though, that even more monetary restraint will be required sooner or later, and that the Treasury financing schedule will be an impediment to further monetary moves later. Perhaps that will be so, but a good part of the Treasury's cash need this spring could conceivably, and desirably, be accomplished in the bill area, which would serve to complement monetary policy by sustaining, or adding to, pressures in short-term markets.

Mr. Hickman noted that Mr. Axilrod had recommended maintaining upward pressure on the bill rate but had also referred to the danger of disintermediation. What would he suggest as an appropriate upper limit on the bill rate?

Mr. Axilrod replied that the bill rate might rise to about 5.35 per cent without triggering extensive disintermediation. Any such judgment was subject to modification, however, depending on the kind of market atmosphere and attitudes that developed. He added that a bill rate of 5.35 per cent might require a Federal funds rate above the 5-3/8 - 5-1/2 per cent range that the blue book suggested was consistent with alternative A for the directive.

In reply to a question by Mr. Mitchell, Mr. Axilrod said his policy prescription was intermediate to those implied by alternatives A and B for the directive.

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

Although we have lived through a major international financial crisis since our last regular meeting, and some new elements have been introduced by President Johnson's message of Sunday night, the basic factors that should determine monetary policy have changed relatively little in that period. The crisis did, however, point up in a most dramatic fashion the perilous position of the dollar, reflecting the acute current problems of inflation, lack of fiscal responsibility, and payments imbalance, coming on top of a 10-year record of excessive payments deficits. Possibly we shall see some respite for the dollar's woes as a result of the heavy technical position of private gold holdings, while the Washington and Stockholm meetings have provided a further helpful reaffirmation of international financial cooperation. But we cannot avoid the conclusion that another international crisis of the utmost severity could confront us at any time within the coming months.

As I have indicated, the underlying situation has not greatly changed since a month ago. The economy remains very strong and appears to be experiencing the excessive rate of expansion that earlier forecasts had indicated, with nearly half of the GNP gains representing higher prices. So far there has been no evidence that the gold crisis has had serious adverse effects on business and consumer psychology. Underlying labor market conditions remain as tight as ever, despite the rapid recent increase in the civilian labor force. It is interesting to observe that corporate profits for the fourth quarter of 1967 showed the first sizable quarterly gain in two years.

Turning to the balance of payments, our international transactions appear to have worsened considerably in March. Tentatively it seems that the underlying deficit for the first quarter may be in the \$4 to \$5 billion range at a seasonally adjusted annual rate, which would approximate or exceed the level recorded for the full year 1967. As has been mentioned in our meetings earlier this year, the most disturbing development has been the sharp deterioration in the trade surplus, which is now perhaps showing a deficit after deduction of exports financed by the U.S. Government. Prospective gains from the President's program may be largely wiped out by the poor performance of the merchandise account.

The slowdown in the growth of bank credit in March is encouraging, together with the prospect of further slowing in April. Although the growth of the money supply and of time deposits accelerated last month as Treasury balances were drawn down, the January-February growth rates were unusually low, and over the first quarter as a whole monetary growth was much slower than in the preceding half-year. But, of course, the 1967 gains in credit and money were so clearly excessive that we must seek to assure no more than a modest growth over the coming months. Deposit flows to the nonbank thrift institutions picked up in February and seemed to be holding up well in March. Disintermediation difficulties may become more visible in connection with the first-quarter interest-crediting period and with April CD runoffs. So far, however, this problem has not been acute.

We have, of course, seen an unusually rapid tightening of monetary policy through open market operations during the past couple of months. This fact, together with the possibility that we have not yet seen all the lagged effects of this tightening, might argue for a policy of no change for a few weeks while we assess further the results of our past action and allow some time for a further evaluation of developments over the past week-end. On the other hand, the vitally needed Federal fiscal program of higher taxes and reduced expenditures still hangs in the balance, and the time is very late, with faith in the dollar at such a low ebb. I think we should also have in mind that the period from now until late April may constitute our last opportunity for some time to take policy actions without the restraint of even keel considerations.

At the very least I think we should maintain the substantially firmer money market conditions achieved during the past month or two, and we should avoid not only the reality, but also the appearance, of any weakening in this posture. I have in mind the fact that special seasonal and liquidity factors may put downward pressure on Treasury bill rates in the coming weeks and thus, as happened some weeks ago, create an erroneous impression of greater ease than we would intend. I think my preference with respect to open market policy would be to move very gradually toward

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even further restraint, with a target range of perhaps \$350 to \$450 million of net borrowed reserves, discount window borrowings of roughly \$700 million, and Federal funds rates fluctuating around 5-3/4 per cent. We might go beyond this degree of restraint if for any reason bank credit begins to demonstrate significantly greater strength than is now expected. I hope too, that within the constraint of over-all policy the Desk will do whatever it can--including the purchase of coupon issues when feasible--to help counter any downward tendency in Treasury bill rates.

The proposed policy might well lead to a modest firming of some market interest rates and to expectations of another discount rate rise. As a matter of fact, I should think that we should be contemplating the possibility of another 1/2 point increase in the discount rate sometime before the end of April, when even keel restraints will commence, so as to make crystal clear the System's determination to do what it reasonably can do to uphold the dollar's international standing. Such an overt move might be necessary to offset any misinterpretation of System policy if short-term interest rates should be forced lower by market pressures. The appropriateness and timing of an additional discount rate increase must be importantly influenced by the progress or lack of it with respect to Vietnam and on the fiscal front, as well as the occurrence of critical developments in the international financial areas. I would not advocate any discount rate action as early as this week.

As for Regulation Q, I think it may well become necessary to raise the ceiling on large CD's if market rates continue to rise, but I would urge that such a move be delayed until pressure on the commercial banks has become rather more intense than it is now.

Alternative B of the directive seems to me a bit better than A, although I would be inclined to say "slightly firmer conditions" rather than "somewhat firmer conditions" just to emphasize that we are moving very cautiously while still preserving some forward momentum. I would use the one-way proviso of alternative A in preference to the two-way proviso of alternative B. I would reverse the order of two sentences in the first paragraph dealing with

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international matters to stress our continuing serious concern in that area, revising the sentence that would then come second to read, "The foreign trade surplus, however, has remained at a sharply reduced level in recent months and the imbalance in U.S. international payments continues to be a matter of serious concern."

Mr. Francis commented that growth in demands for goods and services continued to be excessive compared to productive capacity, and prices were rising at about a 4 per cent annual rate. Despite the obvious desirability for fiscal restraint for both domestic and international purposes, little real progress had been made in either cutting expenditures or raising taxes. Hence, he felt that movement towards greater monetary restraint was still needed. Much of the recent slowdown in growth of bank credit had merely been a disintermediation because of Regulation Q, and it did not represent an equivalent reduction in the rate of total credit expansion. Although the annual growth rate in money had slowed from 7 per cent during most of last year to about 4 per cent in the past three months, that was still relatively large compared with the 2.6 per cent trend rate of the past decade.

Mr. Francis recalled that many members of the Committee had expressed much concern about the viability of the housing market and financial intermediaries in a period of monetary restraint. As a result, the Committee had at times been hesitant in moving toward a less expansive policy because of a fear that most of the impact

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might focus on that one sector, causing undue harm. Because of that, the staff of the St. Louis Bank had been investigating the impact of monetary restraint on the construction of housing.

Mr. Francis remarked that the need for restraint arose when total demands for goods and services exceeded the ability of the economy to supply them at relatively steady prices. Hence, some demands had to be eliminated or reduced if the objectives of policy were to be achieved. The Bank's preliminary investigations indicated that housing outlays were affected by monetary conditions, but so were most other types of outlays.

