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, November 26, 1968, at 9:30 a.m.

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

Messrs. Bopp, Clay, Coldwell, Scanlon, and Treiber, 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. Broida, 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

Mr. Cardon, Assistant to the Board of Governors
Mr. O'Connell, Deputy General Counsel, Board of Governors
Mr. Nichols, Special Assistant to the Board of Governors

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

Messrs. Eisenmenger, Eastburn, Parthemos, Baughman, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, Philadelphia, Richmond, Chicago, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York
Mr. 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 October 29, 1968, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on October 29, 1968, was accepted.

Chairman Martin noted that on the preceding Friday (November 22) Committee members had approved recommendations of the Special Manager for an increase of $300 million, to $1 billion, in the Federal Reserve swap arrangement with the Bank of France, as part of an international package of credit assistance to France that had been agreed upon at the meeting in Bonn last week of the Ministers and Governors of the Group of Ten. The members also had approved renewal of the French swap arrangement at the enlarged amount for a period of one year when it matured on December 27, 1968. The Chairman invited Mr. Coombs to comment.

Mr. Coombs remarked that the action to increase the French swap arrangement to $1 billion, the present size of the arrangements with the central banks of Canada, Germany, Italy, and Japan, brought the System's over-all swap network into better balance. Lengthening the term of the French line from three months to one year as of the December maturity date meant that the System's whole network was now on a uniform basis in that respect. The action to lengthen the term also might serve to avoid some minor but potentially troublesome problems that could have arisen had the French line been continued on its previous three-month term.

By unanimous vote, the Committee ratified the actions of members on November 22, 1968, (1) approving an increase from $700 million to $1 billion in the Federal Reserve reciprocal currency arrangement with Bank of France, and the conforming amendment to paragraph 2 of the authorization for System foreign currency operations, effective November 22, 1968; and (2) approving renewal of the French swap arrangement for a period of one year when it matured on December 27, 1968.

Chairman Martin then said he might report briefly on the three-day meeting of the G-10 Ministers and Governors held last week in Bonn, Germany. The first session began on Wednesday, November 20, at 4 p.m. and the last session adjourned on Friday at about 4 p.m. The System's representatives, in addition to himself, were Messrs. Daane and Coombs, although not all three were present at all sessions.

By and large, the Chairman continued, the press reports on developments at the meeting were accurate; at the end of the meeting the situation had not been advanced very far from where it stood at the beginning. Dr. Schiller, the German Finance Minister, opened the first session with a lengthy statement explaining why the mark would not be revalued under any circumstances. Dr. Schiller indicated that his Government had decided instead to lower the border tax on imports and the tax rebate on exports, both by 4 percentage points--measures which, they estimated, would reduce their foreign trade surplus by about $1 billion at an annual rate--and to take certain measures to discourage speculative inflows of funds. The representatives of practically every other country argued that it would be preferable for the Germans to revalue the mark; or, if there were to be no revaluation, to change their border taxes and rebates by an amount in the neighborhood of 7-1/2 rather than 4 percentage points. Indeed, there were some suggestions for a change of slightly more than 7-1/2 points.

However, Chairman Martin said, it was apparent that the Germans had determined on their course of action before the meeting and did not intend to give ground. The discussion turned next to the question of what France might do. On Thursday evening the French Finance Minister, Mr. Ortoli, consulted with his Government and then reported, in effect, that while the French were not yet prepared to make a decision the alternatives they saw were a devaluation of 15 per cent or none at all. Much of the remaining discussion consisted of efforts to persuade the French to reduce that percentage, and they finally agreed that they would not devalue by more than 11.11 per cent. After his consultation with Paris Mr. Ortoli asked that a statement included in the original draft of the communique, to the effect that the franc would be devalued, be stricken.[1/] Thus, it was clear that the French Government had been keeping its options open at that time.

At one stage, the Chairman observed, the central bank governors met separately to discuss increased credit facilities for France. The discussion proceeded largely on the assumption that the franc would be devalued. However, he did not think the French could be charged with failing to honor an agreement when they decided against devaluation, and in his judgment the credit package could have been arranged even if it had been understood

1/ A copy of the final communique, issued on November 22, 1968, has been placed in the Committee's files.

at the time that the franc parity would not be changed. Certainly that was the U.S. position. Nevertheless, some of the central banks participating in the package were now disturbed by the fact that the franc had not been devalued.

The Chairman noted that Secretary Fowler had spoken in favor of a revaluation of the mark and, later, for an adjustment of German border taxes and rebates of more than 4 percentage points. At each point the Secretary had made it clear that he was simply expressing a preference. When the discussion turned to the question of the maximum amount of any French devaluation Secretary Fowler had employed an effective approach by reserving his position until the others, beginning with the Dutch, concurred in a figure of 11.11 per cent. He then indicated that he also would accept that figure as a maximum provided that all other countries in the Group of Ten--including Britain--would agree to hold to the present parities for their currencies. The Secretary was successful in getting commitments to that effect which in his (Chairman Martin's) judgment probably would be held to for the time being.

Despite all the discussion, the Chairman observed, there had been neither a revaluation of the mark nor a devaluation of the franc. The focus appeared to be more on political matters than on economic problems. One observation that recurred repeatedly at Bonn and in the press reports was that Germany, having become an economic giant, no longer intended to remain a "political dwarf."

To his mind, the Chairman said, the essence of recent developments was that no country wanted to change the parity of its currency if it could possibly avoid doing so. But one useful result of the Bonn meeting was Secretary Fowler's success in establishing the proposition that the parity of a major currency should be changed only after there had been multilateral discussions.

Chairman Martin then invited Mr. Daane to report on developments at the meeting at the Bank for International Settlements in Basle that preceded the Bonn meeting.

Mr. Daane noted that the Basle meeting of central bank governors was held on Sunday, November 17. Mr. Coombs and he had attended both the general session that began at 3:30 o'clock and the subsequent limited session in President Zijlstra's office.

Upon his arrival on Saturday, Mr. Daane said, he found that the group of foreign exchange market experts, including Mr. Coombs, had discussed the situation and were thinking in terms of a three-prong approach: (1) a package of credits to France of the conventional type; (2) a rather new "recycling process," under which speculative flows of funds would be immediately rechanneled back to the country from which they had originated; and (3) adjustments in German border taxes.

In the sessions on Sunday, Mr. Daane continued, that approach was temporarily derailed by the French representative. The latter reported that after considering the rate at which France's reserves were dwindling the French Government had concluded that the franc would have to be devalued by 15 per cent if the parity of the mark were maintained and by some amount ranging down to 10 per cent if the mark were revalued. On three separate occasions during the meeting the French asserted that a credit package would not be useful to them. They said such a package would have to be massive to have any significant psychological impact, and that in any case they did not want to get into the position in which the British now found themselves, of having a large overhang of liabilities.

As to the Germans, Mr. Daane continued, it was clear at the meeting that the Federal Bank had concluded that a revaluation of the mark was in order--perhaps of more than 5 per cent, although a 5 per cent revaluation was viewed as acceptable. They felt strongly, however, that Germany should not act alone, and they were bitter about President de Gaulle's statement regarding the "absurdity" of a franc devaluation, which seemed to place the whole burden on Germany.

Speaking for the United States, Mr. Daane observed, he had put forward the position of the Administration that had been developed by Secretary Fowler and Under Secretary Deming and relayed to him from Rome by Mr. Deming. That position consisted of three points: first, an international meeting should be held on the following weekend, November 23-24, preferably in Washington but alternatively in Frankfurt or Bonn; secondly, the mark should be revalued by 10 per cent; and third, the franc should not be devalued, since there was no evidence of fundamental disequilibrium in the external position of France.

On the first point, Mr. Daane remarked, it was the consensus of the governors that it would be highly unwise to hold a conference for the purpose of considering changes in currency parities. After considerable discussion of the other two points, a consensus emerged in favor of a German revaluation. He thought it was fair to say that the figure most frequently mentioned was 7.5 per cent; President Blessing of the German Federal Bank indicated that 10 per cent was out of the question. As to the franc, although the French agreed that there was no fundamental disequilibrium, they thought the realities of the existing situation argued for a combined move. That view seemed to be shared by most of the central bank governors present, and when he left Basle to go to Bonn on Monday he thought a willingness was emerging to accept both a revaluation of the mark and a devaluation of the franc.

In response to the Chairman's request for comments, Mr. Coombs said he would add two observations. First, Friday, November 15, had been a very bad day on the exchanges and there was a real risk that both the French and the British would be bankrupted unless their markets were closed soon. At the conclusion of the Sunday meeting it was understood that Dr. Blessing would discuss the question of a revaluation of the mark with his Government. On the assumption that such discussion would not require more than two days, it was agreed that both the French and the British exchange markets should be closed on Wednesday, November 20, which would also be a holiday in Germany. Reopening of the French, German, and British markets would depend upon the success of the negotiations in the meanwhile. There was no suggestion that the New York or Swiss markets should be closed.

Secondly, Mr. Coombs observed, in light of the possibility of a revaluation of the mark, he had gone directly from Basle to Frankfurt on Monday to review contingency plans with the German Federal Bank. As the Committee knew, the U.S. Treasury had about $1 billion equivalent outstanding in mark-denominated bonds issued to the Federal Bank, and the System had drawings of $40 million outstanding under the swap line with that Bank. In both cases there were guarantees against losses in the event of a change in currency parities, in the form of standing orders to be executed if parities were changed. His purpose in going to Frankfurt was to help coordinate the execution of the standing orders if the mark were revalued. The German Federal Bank officials were most cooperative and this test of emergency procedures to be followed in the event of revaluation was satisfactory in all respects.

Chairman Martin then invited Mr. Brimmer to report on the meeting in Paris last week of the Economic Policy Committee of the OECD that the latter had attended.

Mr. Brimmer commented that the EPC seemed to be rapidly becoming an appendage to the Group of Ten and Working Party 3. That fact was highlighted sharply last week when both the U.S. and British delegations had proposed that the meeting be canceled, and when it became evident early Wednesday that the usual delegates from Germany, Italy, and France were in Bonn and would not be present at the EPC meeting. The meeting was held nevertheless, beginning on Wednesday with a good discussion of the U.S. situation. The representatives of other countries expressed the hope that the incoming Administration would permit the existing measures of economic restraint to remain in place for the sake of greater domestic stability. Also, they strongly urged the United States not to abandon its program of foreign credit restraint.

Mr. Brimmer said he had found of particular interest the discussion of the Italian situation that was held on Thursday morning. It was clear that most of those present thought Italy's surplus on current account was as troublesome as Germany's, and they were hopeful that the Italian authorities would take steps to minimize its adverse effects. Unfortunately the key Italian delegates were not present and their substitutes were not in a position to discuss the matter effectively. Hopefully, the EPC would return to the subject at a later time.

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 October 29 through November 20, 1968, and a supplemental report covering the period November 21 through 25, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the Treasury gold stock would remain unchanged again this week. Stabilization Fund holdings now totaled $520 million, with only minimal gold orders in sight. The price of gold on the London market rose to $40.75 last week, but had fallen back to a level of $40.07 this morning. By and large, the gold market had not proved to be a disturbing element during the exchange crisis. That reflected not only the continuing overhang of gold on the market but also, he thought, the improvement in the U.S. balance of payments figures, which helped to protect the dollar against speculation. With exchange controls now reinstituted in France, the price of gold in Paris probably could be expected to move $4 or $5 above the London level, and that might introduce a new disturbing element into the gold market picture.

On the exchange markets, Mr. Coombs noted, over the past two weeks or so there had been the wildest burst of speculation since the last war. The main targets were the mark, the French franc, and sterling. As of the close of business last Tuesday, the German Federal Bank had taken in $2.8 billion, the Bank of France had lost $1.1 billion, and the Bank of England had lost $800 million. Other currencies, particularly the dollar, were relatively unaffected, while the Euro-dollar market also remained remarkably steady.

Mr. Coombs said he assumed the Committee members had a reasonably full picture of market developments during the past two weeks from the Account Management's written reports and newspaper coverage, and so he would not take the time to review those developments in detail. The Committee might, however, be interested in the origins of the latest speculative outburst. As the members would recall, there had been a similar, although much less intense, burst of speculation in the mark and French franc in late August. At a meeting of the Committee shortly thereafter he had suggested that such speculation seemed to have been generated by rumors that the British, French, and U.S. Governments were putting pressure on the Germans to revalue. That was a pretty dangerous game, at least as far as the French and British were concerned, since the Germans were in a position to hold out so long as they were prepared to take in dollars, while the Bank of France and Bank of England could run out of reserves within a few weeks' time.

In any event, Mr. Coombs continued, after Chancellor Jenkins and others formally denied that they were putting pressure on the Germans to revalue, the exchange markets remained relatively quiet during September and October. In early November, however, the markets again began to get persuasive reports of new pressures on the Germans to revalue, particularly French and British pressures, together with suggestions that some deal might be worked out under which a moderate French devaluation would be accompanied by an equally moderate German revaluation. Even more damaging, word began to circulate that several important directors of the German Federal Bank had swung around to favor revaluation. As the Bonn conference clearly demonstrated, those rumors were in fact correct, and it was no wonder that the market reacted as violently as it did.

It was bad enough, Mr. Coombs remarked, that leakages of official thinking should have occurred and thus touched off such a hurricane of speculation. But the decision to compound the problem by holding a G-10 conference in Bonn at which official positions on a mark revaluation and a French franc devaluation were fully exposed in a blaze of publicity had now seriously undermined confidence in the whole international financial system. So far as he could see, the only saving grace of the Bonn meeting was that no one seemed to have questioned the official price of gold; but if any government had the temerity to engineer another such conference the United States might not be so lucky. Aside from the central bank credit package, which could just as easily have been negotiated at Basle the previous weekend or even over the telephone, the positive accomplishments of the Bonn conference were nil. Neither of the two proposed parity changes was accomplished, while the markets remained more persuaded than ever that the mark was undervalued and the French franc overvalued.

Mr. Coombs observed that there had been a good deal of discussion at Basle and at the subsequent Bonn meeting as to what market operations might be conducted to try to salvage the situation. He thought there was a reasonable chance that the determined refusal of the German Government to revalue the mark might encourage the market to believe that the parity would remain unchanged for at least another six months or so. To reinforce that hoped-for improvement in market sentiment, he had strongly urged the German Federal Bank to launch outright sales of forward marks at an initial premium of 3 per cent on the understanding that the Federal Reserve would undertake parallel operations in New York for either Treasury or Federal Reserve account. They finally agreed, and the forward operations initiated yesterday seemed to be exerting a helpful market influence. Forward sales by the German Federal Bank as of about an hour or so ago amounted to $110 million, while the System's forward operations in New York yesterday came to $65 million. The willingness of both central banks to offer such forward cover in unlimited volume had probably contributed to outflows of short-term funds from Germany. Those outflows had amounted to $350 million yesterday and $150 million so far today, for a total of $500 million; and the total might rise to $600 million before the close of business today. He hoped that the outflows would help relieve pressures on sterling and the French franc.

One of the focal points of concern at both Basle and Bonn, Mr. Coombs said, was the prospective effect on the pound sterling of the showdown between German and French exchange rate policy. The British had been wise in closing the London market from Wednesday through Friday of last week to avoid a dangerous backwash from the closing of the French and German markets. They could have refused to support sterling in New York and allowed nominal quotations on sterling outside of the official limits to appear. Both the German Federal Bank and the Bank of France followed that policy when their markets were closed last week. Also, as the Committee might recall, on the Friday preceding the meeting of gold pool members in Washington last March, sterling had been allowed to drop below the floor in New York for most of the day before it was brought slightly above the floor near the end of the day. The Bank of England had incurred only minimal losses through that approach. On this occasion, however, the Bank of England had insisted on supporting sterling at the floor in New York, and in the process had lost a large amount of dollars on Wednesday and Thursday. On Friday he had persuaded the British authorities to shift their support operations from the spot to forward market. In his judgment their resumption of forward operations, which they had not employed since the devaluation of sterling last November, probably saved them a substantial amount of dollars. He was hopeful that the Bank of England would again see fit to use that powerful weapon as needed over coming weeks to economize on their cash reserves and their use of the System swap facility. Since the Bonn meeting the sterling exchange rate had moved somewhat above the floor. However, no reflow of funds to London had developed despite the fact that there were strong technical reasons for such a reflow.

The main question mark in the present situation was the French franc, Mr. Coombs continued. Here there was the strange situation in which the market knew that the French financial authorities favored a devaluation of the franc but had been overruled by a political decision imposed by General de Gaulle. The market also knew that the G-10 governments and central banks were prepared to accept a French franc devaluation of as much as 11 per cent; and that exchange control, which was a key point in the new French program, had been abandoned last August by the present French Government on the grounds that it was administratively unworkable and even counterproductive. The market also was fully aware of the General's advanced age and of the social pressures that had led to what the French called "the events of May." Against that background, it was not surprising that the market had greeted the General's decision to hold the parity with deep skepticism. The show of military and police force in searching travelers at the frontiers was also likely to generate considerable resentment.

During the past two days, Mr. Coombs said, the Paris market had been open but only theoretically so because the new exchange regulations, which were to be announced today, has not yet been issued. The Bank of France lifted the franc exchange rate above the floor yesterday, and the rate was holding there on its own today in a thin market. At Bonn, officials of the Bank of France had said that it was their intention, as soon as the Paris market reopened, to execute market swaps with the French commercial banks up to an amount of $300 million, and to use the proceeds to pay down central bank credits. In the process they expected to restore an unutilized margin of $500 million under the credit lines extended to them in July. In that connection he might note that word had just been received that the French would repay $40 million to the System tomorrow, bringing their outstanding drawings on the Federal Reserve swap line down from $611 million to $571 million.

Mr. Coombs observed that restoration of a $500 million margin under the July package, together with the new package of $2.1 billion, would give the Bank of France resources of $2.6 billion. He suspected, however, that a substantial part of the new package--perhaps $400 million or $500 million--was only nominally available. For instance, the Bank of England had a $100 million share in the package, but it was hardly in a position to lend dollars to the French. Other participating central banks, including those of Belgium and the Netherlands, also were short of dollars. He had taken the liberty of suggesting to those central banks that they should obtain any dollars they might need by borrowing from the German Federal Bank rather than by drawing on their swap lines with the Federal Reserve, and they had concurred.

Mr. Coombs remarked that he personally had very little confidence that the French situation would work out satisfactorily. With that in mind, he had suggested to the U.S. Treasury that, in view of the fact that the Federal Reserve already had a substantial volume of credits outstanding to the Bank of France, the Treasury should undertake to meet any new French requests for credit. As the Committee knew, the Treasury had made a $200 million credit facility available to France as part of the total U.S. contribution to the new credit package.

Chairman Martin noted that there had been comment in today's press about the plan to which Mr. Daane had referred for "recycling" speculative flows of funds, and indicated that it would be helpful if Mr. Coombs gave the Committee some background on the plan.

Mr. Coombs said that when he had met with the group of foreign exchange market experts on the Saturday before the BIS meeting, it had been quite clear to everyone that--in light of market developments in the preceding week--it would be necessary to arrange additional credit facilities if the situation were to be relieved. It was also recognized, however, that there were severe limits to the volume of funds that could be made available immediately, since the British were in a precarious situation and the Belgians, Dutch, and Scandinavians were short of dollars. It seemed desirable to arrange matters so that Germany would meet any residual needs; and the "recycling" plan was advanced as a qualitative means--that is, not involving a specific quantity of credit--for doing so. Basically, the plan called for countries receiving speculative inflows to return the funds to the countries from which they came, although it was recognized that there would be difficulties in tracing the flows with precision. As envisaged at the time, the plan would have been put into effect on an informal, _ad hoc_ basis. For example, if Germany experienced speculative inflows of dollars, the Federal Bank would deposit the funds with the BIS--in a simple act of portfolio management and without any headlines--and the BIS would relend the funds to the countries experiencing outflows, perhaps France and England.

When the proposal was advanced on Saturday, Mr. Coombs said, it won the unanimous endorsement of those present except for the Germans; the latter took a neutral position. In his judgment Germany probably would have agreed so long as the arrangements were kept informal, and it might still agree on that basis.

As Mr. Daane had indicated, Mr. Coombs continued, the plan was temporarily derailed in the meeting of central bank governors on Sunday. When he reached Bonn later in the week he discovered to his dismay that the Bank of Italy was advancing a formal and complex version of the proposal that undoubtedly would require years to implement. In effect, the Italian proposal was not simply for hot money to be rechanneled from recipient countries back to its sources, but for all countries in the Common Market to pool their reserves. Clearly, so grandiose a proposal would require long negotiations and, eventually, parliamentary action before it could be put into effect and it therefore was useless for dealing with the immediate problem.

Mr. Coombs remarked that he had been astonished at the publicity the recycling plan had received. Its status at the moment, under an agreement reached at Bonn, was that it should be studied.

Chairman Martin added that the study in question was to be made at the Bank for International Settlements.

Mr. Brimmer referred to Mr. Coombs' suggestion that any new French requests for U.S. credits be met out of the $200 million facility provided by the Treasury rather than under the System swap line with the Bank of France. He (Mr. Brimmer) recalled that at the time the sterling balance credit package was arranged last summer the System had agreed to increase the amount of guaranteed sterling it was prepared to warehouse for the Stabilization Fund, in light of the possibility that the Treasury would have insufficient funds to meet its commitments. He asked whether there was still reason to believe that the Treasury might have insufficient funds to meet its commitments. If so, it seemed to him that the System might be the ultimate supplier of funds to the French, whether the credits were initially extended by the System or by the Treasury.

Mr. Coombs replied that under existing arrangements the Treasury could ask the System at any time to warehouse some of its holdings of guaranteed sterling if the Stabilization Fund's resources were inadequate to meet outstanding commitments. Such an inadequacy might arise for any of a number of reasons, including the extension by the Treasury of credits to the French, but in his judgment no purpose would be served by attempting to go behind the Treasury's request to an analysis of the causes of the Stabilization Fund's need for cash. However, even if it was clear that the need arose because of credits extended by the Treasury to the Bank of France, the situation would be different from that in which the System supplied credits directly to the French under the swap line. In one case, the Treasury would be the principal in the extension of credit to the Bank of France; in the other case the System would be the principal.

Mr. Brimmer then asked whether the System might not be inadvertently getting into a position in which the Treasury was likely to ask it to warehouse French francs the Treasury had acquired through a credit extension to the Bank of France.

Mr. Coombs said he thought that was highly unlikely, since the existing arrangement for warehousing sterling probably would suffice. If the Treasury should propose that the System warehouse some of its holdings of francs he would recommend that the Committee resist the suggestion.

Mr. Brimmer said he concurred in that view.

Mr. Robertson then asked Mr. Coombs to amplify his statement that he lacked confidence that the French situation would work out satisfactorily. In particular, did Mr. Coombs expect another wave of speculation against the franc? If so, what course should be followed in the event that expectation was realized?

Mr. Coombs replied that it was difficult to make independent judgments concerning the policies of foreign countries because of the lack of detailed information on their circumstances. The judgment he has expressed earlier about the outlook for the franc was based primarily on the statements of the Governor of the Bank of France and the French Minister of Finance to the effect that the present franc parity was untenable. To him those statements implied that the franc would be devalued, but of course he could not say how soon. It appeared that the decision to maintain the franc parity reflected political considerations, and he thought that decision would be reconsidered if France experienced new heavy outflows.

Mr. Daane said he would put the matter somewhat differently from Mr. Coombs. When the point had been made at the Basle meeting that U.S. studies indicated that the franc was not in fundamental disequilibrium, Governor Brunet of the Bank of France had said the situation could change quickly if, for example, speculative purchases of goods by French consumers drove up their domestic price level. However, he had concurred in the view that there was not a fundamental disequilibrium at the moment.

Mr. Coombs remarked that he had interpreted the observation by Governor Brunet at Basle that France was not prepared to accept a large package of credits to imply the view that such credits would not be useful in maintaining the present franc parity.

Mr. Solomon commented that it would be helpful to the staff if the Committee would reach an understanding on a question of policy that had been raised earlier. Specifically, should the System resist any further French drawings on the swap line until the Treasury's $200 million line of credit to the Bank of France had been fully used?

Mr. Hickman remarked that he would favor such a course in view of the fact that the System already had $571 million outstanding to the Bank of France whereas the Treasury had no such credits outstanding at present.

Mr. Coombs noted that it was his understanding from discussions with Treasury officials that they had no objection to the suggested procedure. The Bank of France was indifferent with respect to the relative use of the two U.S. credit lines.

Mr. Brimmer remarked that the basic question seemed to be one that had concerned him and others at the time the sterling balances credit package was arranged. The risk which was then seen, and which it was thought desirable to avoid, was that through the process of facilitating Treasury credits to the British the System might find itself holding long-term sterling assets. It also was considered desirable to avoid a situation in which there were repeated roll-overs of short-term credits since that would, in effect, be equivalent to extending long-term credits. He asked whether it was likely now--if the Treasury extended credit to France and as a result had to warehouse sterling with the System--that the System would actually be financing the Treasury's French credits on a long-term basis.

Mr. Coombs said he had been worried in connection with U.S. credits to Britain about the possibility that the type of situation Mr. Brimmer had described would arise. However, he thought the corresponding risk was much smaller in connection with credits to France. The French still had about $2 billion in gold and sizable unutilized drawing facilities at the International Monetary Fund--on the order of $1 billion. With those resources available to the French as a backstop, he would be quite hopeful that France's existing short-term debts and any new short-term credits that might be extended would be repaid. France had not yet reached the position of Britain, which was quite literally bankrupt.

Mr. Mitchell noted that, as Mr. Daane had reported earlier, France was not inclined to go into debt to the extent that Britain had. Although Mr. Coombs viewed the present position of the franc as unstable he had also implied that any additional credits extended to France would be adequately covered.

Mr. Coombs said that was a correct statement of his position. It was his hope that if France experienced further substantial outflows in coming weeks the voice of reason would prevail and the franc would be devalued.

Chairman Martin concurred in the view that the positions of Britain and France were quite different. Britain's total reserves at the moment were inadequate to meet her liabilities, whereas France still had a sizable volume of resources.

Mr. Daane added that France also was not inclined to see its reserves run down substantially further.

Mr. Maisel said that as he understood the question the Federal Reserve would still be backstopping the Treasury but not in the form of an agreement to warehouse francs. Since the System had agreed to warehouse sterling for the Treasury as long as the Stabilization Fund held sterling, the Fund could obtain dollars for franc or other loans by warehousing some additional part of their sterling holdings with the System. It seemed to him that the main consequence of asking the Treasury to accept francs would be that since the sterling warehousing arrangement had a limit in the length of time it could be outstanding any use of it by the Treasury to get dollars if they were stuck with francs would put pressure on the Treasury to go to Congress sooner than it might otherwise have done for needed legislation to increase the resources of the Stabilization Fund.

Chairman Martin did not agree with Mr. Maisel's observation. In his judgment all that was involved was a technical question of achieving some balance in the contributions of the Treasury and the System to the assistance provided to the French.

Mr. Robertson remarked that the suggested procedure was agreeable with him if it was acceptable to the Treasury. However, he would not want to have the System resist if the Treasury preferred some other distribution of U.S. credits to the French, since in his judgment the particular distribution used did not make a great deal of difference.

Mr. Coombs commented that he thought there was some difference in the approaches appropriate for the two agencies. The Treasury necessarily had to take account of political considerations, whereas it was desirable for the System, in his view, to approach the matter from a financial viewpoint and not extend more credit than necessary.

Mr. Hayes observed that from time to time since the inception of Federal Reserve foreign currency operations in 1962 the System and the Treasury had found it mutually beneficial to share the risks in particular operations. In the present case he assumed that the Treasury would not be averse to bearing some of the risks of credit extension to the Bank of France.

Mr. Mitchell said he thought Mr. Maisel's point would have some validity if the Treasury were not prepared to go along with the suggestion. It was not clear to him (Mr. Mitchell) whether the Treasury was reluctant to do so.

Mr. Coombs commented that the Treasury had not offered any objections when the matter was discussed with them.