Mr. Francis went on to say that inflation, which was an alternative to monetary restraint, also affected the housing industry, since it resulted in higher nominal rates of interest and higher prices of all inputs. According to data published by the U.S. Department of Housing and Urban Development for twenty major pricing areas of the country, the labor and materials costs of constructing a selected sample of brick and frame houses rose at a 4.1 per cent annual rate from 1963 to 1967 and at a 6 per cent rate from 1966 to 1967. By comparison, the over-all price index had increased at a 2.7 per cent annual rate since 1963. Interest rates on mortgages had risen about 1-1/4 percentage points since 1963, causing monthly payments on a 25-year mortgage to be 12.5 per cent

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higher. By comparison, the inflation of building costs since 1963 had increased monthly payments 17 per cent. Interest rates were apt to come back down after the excessive demands were controlled, but the higher costs of housing to the original buyer as a result of inflation were not very likely to be reduced. In short, a home mortgage could be refinanced at a lower rate of interest, but a home could not without compromise be repurchased at a lower price.

It did not appear to Mr. Francis, at this stage of the investigation, that monetary restraint affected the housing market any more severely than the economy in general. Most of the problems in the industry that were blamed on monetary restraint resulted from Governmental interferences in the market place for funds. Usury laws, Regulation Q, and rate regulation on other financial intermediaries were prime examples of practices that discriminated against housing in periods of high interest rates. Other practices included pressures on the Federal Home Loan Bank to restrain its borrowing and lending and the rigidity of rates on FHA and VA loans, with the accompanying insidious "point" system of financing.

Repeal or liberalization of such laws, regulations, and practices, Mr. Francis continued, would contribute to a more viable housing situation, but even with those market imperfections it did not appear that monetary restraint had a concentrated effect on the

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housing market. The St. Louis Bank staff had prepared a chart,^{1/} which he would ask be included in the record, showing expenditures on housing as a per cent of GNP since early 1952 and the rates of change in the money stock during the same period. From the chart, it appeared that when the rate of expansion in money slowed, housing might be affected more than other activities (in terms of declines as a per cent of GNP) for a few months. However, following that brief period, housing generally was less affected than over-all activity (rises relative to GNP) while monetary restraint continued. Housing then boomed in the initial period of the following monetary expansion but usually declined relative to other activities after a year or two of rapid expansion in money.

In short, Mr. Francis said, housing seemed to be adversely affected in periods when monetary growth became excessive and caused inflation and relatively high interest rates. Housing continued to be depressed in the first few months after monetary growth was slowed. On the other hand, housing was less affected than other sectors by monetary restraint after the first few months, when excessive demands were weakened and upward pressure on prices and interest rates moderated. Housing thrived best in the initial stages of a renewal of monetary expansion after excessive total

^{1/} Appended to this memorandum as Attachment B.

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demands were eliminated. From the point of view of housing alone, it appeared that a sustainable rate of monetary growth was more desirable than continued rapid monetary expansion.

Because of the excessive total demands for goods and services and the strong inflationary pressures, Mr. Francis suggested another move toward monetary restraint. If and when action was taken to reduce Federal spending or increase taxes, monetary conditions could quickly be relaxed. In the near future, he would prefer that the money supply rise at a 2 or 3 per cent annual rate, somewhat slower than the 4 per cent rate since December. Conditions in the money market during April which might be consistent with a more moderate growth in monetary aggregates included a three-month bill rate of about 5.50 per cent, Federal funds rates at or above 5.50 per cent most of the time, and net borrowed reserves of about \$400 to \$500 million.

Mr. Francis preferred alternative B of the draft directives.

Mr. Kimbrel remarked that if there was anything encouraging to be found in the latest economic and financial moves, it was that the System had apparently achieved a move toward further restraint without creating disorderly or panic conditions. That, he believed, followed the intention of the Committee. The Committee had hoped that in applying the brakes it could slow down the rate of expansion in the credit base without bringing about a complete stop

or reversal. It had hoped that, in the process, the very necessary restraints would be more evenly distributed among the different sectors of the economy than during the last period when it became necessary to adopt a restrictive policy. Nevertheless, the nation was still faced with the same basic economic and monetary problems, as the President had pointed out in his address Sunday evening. There still were rising prices, a balance of payments deficit, and prospects for a large budget deficit. Thus, the Committee now faced the question as to whether this slowing-down policy could do the job.

Mr. Kimbrel recalled that he had indicated at the March 5 meeting of the Committee that bankers in the Sixth District did not seem to be feeling much effect of the System's move toward a less expansive policy. In the last week or two, however, evidence seemed to be accumulating that at least the large banks of the District were coming under more pressure. Their demand deposits had declined and they had lost some funds through failure to replace maturing CD's. Thus, in order to increase their loans they had to draw down their correspondent balances, increase their borrowings from the Federal Reserve Bank, make more extensive use of Federal funds, and liquidate some of their short-term Government security holdings. Sixth District reserve city banks had now been

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in a net borrowed reserve position for six weeks, in contrast with the free reserve position they enjoyed during most of 1967 and early 1968.

Mr. Kimbrel remarked that the Committee was meeting at an awkward time to assess the degree of disintermediation over the dividend date. Inquiries made by members of the Atlanta Bank's staff to leading savings and loan associations and some commercial banks suggested that the amount of switching from the savings institutions might be somewhat less than it had been feared previously. Savers apparently were becoming more interested in preserving liquidity and in achieving immediate availability than in a one-half point or so interest rate differential that might be achieved by tying up their funds. The rash of newspaper advertisements that characterized the end of the last quarter of 1967 was absent at the present time.

With rates on large denomination CD's at the ceiling and rates on short-term securities tempting holders of consumer-type savings certificates, Mr. Kimbrel said, some banks would undoubtedly have some difficulties in retaining and attracting time deposits. That might be a desirable development as part of the package of a move toward more restraint. The case for an increase in the Regulation Q ceiling, therefore, was not completely convincing to him at the moment.

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Mr. Kimbrel believed that at present the Committee should keep about the same policy posture it had achieved, while avoiding giving the impression that there had been any relaxation. At this time the Committee could not accurately assess the financial developments that might stem from the decision of President Johnson not to seek another term of office. Nor could the Committee predict with any degree of confidence the financial changes that might follow the quarter-end dividend date and the April 15 tax payment date, international developments, and possible action on taxes or Government expenditures. Therefore, a considerable amount of discretion probably should be allowed the Manager in carrying out the instructions. Under those circumstances, he favored alternative A for the directive, possibly with a slight shading to firmer conditions than those associated with that alternative. He had no objection to a flexible but cautious experiment with higher RP rates such as Mr. Holmes had suggested.

Mr. Bopp observed that progress continued to be made in slowing down rates of growth of bank credit and the money supply. That was all to the good. For both economic and psychological reasons, however, he thought that some further move toward tightening was appropriate.

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In terms of economics, Mr. Bopp said, prices were rising at a rapid rate. Defense spending was increasing faster than estimated in the January budget. The deficit in the balance of payments was extremely high, and the deterioration in the trade surplus was alarming.

In terms of psychology, Mr. Bopp continued, further tightening would confirm that the Committee meant business, and that was necessary for both international and domestic reasons. Most important was the precarious state of gold and the dollar. The gold crisis of three weeks ago had been met, but the current arrangements could only be regarded as interim ones, the success of which depended on continuing confidence that the United States was moving steadily toward solving its balance of payments problem. In addition, both consumers and businesses needed to be reassured that steps were being taken to restrain demand. Otherwise they might be inclined to make spending decisions that would further complicate the tasks of monetary management.

The question today was the best way to meet those dual requirements of economics and psychology, Mr. Bopp remarked. The most delicate instrument the System had was, of course, open market operations and, given the many uncertainties present at the moment, that characteristic had much to recommend it. A modest restrictive

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move with that tool would be least likely to precipitate disintermediation and least likely to discourage what appeared to be more promising efforts on the fiscal front. Also, because further effects of the recent discount rate change might be felt, the flexibility of open market operations was desirable. On balance, therefore, he would be inclined to use open market operations to bring about somewhat tighter monetary conditions.

Mr. Bopp had also been thinking, however, about the possibilities of other actions which would give a clearer signal of the System's intent to use its monetary instruments as vigorously as necessary to protect the dollar. The present moment might not be the best time for such a signal, but it would be well to consider the use of it on short notice.