Mr. Daane remarked that it was his impression also that the Treasury was quite prepared to follow the suggested procedure. Accordingly, he saw little point in the Committee's pursuing the matter further.

Chairman Martin concurred in Mr. Daane's observation. He added that Mr. Coombs was performing a service in reminding the Committee of the risks involved in operations such as that under discussion. It was important for the members to recognize that if there were a general collapse of the international financial structure the System and the Treasury could find themselves holding frozen assets.

> By unanimous vote, the System open market transactions in foreign currencies during the period October 29 through November 25, 1968, were approved, ratified, and confirmed.

In response to the Chairman's request for his recommendations, Mr. Coombs noted that a $50 million drawing by the Bank of England would mature for the first time on December 9, 1968. He would recommend that the drawing be renewed for a further period of three months if, as he thought likely, the Bank of England so proposed.

> Renewal of the drawing by the Bank of England was noted without objection.

Mr. Coombs then noted that two drawings by the Bank of France would mature for the first time soon--one for $151 million on December 10, and one for $50 million on December 17. Unless the Bank of France managed to repay those drawings with the proceeds of swap operations with French commercial banks they presumably would ask that the drawings be renewed for further periods of three months. He would recommend such renewals.

Renewal of the two drawings by Bank of France was noted without objection.

Mr. Coombs said his next recommendation related to the forward operations in German marks for System account that had been initiated yesterday, in conjunction with similar operations by the German Federal Bank, to encourage outflows from Germany. Such cooperative forward operations in marks were not new; in 1961, after the German revaluation, they had been conducted on a joint basis by the Federal Bank and the U.S. Treasury. At that time, as now, the Germans provided the U.S. authorities with a firm guarantee against losses as a result of revaluation. Since the operations were risk-free, the Treasury had agreed in 1961 to share the profits on them equally with the Federal Bank.

Mr. Coombs noted that the System would make profits of 3 per cent on its current forward operations in marks and that the total earnings could amount to a sizable sum. He thought it would be appropriate again to divide those earnings equally with the Federal Bank. There was a simple technical procedure available for doing so. As his written report indicated, the System was drawing on its swap line with the German Federal Bank in order to obtain the marks needed to cover its forward sales. The interest rates in those swap transactions could be set at levels that would result in the Federal Bank's gaining an amount equal to one-half of the System's earnings on its forward transactions in the market.

In reply to questions by Mr. Maisel, Mr. Coombs said that ordinarily, if the System made a drawing on the German Federal Bank, that Bank would invest the dollar proceeds in U.S. Treasury securities. In the present case, however, it had been agreed that the Germans would leave their dollar balances on deposit at the Federal Reserve Bank of New York, in order to avoid the effects on U.S. member bank reserves that would result from their disbursement, and that a zero interest rate would apply to the spot balances of both parties with the other. Under the terms of the drawing, the increases in both parties' spot balances would be accompanied by three-month forward sales to the other in amounts equal to the spot drawings. It was through the use of drawings that the System obtained its guarantee against revaluation losses, and it was proposed to establish rates on the forward contracts involved in the drawings that would result in an equal sharing with the Federal Bank of the System's profits on its concurrent market transactions.

Chairman Martin remarked that the procedure Mr. Coombs had described struck him as quite reasonable. The only question he had was whether it was clear that the proposed operation would not raise any legal problems.

Mr. Coombs responded that the legal staff at the Federal Reserve Bank of New York had reviewed the proposal and concluded that it was acceptable, but he did not know whether they had consulted with the Committee's General Counsel. He added that in the past forward rates in connection with swap transactions had been adjusted in a similar manner to deal with special situations that had arisen from time to time.

The Chairman then suggested that it might be well for the Committee's Counsel, Mr. Hackley, and Mr. O'Connell of the Board's staff to make an independent review of the matter. If they concurred in the view that no legal questions were raised he thought the arrangement Mr. Coombs had outlined would be acceptable, unless members of the Committee objected.

No objections were heard.

> Secretary's Note: On November 27, 1968, Mr. O'Connell advised staff at the Federal Reserve Bank of New York that Mr. Hackley and he had concluded after their review that the proposed procedure raised no legal questions.

Mr. Coombs remarked that he had no further recommendations for action today. However, he would like to provide the Committee with background information on two situations that might lead him to make recommendations--possibly by telegram--for action at a later time. First, under paragraph 1C(3) of the authorization for System foreign currency operations, the Desk had authority to engage in forward operations for System account up to a limit of $550 million. The Desk also had a rather substantial authorization at present from the Treasury to engage in forward operations for Treasury account. It was possible, however, that the System's present forward operations in marks could cumulate to several hundred millions of dollars; in 1961, the Treasury had undertaken a total of $350 million in such commitments. Moreover, sizable forward operations in Swiss francs might become desirable in the near future, particularly if there were a break in the French situation. Accordingly, he might find it necessary at some point to recommend an increase in the limit set by paragraph 1C(3) of the System's authorization, perhaps to $750 million, to provide an additional margin of safety.

Mr. Daane said he hoped the need for forward operations on the scale Mr. Coombs had suggested did not arise. In view of the possibility that it would, however, it might be better for the Committee to amend its authorization today to avoid the risk of having to act under emergency circumstances.

Chairman Martin suggested an alternative approach, under which Mr. Coombs would prepare a memorandum for the Committee on the possible need for enlarging the authority for forward operations. The members would thus have an opportunity for a careful review of the considerations involved and would be prepared to act quickly if circumstances required action, by telegram or otherwise.

There was general agreement with the Chairman's suggestion.

Mr. Coombs then said that another recommendation he might make soon related to the System's swap arrangements with the Swiss National Bank and the BIS. As the members knew, the Federal Reserve had $600 million swap lines with each of those institutions providing for System drawings in Swiss francs, in addition to the $1 billion line with the BIS providing for System drawings in other European currencies. At the moment, the System had outstanding $320 million of Swiss franc drawings, all of which were on the Swiss National Bank.

Under its new president, Mr. Coombs continued, the Swiss National Bank was becoming increasingly unhappy about the existence of dual swap lines providing for Swiss franc drawings. It was quite likely that the Bank would suggest an enlargement of its swap line with the System to $1.2 billion and a concurrent cancellation of the $600 million Swiss franc line with the BIS. He understood that such a rearrangement would be agreeable with the BIS, and of course it would not affect the size of the System's network nor the availability of particular currencies. Even under present arrangements the Swiss National Bank was the ultimate source of any francs the System obtained by drawing on the BIS. While there appeared to be no urgency about the matter at the moment, circumstances might arise under which he would want to recommend the change to the Committee by telegram.

Mr. Robertson suggested that Mr. Coombs be asked to prepare a memorandum on this subject also, including an explanation of the reasons for originally establishing the swap lines with the Swiss National Bank and the BIS in their present form.

There was general agreement with Mr. Robertson's suggestion.

Mr. Swan asked whether the Committee might hear some brief comments about the implications of recent developments for the position of the pound.

Chairman Martin replied that the pound was in a highly vulnerable position. The Bank of England had lost a substantial amount of dollars recently, and he did not think it likely that there would be an immediate shift of flows in the opposite direction. The British had taken some strenuous internal measures; in particular, the requirement for deposits equal to half of the value of imports was said to be a highly vigorous measure. Whether or not the Government's actions would achieve the intended results remained to be seen. That was also the case with the steps taken by the French Government.

Mr. Daane concurred in the Chairman's assessment of the British situation. The U.K. representatives at the meetings in Basle and Bonn had made it quite clear that the position of sterling was very precarious. They had left no doubt that their existing programs were going forward and that they were prepared to take any further steps necessary to defend the pound. However, they were faced with a continuing problem of confidence in sterling, and had expressed concern about the possible consequences for the pound of a unilateral devaluation of the franc.

Mr. Brimmer added that even before the recent crisis developed it had become clear that the program the British had adopted at the time of the sterling devaluation and the additional steps they had taken subsequently were not having the intended effects on their foreign trade balance. Thus, it had been evident then that the British would have to take further measures.

Mr. Sherrill asked whether there were any signs of a change in leadership in the Common Market that might have desirable consequences for the United States.

Chairman Martin replied that the Common Market seemed to be in serious trouble at present. Its members had been stunned by recent developments. One thing that had become evident at the Bonn meeting was that the Germans had given serious consideration to a revaluation of the mark but had discarded the idea primarily because of the implications of Common Market regulations in the agricultural area.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period October 29 through November 20, 1968, and a supplemental report covering November 21 through 25, 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:

> Domestic financial markets reacted with surprising calm to the international monetary crisis. While the events abroad tended to reinforce the already cautious attitude of investors, most market participants appeared to be satisfied that this time, at least, the dollar was not a focal point of the problem. There is, however, considerable uncertainty about the outlook for interest rates. On the one hand, December could be a month of pressure in the CD and Euro-dollar markets, and it is by no means clear at this point of time what impact further developments in the exchange markets will have on domestic markets. On the other hand, the Treasury has passed the period of its heavy money needs, and the scattered signs of weakness in some economic indicators have introduced the feeling among some market participants that interest rates may have reached their peak. There obviously are conflicting forces at work, and the outcome for interest rates in the weeks ahead will depend on emerging evidence about the state of the economy, and on developmemts in the Vietnam peace talks and in the foreign exchange markets.
>
> As the written reports detail, long-term interest rates moved higher during the period since the Committee last met; the corporate and municipal bond markets became congested for a time, but by the close of the period

a somewhat better investment interest was evident at the prevailing higher rate levels. The three-month Treasury bill, on the other hand, was relatively steady, reflecting in part a scarcity of short bills in the market; longer-term Treasury bill rates moved up by 10 to 20 basis points. In yesterday's regular Treasury bill auction average rates of 5.45 and 5.57 per cent were set respectively on the new three- and six-month bills, down 2 and up 10 basis points from the rates established in the auction just preceding the last meeting of the Committee.

Money market conditions swung widely over the period for reasons that are not easy to analyze. Rather tight conditions prevailed early in the period as reserve distribution favored the country banks and banks generally seemed to prefer to bid up the Federal funds rate rather than to come to the discount window. In the week ending November 6, for example, borrowings at the Reserve Banks dipped below $400 million on average while the Federal funds rate persisted well above 6 per cent. In the week ending last Wednesday, in contrast, a higher level of borrowings was associated with a far lower Federal funds rate. Banks appear to be experiencing some difficulties in managing their money positions--in part because of the heavy flows of funds through the foreign exchange markets. The new reserve accounting measures have also affected money market patterns, with tighter conditions prevailing early in weeks into which banks have carried over deficiencies, and easier conditions in weeks when banks have large excesses to work off.

Open market operations were directed to moderating these swings between tightness and ease in the money market during a period of Treasury financing and of international uncertainty. Extensive use of repurchase agreements was made early in the period to relieve the prevailing tightness in the market, while still heavier use of matched sale-purchase agreements was required to resist the ease that developed later in the period. On balance the System portfolio changed but little over the period--a decline of around $325 million--but total transactions were in excess of $5 billion. In addition to the problems posed by the swings in money market conditions, operations also had to cope with a supply of reserves stemming from the decline in the Treasury balance and from drawings on swap lines by foreign central banks. The massive speculative flow of funds into Germany, together with the German decision not to rechannel the flow back into the Euro-dollar market, created some problem of investment for German account--a problem that has required a very flexible approach. Last week, for example, the German Federal Bank had about $1-3/4 billion to invest, including nearly $1 billion on Friday alone. On Friday, the German investment was split between a special Treasury issue (helping the Treasury's cash position), market purchases of bills, outright purchases from System account, and matched purchase-sale transactions with the System. The division of the German investment among market purchases, special Treasury issues, and transactions with the System Account helped avoid the obvious risk of an undue market impact from such a large volume of activity.

The Treasury, as you know, is completing its financing activity for the calendar year with an auction today of $2 billion June tax-anticipation bills. The amount is at the lower end of the range anticipated by the market and no particular problems are expected in the auction, despite the fact that there will not be much tax-and-loan account value involved. The Treasury will be sailing close to the wind as far as its cash position is concerned until after the December tax payments are received. So far, however, the Treasury's cash estimates--which were more optimistic than those at the Board or the New York Bank--have been working out quite well, and the Treasury has picked up some unexpected cash from special certificates issued to foreign central banks. There now seems to be a reasonable chance that the Treasury can get through the period of seasonally low cash balances without direct borrowing from the Federal Reserve Banks, although this may depend on how international money flows affect its position.

Mr. Mitchell commented that the staff reports left the impression that the fluctuations in money market conditions in the recent period were largely attributable to the market impact of international transactions. He wondered if the Desk's problems in maintaining an even keel had not stemmed mainly from the way in which commercial banks managed their money positions rather than from international flows of funds.

Mr. Holmes replied that the Desk had not been altogether successful in its efforts to resist pressures in both directions in part because banks had continued to experience difficulties in managing their money positions. In the recent period, however, the banks' difficulties had been increased by the sizable foreign transactions, which had led from time to time to sudden large availabilities and stringencies in the Federal funds market. The Desk's problems had been compounded by the fact that it was not always able to anticipate the timing and amounts of foreign drawings on swap lines.

Mr. Hickman inquired whether in Mr. Holmes' opinion the market had been somewhat easier at times in the recent period than had been intended.

Mr. Holmes replied that the market had become quite easy on some Wednesdays. The Desk frequently had been in the position of hesitating to move aggressively to mop up excess reserves accumulating during the statement week because the Federal funds market was remaining tight. It then found it difficult to offset easing tendencies late in the week, when the excess reserves were finally sold into the market.

Mr. Maisel observed that the matched sale-purchase transactions which the Desk recently had used extensively in counteracting easing tendencies had the effect of transferring income from the

System to the other parties. He asked whether in Mr. Holmes' judgment the policy benefits of such transactions were sufficient to compensate the System for the loss of income.

Mr. Holmes replied affirmatively. He added that he considered matched sale-purchase transactions to be a highly useful operating technique for absorbing reserves temporarily and for conveying the impression that the System was trying to resist the development of excessive ease in the market. As he had indicated, however, the Desk had not succeeded in resisting all easing tendencies in the recent period.

Mr. Brimmer commented that like Mr. Mitchell he had gotten the impression from the staff reports that international transactions had been the principal source of disturbance in the money market. In that connection he noted that according to Mr. Coombs' report today the recent dollar gains of the German Federal Bank--amounting to some $2.8 billion--were larger than the losses of the French and British, which totaled $1.9 billion. He asked whether some of the dollar flows to Germany might have originated in the United States.

Mr. Coombs expressed the view that the bulk of the residual dollar flows to Germany probably came from the Euro-dollar market, which provided facilities for moving out of dollars fairly readily. Indeed, there had been many expressions of concern about speculative movements out of the Euro-dollar market. He had not heard of any direct movements of dollars from New York City to Germany.

Mr. Holmes indicated that while it was difficult to identify specific sources of such flows he also had heard of movements from the Euro-dollar market to Germany.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period October 29 through November 25, 1968, were approved, ratified, and confirmed.

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

Mr. Brill made the following statement concerning economic developments:

Just about the time I get set to throw my hat in the air and shout "Hosannah, fiscal restraint is working at last!" some new economic statistic comes along to set me back on my heels. The slackening in the pace of consumer demands evident in retail sales reports for September and October has been encouraging. However, any optimism this generates has to be tempered by the buoyancy evident in business attitudes and plans, indicated most recently by the October figures on new orders for durable goods and, earlier, by the McGraw-Hill capital spending plans survey. Perhaps the difference between consumer and business behavior is a difference in time horizons, with consumers reacting to recent and current income developments and businessmen looking past a slower first half, confident of a rebound and sustained expansion thereafter.

In any event, it does seem clear that the driving force in the surprising developments of early summer--consumer spending--has not been driving so vigorously in recent months. This year, as in 1966, the quarterly saw-tooth pattern of a surge in consumer spending followed by a period of slower rise has mirrored fluctuations in consumer demands for durable goods. It looks as though this pattern is continuing, for the principal recent weakening in consumer sales has been in expenditures for durables. Even with a rebound in the mid-month period, auto sales so far in November are down significantly from the 9-million average of the third quarter. The reduced pace of sales--aside from exceptionally large fleet sales, which boosted the October totals--has put dealer stocks at record levels. It is somewhat unusual to find auto makers cutting back production schedules so early in the model year, but such cut-backs reportedly are being planned for December. Indicative of some sluggishness in consumer demand, too, is a report of easing in used car prices recently. Consumer sluggishness has expanded to other lines, particularly appliances and TV, and with recent increases in production of these items, inventories of these goods are mounting.

As we have learned painfully, in an affluent society such as ours, with high liquidity and an ample credit mechanism, the consumer can easily embarrass forecasters. It could be that with further progress towards peace and with a blowing over of uncertainties stemming from the current international financial situation, consumer spending will again surge forward as it did last winter and again this summer. But I think it more probable that current and prospective incomes will prove to be dominant factors influencing consumer behavior in the months ahead. With the rise in incomes already slowing and with a substantial tax bite ahear from higher social security taxes and retroactive income tax payments, it seems more likely that the rate of increase in consumer spending will decline progressively through winter and spring of next year. Our current green book[1/] projection, it might be noted, shows such a slower advance of consumer expenditures even with a further drop in the saving rate.

The stimulus to consumer incomes arising from increases in Government spending has already dwindled. Federal purchases of goods and services rose at an annual rate of over $3 billion a quarter in the first half of this year, but slowed to a rate of $1-1/4 billion

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

over the summer. We are estimating the rise at less than a $1 billion annual rate this quarter, and only about half that rate in the first half of next year. This progressive reduction in the Government's contribution to private incomes must take its toll.

It is hard for me to envisage continued overheating--or indeed much sustained vigor--in an economy in which neither Government nor consumer spending is providing significant impetus, especially since we are not looking for very much drive from other sectors of the economy. While business fixed investment is rising at a moderately strong pace, there is little evidence of an investment boom getting under way. Most of the factors one usually thinks of as influencing investment decisions--including, in particular, the extent of capacity use and trends in corporate profits--would militate against a boom. In another area of potential strength, housing starts were much higher over the summer than we had estimated earlier and, as a result, the dollar value of construction work in progress--the stage at which construction activity enters GNP--is expected to rise substantially this quarter. But with credit conditions still tight, the volume of housing activity appears to be leveling off now, and this should result in a leveling off in the dollar outlay figures next winter and spring.

Thus, the information which has become available since the last Committee meeting, as I see it, lends more credibility to the outlook, as described in the chart show presented at that meeting, for further slowing in the rate of increase in GNP as we move into the new year. If I were to modify our current projection in any significant way, it would probably be to shave it, particularly in the estimates of inventory accumulation. I would do this only with trepidation, for in the area of inventory movements both judgmental and econometric forecasters have miserable records. A relatively large accumulation in this (the fourth) quarter--on the order of magnitude projected in the green book of a little over $8 billion annual rate--seems reasonable. Even with production cutbacks scheduled in autos and other consumer durables, these may be coming too late in the quarter to bring about a more appropriate balance between production and sales by year-end.

But I suspect we are in for more of an inventory adjustment, showing up perhaps in early 1969, than our projections indicate at the moment. The adjustment need not be very large--certainly not of the order of early 1967--for inventories generally are not that much out of line. But a slower pace in inventory investment than we are now projecting, bringing with it a slower pace to over-all GNP, seems to me an increasing likelihood.

Whether this would carry with it the implication of a swifter return to price stability than we have projected is not clear. The price picture, at the moment, is confusing and disheartening. At the consumer level, our analysis indicated that there was some slowing in the pace of increase over the summer but not as much as either the unadjusted consumer price index or the third-quarter GNP deflator suggested. The index for October, however--strictly confidential until released by the BLS tomorrow--will show a resumption of a rapid rate of rise, with large gains in prices of apparel, food, and services as well as the introduction of higher prices on new cars.

In contrast, the industrial price index, which had been showing stronger and more pervasive upward pressure in recent months, slowed in November. I don't have all the details yet, but the showing appears to reflect more than just the price cuts on some steel products. Perhaps this is a harbinger of better things to come; perhaps I am just grasping at straws. At a minimum, the recent price cutting in steel is indicative of the kind of reaction likely when demands begin to weaken. In the first half of 1967, when aggregate demand slowed, we did have a significant slowing in the GNP deflator from a rate of 3-1/2 per cent to about 2 per cent in half a year--even though cost pressures continued to mount.

Until there are more consistent signals of current and prospective economic slowing, however, and more persuasive evidence of cooling in price pressures, it would seem premature to shift away from the present stance of policy, which has achieved firm conditions in short-term credit markets and substantial tightening of conditions in long-term markets. Moreover, we must increasingly take into the time horizon for policy consideration the prospects for expansion after mid-year 1969, and it will be some time before the critical factors bearing on this period--particularly fiscal policies--become clear. It would be most unfortunate if stabilization policies were to permit a replay of the second half of 1967, and fail to contain a rebound in momentum and price pressures after a brief slowdown. But given some improvement in the prospects for further slowing in the months ahead, it would also be inappropriate, I think, to permit the current drift toward tighter credit conditions to continue or intensify, particularly after the seasonal upward pressures between now and mid-December are over.

Mr. Axilrod made the following statement regarding financial developments:

While there appear to have been a few more signs pointing to moderation of economic activity over the past few weeks, as Mr. Brill has suggested, this has not been reflected in any easing of over-all financial market conditions. Indeed, credit markets appear to have tightened. This seems to have been partly a seasonal phenomenon and partly an expectational or psychological development. But it has also in part reflected the very heavy credit demands that have weighed on the market since mid-year at the same time as, and also as an aspect of, a sharp reduction in the rate of personal saving.

The extent of these credit demands is well illustrated by the third-quarter data recently available in our flow of funds accounts. Net funds raises in credit markets in that quarter were about two-fifths more than in the first half of 1968, reaching a record $122 billion (seasonally adjusted annual rate). Increased Federal Government borrowing was an important factor, but private sectors contributed more than half of the rise, with the increases being shared by State and local governments, business, and households. The total amount of funds borrowed privately during the third quarter came to $86 billion, well in excess of the previous record.

Some of the private borrowing, particularly by households, was related to the rise during the summer in spending on durable goods. But the aggregate of additional private credit demands was larger than could normally be explained by the increase in private spending during the quarter. Thus, there was considerable anticipatory borrowing or borrowing related to current financial transactions such as tax payments. State and local governments, taking advantage of banks' resumed ability to buy securities, appeared to anticipate financing needs to some extent; as partial evidence, these governmental units increased holdings of time deposits and U.S. Government securities much more rapidly over the summer than earlier in the year. As to businesses, which showed the smallest percentage increase in borrowings, the need to pay additional taxes probably served to maintain their credit demands.

The considerable strengthening of Federal and private credit demands in summer, and a partial holdover of the very sizable private demands into the autumn, would appear to help explain why interest rates backed up so sharply from their mid-summer lows even though open market operations were leading to a renewed and sizable expansion in the banks' reserve base. Mortgage demands have apparently remained strong, and there has been no significant abatement yet in State and local government bond offerings, although high interest rate levels have led to some postponements. Moreover, corporate bond offerings, while at a reduced pace relative to a year ago in the third quarter, have not weakened further--and, in fact, the calendar has tended to creep up as compared with expectations in more recent months.

However, the sustainability of such high levels of aggregate credit demands over the whole of the fourth quarter and into 1969 at the third-quarter record rate is open to doubt. We have already begun to see the much hoped for reduction in Federal Government demands; the new $2 billion of June tax bills being auctioned today were at the low range of market expectations and will do little more than replace attrition from the mid-November exchange offering. Also, it is probable that State and local government demands will calm after the turn of the year when, at a minimum, large-denomination industrial revenue bonds will not be coming to market. Finally, the further slowing generally anticipated in economic expansion will probably moderate both business and consumer credit demands, apart from potential very short-term credit needs to pay additional taxes.

This credit demand outlook--especially the seemingly relatively certain outlook for Federal Government demands--would appear to betoken lower interest rates ahead. In that event, one might not have anticipated so rapid a run-up in longer-term interest rates as developed in recent weeks. But this is where other expectational factors appear to come in. First, inflationary expectations still appear to be an important market factor affecting the level of long-term interest rates, causing investors to discount the value of bonds and to appreciate the value of stocks; it is noteworthy in this respect that common stock yields have declined further, on balance, even after passage of the fiscal restraint package. A second expectational factor influencing the recent rise in longer-term interest rates has been gathering doubts about the course of monetary policy.

It is probably fair to say that money market conditions, though fluctuating, have generally run tighter than many market participants may have expected following the mid-summer discount rate decrease. However, the associated upward pressure on the short-term interest rate structure, which has been transmitted to an extent to longer-term rates, has been intensified some in recent weeks by the usual autumn seasonal factors that work on the short-rate structure, and this may continue until around mid-December. And the market picture is clouded further by doubts as to the ultimate impact of current exchange market uncertainties and of efforts to resolve them.

The outlook for more temperate credit demands and the ebbing of seasonal pressures could lead, however, to a lessening in the degree of credit market tightness early next year, or even before as markets begin to look ahead to the new year. But in the meantime, the banking system has come to be on a somewhat tighter rein, as market interest rates press against Regulation Z ceiling rates. And the position of thrift institutions has not improved significantly further relative to the backlog of their mortgage loan commitments, despite a modest pick-up in net inflows to savings and loan associations in October.

The closeness of market rates to Regulation Q ceiling rates, the none too comfortable position of thrift institutions relative to mortgage demands, and the delicate state of market expectations in the face of international exchange market and domestic economic uncertainties would suggest no tightening in the stance of monetary policy at this time, particularly since the economic outlook has not become stronger. Even if the Committee were to maintain an unchanged policy stance, it may still also wish to consider hedging against excessively severe CD market pressures--with almost two-thirds of outstanding CD's maturing within three months--by using a two-way proviso in the directive. A slowing in the growth rate of bank credit next month is anticipated at current market rates in any event. But if a sustained 20-25 basis point further rise in short-term market rates were to develop, for expectational or other reasons, this could lead to considerable involuntary CD attrition and to a sharp curtailment in bank credit availability.

Mr. Mitchell commented that he had been somewhat surprised by the flow of funds data indicating that the total amount of funds raised in credit markets had increased to a record level in the third quarter. From Mr. Axilrod's remarks he had the impression that the latter also had been surprised. He asked about the basis for thinking that aggregate credit demands in the fourth quarter might fall short of their third-quarter total

Mr. Axilrod observed that he had been surprised by the magnitude of credit demands in the third quarter, although he had expected a large increase. As to the fourth quarter--and setting aside the perennial problems of seasonal adjustments in the flow of funds accounts--he thought the main factor reducing credit demands, certainly in terms of market impact, would be smaller cash borrowing by the Federal Government. He did not see much abatement in evidence with respect to private credit demands It was possible that consumer demands might diminish on a seasonally adjusted basis, but he did not foresee any decline in business loan demands at banks, and capital market borrowing remained fairly sizable. And although inflows of savings to thrift institutions had continued to expand at a relatively moderate pace, he expected the volume of mortgage loans to be maintained, and probably to rise, because of the high level of mortgage commitments that had already been made

In response to a further question by Mr. Mitchell, Mr. Axilrod said that according to the flow of funds data a large part of the funds raised in credit markets in the third quarter had been advanced by banks

Mr Mitchell remarked that, in light of the large private credit demands anticipated in the period ahead and the likelihood that they would be financed in good part through banks, he found it difficult to be concerned about the prospect that Regulation Q ceilings would tend to curtail inflows of funds to banks. In particular, he would welcome a somewhat larger than seasonal reduction in outstanding CD's in December, although, of course, he would not want disintermediation to proceed to the point at which a crisis threatened to develop. He gathered that the staff was projecting a CD runoff in December of roughly seasonal proportions.

Mr Axilrod replied that that was the tentative staff estimate. However, projections for the forthcoming period of peak seasonal pressures were particularly uncertain, since much depended on the day-to-day money market conditions that were allowed to develop. He added that the market impact of a CD runoff would be affected by the environment in which it was occurring. It would be one thing if the runoff were taking place in a situation that the market considered temporary. But if doubts about future market interest rate declines should continue to erode--because, for example, foreign interest rates rose further in the period ahead--the market atmosphere could become quite sticky. In short, it was considerably more hazardous to project the possible amount of bank disintermediation in the current market environment than it would be in a more placid situation, and it was also difficult to evaluate the repercussions of a runoff on markets in general because the psychological state of the market was so delicate.