Mr. Bopp thought another increase in the discount rate would not be particularly appropriate or effective because it would raise the question of whether the initial increase should have been larger. But one action that the Board might consider was a modest, graduated increase in reserve requirements of the type employed last December. An advantage of that would be that, coming on the heels of the recent increase in the discount rate, it would probably be read as part of a program to correct the balance of payments. It might, of course, precipitate disintermediation,

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and hence raise the question about the ceiling rate on negotiable certificates of deposit. Even if no sizable disintermediation was now occurring, which seemed to be true in the Third District at least, the threat was likely to persist for many months to come. It might prove better strategy to raise the ceiling rates in advance of a crisis or in order to forestall one. In addition, a package of simultaneous increases in reserve requirements and in the ceiling rate on large CD's might achieve the benefits of the announcement effect while minimizing the possibility of a "crunch".

Mr. Bopp noted that an increase in reserve requirements some time in the next few weeks would be less likely to conflict with even keel considerations than would be true later on. On the other hand, it would be more feasible to use open market operations to tighten further during those even keel periods.

Mr. Bopp's recommendation was that the Desk be instructed to make a modest move to further tightening. That would be consistent with alternative B for the directive. Should the Board decide that an increase in reserve requirements was appropriate, open market operations should be adjusted accordingly.

Mr. Hickman commented that GNP and prices continued to advance at excessive rates. In that environment of too rapid

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expansion of real output and price inflation, the present restrictive stance of monetary policy was clearly appropriate. On the whole, the March estimates for bank reserves, credit, and money, and the projections for April were compatible with sustainable real rates of growth in the economy. That being the case, the present degree of restraint appeared adequate, and he would favor a change only if the credit proxy increased at a rate of more than 6 per cent. He would leave Regulation Q ceilings alone for the moment; the longer the Board delayed in changing them, the more likely it was that bankers would be more selective in their lending and investing policies. He would be concerned, however, if the 91-day bill rate moved above the 5-3/8 per cent level mentioned in the blue book, since that could lead to serious disintermediation and an undesirable degree of credit restraint.

In short, Mr. Hickman said, he would be happy to see money and credit conditions remain about as they were, and would support alternative A for the directive. Needless to say, he would be prepared to move promptly in either direction if a move was indicated by fiscal policy actions or international developments.

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Mr. Sherrill commented that he was in the "chicken hawk" camp today; he favored the policy called for by alternative A of the directive, perhaps with some shading toward firmness. In his judgment the money market conditions likely to result under alternative B would lead into the thicket of disintermediation and might possibly represent an effort to accomplish more with monetary policy than was feasible at this time. He also was persuaded in the direction of alternative A by the various existing uncertainties. There had been so many recent developments and so little time to evaluate their significance that he thought it best to maintain about the existing posture of policy at present. He would be reluctant to see any lessening of restraint in the coming period. He thought it would be feasible to attain the conditions outlined by Mr. Axilrod, including a three-month bill rate ranging up to 5-3/8 per cent, and to maintain firm conditions during the next few months despite expected Treasury financings.

Mr. Brimmer said he favored a policy course between those associated with alternatives A and B. He thought the Committee should take advantage of the present opportunity to attain a little more restraint since it was likely to be operating under serious even keel constraints after the end of April unless it chose to depart from past practice in periods of Treasury financings.

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Mr. Brimmer remarked that the Committee should not lose sight of the implications of the decision to firm policy it had taken at its meeting on March 5. In view of the prevailing inflationary pressures and the expectation of substantial increases in aggregate demands, it was necessary to look toward some moderation of outlays on residential construction as one means of effecting restraint. That would imply moderation in the inflow of funds to financial intermediaries. Thus, while he certainly would not want to see disintermediation get out of hand, he thought the Committee should not work on the assumption that it could be avoided entirely.

Mr. Brimmer indicated that he would not be willing to support an increase in the Regulation Q ceilings at this time. The kind of probing toward greater firmness that he advocated might lead to the need for an adjustment of the ceiling rate on large CD's at a later point, but he did not presently contemplate an adjustment in the ceilings on consumer-type CD's or on savings deposits.

Turning to the drafts of the directive, Mr. Brimmer expressed the view that it would be desirable to take note of the fact that a renewed effort was being made in Congress to reduce Federal expenditures and to enact a tax increase. The Committee had taken account of the possibility of fiscal action

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in earlier directives but had dropped the reference after it began to appear that the prospects for Congressional action were poor. At present, however, the prospects for action by the Senate were far more promising than in some time. Accordingly, he would suggest adding a sentence to the first paragraph, immediately before the statement of the Committee's general policy stance, reading "While renewed efforts are being made in the Congress to bring about a reduction in Government expenditures and to enact an increase in taxes, the outcome of these moves remains in doubt." He had no strong feelings with respect to the rest of the directive, but was inclined to favor the two-way proviso clause shown under alternative B.

Mr. Maisel commented that the Committee was clearly in a period of surprise and major change. At times such as this, it was particularly desirable for the System to demonstrate its responsiveness and responsibility. That meant that the System must continue to recognize that it was concerned with the medium-term outlook because of the lags in monetary policy.

Mr. Maisel did not think the Committee was at a point at which it should shift its goals, certainly not without careful consideration of all that was involved. The growth rate projected for the second half of the year was one-half of normal. What

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would be gained or lost by attempting to hold to that reduced rate? In his judgment, the System should furnish reserves and allow credit to expand at the minimal rates outlined at the March 5 meeting to meet that goal. The amount of tightening that would entail would be large. How large, if the Committee rejected the basic reserve and credit data, could only be estimated by each member in a subjective manner. It would, he believed, be a serious error to make such subjective evaluations the basis of policy. Furthermore, it should be recognized that, as the Manager had pointed out, the markets might fluctuate widely in the short run--particularly under the impact of the types of news filling the headlines. Those fluctuations resulted partly from rapidly changing expectations, but they also reflected variations in demand and supply for both credit and output.

Notwithstanding the current news, Mr. Maisel felt it would be wrong for the Committee at this time to assume that there would be a major shift in fiscal policy and, therefore, to change its goals. On the other hand, it would be just as erroneous to adopt a policy that could not be accommodated to actual changes in the fiscal situation.

Mr. Maisel thought this would be a particularly apt time to reverse the substance of the clauses in the second paragraph

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of the directive. Since what was meant by "firm markets" would be extremely hard to judge if expectations continued to shift drastically or if real fiscal changes were made, it would be far better to state the Committee's goals in terms of money and credit growth levels rather than in terms of interest rates and free reserves.

Thus, Mr. Maisel said, he would like to see the directive instruct the Manager to allow reserves to grow sufficiently to take care of seasonal requirements. As long as the annual rate of bank credit growth remained within the range of plus 2 to minus 2 per cent projected in the blue book, the Manager should maintain prevailing money market conditions. If the projections moved outside that range, he should be instructed to alter conditions in the direction which would lead bank credit growth back within the desired range.

As the Committee members all recognized, Mr. Maisel continued, the rate of growth in bank credit had been going down steadily. Using the blue book projection for April, both the six-month and three-month rates of growth in bank credit through that month were considerably below the growth rates for both the first and second half of the year which the tight monetary policy model, presented at the Committee's March 5 meeting, showed as necessary to move toward a desirable equilibrium. The growth

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rate in the recent period was lower than the projection, even recognizing that there had been no Treasury financing in March, since there had been such financing earlier in the period. If the form of the second paragraph of the directive were shifted, the Committee could hold to it even in periods of even keel; the Committee would not be locked in.

Mr. Maisel commented that the Committee did not really know how sharp a change it had caused in the rates of growth. Its actions had not yet worked their way through the monetary system. The increased tightness had led to rapidly deepening negative free reserves which, however, had been partially offset in the bill market by unusually heavy demand. The likelihood of disintermediation was reported as high by both commercial bankers and other financial institutions. That threat plus a lack of basic knowledge as to events between now and the next meeting were his reasons for desiring a new form for the directive.

If the Committee could not agree upon a shift in the directive, Mr. Maisel would support alternative A. However, he would include a two-way proviso, reading "provided, however, that operations shall be modified as needed to moderate any apparently significant deviations of bank credit from current expectations." All of the factors arguing for a change in the form of the directive applied equally to the desirability of a two-way proviso.