Mr. Solomon preceded his prepared remarks by noting that the first newswire reports had just been received concerning French Premier Couve de Murville's speech to the National Assembly. The Premier had announced the cancellation of France's atomic test program for 1969 and also had indicated that France's participation in the Concorde supersonic-plane project was being reduced.

Mr. Solomon then made the following statement on international financial developments:

> The international monetary system has experienced another crisis. It is clearly too early to know whether the measures adopted in the three countries most directly affected--Germany, France, and the United Kingdom--will be adequate to solve the current problems. But this crisis, which rounded out a year of turmoil following the devaluation of sterling, has led many observers to state that the international mometary system is in need of an overhaul that will prevent the recurrence of such acute difficulties. It may be worthwhile, therefore, to ask ourselves whether this latest crisis teaches us any lessons as to the need for international monetary reform.
>
> The crisis arose as the result of market expectations that the German mark would soon have to be revalued. Germany's very large current account surplus seemed to be chronic, strengthened by declining unit labor costs and, incidentally, by an increase in import taxes and export rebates last January 1. Germany had succeeded in offsetting its large current account surplus with massive

capital ourflows but it was becoming increasingly doubtful that the Federal Bank would be willing or able to maintain its easy money policy, which is a necessary condition for the continuance of the capital outflow in a volume more or less equal to the current surplus.

The speculative inflow to Germany naturally was at the expense primarily of the two currencies regarded as most vulnerable--the French franc and the pound. But it is our belief that, in the absence of the speculation on an appreciation of the mark, there would not have been a crisis over either the franc or the pound. France seemed to be adjusting as well as could be expected to the disturbances of last spring. Sterling, despite poor trade figures last month, was not under severe pressure; furthermore, it is likely that the British authorities would have taken further steps to restrain consumer spending even in the absence of a crisis. But neither the United Kingdom nor France could go on for long losing reserves heavily as speculators continued to bet on a revaluation of the mark.

The crisis thus involved the danger that a devaluation forced on either France or the United Kingdom could set off a chain reaction in which other countries would also be forced to devalue. The crisis also involved a power struggle between Germany and France as to who would have to act. Movement in the exchange rate of one would lessen if not eliminate the need for a move in the exchange rate of the other.

The first observation we can make about this crisis is that it did not in any direct way reflect the nature of the present international monetary structure. The fact that the dollar is widely held as a reserve currency was in no way responsible for the difficulties. One could imagine a similar crisis--involving the danger of competitive exchange rate moves and a political power struggle--in a Jacques Rueff gold standard world or in a Robert Triffin conversion account world in which there is only one reserve asset. In other words, the so-called confidence problem--involving the interconvertibility of two or more reserve assets--had nothing to do with this crisis. It is one of the many ironies of the events of the past two weeks that the monetary crisis which embroiled France should not reflect the alleged weaknesses in the system that French officials have been pointing to for years.

The positive lesson that many observers are drawing from the crisis is that there is a need for a more flexible means of correcting payments imbalances. It may be significant that the Wall Street Journal recently ran an editorial calling for greater flexibility of exchange rates

While there is much to be said for studying ways of facilitating exchange rate adjustment, it would be a great oversimplification to believe that the problem stems simply from a fetish regarding fixed exchange rates on the part of monetary authorities. In the case of Germany, for example, the major obstacle to revaluation appears to be the political fallout from a drop in farm prices that would result from an appreciation of the mark. It would be naive to think that Germany's political leaders would have been more ready to revalue the mark had there been in effect an approved technique involving greater flexibility of exchange rates

My point here is not to strike a blow against consideration of techniques for limited flexibility of exchange rates but to call attention to the fact that resistance to such techniques is not easily overcome If that resistance on the part of governments could be overcome there is nothing in the present IMF system to prevent adjustments as and when needed.

The most powerful argument on the side of those who favor greater exchange rate flexibility is that it would prevent the buildup of very large imbalances whose correction requires drastic and disruptive action both externally and internally If gradual adjustment of exchange rates could occur in a routine way without engaging the prestige of governments, the sort of crisis just experienced would be less likely

Perhaps another lesson from the recent experience is that adjustments in border taxes and export rebates can at times be a useful and less disruptive substitute for adjustment of exchange rates Germany has reduced by 4 percentage points both its import taxes and its export rebates (authorized under GATT to compensate for domestic indirect taxes) France has apparently folded its 4-1/2 per cent payroll tax into its value-added tax. This will permit France to raise import taxes and export rebates This technique of balance of payments adjustment is not a complete substitute for exchange rate changes--but that may be a virtue as well as a shortcoming One advantage of this technique is that it does not induce large anticipatory capital flows To benefit speculatively from this type of adjustment one must buy or sell commodities Another advantage is that changes in border taxes and rebates appear less permanent than exchange rate adjustments and may therefore encounter less resistance But a disadvantage is that such border tax changes, being essentially temporary, may not be suitable to correct structural imbalances.

In any event, it seems worthwhile to examine this technique as possibly representing not the optimal theoretical adjustment method but one that might make up in acceptability and feasibility for what it lacks in elegance. Another lesson, this time from the U.K. experience of the past year, is that domestic policies are crucially important to the success of an exchange rate adjustment.

Finally, nothing that has occurred in the recent crisis has a direct implication, one way or the other, for the posture of monetary policy in the period immediately ahead. It seems to me that, as in recent months, there is no conflict between domestic and balance of payments considerations as concerns monetary policy. Both types of considerations call for achieving a cooling off in aggregate demand and a lessening of upward price pressures.

Mr. Hayes asked whether the prospect that a number of countries would be making greater use of border taxes and rebates as a means of facilitating adjustments in their balance of payments did not suggest that the United States should also investigate the possibilities of imposing such taxes and rebates in appropriate circumstances. Otherwise, a situation would be created in which all such adjustments were made by other countries.

Mr. Solomon noted that various U.S. Government agencies, including the Treasury, had been studying the question. It was his impression that the United States already had a number of indirect taxes which would permit the imposition of some import taxes and export rebates under the General Agreement on Tariffs and Trade. It was on the basis of such indirect taxes that the French Government had justified its recent measures He was not proposing any basic changes in the domestic tax system in order to make this method of adjustment more fully available to the United States.

Mr. Hayes remarked that U.S. businessmen were becoming increasingly aware of and interested in the idea of a value added tax which would permit border taxes and rebates to be made under present GATT regulations.

Mr. Mitchell observed that the introduction of a value added tax system would be difficult to achieve. However, the adoption of rebates and border taxes was immediately possible under GATT regulations.

Mr. Brimmer recalled that when France had previously considered imposing import taxes and export rebates on the basis of payroll taxes, it had been decided that such measures were not consistent with the GATT agreements. If payroll taxes were omitted in the U.S. case, he thought there would remain little scope for imposition of such measures by the United States.

Mr. Solomon agreed that if the United States was to derive any significant benefit from such taxes and rebates, it might be necessary to secure a change in the GATT regulations. That approach would have the advantage of not requiring legislation; any new GATT agreement could be implemented through executive action.

Chairman Martin expressed the view that the French measures were likely to lead to repercussions from other GATT member nations.

In response to a question by Mr. Heflin, Mr. Solomon said it was his judgment that a moderate change in the Committee's policy at the present time would not have a significant effect on the French franc or the British pound. With respect to the latter currency, he would expect short-term interest rates to be under upward pressure in the United Kingdom as a result of the new credit ceiling and import deposit scheme. Accordingly, a tightening in U.S. money market conditions would probably not in itself serve to attract short-term funds from the United Kingdom.

Mr. Coombs noted his agreement with Mr. Solomon's view and indicated that the currency problems overseas were of such magnitude that they were likely to be little affected by marginal changes in U.S. monetary policy. In his judgment, the Committee could base its policy decision today almost entirely on domestic considerations.

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:

> Convincing evidence of an economic slowdown is still lacking, and the outlook remains stronger than would seem desirable, if there is to be a real change in the current highly inflationary environment. The labor market remains very tight. On balance there has been no letup so far in price pressures; the October rise in wholesale industrial prices was disturbingly large. The outlook perhaps is for some further moderate slowing of the economy in the current quarter and the first half of 1969. Many economists are thinking, however, in terms of a substantial speed-up in the economy after the first half of next year. If such

expectations become sufficiently widespread, the first-half slowdown may be very mild indeed, with little chance of appreciable progress on the price front.

After a considerable improvement in the third quarter, the underlying liquidity deficit in the balance of payments rose rather sharply in October, and large imbalances have continued into the first two weeks of November. In contrast with the March-September period, October and early November saw a heavy accumulation of dollar balances in official hands. The trade surplus this year will be at a very low level, and no big improvement is in sight for 1969 unless the current inflationary tendencies are substantially lessened. So far, of course, the heavy speculative flows in European exchange markets have left the dollar more or less unscathed. But the underlying payments situation suggests that this relatively happy state of affairs may not last very long. Certainly, we would do well to try to shore up the dollar's basic position before the next storm breaks. The current crisis abroad will almost surely lead to higher interest rates in some major countries, so that firmer conditions here may be needed to protect the dollar.

The credit proxy is now expected to grow at about a 10-1/2 per cent annual rate in November. This is in the range expected at the last meeting, but I continue to feel that it is excessive, particularly coming on top of the very rapid expansion of the summer and early autumn. A slower pace is projected for December, but once again I feel that little comfort can be taken from this projection, given the consistent experience in recent months for credit growth to exceed projected rates by a wide margin. Meanwhile, growth of the money supply is accelerating, and while I hesitate to put much weight on this yardstick it is another factor that gives one pause.

Immediately following the last meeting we saw the market tighten itself to some extent with altered expectations leading to higher interest rates. However, as I have indicated, such firming was not enough to check appreciably the credit expansion that has been giving the Committee so much concern for many months. Now that the Treasury refunding is out of the way, we need no longer feel inhibited about modifying policy, since the current offering of tax-anticipation bills is routine and not large enough to require even keel restraint. In the light of the strength of the inflationary bias now clearly visible in so many aspects of the economy, with all the consequences thereof, both domestic and international, I continue to feel that the System should strive for greater effect in slowing the pace of credit expansion for a period of several months. Thus, it seems to me that the Committee should instruct the Manager to seek slightly firmer money market conditions, having in mind a Federal funds rate of 6 to 6-1/4 per cent and borrowings of $500 to $700 million. We should not be overly concerned with the Treasury bill rate, but we might perhaps expect it to range between 5.30 and 5.70 per cent.

As for the directive, I think the reference to speculation in foreign exchange markets in the first paragraph of the staff's draft[1/] should be modified to make clear that the international situation remains highly uncertain. In particular, I would omit the words "a period of" from the draft statement, since it is not at all clear that a fixed period of time will be involved, and I would add the words "but great uncertainties remain" at the end of the sentence. And in view of the importance of achieving a slowdown in credit expansion, I would also like to amend the statement of the Committee's general policy stance at the end of the first paragraph to read in part "...to foster financial conditions, including a rate of bank credit growth that does not exceed moderate proportions, conducive to sustainable economic growth..." I would favor alternative B for the second paragraph. If a two-way proviso is included this time, I would not be inclined to invoke it as readily if credit expansion falls short of the 3 to 6 per cent projected range than if the rate of expansion exceeds that range.

Mr. Morris observed that he would also vote for alternative B of the directive, although he would propose some modifications of language. Basically, his reason for changing from the position that he had taken at other recent meetings of the Committee was the character of the business statistics for October that had become available during the past four weeks.

1/ Appended to this memorandum as Attachment A.

Mr. Morris disagreed with Mr. Brill's view that the recent statistics added credibility to the forecast of a substantial slowing of economic growth in the first half of 1969. Quite the contrary; they raised some considerable doubts in his mind as to the degree of slowing there would in fact be if the Committee adhered to its present policy. In particular, he was impressed with the great strength in new orders for durable goods in October, even if automobiles were excluded, and with the substantial advance in contracts and orders for plant and equipment. Those figures were difficult to reconcile with the staff's GNP projections for the first half of 1969.

Mr. Morris said he had come to that conclusion reluctantly since until quite recently he had had great confidence that the fiscal package would be effective even with a move of monetary policy away from the restrictive stance of last spring. The mixed and indecisive behavior of the leading indicators in August and September had done nothing to weaken that confidence, even though current business trends had been stronger than expected. However, his confidence that the fiscal package would succeed in dampening inflationary trends sufficiently without additional help from monetary policy had been weakened by the broadly diffused strength in the leading indicators in October, particularly the unexpected surge of strength in the indicators of new investment commitments.

Mr. Morris commended the staff for updating the GNP projections presented at the previous meeting by revisions to incorporate the new data received during the past four weeks, even though the revisions were minor. At the last meeting the staff had estimated that a 7 per cent annual rate of growth in bank credit through mid-1969 would be consistent with the financial requirements implied by their GNP projections. That would be less than half the actual rate of growth in bank credit since June. In the light of the new evidence of accelerating business investment commitments it seemed probable to him that a more restrictive monetary policy probably would be required if growth in bank credit was to be reduced to a 7 per cent rate.

It was for that reason, Mr. Morris observed, that he would vote for alternative B for the directive. The wording changes in the first paragraph proposed by Mr. Hayes were acceptable to him. He would also favor revising the opening sentence of that paragraph to read as follows: "The information reviewed at this meeting suggests that the expansion in over-all economic activity has moderated somewhat from its very rapid pace earlier in the year, but is still extremely strong."

Mr. Coldwell said he would not review Eleventh District conditions today because they remained at the steady advanced level he had reported at each of the past two meetings. National economic data, as he interpreted them, seemed to point in the same direction--a very high level position lacking any apparent strong stimulant but showing only small signs of weakening. In his view the growth rate had tapered off only slightly from that of the third quarter.

Credit availability appeared to Mr. Coldwell to be quite easy, with sizable borrowings from the Reserve Bank limited to a few large commercial banks and with Federal funds available at the going rate. Bankers told him they were not under any pressure and could make whatever loans they wished; they were even seeking participations to put their excesses to work. If that was monetary restraint certainly very few demanders of credit were being restrained. In fact, as he saw it, the interest rate was the only restraint and for only a few was it effective. The others wanted the credit despite the cost within a fairly broad range. The directors of the Dallas Reserve Bank, and he himself, were becoming increasingly restive concerning the lack of proper controlling action.

In addition to a respite from Treasury financing, Mr. Coldwell said, he thought the near-term future would be marked by some further seasonal credit needs and a highly tenuous international financial situation. He expected the period to be one of continued, although marginally slower, economic growth and further increases in bank credit and the money supply.

In light of the current situation and the near-term prospects for the domestic economy, Mr. Coldwell felt that the Committee should be exercising greater monetary restraint, especially on the availability of lendable funds. If that could be achieved promptly and effectively by curtailing open market provision of reserves for seasonal purposes, then perhaps that might be the best approach. However, that method lacked the visibility and public impact of a more overt move. A discount rate action would fail to come to grips with the problem of credit availability unless it were accompanied by Committee action. Perhaps it might even be worthwhile to consider a change in reserve requirements, although a move of that nature might be too strong an action.

In any case, Mr. Coldwell said, he believed that positive, forceful action was needed promptly to stem the tide of inflation for both domestic and international reasons. The Committee could not hope to stop all inflationary pressures in one fell swoop, but further temporizing with either the domestic inflation or the resultant balance of payments deficit and international financial unrest would never correct the problems. Thus, he would favor adoption of alternative B for the directive.

Mr. Coldwell added that he would like to append a footnote to the earlier discussion of international problems, to the effect that he continued to question the Committee's consistent response to those problems by further increases in the swap lines and participation in new credit packages. He hoped work was going forward on a more stable and long-term solution, for he foresaw a very large build-up of the total credits or contingent liabilities outstanding.

Mr. Swan commented that business activity in the Twelfth District had continued to be very well sustained. In October the unemployment rate fell by one-tenth of one percentage point in the Pacific Coast States and employment expanded at a significantly higher rate than in the nation as a whole, even though aero-space employment continued to decline.

He had not found it easy to reach a conclusion about appropriate policy at present, Mr. Swan said, partly because he was impressed by the continuing strength being displayed by the domestic economy. However, for several reasons he would hesitate to advocate a definitely more restrictive position at the moment. First, there had been a slackening in consumer demands recently, even if it were not as substantial as might have been desirable. Secondly, the period from mid-December into January was approaching in which seasonal pressures in the money market would be operating in the other direction. Finally, although the point had been made that the Committee need not consider the current uncertainties in the international financial area as a constraint on its policy decision today, he had the feeling that an overt action to increase monetary restraint might have undesired consequences in that area.

Nevertheless, Mr. Swan continued, he would like to see bank credit expand in December at an annual rate less than the upper end of the 5 to 8 per cent range associated with alternative A in the blue book.[1/] He would prefer growth at a 5 to 6 per cent rate; and since

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

the range associated with alternative B was 3 to 6 per cent, he found the choice between the two alternatives to be a close one. On balance, he favored alternative A, but with certain changes in the staff's draft language. Since he thought it would not be desirable to seek easier money market conditions if bank credit expansion was below the projected range, he would replace the two-way proviso shown in the staff's draft of alternative A with a one-way proviso guarding against excessive bank credit growth. Moreover, he would want to see the proviso clause implemented before bank credit growth was "significantly" in excess of the 8 per cent upper limit of the projected range. Accordingly, he would delete that word from the clause. In short, he would favor using the same kind of proviso clause as in the directive issued at the previous meeting.

If the Committee were to adopt alternative B, Mr. Swan observed, he would suggest that it revise the staff's draft language to call for attaining somewhat firmer conditions in "money and short-term credit markets," rather than referring to conditions in the money market alone. He did not concur in the reason given in the staff notes for deleting the reference to short-term credit markets.[1/]

1/ The staff note indicated that the deletion referred to was suggested "on the assumption that the Committee would not want to foster higher Treasury bill rates for their own sake, although somewhat higher bill rates might be associated with a firmer money market."

Mr. Galusha said that again this morning he found himself favoring no change in Committee policy. The willingness of foreigners to hold dollar assets did not seem to have decreased, and apparently no decrease was in prospect. Maintaining U.S. reserves therefore would not seem to require an increase in money market rates--a conclusion that seemed to him to have been buttressed by the statements of Messrs. Coombs and Solomon. Moreover, with an increase in U.S. interest rates such funds as flowed to the United States presumably would come from Britain. But even without an increase in U.S. rates Britain might be hard pressed to avoid imposing exchange controls.

It would be different, Mr. Galusha continued, if the U.S. economic outlook were such as to demand a change in Committee policy. In his judgment, however, it was not. The pace of the economic advance had slowed and it would slow further, he believed, even if Committee policy remained unchanged.

It seemed to Mr. Galusha that it was essential for the Committee to avoid threatening banks and other financial intermediaries with substantial decreases in their liabilities. Forcing banks to increase their demands for Euro-dollars would be highly undesirable. If it were for him alone to decide, therefore, he would have the Manager give the highest priority to resisting any tendency for short-term rates to increase sharply, and more particularly to keeping the three-month bill rate within the 5.30 to 5.60 per cent range.

Mr. Galusha remarked that the reports of world developments coupled with the first-rate reports of the staff today buttressed a conviction frequently expressed at meetings of the Committee that in times of sharp uncertainty changes in policy should be made only when they were clearly and unequivocally required; otherwise the result was simply to enlarge the areas of anxiety. He believed there had been a moderate and wholly appropriate tension maintained on the money markets, but he did not believe that a decisive move was now warranted. A recent issue of the magazine "Business Week" had carried an editorial sharply critical of Federal Reserve policy that on the whole had not made much sense to him. But the editorial did carry one useful message, in the plea that the System maintain its nerve and react slowly and modestly on the basis of clear evidence.

Mr. Galusha commented that in the blue book's discussion of alternative B it was noted that money market variables would have to be at the tight end of the ranges indicated to communicate the fact of a policy change to the market.[1/] He agreed that if the Committee were to change policy it should get the message across. But in his

1/ The blue book passage referred to read as follows: "If the Committee wishes to intensify the degree of monetary restraint at this time, it may wish to consider a constellation of money market conditions including a Federal funds rate fluctuating around 6-1/8 per cent, member bank borrowings in a $550-$700 million range, and net borrowed reserves of $300-$500 million. In view of the relatively firm money and short-term credit market conditions of recent weeks, and given anticipations of seasonal tightness by market participants, these money market variables would probably have to be rather consistently toward the tight ends of the indicated ranges for the market to become aware of a shift in policy over the next three weeks."

judgment the need for the policy course contemplated in connection with alternative B simply was not in evidence at present. He shared the concern that had been expressed over the uncertainty that the economic advance would slow as much in the first half of 1969 as the staff's projections implied. But there seemed to him to be more signs suggesting that the Committee should hold to its present policy than that it should change policy. Accordingly, he favored alternative A for the directive.

Mr. Scanlon remarked that while some forecasts of economic activity indicated a substantial slowing in the rate of growth, and even an absolute decline in real GNP in the first half of 1969, the evidence currently available to him for the Seventh District cast doubt upon the validity of such projections. Job markets had not eased, retail sales continued strong, construction activity pressed against capacity, capital expenditures probably would rise at a faster pace, and net business investment in inventories apparently would remain large to accommodate increases in sales and new orders. Prices of manufactured goods, with the spectacular exception of hot rolled steel, were continuing to rise at the pace of recent months. Midwest business economists reported that orders and shipments in recent weeks had been larger than expected--although not necessarily at record levels--for a wide variety of capital equipment.

Mr. Scanlon commented that capital expenditures in 1969 were expected by most observers in his District to at least equal the 8 per cent increase recently projected by McGraw-Hill. Most companies emphasized their need for new plant and equipment to turn out products that met today's quality standards and the need to cut, or hold down, rising labor costs. Such projects proceeded in the face of unused aggregate capacity. Evidence provided by bank debits and scattered reports on retail trade indicated that Seventh District consumers were continuing to spend at a rapid pace.

Orders for steel had improved substantially on a broad front and more than expected a short time ago, Mr. Scanlon noted. Work orders to steel warehouses had increased, indicating strength in demand for smaller users of steel. Some industry analysts in the District now believed they had been overestimating user inventories.

Labor shortages continued, Mr. Scanlon said. In November the proportion of covered workers receiving unemployment compensation ranged from only 0.8 per cent in Iowa to 1.3 per cent in Michigan, compared to 1.6 per cent for the nation. He continued to hear reports that some plants that had allowed employment to decline last year were experiencing great difficulty in rebuilding their staffs.

Bank lending activity appeared to Mr. Scanlon to have strengthened in recent weeks. The spurt in business loans in the past three weeks was seasonal in part, with a large portion concentrated in the trade categories In the November lending practices survey, however, more than a third of the District's respondents indicated that loan demand had strengthened and that they expected it to remain strong or strengthen further in the next three months. Only one bank expected weaker demand. One bank reported that smaller correspondents had been adjusting their lending rates upwards into better alignment with rates at city banks.

However, Mr. Scanlon continued, loan expansion at the Chicago money market banks had been moderate and the money positions of those banks had been eased by deposit inflows as well as by reductions in dealer loans and inventories of U.S. Governments. Their CD's had been rising and they had room under Regulation Q ceilings to bid for funds, especially those with maturities beyond the six-month area. They were in reasonably good shape to absorb the new tax-anticipation bills. Nevertheless, their liquidity was still low relative to several months earlier and their ability to meet credit demands would be adversely affected by a significant decline in the availability of Euro-dollars.

As to policy, Mr. Scanlon said, recent growth in most aggregate monetary and credit measures appeared to be consistent with staff projections. He still considered those rates to be faster than appropriate, however, in light of the probable strength of expansionary forces in the economy. Therefore, he would recommend that the Committee move to a slightly firmer policy, and he would support alternative B for the directive. Like Mr. Morris, he favored revising the opening sentence of the first paragraph, but he had a somewhat different suggestion which would also incorporate the second sentence of the staff's draft. Specifically, he proposed a first sentence reading as follows: "The information reviewed at this meeting suggests that the expansion in over-all economic activity, while moderating somewhat further from its very rapid pace earlier in the year, remains strong, and upward pressures on price and costs are persisting." The changes Mr. Hayes had suggested in the first paragraph were acceptable to him.

Mr. Clay said that economic developments continued to call for a slower rate of credit expansion. Resources, particularly manpower, remained under pressure, and price inflation showed little evidence of slackening. Whatever change of economic pace had taken place or was in prospect had had no appreciable ameliorating effect on costs and prices. On the contrary, the forces of inflation appeared to be very strong. A lesser rate of increase in bank reserves and credit would be more compatible with the goal of a gradual and orderly transition to balanced economic growth and stable prices. A solution to the price inflation problem also continued to be essential to improvement in the country's foreign trade as a necessary step toward balance in its international payments.

According to staff projections, Mr. Clay noted, maintenance of prevailing money market conditions would be associated with an annual rate of increase of 5 to 8 per cent in the bank credit proxy in December. That would be a more satisfactory rate of credit expansion than that of recent months. However, recent experience had frequently involved a significantly larger credit growth for any given set of money market conditions than had been projected. If that were to be the case in the period ahead, it would represent a continuation of credit expansion at a pace that was inappropriate for the state of the economy. In view of the tendency toward larger credit growth than projected, the better course would appear to be the adoption of the money market assumptions of the tighter policy alternative, as presented in the blue book.

Such an approach to policy should not be constrained by Treasury financing activities at the present time, Mr. Clay remarked. He recognized, however, that developments in the foreign exchange markets were an important uncertainty that could affect the execution of monetary policy in the period ahead.

Alternative B of the directive drafts was satisfactory to Mr. Clay.

Mr. Heflin said that in view of the overriding importance of recent international developments in today's policy decision, he would make only brief reference to the Fifth District economy. The latest information indicated that, except in textiles, Fifth District business continued to move along at a strong pace, with little evidence of any notable moderation in the pace of activity.

At the national level, Mr. Heflin continued, signs of some moderation in the rate of advance were more evident. Nonetheless, as he read the latest statistics, they were still something of a mixed bag. It was reasonably clear that growth in consumer spending had tapered off and that the Federal budget would be less stimulative in the months ahead. On the other hand, the latest production, employment, and price data continued to paint a strong business picture and he was not yet convinced that the moderation which appeared to be developing would be sufficient to dissipate the inflationary psychology pervading the business community.

Mr. Heflin agreed with those who thought that domestic developments, taken alone, suggested the desirability of some movement toward greater firmness in monetary policy. However, domestic developments appeared to him to have less immediate relevancy to today's policy decision than did conditions in the U.S. financial markets and in the foreign exchanges. Even before the emergence of the latest crisis in the foreign exchanges, domestic credit markets were dominated by a heavy pall of uncertainty associated with the business news and with the Vietnam negotiations. Because of that uncertainty, markets remained surprisingly insensitive to developments that might have been expected to trigger at least a modest rally, and rates had drifted up to levels that posed some danger of disintermediation. The international financial crisis seriously aggravated that uncertainty and he thought it was important that the Committee preserve a posture that would allow it to move quickly to deal with any market disorders that might develop. Thus far the markets had stood up surprisingly well in the face of the confusion in the foreign exchanges, but it was clear that they were rather delicately poised and that the Committee was dealing with a highly volatile situation.

Thus it seemed to Mr. Heflin that the paramount question in today's policy decision was the situation in the foreign exchanges. There was little doubt that the exchange markets were confronting a crisis of the first magnitude and it was by no means clear that the measures taken to date were sufficient to restore confidence in existing exchange parities. So far as he could see the situation remained extremely delicate. Given such a climate, he believed that all the Committee should do for the moment was to remain poised and ready to act. Any overt tightening move, it seemed to him, involved an unnecessary risk of adding to the pressures on the pound and on the franc and it also risked a possible perverse effect on confidence in the dollar. Moreover, he would hope that, consistent with the Committee's responsibility for maintaining orderly conditions in domestic and foreign exchange markets, the rate of bank credit growth could be held within the 5 to 8 per cent range projected in the blue book. He would favor alternative A with the two-way proviso shown in the staff's draft.