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Mr. Maisel thought that failure to shift the form of the directive, or at a minimum to include a two-way proviso, at a meeting such as this, when such a potentially dynamic future was faced, would mean adopting a very myopic view of where the Committee wanted, and was likely, to go in the immediate future.

Mr. Daane commented that the rapidly deteriorating position of the balance of payments, with the ominous signs apparent in the trade sector, and the inflationary developments in the domestic economy pointed clearly to further restraining actions by the Federal Reserve. To him the questions were confined to those of the desirable degree of restraint, the choice of instruments, and the timing of actions. Perhaps he had been too much involved with the international monetary area, where conditions had been in turmoil recently, but he thought greater monetary restraint in the United States was necessary to support the decisions at the recent meetings in Washington and Stockholm. Accordingly, he would prefer alternative B for the directive. He did not regard that as particularly hawk-like, in light of current international developments and the efforts under way to strengthen the international monetary system.

Along the same lines, Mr. Daane said, he would be quite amenable to another increase in the discount rate and he would

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favor such action sooner rather than later. In reference to Mr. Bopp's suggestion that the Board consider raising reserve requirements, he would say an increase in discount rates in the United States in general was more clearly perceived as signaling a change in System policy than was an increase in reserve requirements or a modification of targets for open market operations. Thus, he saw an important psychological advantage in a further change in the discount rate. He was concerned about the possibility that the United States might show undue timidity in its use of stabilization measures. While the Committee was generally agreed that fiscal action was needed, the System had to meet its responsibilities in connection with monetary policy.

Mr. Mitchell remarked that the outcome of the debate on fiscal measures now under way in the Senate had a major bearing on the appropriate course for monetary policy. Indeed, a case could be made for adjourning today's meeting of the Committee pending the vote in the Senate.

Mr. Mitchell agreed with those who favored the policy called for by alternative A of the drafts of the directive with a possible shading toward firmness. His reason, however, was simply that the possibility of fiscal action now seemed sufficiently strong to warrant avoiding a full-scale change in policy,

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such as was implied by alternative B. He would be prepared to take the alternative B route, and to employ other monetary policy tools as well, if the Senate failed to take affirmative action on fiscal policy. In that event, he thought the Committee should hold another meeting in the near future to reconsider its policy. At the moment, however, he would favor money market conditions along the lines implied by Mr. Axilrod's policy prescription. He understood that such conditions would include net borrowed reserves of about \$400 million; a Treasury bill rate of up to 5-3/8 per cent; a Federal funds rate in the 5-1/2 to 5-5/8 per cent range; and dealer loan rates of 5-3/4 per cent and above. Such conditions might be associated with a change in the bank credit proxy in April at an annual rate in the range from plus 1 to minus 3 per cent.

Mr. Heflin reported that all of the latest data on Fifth District business suggested an accelerating pace of activity, with a further buildup of pressures on prices and costs. Respondents in the Richmond Bank's most recent survey reported further improvement in retail sales generally and in automobile sales particularly, with manufacturers indicating further increases in new orders, backlogs, shipments, and

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employment. While general business sentiment remained cautiously optimistic, both businessmen and bankers expressed increasing concern over rising prices and costs.

So far as the Committee's policy deliberations today were concerned, Mr. Heflin said, the single overriding issue continued to be the position of the dollar in the international exchanges and the current grave threat to the international monetary order. He could not feel that the urgency of the U.S. balance of payments problem had been diminished by any recent international agreement. The encouraging degree of cooperation now being received from abroad was perhaps a necessary condition to a satisfactory resolution of the current problem. He believed it would be a serious mistake, however, to view it as a sufficient condition. Rather, as he saw the problem, the basic ingredient of any permanent solution could be found only in the fiscal and credit policies of this country.

The analyses of both domestic and balance of payments prospects presented in the latest green book^{1/} made very gloomy reading indeed, Mr. Heflin remarked. Current inflationary trends clearly had to be arrested if a major crisis was to be avoided. It seemed to him that any other course was like playing Russian roulette not only with the domestic economy but also with the

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

economic base of the nation's entire foreign policy posture.

It was his conviction that the time remaining for an appropriate adjustment of policies in this country was short indeed, and that the Committee no longer had time to await action on the fiscal front. The System's recent tightening moves had taken it in the right direction but, in his judgment, not far enough. He realized that further tightening involved serious risks of dislocations in the credit markets and in important sectors of the economy. But, in view of the urgency of the situation the country was facing, he was prepared to run those risks. He believed that over the next four weeks the Committee should work towards some further firmness in the market and should even be prepared to accept actual reductions in the rates of reserve and bank credit expansion. Net borrowed reserves of the order of \$450 to \$500 million would not seem inappropriate and he would not be troubled by Federal funds rates in the neighborhood of 5-3/4 to 6 per cent. For the present he would favor alternative B for the directive. Also, in the absence of a dramatic improvement in the prospects for fiscal action he would be prepared to consider further discount rate action during the month of April.

Mr. Clay commented that evidence pointed increasingly to an aggregate demand for goods and services in excess of the

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real productive capacity of the economy. The impact was not uniform upon the various sectors of the economy and that fact was reflected in the variations in price movements and utilization of productive capacity. The convergence of civilian and military demands continue to make for a tight labor market and to encourage advancing wage rates. The over-all demands on the economy also continued to produce an accelerating rate of price inflation. The seriousness of those resource pressures and the accompanying price inflation was underscored by the large deficit in the U.S. international balance of payments, including the discouraging developments in the balance of trade.

It was evident to Mr. Clay that the national economy required added measures of economic restraint. The need for fiscal action and the uncertainties surrounding that possibility were an old story, but the need mounted rather than diminished. There also was something seriously wrong with respect to the determination of wage rates and the commodity pricing that accompanied it that had become an integral part of the price inflation spiral. The demand for labor was a significant underlying factor, but the functioning of the institutional arrangements for setting the pattern of wages was an important part of the price inflation problem.

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Mr. Clay noted that monetary policy had become distinctly more restrictive recently. The impact of that action on the credit markets was not fully known as yet. If there were no constraints imposed by Treasury financing, it would be desirable to allow the present degree of monetary restraint to work itself out and to make future changes in the light of the developing situation. It had to be recognized, however, that Treasury financing in May, June, and July might limit the scope of policy actions during that period. Thus there might not be another opportunity to make a further overt move for a considerable time.

Under the circumstances, Mr. Clay said, it became particularly difficult to determine whether monetary policy should be held in its present degree of restrictiveness or should be tightened further at this time. On balance, a slight further tightening of policy appeared to be the preferable course.

The forthcoming Treasury financing activities underscored to Mr. Clay the importance of not relaxing monetary policy. It also made quite secondary the possible lack of bank credit growth in April, as the succeeding months of Treasury financing could be expected to result in a significant degree of credit expansion. In fact, such successive periods of Treasury financing usually led to credit growth beyond the needs of the national economy.

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Mr. Clay said alternative B of the draft directives would be in line with his policy prescription.

Mr. Scanlon said he would summarize the statement he had prepared and submit the full statement for inclusion in the record. He then summarized the following statement:

Probably the most significant development of recent weeks has been the stronger tone of retail sales, which calls into question the view that consumer caution would take the edge from inflationary pressures in 1968.

We see no abatement of the uptrend in prices of goods and services. The resistance of purchasing agents to increases in prices of broad classes of both durable and nondurable goods, evident a year ago, has given way to an acceptance of the "inevitable." In each month from November through February more than 70 per cent of Chicago purchasing agents have been reporting higher prices paid. For a precedent to this experience it is necessary to go back to the early Korean War period.

Businessmen and bankers in the Seventh District are increasingly concerned that wage, price, and possibly qualitative credit controls will be imposed in the near future. This view may be playing a significant role in current trends in prices and wages. Some are concerned that they would be "frozen in" at relatively low levels.

Labor markets continue tight, although possibly not quite as tight as a year or two years ago, if insured unemployment totals and help wanted ad volume can be taken as useful indicators. However, surveys of employers' intentions suggest increased hirings, even in nonseasonal activities, in the spring. The recent wage settlement in the farm implement industry is believed to be more generous than the auto settlement--amounting to 6.6 per cent per year in total compensation, assuming that maximum upward cost-of-living adjustments are required.