Mr. Mitchell observed that he agreed with the staff's analysis of the economic and financial situation. If he had any disagreement with the staff it was that he expected signs of easing in the economy to show up sooner than they anticipated. Despite the economic situation and outlook, however, there was an inflationary psychology in the country--and it was that psychology that evidently had led some members of the Committee to favor a tighter monetary policy at this time.

In his judgment, Mr. Mitchell continued, for the System to deal effectively with the prevailing inflationary psychology it would have to make a dramatic move of some sort--perhaps a one-half point increase in the discount rate. Personally, he would not be prepared to take such action at present. At the same time, he thought a modest move such as was contemplated in connection with alternative B of the directive drafts would be ineffectual.

Mr. Mitchell said he would not favor a change in open market policy for another reason also--it could be expected to have lagged effects. While he did not know the length of the lag, a shift to a firmer policy now probably would be inappropriate in view of the slow pace of economic advance projected for the first half of 1969. Of course, a half-point increase in the discount rate would have an instantaneous effect on expectations, but a larger one than he thought appropriate.

In sum, Mr. Mitchell remarked, he favored alternative A of the directive drafts. The changes Mr. Swan had suggested were acceptable to him. Of the other language changes proposed, he would be inclined to adopt only the one Mr. Hayes had recommended in the first clause of the sentence relating to foreign exchange market developments.

Mr. Daane said his views on policy were similar to those of Mr. Mitchell. He was as disturbed as anyone around the table today by the prevailing inflationary pressures and psychology, but in words Chairman Martin had often used he thought they represented the heritage of past errors. He did not think that adopting the type of policy course called for by alternative B would accomplish much at this juncture. Moreover, such a directive might imply a bit more than the Committee could deliver. As the blue book indicated, given the recent firm money market conditions and market anticipations of seasonal pressures, it would be necessary to press rather hard toward firmer conditions to communicate the message that policy had changed.

He would be reluctant to follow such a course, Mr. Daane continued, partly because of the existing circumstances in the international financial area. It might well be true that a small move toward firming or easing would not have very much effect in that area. But if firming was pressed far enough for the policy change to be evident to the market, the resulting shift in international interest rate relationships probably would have undesired consequences.

His conclusion, Mr. Daane observed, was that the best course for the System was to hold to a steady policy at this juncture. Operationally, within that general framework he would be perfectly willing to have some of the expected seasonal pressures show through, and to have doubts resolved on the side of firmness. But he would not want to make an overt change in the basic posture of policy. With that kind of operational interpretation he favored alternative A for the directive, and would accept the changes in language Mr. Swan had proposed.

Mr. Maisel said he could be brief in his statement today because for the past six months virtually each time the Committee had met he had suggested that, lacking any good reason to shift its target as a result of changes in the economy or credit markets, the Committee should primarily stick with a target based on a broadly defined money supply or on bank credit. Specifically, he had urged that the Committee use as a target an annual growth rate of 8 to 9 per cent in total deposits including those at banks and thrift institutions, assuming that the goal was to slow down the rate of growth in current dollar GNP to about 6 to 7 per cent per annum.

Mr. Maisel saw no reason, given the uncertainties of current conditions and projections, to change from that target. That was particularly so since, as he had pointed out before and as Mr. Galusha had pointed out so strongly today, a change in policy was costly and should not be undertaken lightly. As a result, today he would support alternative A, the no-change directive, even though it meant in actuality that under the present conditions in the money and short-term credit markets, there probably would be some short-fall below a desirable target goal. The desired level of deposit growth would not be reached for the coming month nor, more seriously, for the coming two quarters. The staff projections presented at the Committee's meeting of October 28 indicated that under current conditions expansion of deposits was likely to fall short of the proper target by a fourth to a third. He might note that, contrary to other statements, recent staff projections of bank credit seemed to him to have been very good, both in the short- and the longer-run.

Mr. Maisel noted that shortfalls from the goal of deposit expansion at an 8 to 9 per cent rate had not been unusual this year, with a large one in the second quarter. In the third quarter the expansion rate was close to the target. Indications for the current--fourth--quarter were for growth above the desirable rate, but only slightly so and not sufficently to make up for past shortfalls.

Since deposit expansion had been running at about the proper level for this half-year, Mr. Maisel thought the Committee probably should stay with its current directive and maintain existing money and credit market conditions. As time passed and the Committee obtained firmer data both on the economy and on the actual growth in total deposits, it could decide if any change was desirable in the directive--

either to reach its strategic target for monetary growth or its ultimate goal of an optimum growth rate for the economy. However, unless some major alterations in either the financial situation or the underlying economic situation occurred, the reasons for maintaining monetary policy as a stable base in an unstable world appeared very strong.

Mr. Brimmer referred to the statement in the green book that there were some indications at the time of writing of a decline in both exports and imports in October. He now understood that the Commerce Department would publish figures tomorrow that would show a substantial drop from September in both. The decline in exports might be as much as 20 per cent and that in imports as much as 11.5 per cent. Such figures would suggest that the trade balance became negative again in October.

Turning to open market policy, Mr. Brimmer said he favored adoption of alternative A for the directive. In his judgment both domestic and international considerations called for no change in policy at this time. With respect to the domestic situation, he had been interested in Mr. Morris' comments about the implications of the October leading indicators for the performance of the economy. It was widely recognized, however, that the behavior of selected indicators frequently was hard to interpret and that figures for a single month often were misleading. For that reason he preferred to make his assessments of the outlook in terms of aggregative GNP models that took account of the whole economy. In doing so now, he found that he agreed with the staff that growth in over-all activity was in the process of slackening, to a large extent because much slower expansion in disposable income was resulting in a weakening of consumer outlays on durable goods. While the economic advance might not slow enough by the first half of 1969 to break the back of the prevailing inflationary psychology, he expected some moderation in the rate of increase of prices. Like Mr. Galusha, he considered it important for the Committee to avoid being erratic in its policy. In his judgment maintaining the present policy at this time was the course most likely to facilitate moderate economic growth during all of 1969.

With respect to international considerations, Mr. Brimmer continued, he was puzzled by the fact that Mr. Hayes had suggested stating in the directive that "grave uncertainties remain" in foreign exchange markets and at the same time had advocated a firming of domestic monetary policy. In his (Mr. Brimmer's) judgment the statement was appropriate but he thought the uncertainties noted argued for no change in policy. He did not favor adopting the additional language Mr. Hayes had proposed for the statement of the Committee's general policy stance in the concluding sentence of the first paragraph. The Committee had--appropriately, in his view--avoided language of the type in recent years.

Mr. Brimmer said he had hoped to be able to give the Committee some information about the guidelines for 1969 under the balance of payments program. Their development had been delayed, however, by the fact that Secretary Fowler recently had been occupied with other matters. Assuming that there would be a program for 1969, he expected that information concerning it would be in the hands of the members by the time of the next meeting of the Committee.

Mr. Sherrill expressed the view that the Committee's current policy was, if anything, more appropriate now than it had been at the time of the previous meeting. Accordingly, he would favor alternative A for the directive. The revisions in the staff's draft that Mr. Swan had proposed were acceptable to him.

It was clear, Mr. Sherrill continued, that the decline in the rate of economic growth after fiscal legislation was enacted had not been as rapid and sharp as the Committee originally had anticipated. But he thought that fact offered an additional argument for maintaining the present stance of policy. If, as he expected, growth would continue to slacken in the first half of 1969, the Committee's current policy was likely to prove appropriate for a longer period of time than would have been the case if the original expectations for the second half of 1968 had been realized.

Mr. Sherrill remarked that one consideration possibly arguing for a firmer policy now was concern over a resumption of an excessive rate of economic expansion in the second half of 1969. He did not know the length of the lag with which monetary policy actions took effect, but at present the main consideration seemed to him to be the prospect for slackened growth in the first half of the coming year.

Mr. Hickman said there was little he could add to this morning's discussion of the business and financial outlook. The economy continued to move forward at a reduced but too rapid pace. Indeed, prices generally were expected to increase more in the fourth quarter than in the third quarter, indicating that the nation was still seriously burdened by price inflation. The current environment and attitudes had to be altered if balanced and sustainable growth was to be restored and maintained.

Mr. Hickman commented that the grave situation in the foreign exchange markets was uppermost in the minds of all the Committee members today. Fortunately, the dollar had remained fairly strong despite huge speculative flows of funds into marks. It was imperative that the Committee do what it could to keep the dollar strong, and at the same time to stabilize the existing international exchange network.

On the assumption of no change in monetary policy over the next three weeks, Mr. Hickman continued, the staff had projected an increase in the bank credit proxy in December within a range of

5 to 8 per cent, plus one-half of a percentage point if allowance were made for Euro-dollar borrowings through foreign branches. If bank credit had been held to that range in recent months, price stability would be more nearly within reach today. However, given the current inflationary environment and the need to protect the dollar, he strongly urged a modest tightening in policy at this juncture. Essentially, what he had in mind--to the extent permitted by international money flows--was bank credit growth at an annual rate of about 6 per cent, a Federal funds rate in the 6 to 6-1/4 per cent range, and a 91-day bill rate in a range of 5-1/2 to 5-3/4 per cent. Those targets were generally consistent with the staff's alternative B, which he would prefer with a two-way proviso.

Mr. Bopp commented that modest progress had been made since the Committee's previous meeting toward domestic stability, but that had been more than offset by a giant step backward on the international front. Additional evidences of slowing in the rate of increase in the domestic economy had been appearing, but only bit by bit and in smaller degree than he believed would be satisfactory from the point of view of containing inflation. Furthermore, the Philadelphia Reserve Bank's projections of the likely rate of growth in the next three quarters suggested that progress in further slowing might also prove disappointingly small. His staff's estimates of the increase in GNP were only $1/2 billion above the projection by the Board's staff for the fourth quarter of this year but they averaged $2 billion higher for the first two quarters of 1969.

Mr. Bopp reported that the Reserve Bank's outlook survey of major manufacturers in the Third District supported the view that the economy would cool off only modestly. A majority of manufacturers shared the thought that the economy would not slow very much by mid-1969 and, equally significant, the percentage holding that view had been increasing. Expectations of future price increases continued and were widespread. More than two-thirds of the survey respondents expected to be paying higher prices for their inputs six months from now. Over 50 per cent expected prices received to increase.

Mr. Bopp observed that the near-term problems on the domestic front were, of course, overshadowed by the crisis of the French franc. But assuming that storm was weathered, the longer-term problem remained. It was clear that in spite of the third-quarter improvement in the country's international accounts, the United States was not yet out of the woods with respect to its balance of payments. It continued to be critically important for international stability that people believe the United States was making progress in getting inflation under control.

Mr. Bopp remarked that the pace at which credit was projected to rise in December was much more appropriate for what lay ahead for the economy--at least as he saw it--than were the rates of growth in the past few months. But the rapid increases that occurred during the period from July to November were yet to be felt fully and would help to sustain inflationary pressures.

In view of both domestic and international considerations, Mr. Bopp thought that a slowdown in the growth of the money and credit aggregates was desirable. The Desk should make every effort to validate the projected increase in the credit proxy, accepting a change in money market conditions if necessary to accomplish that. During the next three weeks the Desk should have authority to act if needed for international reasons. He favored alternative B of the directive drafts.

Mr. Kimbrel recalled that at the previous meeting he had expressed the hope that by this time the Committee might be able to assess more accurately the effects that forthcoming events might have on expectations. In his own mind at least, that hope had not been fulfilled. The outlook seemed to be just as murky as ever. Moreover, further complications, especially in the international area, had developed that made it even more difficult to make policy decisions.

The thing that impressed Mr. Kimbrel about the period since the previous meeting of the Committee was how little impact the events of the past few weeks seemed to have had on expectations so far as businessmen were concerned. Businessmen and bankers with whom he came in contact continued to have an almost unbridled optimism about the future. Some of them would acknowledge that perhaps the next three to six months or so might be a period of less-than-usual buoyancy, but they were not cutting back on their plans for expansion. Rather, they were basing their plans on an optimistic assessment of long-run developments.

Loan demands remained strong at District banks, Mr. Kimbrel said. On a seasonally adjusted basis, loans at all member banks rose at an annual rate of 13 per cent in October. They were higher at the end of October than three months earlier in 85 per cent of the 27 trade and banking areas into which the District was divided for analytical purposes. In mid-November large District banks registered a significant increase from mid-October, reflecting an advance at two-thirds of the banks. All types of loans increased. Along with that loan expansion was a growth in investments.

Of the 18 large banks that had reported so far in the quarterly survey of bank lending practices, Mr. Kimbrel continued, only two found the demand for business loans weaker now than in August and only one expected any weakening by January. Several banks commented that, although the prime rate had been lowered in

September, no across-the-board reductions had been made in the rates actually charged.

Of course, Mr. Kimbrel remarked, not all areas of the District were sharing equally in the expansion, either in loans or economic activity. For example, several areas within the District had been adversely affected by the de-escalation of the U.S. space efforts. Huntsville, Alabama, with the Marshall Space Flight Center; New Orleans, with a large test facility; and Cape Kennedy had all lost employment in space work and related areas.

At the previous meeting, Mr. Kimbrel observed, he had expressed the view that it would be desirable to have the directive give some indication of the Committee's concern about inflationary expectations and a decision to bring about somewhat firmer conditions to the extent consistent with Treasury financing. As it turned out, conditions had remained relatively firm since that time, and it could be argued that they had tightened up a little. That was desirable. The poor performance of recent new issues in both corporate and municipal markets reflected, he hoped, a slight abatement of the inflationary psychology so prevalent this autumn.

Mr. Kimbrel said he would like to see any trend toward reducing the inflationary psychology continued. Therefore, he favored moving perceptibly toward more monetary restraint and adopting alternative B for the directive. He would be inclined to accept the change suggested by Mr. Scanlon in the opening sentences of the first paragraph and that suggested by Mr. Hayes in the first part of the statement concerning foreign exchange market developments.