District employers, at least the large firms, appear to be making a real effort to hire hard-core unemployed, even when this means scrapping normal minimum requirements

with regard to training, language, mechanical skills, and police records. Efforts to hire and train these hard-core unemployed, while encountering great difficulties, are meeting with some success.

Strike hedge demand for steel is not quite as strong as had been expected. Nevertheless, Chicago area steel producers are operating at effective capacity. Order backlogs for steel are as large relative to shipments now as at a comparable stage of the 1965 buildup, but are appreciably smaller when compared to capacity.

Auto firms are keeping their May-June output schedules flexible depending upon sales trends in the next few weeks. Tentative schedules call for output of 2.3 million cars in the second quarter, about the same as in the first quarter, and 7 per cent more than in the comparable period of 1967. However, this volume would be smaller than in the comparable periods of 1965 or 1966. Demand for used cars remains strong. But the auto industry is increasingly worried about imports. About 900,000 imports are projected for 1968--up from 760,000 in 1967--and amounting to 10 per cent of the domestic market, equaling the all-time high proportion reached in 1959.

Permits for new apartment buildings and single-family homes have been very large in the District in recent months, especially in centers of 250,000 population or more. Share accounts at savings and loan associations held up fairly well in February. Nevertheless, the possibility of a sharp turn to disintermediation has not been ruled out. In fact, spokesmen for the S&L's insist that the residential housing activity in the remainder of the year may yet be substantially curtailed by credit stringencies. Life insurance companies have not resumed their interest in mortgages, other than large apartment projects and industrial mortgages. Some life insurance companies insist on a 1-1/2 per cent spread on mortgages over yields on bonds. Today this would mean rates of almost 8 per cent, forbidden by usury laws in a number of States.

Farmers are expected to cut total planted acreage by 4 per cent in 1968. Corn acreage is expected to be off 8 per cent, to the smallest total seeded since the turn of the century. Soybean plantings will be larger than last year. Smaller agricultural plantings doubtless will moderate demand for farm equipment and also demands for credit by country banks.

The banks show evidence of some renewed vigor in business loan demand and reduced liquidity. The expansion of business loans in March, though less than in 1967, was above comparable periods of most other recent years despite a smaller carry-over of prior-year corporate tax liabilities. Increases were quite widely distributed among industry groups. Metals manufacturing firms were the heaviest borrowers, but there is no indication that a large amount of bank credit is being used in stockpiling steel. Other loans remain moderate.

Preliminary impressions from our exploratory loan commitment survey suggest that a good many banks are anxious to see a larger part of their commitments turned into loans and show no serious concern about their ability to accommodate this. There were a few, however, that added qualifications with respect to monetary policy and Regulation Q adjustments. Several banks urged raising the ceilings on all types of time and savings deposits. CD's have been declining, but so far at a moderate rate.

Major Chicago banks are now consistently showing a basic deficit position for the first time since last summer. This may reflect in part the usual preparations for the April 1 Cook County tax assessment, but there has been substantial borrowing also by reserve city banks in District States other than Illinois in the past month.

The significant slowing in the rates of expansion in reserves and bank credit in March and in the money supply in the last two months is consistent with both the intent of recent directives and current and projected developments in economic activity. It appears appropriate to maintain these reduced rates of expansion at least until the next meeting of the Committee. At the same time, I would not be averse

to some additional reductions in the rates of growth, although not to negative values, in anticipation of accelerated rates that may be expected when the Treasury re-enters the market later.

I feel that we would have attained current slower rates of monetary and credit expansion sooner if we had placed primary emphasis on aggregate measures of reserves, money, or credit in the directive. I again urge that we do so.

Mr. Scanlon added that he favored alternative B for the directive with the word "somewhat" changed to "slightly" before "firmer conditions in the money market." Such a course, he felt, would maintain the desirable degree of pressure in financial markets. He believed that the two-way proviso clause included in alternative B would give the Manager latitude to achieve some further firming, but yet permit him to back away if unusual liquidity pressures should develop.

Mr. Galusha said he also would summarize his prepared statement, and submit the full statement for the record. He then summarized the following statement:

The Ninth District economy continues, as it were, on course. There have been no unusual or portentous developments. I shall therefore spare you a recitation of District statistics. I did, however, want to note briefly a few of the findings of our most recent survey of farm credit conditions. There appears to have been an increase in farm loan rates, but most of our rural bankers see farm loan demand as about normal and few anticipate any difficulties in meeting loan demand over the next few months. Presently, then, there is little if any concern about a "credit squeeze" among

our rural bankers, possibly because, as many have reported, farmers are being very cautious in their capital purchases. By all accounts, the outlook is for no increase in sales of farm equipment.

Let me turn now to monetary policy. Interest rates, short-term and long, increased in March; and, to quote the blue book, "The rate of bank credit expansion moderated further." Has the System done enough, though, at least for the time being? Or should monetary policy be made still more restrictive? Last Sunday morning I had no difficulty saying yes; and I likely will return to that point of clarity before the month is out. But this morning I find myself in favor of delaying until we have had a chance to see what effect, if any, the President's speech is going to have.

Had the President not made his speech, I would have urged greater monetary restraint this morning, and in particular an increase in Regulation Q rate ceilings. Now, however, I would wait, although only briefly, to see what happens. I do not know whether Congress will heed the President's appeal for fiscal action, nor whether the North Vietnamese will respond to the President's overtures in that area. But it is hard to believe that the de-escalation of the bombing was not prompted by a rationally determined conviction that it would accomplish something. There is a hope, however slim, that the fiscal outlook will change for the better.

There is risk in waiting. This Committee may find itself wanting to adopt a more restrictive policy, but be unable to because the Treasury is in the market. It ought to be able, however, even with the Treasury in the market more or less continuously, to find a time to increase monetary restraint, should it again become quite clear that Congress is going to increase spending but not tax rates. There is always the possibility of an appropriately scheduled special meeting of this Committee, perhaps in two weeks.

In present circumstances, I would favor having the Manager concentrate on maintaining short-term rates about where they were on average last week.

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This is not a time for maintaining some given level of net borrowed reserves. The attitudes of member banks and the administration of the discount windows are still going through the process of accommodation to the changed market levels. Expectations could change considerably, even from day to day. And we should not want to see either a dramatic decrease in rates or an increase, which without a change in Regulation Q ceiling rates would sharply cut the supplies of bank and mortgage loans.

I am for alternative A of the staff drafts of the directive; but to repeat what I said before, I would favor having the Manager keep his eye on short-term rates, and particularly the 3-month bill rate.

I should like to offer my congratulations to those of you who participated in the Washington and Stockholm meetings. If I may presume to judge, you have served us all very well indeed, and are deserving of our thanks.

Mr. Swan said he would not comment on economic conditions in the Twelfth District except to report the results of a check the San Francisco Reserve Bank had made late yesterday with five of the District's larger savings and loan associations. The associations had been asked about their withdrawal experience during the last three business days of March and the first day of April. He recognized, of course, that the sample was far from adequate, with respect both to its size and to the time period covered. For what it was worth, the five associations together had experienced withdrawals of about \$22 million over the four business days in question, compared to \$4.5 million in the

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comparable period of 1967. As Mr. Brimmer had observed, however, the Committee had to expect some pressure on thrift institutions if the necessary degree of restraint were to be maintained on the economy as a whole.

As to policy, Mr. Swan thought the Committee should continue to tighten, despite the various existing uncertainties. He reached that conclusion because of the increased urgency of the problems with respect to the U.S. balance of payments and the general international situation, the fact that after April the Treasury would be engaged in frequent financings, and the lack of action thus far with respect to fiscal policy. In his judgment fiscal action could not be counted on, but if that situation changed, the Committee certainly could hold an interim meeting to reconsider its policy. He favored a rather gradual and cautious firming. There should be no question, however, but that monetary policy was moving toward greater firmness even though somewhat slowly.

Mr. Swan remarked that he would be reluctant to see the Regulation Q ceilings raised at this point. He agreed with the implication of Mr. Hayes' comments that there was room under present ceilings for some additional pressure on banks. It

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might be helpful in that connection to advise those member banks losing substantial volumes of CD's and coming to the discount window that their needs would be accommodated somewhat more readily and for longer periods than earlier.

Mr. Swan said he supported Mr. Maisel's proposal for reformulating the second paragraph of the directive, although at this point he would favor a lower target range for bank credit than Mr. Maisel had suggested. However, he did not expect a reformulated directive to be adopted today, and so would note that alternative B of the second paragraph was acceptable to him as drafted. As to the first paragraph, he observed that it was proposed to continue using the statement of the Committee's general policy stance that had been employed for some time, reading as follows: "In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments." In his judgment, the final clause of that statement was now too weak, in view of the much greater urgency of the balance of payments problem. He proposed replacing it with a clause reading ". . . and attainment of reasonable equilibrium in the country's balance of payments."

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Mr. Coldwell commented that while recent economic developments in the Eleventh District were not dramatic they did point toward further expansion in virtually all areas, including production, employment, construction, and retail sales. Even the agricultural outlook had improved. He would mention only one development in the financial area. In a recent meeting the presidents of some of the large banks in the District reported growth in term loan commitments which were designed to provide insurance against the possibility of specific controls by the Federal Reserve. The commitments, for which a rate of 1/4 per cent was charged on the unused balance, provided for renewal at three-month intervals for a period of three years, at the end of which the amount of take-downs could be converted to a term loan for an additional period of five years, making a total of eight years in all. It was surprising to him that banks were willing to make such commitments.

Mr. Coldwell said he had nothing to add to the discussion of national conditions. As to policy, he would have preferred to wait for a time to evaluate the impact of the firming actions already taken and to see whether fiscal action was likely. But it was clear that the economy was presently in an inflationary spiral, and he was concerned about the need to dampen inflationary expectations. Accordingly, he favored some further monetary

restraint, the resolution of doubts on the side of restraint, and minimal growth in bank credit. He would not want to make a more overt move at the moment, but he thought further monetary firming would be in order if it became clear that fiscal action was not likely to be taken.

Mr. Ellis said he would submit for the record the remarks he had prepared on economic conditions in New England. These were as follows:

February data made it clear that the advance of the New England economy which resumed in mid-1967 is continuing. Available data for March indicate a further advance. Initial unemployment claims are down, department store sales are showing well considering the late date for Easter this year, and manufacturers' new orders are continuing at a high level with some indications that further inventory building is in progress.

In spite of a relatively modest (5 per cent) sales increase expected for the year, and continued operation at about 85 per cent capacity, New England manufacturing firms reporting in our capital expenditures survey plan their third year of capital investment at \$1.1 billion, roughly a no-change position from 1967.

In the financial arena, our ten largest life insurance companies have been somewhat surprised by a partially estimated 44 per cent increase in policy loans between the fourth quarter of last year and the first quarter of this year.

Our eight largest banks have continued to expand their willingness to rely on interest-sensitive borrowed funds. With their short-term liquid asset ratios now below their previous August 1966 lows, they have increased their reliance on negotiable CD's, Federal funds, and Federal Reserve borrowing

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from their average level of 162 per cent of required reserves in August of 1966 to a current ratio of 192 per cent. For comparison, I note that the New York City 8-bank average ratio dropped from 194 per cent in August 1966 to about 150 per cent now.

As a group, our weekly reporting banks have experienced strong business loan demand and continue to expand their commitments without substantial concern. During our exploratory survey of loan commitments, the question "Are your unused commitments larger than you prefer?" brought a confusing response. They wanted to answer "Yes", meaning they would like to reduce the "unused" portion by putting on more loans!

Mr. Ellis then turned to the subject of monetary policy. Starting from the assurance by the President that the Federal sector would be expanding its outlays, financed in part by a \$20 billion--or perhaps only a \$12 billion--deficit, he said, it was relatively easy to conclude that monetary policy should be playing a restraining role. It was clear that monetary policy had been shifting to a posture of restraint. Reserve requirements had been raised, member banks had been forced to borrow more of their reserves, and the cost of borrowing funds, both from the Federal Reserve and in other reserve adjustment markets, had risen. The central issue of policy today, therefore, was whether the Committee had made enough of a shift--had it applied enough restraint for now? He believed it had not quite done so.

Mr. Ellis went on to say that Mr. Brill's remarks today provided a number of arguments in support of that conclusion. He

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would emphasize Mr. Brill's statement that the job to be done was greater now than it had appeared when the Committee met on March 5. On the subject of scenarios, he thought the present course could best be described as falling under "scenario chaos." The balance of payments situation had worsened, especially in the trade sector which was affected by faster price rises. There was greater recognition that the success or failure of the balance of payments effort held the key to the whole future. In addition, the demand-pull aspect of the inflationary trend had increased. The growth in Federal demands was obvious, and as Mr. Brill had suggested, consumers were likely to contribute more to total demand pressures.

Mr. Ellis remarked that the table in the blue book comparing recent and earlier rates of growth in monetary aggregates indicated the accomplishments of the System during the past four months, but it might also contribute to delusion. The latest four months included two months in which there had been no Treasury financing, and that was hardly typical of the previous six months or of the coming nine months. With demands strengthening, the Committee's existing policy posture would turn out to be relatively less restrictive. Finally, it would be desirable for the Committee to act in advance of the long period of Treasury financing activity ahead, in which it would be necessary to maintain an even keel.

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In the fortunate but unlikely event of fiscal restraint, monetary policy could be modified; certainly there was enough flexibility in monetary policy to make that possible.

Mr. Ellis said he would favor alternative B for the directive, with the amendments Mr. Hayes and Mr. Swan had suggested. He would interpret such a directive as calling for probing toward greater firmness, with sensitivity to the possible liquidity pressures referred to in the proviso clause. For targets, he favored net borrowed reserves of \$400-\$500 million, a Federal funds rate of 5.5 per cent or above, member bank borrowings around \$700 million, and the three-month bill rate ranging up to 5-3/8 per cent.

Mr. Robertson made the following statement:

I think it is clear that the challenge facing monetary policy is mounting. During the last month or so we have pulled significantly harder on the reins of monetary restraint. Most of the usual financial indicators, both of money market pressures and aggregate credit flows, have reflected our tightening actions.

Yet the stream of business information reaching us describes an economy caught in an intensified inflationary spiral, with nothing like the needed degree of fiscal restraint forthcoming, and with international developments signaling that precious little time may remain for us to proceed in an orderly fashion to introduce appropriate stabilization policies. Accordingly, I think the only responsible course open to this Committee is to proceed, carefully and gradually but determinedly, to tighten monetary policy further.

Incidentally, we should be careful not to be lulled into a too complacent attitude by the recent slowing of aggregate bank credit flows. In good part this reflects the lull in Treasury cash financing, and a new and powerful upward push on such flows will develop as the big deficit financing operations get under way a little later this year. As a matter of fact, Treasury operations may well impel us toward an even keel posture in most if not all of our meetings from April 30 through August; and this represents one other important reason for voting to firm conditions a bit more today.

Because we have managed to move as far as we have in recent weeks in holding down nonborrowed reserves, pressing more banks into borrowing and raising the cost of day-to-day money, I think we do not have to make a sharp further tightening move today. Our basic aim, after all, has to be thought of in terms of generating the kind of monetary atmosphere that will, with inevitable lags, moderate inflationary demands later in the year. I want no slam-bang crunch right now, and the fact that we are in the middle of the quarterly earnings crediting period for savings intermediaries increases our exposure to that risk at this meeting.

Nonetheless, I recognize full well that the gradual further tightening I am advocating may well, perhaps in a matter of weeks or less, interact with credit demands and market expectations to move market rates enough higher to produce considerably greater pressure on Regulation Q ceilings, nonbank savings institutions, and the discount rate. When and as such pressures reach the point where they are interfering with credit flows unduly, I would be prepared to consider appropriate adjustments in the rate structure, although I want to go on to say that I think we should limit the extent and nature of any such rate increases in the interest of minimizing the threat of competitive rate escalation. I would not favor lifting ceilings for the purpose of enabling large banks to expand their CD's in order to expand their loans and thus contradict the very purpose of restrictive monetary policy. Furthermore, I would not favor big changes simply for "signal" or "symbol" effects alone;

the world has become increasingly cynical concerning such Madison Avenue tactics, and I think the Federal Reserve image is better served by "speaking softly" and making workmanlike use of our "big stick."