Mr. Francis commented that inflation continued to be the most serious stabilization problem facing the nation. The rise of prices had accelerated from a rate of 1.5 per cent a year in the first half of the decade to 4 per cent in the past year. Evidence of any slowing in the rate of price increase this fall was slight.

Mr. Francis believed that inflation would remain a serious problem for some time in the future. Prices were slow to adjust to excessive demands because of the rigidity of terms in contracts, lack of knowledge on costs, a money illusion, and inertia. That might have been helpful in limiting price increases in periods of excessive demands, but inertia was also likely to continue pushing prices up after the growth of total demand decelerated. Since the task of reducing inflationary expectations was sizable and would probably take considerable patience if it was to be accomplished without undue slowing in the growth rate of real output, it was imperative that the Committee start as soon as possible to reduce the excessive demands for goods and services.

Mr. Francis thought the inflation of recent years might have been partly the indirect result of fiscal influence.

Military outlays for the Vietnam conflict had expanded rapidly since 1964. Meanwhile, the Government had continued to increase nondefense programs and had not raised tax rates until mid-1968.

In addition, Mr. Francis said, the private demands for goods and services were stimulated by the monetary climate. Monetary expansion, according to virtually any aggregate measure, had been very rapid. For example, the growth of total member bank reserves, which was at a 2.8 per cent annual rate from 1957 to 1964, had accelerated to a 4.8 per cent annual rate from 1964 to 1967 and to a 6 per cent rate in the last twelve months.

At midyear the Government imposed the surtax and undertook to slow the rate of increase in Federal spending, Mr. Francis continued. However, many monetary aggregates had continued to rise rapidly. Since July, Federal Reserve credit had risen at a 12 per cent annual rate and the monetary base had continued its 6 per cent rate of expansion. Growth in the money stock slowed to about half its former rate, but that had not been the result of a change in System operations. The slower growth in money had reflected a utilization of bank reserves in a rebuilding of Treasury cash balances and in a reintermediation through time deposits. Insofar as those conditions proved to be temporary, continued slower growth in money would depend upon restriction in the growth of member bank reserves.

As to policy for the near future, Mr. Francis suggested a move toward a less expansive monetary stance. The projections indicated that unless the stimulative effects of monetary developments were moderated, there would be little likelihood of dampening the inflationary forces and improving the fundamental U.S. balance of payments position. He preferred directing the Desk in terms of some monetary aggregate rather than in terms of conditions in the money market which were so heavily influenced by changing credit demands. However, a moderate rise in short-term interest rates should improve the chances of reducing the growth rates of member bank reserves and the monetary base. With reduced rates of increase in those magnitudes, the chances would be better for money to continue to rise at the more moderate 2 to 4 per cent annual rate which had prevailed since July and for growth in GNP to gradually slow from the recent 9 per cent rate to a more desirable 6 per cent rate.

It seemed to Mr. Francis that consideration might be given to restoring the 5-1/2 per cent discount rate until the demand for credit subsided and market interest rates declined from present levels. He favored a move toward a less expansive monetary stance and preferred alternative B of the directive drafts.

Mr. Robertson made the following statement:

> In today's circumstances, with the viability of the latest international financial actions still

unproven, I think we need to be especially careful of our actions. We do not want to avoid doing anything needed to adequately defend the dollar, but neither should we act to put untoward pressure on the delicate position of other leading currencies.

As I see it, the dollar's role as an international currency has come through this crisis comparatively well, and needs no short-term shoring up by a further move on the part of monetary policy. At the same time, I read the evidence on the domestic front as a shade more reassuring than a month ago. There are a few more straws in the wind suggesting that the rise in consumption spending is moderating. On the financial side, bank credit and reserve aggregates seem a little less ebullient, and most interest rates outside the money market area have moved up a notch higher.

We still have an inflationary problem to conquer, but it looks like we are reasonably close to the proper policy track for dealing with it responsibly.

Accordingly, I would be in favor of the Committee's voting to maintain policy essentially unchanged. However, I would like to have the Manager be quick to counter any easing tendencies that appear in the market. Given the occasional upward pressures to be expected at this season of the year, this stance may give a preponderance of firm market conditions between now and the next meeting which would not be inappropriate in my view. But this is about as far as we should go in the direction of further restraint pending greater clarification as to how both domestic and international trends are likely to develop. On this understanding, I would vote in favor of alternative A of the directive drafts. However, I would like to suggest some changes in the first paragraph having to do with the international sentences. In the second of those sentences the draft says, as Committee directives have said for some time now, that the United States "payments position continues to be a matter of serious concern".

I suspect we have inadvertently fallen into a bad habit of referring to our balance of payments position in this manner, a manner that is different from the way in which we refer to problems of at least equal concern--e.g., inflation and unemployment. I do not want to suggest that the problem is not a matter of concern, though one might argue about degrees of seriousness, but I wonder if it serves a useful purpose to continue saying so, especially in a period when the dollar does not appear to be a matter of as serious concern to exchange market participants as do some other currencies.

Rather than the general statement of concern, I think it would be better for that sentence to be stated in a fashion more parallel with the rest of the directive, where we try to give the facts or trends that either aggravate or allay our many concerns. For example, we could substitute for that portion of the sentence expressing the Committee's concern the following: "but partial data for recent weeks suggest that the improvement is not being sustained."

In addition, I suggest that the preceding sentence, concerning foreign exchange market developments, be deleted or rewritten. In its present form, its juxtaposition to the next sentence implies that while we <u>should</u> be, we are <u>not</u> making additional efforts to correct our balance of payments problem, while other countries are taking strong corrective measures. Since I do not think that we should be taking further measures at this time, at least not in the form of a more restrictive monetary policy, I think it would be unfortunate to leave any such implication in the record--especially now.

To be specific, I suggest that the two sentences in question be revised to read: "Following discussions among leading industrial countries, France, Germany, and Britain have taken steps to combat the recent speculation in their currencies by steps designed to reduce imbalances in their external payments. The U.S. foreign trade balance and over-all payments position improved in the third quarter, but partial data for recent weeks suggest that the improvement is not being sustained."

Chairman Martin said the Committee's discussion today had been quite useful in highlighting the various considerations that had to be taken into account in deciding on the proper stance of monetary policy. Personally, he found the question to be a close one, and he thought a good case could be made for firming. On balance, however, he favored alternative A for the directive, on the understanding that the Desk would resist any tendencies toward ease in the coming period. It appeared from the go-around that a majority of the members were of a similar view.

It was clear, the Chairman continued, that members of the Committee, including himself, as well as the staff had underestimated the strength of the economy. While there were some signs of a slowing in the economic expansion, the amount of slowing that had occurred thus far was much less than had been expected. No useful purpose would be served by attempting to ignore that fact; indeed, the System should always be engaged in a ruthless examination of its past record. Moreover, as he had indicated on previous occasions, he thought that the fiscal legislation enacted at mid-year and the preceding firming of monetary policy had been delayed too long. But he had concluded--with reluctance--that policy should not be firmed now because he thought it was too late for such action. It would be asking too much of current monetary policy to expect it to deal with the inflationary psychology that had resulted from the cumulated heritage of past failures of public policy.

To some extent, Chairman Martin observed, the situation in the United States was the same as that in Britain, where strong policy measures had thus far failed to curb consumer spending; in both countries people were willing to dip into their savings since they expected rising prices to erode their purchasing power. But he agreed with Mr. Mitchell that to affect the prevailing inflationary psychology the System would have to take more drastic firming action than represented by alternative B for the directive, and that such action would not be desirable at this time.

There were certain other considerations that led him to favor alternative A today, the Chairman remarked. Among them were the existing uncertainties that had been mentioned and the seasonal pressures in financial markets that were typical of the period before year-end. Also, there were risks that a firming of policy might result in massive disintermediation at commercial banks. A moderate runoff of outstanding CD's would have some desirable aspects, but the process might well proceed too far.

Chairman Martin commented that evidences of a slowing of the economic expansion were likely to become more pronounced in coming months. If the Committee decided to make no change in policy today he hoped it would do so in the expectation that the System would not act precipitately to ease policy--by reducing the discount rate prematurely or flooding the market with reserves--when those evidences appeared. Many informed people already held the Federal Reserve responsible for the existing inflation, and unduly aggressive action to stem a slackening of the expansion might well destroy the System's reputation as a bulwark against inflation.

At the Chairman's suggestion the Committee then turned to a review of the various changes that had been suggested in the staff's draft of the directive. It was agreed that the language of alternative A for the second paragraph should be modified in the manner Mr. Swan had proposed, and that no modifications should be made in the draft of the first paragraph except possibly in the sentences concerning foreign exchange market and balance of payments developments.

In the discussion of those two sentences, Messrs. Daane and Hayes said that they would not favor omitting the statement that the underlying payments position continued to be a matter of serious concern, as contemplated in Mr. Robertson's proposed revision, because such an omission might imply that the Committee no longer thought the payments problem was serious.

Mr. Robertson reviewed the reasons he had set forth earlier for his proposal, and Mr. Mitchell indicated that he found Mr. Robertson's position persuasive.

Chairman Martin suggested that the Committee accept the language Mr. Robertson had proposed for the sentences in question--with certain editorial changes that members had suggested in passing--and add a statement to the effect that the underlying U.S. payments position remained a serious problem.

There was general agreement with the Chairman's suggestion.

Chairman Martin then suggested that the Committee vote on the proposed directive.

> With Messrs. Hayes, Hickman, Kimbrel, and Morris dissenting, 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 suggests that the expansion in over-all economic activity, while still strong, is moderating somewhat further from its very rapid pace earlier in the year. Upward pressures on prices and costs are persisting. Most market interest rates have risen further in recent weeks. Bank credit has continued to expand rapidly. Growth in the money supply has accelerated from the low average rate of recent months, while expansion in commercial bank time and savings deposits has slowed. Savings inflows to thrift institutions increased somewhat further in October but remained moderate. Following discussions among leading industrial countries, France, Germany, and Britain have acted to combat the recent speculation in their currencies by taking steps designed to reduce imbalances in their external payments. The U.S. foreign trade balance and over-all balance of payments improved in the third quarter but partial data for recent weeks suggest that the improvement is not being sustained, and the underlying U.S. payments position remains a serious problem. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued

> resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit expansion appears to be exceeding current projections.

In casting his dissenting vote, Mr. Hayes said he thought some firming of monetary policy was required in order to achieve more moderate growth in bank credit, for both domestic and balance of payments reasons. He had been puzzled by certain of the arguments that had been advanced for not changing policy. Thus, he did not understand the argument that the situation in foreign exchange markets militated against any firming, particularly after both Mr. Solomon and Mr. Coombs had expressed the view that those uncertainties did not offer material grounds for avoiding moderate action. In his judgment the Committee's primary concern in the international area should be with the position of the dollar, and the foreign trade figures for October to which Mr. Brimmer had referred earlier reinforced his belief that action to defend the dollar was needed. He also did not understand the view implied by the comments of some members that the only meaningful choice was between a drastic move--such as a half-point increase in the discount rate--and no action at all.

While he did not put much weight on the argument that a firmer U.S. monetary policy would endanger the currencies of other countries, it seemed to him that any risks to other currencies would be greater with a drastic policy change than with a moderate one.

Mr. Hickman said he had dissented for reasons similar to those advanced by Mr. Hayes. In general, in light of the inflationary environment he thought that some firming of policy was needed in order to slow the growth of bank credit.

Chairman Martin then noted that on October 29, when the Committee had decided on its tentative meeting schedule for 1969, it had been agreed that the Federal Advisory Council should be asked about the feasibility of a change in FAC meeting dates in 1970 and later years to facilitate FOMC meetings on third Tuesdays of the month. He asked Mr. Holland to report on subsequent developments in that connection.

Mr. Holland remarked that the question had been raised with the Council at its November meeting with the Board. A poll of the nine present members who were expected to still be on the Council next year indicated that at least three had conflicting commitments on each of the alternative meeting dates that had been suggested. The conflicts reported were limited to those that could not be removed easily; they involved such matters as regular meetings of boards of directors that could not be readily rescheduled.

Mr. Hayes said he continued to feel that the preference of FAC members for their present meeting schedule resulted largely from the fact that they had adjusted their other commitments to conform with that schedule, which was of long standing. In his judgment the FAC would be agreeable to shifting its regular meeting dates if there were overriding reasons for freeing third Tuesdays of each month for FOMC meetings.

Chairman Martin said he did not doubt that the Council would change its meeting schedule if it were advised that there were important reasons for doing so. The real question, however, was how important the matter was to the Federal Open Market Committee.

Mr. Daane commented that the advantages to the Committee of a schedule calling for monthly meetings on third Tuesdays, as set forth in earlier discussions of the subject, struck him as being of major importance.

Messrs. Francis and Hickman concurred in Mr. Daane's statement.

Mr. Bopp expressed the view that the FAC could probably work out another acceptable schedule for its meetings if given enough advance notice. He knew of no case in which an individual had declined membership on the FAC because of schedule conflicts.

Mr. Maisel suggested that the Committee undertake a new review of the desirability of adopting a schedule involving twelve meetings each year, on the third Tuesday of each month.

There was general agreement with Mr. Maisel's suggestion. Mr. Holland indicated that the staff would prepare a memorandum on the subject for consideration by the Committee.

It was agreed that the next meeting of the Committee would be held on December 17, 1968, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

November 25, 1968

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on November 26, 1968

The information reviewed at this meeting suggests that the expansion in over-all economic activity, while still strong, is moderating somewhat further from its very rapid pace earlier in the year. Upward pressures on prices and costs are persisting. Most market interest rates have risen further in recent weeks. Bank credit has continued to expand rapidly. Growth in the money supply has accelerated from the low average rate of recent months, while expansion in commercial bank time and savings deposits has slowed. Savings inflows to thrift institutions increased somewhat further in October but remained moderate. Following a period of intense speculation in foreign exchange markets and discussions among leading industrial countries, France, Germany, and Britain have taken steps directed at reducing imbalances in their external payments. The U.S. foreign trade balance and the over-all balance of payments improved in the third quarter, but the underlying payments position continues to be a matter of serious concern. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing conditions in money and short-term credit markets; provided, however, that operations shall be modified if bank credit expansion appears to be deviating significantly from current projections.

Alternative B

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