With these views I would vote in favor of alternative B of the directive as drafted by the staff, with the prudent inclusion of a two-way proviso, and aimed generally at the kinds of money market conditions outlined in the corresponding pages of the blue book.^{1/}

Mr. Robertson added that he was not concerned about the risk that the monetary policy he advocated would prove too tight if fiscal action were taken. The Committee's decisions had been influenced for a long time by the possibility of action on Federal taxes and expenditures. He would not want that situation to continue, particularly since the direction of monetary policy could be reversed readily in the event of fiscal action.

Chairman Martin remarked that an affirmative vote in the Senate would, of course, enhance the prospects for fiscal action, but it would not necessarily mean that those prospects were highly

^{1/} The blue book passage referred to read as follows: "If the Committee should wish to achieve more restrictive monetary conditions during the coming period, it may want to consider adjusting open market operations with a view to attaining the following ranges of money market variables: net borrowed reserves, \$400 - \$500 million; the Federal funds rate most frequently trading 5-1/2 -- 5-3/4 per cent and occasionally higher; new dealer loan rates in New York, 5-3/4 -- 6 per cent; and member bank borrowings, \$650 - \$850 million. The 3-month bill rate under these conditions is likely to move into and toward the upper end of a 5-1/4 -- 5-1/2 per cent range, partly as expectations of a further discount rate increase begin to take hold in markets."

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favorable. In his judgment the House was likely to guard its prerogatives with respect to initiating tax measures and develop a bill of its own. It was likely to be three or four weeks before the House voted on a fiscal policy package, and the chances for eventual enactment struck him as no better than even.

The Chairman said that while the President's speech Sunday evening had contained surprises, it had not altered his conviction that the Committee should move to slightly firmer money market conditions now. He would want to wait a few weeks before deciding whether to take more overt action. He agreed with Mr. Robertson that the System should proceed gradually in firming, as it had been doing over the recent period. He thought it would be a mistake to hasten the firming process, and a still greater mistake to permit an easing of conditions; a delicate balance was needed under present circumstances. He agreed that monetary policy was sufficiently flexible to reverse its course quickly, and knew of no reason for not holding a meeting of the Committee in two weeks if developments required one. He doubted, however, that there would be a sufficiently clear-cut change in the outlook for fiscal restraint to require such a meeting on that account.

In his judgment, Chairman Martin continued, the System had been pursuing a proper policy in firming over the past four

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months, and it was now in a position to take more overt action if that became necessary. It might well be necessary before long to take drastic action. Mr. Daane and others had pointed up the recent deterioration in the U.S. balance of payments. If there was no fiscal restraint and another gold crisis erupted, the System might have to do everything possible through monetary policy to deal with what would certainly be a very serious and very difficult situation.

The Chairman noted that the members had expressed divergent views on the second paragraph of the directive, with some indicating a preference for a policy course intermediate to those called for by alternatives A and B. In his judgment, however, the differences of view were not great. He personally preferred alternative B for the second paragraph, with the words "somewhat firmer conditions" changed to "slightly firmer conditions," as Mr. Hayes had suggested.

Mr. Mitchell noted that several members had expressed the view that the course of monetary policy could be reversed quickly if necessary. However, an action to increase Regulation Q ceilings would have consequences that ramified rapidly through the financial structure and that would be difficult to reverse. As he had indicated earlier, he would favor the policy called for by alternative B if it appeared that fiscal restraint was not forthcoming.

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However, he would not want to take such action just before fiscal legislation was enacted, particularly since he inferred from the blue book that the alternative B policy would lead to a degree of disintermediation that would require action on Regulation Q.

Mr. Robertson said he did not share the staff's judgment in that regard.

Mr. Hickman remarked that he would share Mr. Mitchell's concern if alternative B were adopted.

Mr. Galusha asked whether there was any feeling in the Committee that bankers had been taking undue advantage of the discount window in the last two or three weeks. Perhaps he had an unusually candid relationship with bankers but some had commented frankly that they could borrow more cheaply from the Reserve Bank than elsewhere, and that, in their judgment, they should be able to borrow if they had been out of the window for some time. It was their impression that bankers in other Districts were taking the same view, and he wondered whether that was the case.

Mr. Clay said there had been a similar development in the Tenth District.

The Chairman then noted that Mr. Brimmer had suggested adding a sentence to the first paragraph of the directive regarding

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fiscal prospects. He (Chairman Martin) was not sure the proposed addition was desirable; it might be considered to place too much emphasis on the present situation in Congress.

Mr. Maisel remarked that he did not favor including the sentence. He thought it would give readers a mistaken impression of the basis of today's action by the Committee when the policy record was published in 90 days.

Mr. Brimmer said he would elaborate briefly on the rationale of his suggestion. The Committee took note in the first paragraph of the directive of economic developments that might have a bearing on its future policy course. Fiscal policy also had such a bearing, and the Committee was meeting today at a time when a major break in the situation in Congress might be imminent. The Chairman had suggested that drastic monetary action might be required if fiscal restraint was not forthcoming, but he (Mr. Brimmer) did not believe that monetary policy alone could do the job. According to the discussion earlier today, European observers thought fiscal action was needed in this country, and many others shared that view. But the only reference to fiscal policy in the staff's draft of the first paragraph was in a sentence explaining recent interest rate fluctuations partly in terms of uncertainty about fiscal prospects. He thought a specific statement of the Committee's assessment of fiscal prospects was desirable.

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Mr. Mitchell said that while he did not feel strongly on the matter he would support Mr. Brimmer's suggestion. The prospects for fiscal action certainly were very much on his mind today.

Mr. Hayes said he was impressed by the Chairman's point that any action the Senate might take at this point would not necessarily be decisive with respect to the eventual outcome for fiscal policy.

Mr. Daane said he had some sympathy with Mr. Brimmer's view. However, he was troubled by the specific proposal because it might mistakenly suggest to the reader that the Committee thought the prospects for fiscal action justified making no change in monetary policy at this time. It would be desirable to add a reference to fiscal prospects, but he would prefer not to link it so closely with the statement of the Committee's general policy stance.

After further discussion it was agreed not to add the proposed sentence. The Committee then considered the revision Mr. Swan had suggested in the final sentence of the first paragraph and decided to incorporate it.

With respect to the second paragraph, Mr. Hayes said that in light of the comments by various members in the go-around he

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would withdraw his earlier suggestion that a one-way proviso clause be used. He now favored alternative B as drafted by the staff, including the two-way proviso, but with the word "somewhat" replaced by "slightly."

Mr. Sherrill asked how "slightly firmer conditions in the money market" might be defined if Mr. Hayes' proposal was adopted.

Mr. Hayes said he had in mind net borrowed reserves in a \$350-\$450 million range, member bank borrowings around \$700 million, and the Federal funds rate moving up to around 5-3/4 per cent. As to the three-month bill rate, he thought the problem was likely to be one of having to offset downward pressures. He would want the Desk to do what it could in that connection.

Mr. Hickman asked what course Mr. Hayes would advocate if the bill rate in fact tended up, say to 5-1/2 per cent.

Mr. Hayes replied that he certainly would not want to see the bill rate that high. He would favor a bill rate not over 5-3/8 per cent.

Chairman Martin commented that as he understood the Committee's intent the emphasis would be placed on the word "slightly" in the instruction to move to "slightly firmer conditions."

Mr. Daane added that he would underscore the Chairman's earlier suggestion that the move should be a gradual one.

Mr. Sherrill remarked that the set of money market conditions Mr. Hayes had described was acceptable to him if it was understood that the Desk was to be alert to the desirability of preventing a rise in the three-month bill rate above a 5-3/8 per cent level.

In response to a question by Mr. Galusha, Mr. Brill said that for each of the money market variables discussed in the blue book, one end of the range associated with the alternative A policy course was the same as the other end of the range associated with alternative B, except in one instance where the two ranges overlapped. In general, the set of conditions the Committee was now discussing was in the neighborhood of the common boundary or overlap.

Mr. Maisel observed that for purposes of interpreting the proviso clause the Manager would need to know the change in bank credit in April that was expected to be associated with the money market conditions the Committee had in view. The bank credit projections given in the blue book in connection with the two alternative sets of money market conditions were, of course, not applicable, since the Committee was discussing an intermediate set of market conditions.

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After discussion, it was agreed that for purposes of the proviso clause the projection of the bank credit proxy in April should be considered as falling in a range of plus 1 to minus 3 per cent, annual rate.

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

The information reviewed at this meeting indicates that over-all economic activity has expanded at a very rapid pace in early 1968, with prices rising substantially, and that prospects are for a continuing rapid advance in activity and persisting inflationary pressures in the period ahead. Since late fall, growth rates of bank credit, the money supply, and time and savings accounts at financial institutions have moderated considerably. Speculative activity in gold and foreign exchange markets, which was intense in early March, abated after the mid-month agreement on gold policy by gold pool members and appears to have slackened further following the Stockholm agreement regarding Special Drawing Rights. The foreign trade surplus, however, has remained at a sharply reduced level in recent months and the imbalance in U.S. international payments continues to be a matter of serious concern. Most market interest rates have fluctuated widely, although rising on balance, in reaction to international financial developments, the firming of monetary policy, and uncertainties regarding military and fiscal prospects. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and attainment of reasonable equilibrium in the country's balance of payments.

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

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, April 30, 1968, at 9:30 a.m. Chairman Martin noted that, as discussed earlier, it might prove desirable to call a meeting at an earlier date.

Thereupon the meeting adjourned.


Secretary

ATTACHMENT A

April 1, 1968

Drafts of Current Economic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on April 2, 1968

FIRST PARAGRAPH

The information reviewed at this meeting indicates that over-all economic activity has expanded at a very rapid pace in early 1968, with prices rising substantially, and that prospects are for a continuing rapid advance in activity and persisting inflationary pressures in the period ahead. Since late fall, growth rates of bank credit, the money supply, and time and savings accounts at financial institutions have moderated considerably. The foreign trade surplus has remained at a sharply reduced level in recent months and the imbalance in U.S. international payments continues serious. Speculative activity in gold and foreign exchange markets, which was intense in early March, abated after the mid-month agreement on gold policy by gold pool members and appears to have slackened further following the Stockholm agreement regarding Special Drawing Rights. Most market interest rates have fluctuated widely, although rising on balance, in reaction to international financial developments, the firming of monetary policy, and uncertainties regarding military and fiscal prospects. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resistance of inflationary pressures and progress toward reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

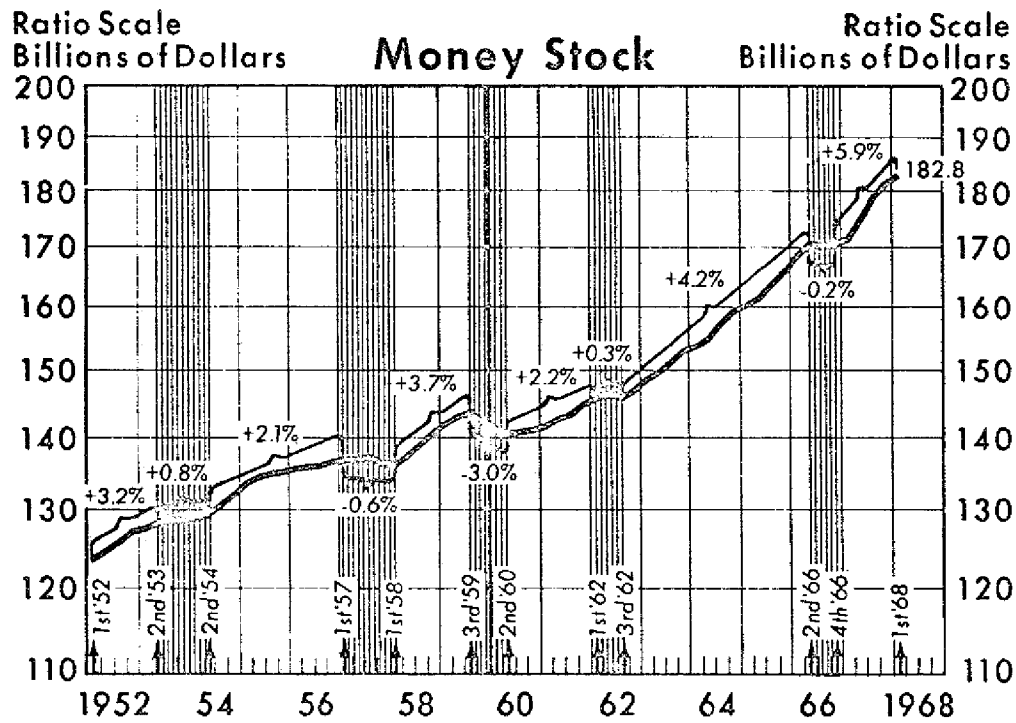
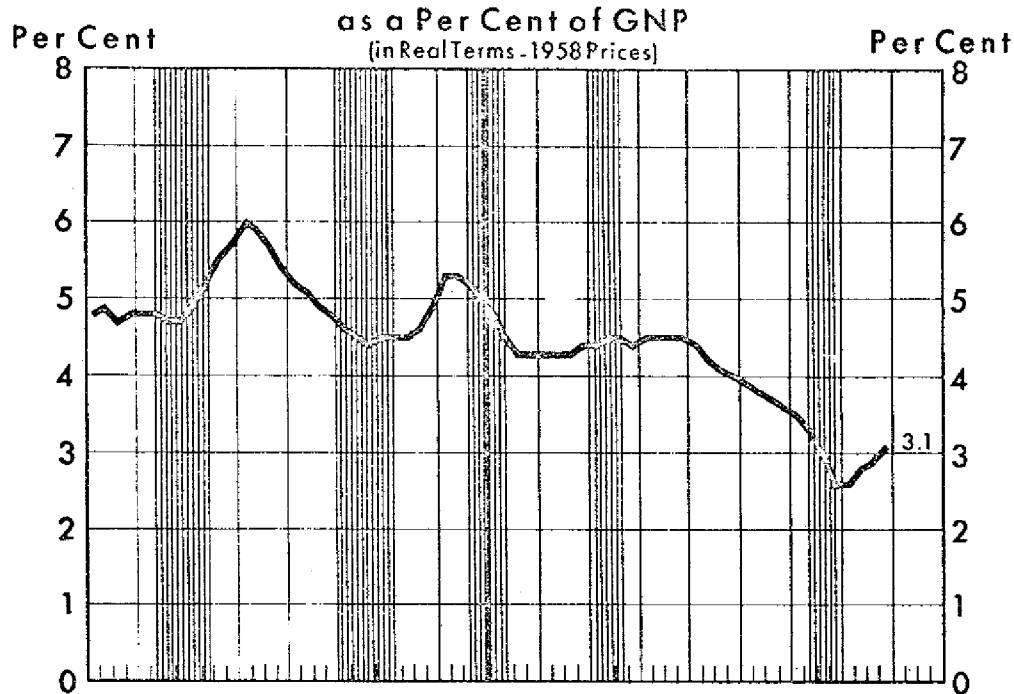
Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the firmer conditions in the money market that have been achieved recently; provided, however, that operations shall be modified if bank credit appears to be exhibiting significantly more strength than is currently projected.

Alternative B

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

Outlays on Residential Structures



Percentages indicate rates of change for periods of relatively uniform rates of growth. Shaded areas are periods of slow growth or decline in money stock.

Latest data plotted: Residential Structures, quarterly totals at annual rates - 4th quarter 1967

Money Stock, quarterly averages of daily figures seasonally adjusted - 1st quarter 1968 estimated

Prepared by Federal Reserve Bank of St. Louis